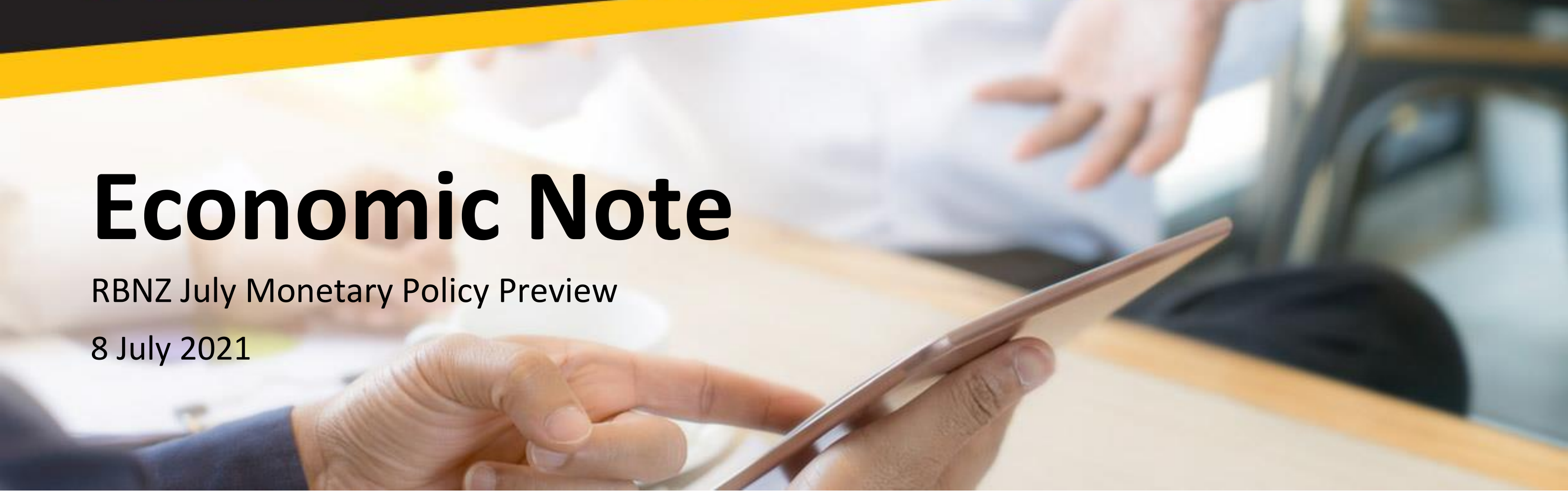

Economic Note

RBNZ July Monetary Policy Preview

8 July 2021

Fast and Furious: ’21

- Since the RBNZ’s last MPS, inflationary pressures and capacity problems have continued to dramatically intensify.
- We now expect the RBNZ’s first post-COVID rate hike to come in November 2021.
- We expect the RBNZ to remain cautious, even as it hikes, with the pace of further OCR hikes to be gradual.

Stronger, faster, sooner. Like an action movie sequel trying to outdo what has come before, recent economic data has smashed through expectations with its strength. The economy is in a much stronger position that the RBNZ anticipated not long ago, with Q1 GDP exceeding its forecasts in dramatic fashion. And inflation pressures are heating up at a much faster pace than the RBNZ previously forecast. The upshot is the Official Cash Rate is likely to head up far sooner than the August 2022 timing signalled in the RBNZ’s May Monetary Policy Statement, when it released its first public OCR forecast since the pandemic began.

We expect the RBNZ to first hike the OCR in November 2021 – yes, that’s 2021. Inflation pressures are getting a NOS boost, despite the economic recovery still being in its early stages. Costs are rising on many fronts. Labour shortages are rife: the border is still largely sealed beyond the trans-Tasman bubble, exacerbated by government reluctance to grant visas to cover growing skill gaps. Significantly, businesses are passing on all these cost increases and starting to expand margins to boot. **Still, our best guess is that the initial pace of OCR increases will still be gradual.** It’s highly uncertain how households and businesses will respond to rising interest rates. And the pandemic is still raging, with many unanswered questions around how open countries will be once vaccination rates are high.

