Economic Note

RBNZ August Monetary Policy Statement Review

18 August 2021

Lockdown prompts RBNZ to pause for now

- The RBNZ kept the OCR on hold, as we had expected at the 11th hour.
- The current COVID outbreak was the reason to remain on hold – otherwise it was clear the RBNZ intended to lift the OCR at an orderly pace starting from today.
- Assuming the outbreak is stamped out relatively soon, we expect the RBNZ to start lifting the OCR from October.

The RBNZ kept the Official Cash Rate (OCR) on hold at 0.25%, as we anticipated at the 11th hour after NZ went into Level 4 lockdown to contain a suspected community outbreak of the delta variant of COVID-19. Given the high current degree of uncertainty about the extent of the lockdown, and that the Government is wheeling out financial support, it makes perfect sense for the RBNZ to hold fire for the time being at least.

The RBNZ's Monetary Policy Statement showed that **the Bank had clearly intended to start its tightening cycle today**. **The underlying state of the economy heading into this lockdown was one of capacity constraints and rising cost pressures** that are poised to generate persistent inflation pressures. But the sensible approach for the August decision, given heightened uncertainty, was to wait and see.

The "where to" for interest rates comes down to how much the current lockdown alters that economic assessment. A short-lived lockdown is likely to have only modest lasting impacts once catch-up activity happens. In that case, the broader economic outlook wouldn't shift too much and the RBNZ will embark on its signalled tightening cycle. But a more drawn-out period of tight restrictions would increasingly chip away at that outlook.

Our outlook for the OCR – based heavily on the lockdown being short enough to cause little long-term damage – is that the RBNZ will lift the OCR 25bp in October, November and February to 1%, before gradually nudging up to 1.5% by the end of 2022. **This is very much a light pencilling in of an outlook and should be taken as a rough guide that can change quickly as the situation unfolds.** Financial markets will be very sensitive to the run of COVID headlines, so brace for a period of volatility.

The RBNZ's pre-lockdown view

The RBNZ pre-lockdown view is that capacity constraints and one-offs will contribute to higher near-term inflation, with its short-term forecasts for inflation (annual CPI peaking slightly above 4% in the second half of this year) close to our own. The RBNZ view is that with medium- and long-term inflation expectations still anchored around 2% these influences will have a transitory impact, with CPI inflation assumed to settle at around 2% towards the end of the projection period. However, the RBNZ did flag uncertainty over the wage outlook, given capacity constraints within the labour market and increased labour mismatches that could keep inflation higher. We don't see inflation expectations as being as contained as the RBNZ asserts and continue to see upside risk to the RBNZ's medium-term inflation outlook. Wage inflation is unlikely to moderate as quickly as the RBNZ asserts.

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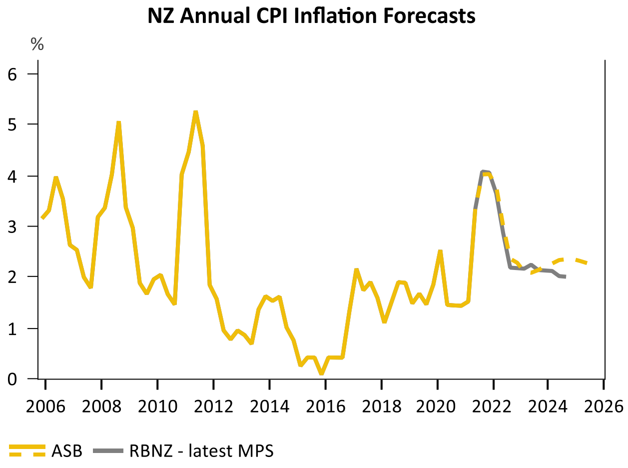
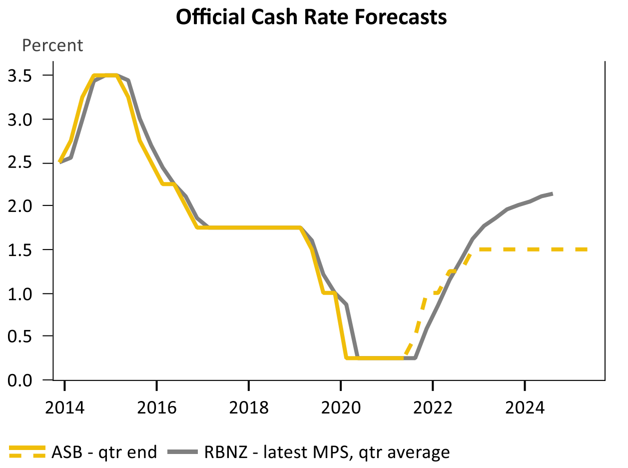
Despite the RBNZ holding the OCR today, the August MPS OCR projections showed a frontloading of hikes relative to the May MPS, with a full 25bp hike priced in by Q4 this year, followed by 100bps of hikes over 2022 and a further 50bp of hikes with the OCR endpoint at 2.14% by mid-2024. The August MPS projections also showed an OCR endpoint more than 30bps above the 1.78% OCR endpoint from the May MPS projections.