We expect the RBNZ will acknowledge that future inflation is likely to be much stronger than its recent forecasts assumed. Dropping the need for “considerable time and patience” would be a key change, as would any Committee decisions to wind down asset purchases earlier – watch for these. Yet, the RBNZ is probably keen to avoid saying anything that pushes wholesale interest rates any higher. It’s a delicate balancing act worthy of a good stunt double. **Our message to borrowers is to be mindful of the risk that interest rates rise sooner rather than later.**

Labour shortages in the spotlight (or with the lights out)

One looming and persistent contributor to inflation pressures is labour market tightness, which will spur stronger wage growth. Up and down the country and across industries, the clarion call for solving labour shortages has become increasingly strident in recent months.

Ordinarily, acute labour shortages only start to surface after economic recovery has been in train for several years. Yet as of March, the level of GDP was only a shade above its pre-COVID level, and employment itself only 1.3% higher. Meanwhile, the NZIER’s business survey indicates a difficulty in finding labour that hasn’t been seen before in records dating back to 1975.

Why such an early start to something that usually appears late in the economic cycle? It appears to be the coming together of several things:

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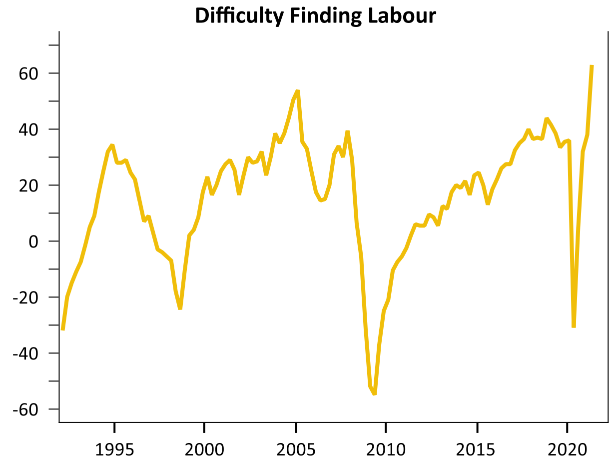
- COVID has for all intents and purposes slammed the border largely closed, a health response that has protected the domestic population, but removed a source of fresh workers that businesses have historically been able to tap;
- MIQ capacity and utilisation constraints are limiting the pace at which people can enter the country (beyond those coming from Australia);
- The Government's approach to labour shortages places heavy weight on businesses finding local workers and on restricting issuance of work visas.



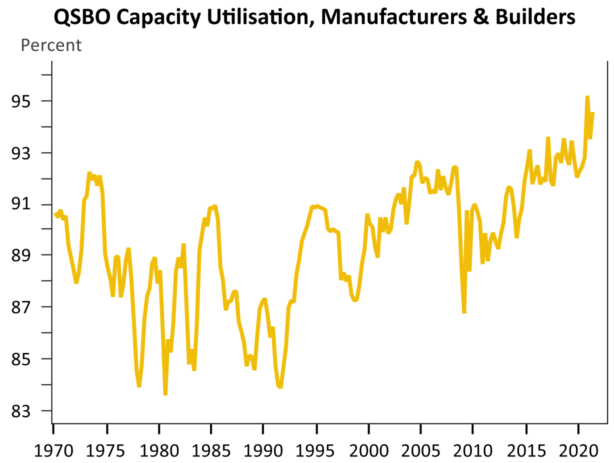
Source: Macrobond, ASB

Although the push to ensure as many incumbent NZ residents as possible are employed is admirable, it appears to have already hit its practical limits. Appropriate technical and 'life skills' training – assuming people are there to train – will take years to properly fill skills gaps. If the necessary skills or people aren't there at present, even with the offer of higher pay, the economy's ability to grow will be constrained and inflation will flare that much sooner. We have reached the point where government policy restrictions on bringing in people to fill labour shortages are factors that are constraining activity, boosting costs, and expanding selling margins. All of these factors will contribute to prices and interest rates rising sooner than would otherwise be the case. The labour market needs the equivalent of a 10-second car to help solve the short-term challenges – alongside a long-term strategy to home-grow the right talent.

Broader inflation pressures are building

Of course, it's not just labour costs that are on the rise. Broader inflationary pressures have continued to build over recent months:

- With demand recovering and supply still constrained, **commodity prices have continued to surge higher**. Oil prices have moved to six-year highs and metal prices have hit similar milestones. Our own NZD ASB Commodities Index (consisting mainly of agricultural commodities) has burst through an all-time high;
- **Freight costs are also on the rise.** Shipping throughput indices remain close to record highs, but demand for freight is running up against widespread logistics disruption and stretched capacity. As a consequence, shipping costs continue to surge for many firms;



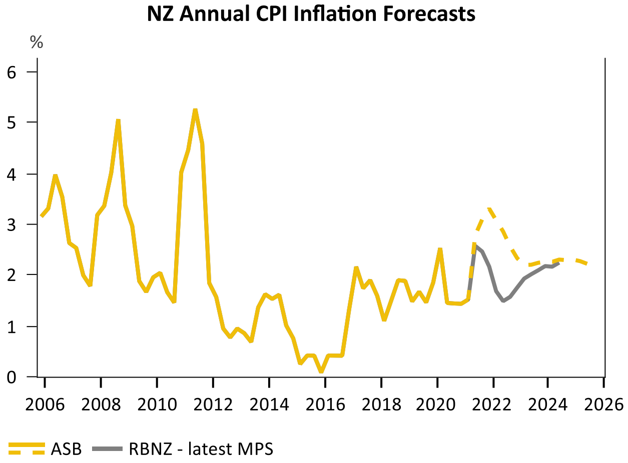
Source: Macrobond, ASB

- Costs from the recent removal of interest rate deductibility for investor property will flow through into **higher rents**. The upshot is that inflation from housing CPI components looks set to be firmer, despite the weaker housing market outlook more broadly, particularly with rising raw material costs and capacity constraints likely to boost construction cost inflation.

With labour shortages abounding and raw materials difficult to come by (and expensive when they can be procured), the economy is starting to rub up against serious capacity pressures (see our recent note on that front). In aggregate, it's a perfect storm set to drive inflation higher. Recent business surveys – like the July Quarterly Survey of Business

Opinion – show dramatic lifts in the number of businesses who expect to raise prices in the coming months. It looks increasingly likely that CPI inflation is likely to be higher and more sustained – perhaps considerably so – than the RBNZ forecast a mere six weeks ago.

Back then, the Bank expected a relatively short, sharp spike with CPI inflation peaking at 2.6% in the June 2021 year before heading lower. At the time, we commented on the risk that the uptick in inflation looked likely to prove more sustained than the RBNZ was pegging. We think that risk has only strengthened in in the weeks since. Our own outlook sees annual CPI inflation heading higher – peaking at 3.3% in the December 2021 quarter – and staying higher for longer.



Source: Macrobond, ASB

Our view

With inflationary pressures set to prove sustained and the labour market looking remarkably close to its maximum sustainable level (at least as long as the border remains closed), we expect the RBNZ to hike the OCR much sooner than signalled in the May Monetary Policy Statement. The first clues should come in next week's Monetary Policy Review. While the Bank won't release updated forecasts, we would expect it to acknowledge inflation pressures will rise sooner than previously thought.

On balance, we expect the RBNZ to lift the OCR 25bps to 0.5% as soon as November this year. Beyond November, we have pencilled in 25bps of hikes every six months until the OCR reaches 1.5% in November 2023. That is a gradual pace that we think is prudent given the uncertainties around how people will react to higher interest rates and the unscripted nature of the ongoing pandemic. It is possible the RBNZ initially hikes in quick succession, though 2014's overtightening should be a cautionary tale. The 1.5% end-point is now 25bps higher, in part reflecting we have revised up our estimate of the neutral 'goldilocks' OCR level.

It would also make sense for the RBNZ to halt routine bond purchases within its Large Scale Asset Purchase programme before lifting the OCR. The July meeting might be too soon to announce any changes to the LSAP programme, but any shift on this front would be a sign the RBNZ is preparing the ground for withdrawing stimulus. Either way, the RBNZ will need to consider the future of the LSAP programme soon.

Implications

The upshot is that higher interest rates look to be on the horizon sooner rather than later. Regardless of whether the first hike comes as soon as November or a bit later in 2022, the direction of travel is clear.

While we still expect rates to peak at historically low levels, it's a prudent time for households and businesses to review their interest rate exposures, to make sure they are appropriate.

For home-owners, make sure you're subscribed to our Home Loan Rate Report for our latest forecasts and analysis of trends in mortgage rates. Expect an updated version soon!

For those in the world of commerce, our Corporate Hedging Toolbox aims to make sense of the best strategies for managing interest rate exposures.

For savers, our Term Deposit Report aims to cover the latest developments in deposit rates.

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