That this stimulus needs to be withdrawn more quickly is testament to the much-improved NZ outlook and concerns on economic overheating. The OCR endpoint is also slightly above the RBNZ's new assessment of the neutral OCR (average of just below 2%), suggesting slightly restrictive OCR settings may be needed. The RBNZ's view on the end-point for the OCR is different from ASB's (2.1% versus 1.50%), with much of the difference stemming from our view on the neutral OCR. We expect the neutral OCR to continue to decline towards 1.50% by late 2022. If we are right, this highlights the risk of a more gradual OCR hiking cycle this time around.



Source: Macrobond, ASB



Source: Macrobond, ASB

The lockdown's influence

The RBNZ rightfully noted the heightened uncertainty the re-emergence of COVID-19 in the community brings to the economic and policy outlook. It's clearly a spanner in the works of the planned timing of the forecast tightening cycle. It's far too early to say anything sensible about the how long and how disruptive the current outbreak will be.

However, the Bank was quick to note the buffering factors. Government support, most notably the return of the wage subsidy, is expected to "significantly" buffer the loss of income associated with lockdown. And the fact the NZ economy has, so far, shown itself to be resilient and quick to bounce back from lockdown conditions was also highlighted. Household have also built up a large amount of savings, which should further help counteract negative economic impacts.

One alternative path: the sharp but short lockdown

In the past, NZ has been able to get on top of community transmission relatively quickly – although the delta variant is more infectious and will likely take more effort to contain. NZ's past short-ish Auckland-centric lockdowns (August last year, February/March this year) have shown that the lasting economic impacts are relatively light. Spending and other activity tends to merely get deferred, with a catch-up period occurring once restrictions ease. Presuming NZ's strict lockdown gets on top of this latest outbreak, the underlying economic picture is very likely to remain one of an economy that has hit capacity constraints and no longer needs the Official Cash Rate to stay as low as 0.25%.

Under this outcome, Official Cash Rate increases remain extremely likely, and the lockdown would merely be slightly delaying the inevitable. We would expect the RBNZ to start lifting the OCR from October, moving quickly to 1% by February. From there, we would still expect the OCR to peak at 1.5% by the end of 2022, consistent with our assessment of the neutral (i.e. goldilocks) level for the OCR. For the time being we are taking this scenario as our base case outlook.

Another path: the more drawn-out return (presumably) to elimination

The other path – broadly speaking – is a lockdown that is sufficiently drawn out that it materially impacts on the economy. Although NZ can learn lessons from Australia and also – hopefully – maintain a higher degree of compliance with COVID restrictions, the delta variant will be harder to get on top of than the strains NZ has dealt with in the past. The NZ Government has stated that elimination remains the strategy – and NZ still appears to have realistic hopes of achieving that by reacting quickly. But there is no guarantee, and also no clarity as yet around how far down the transmission chain this outbreak already is.

If the outbreak isn't contained by early October then the RBNZ will undoubtedly remain on the sidelines then. And the outlook would need a more fundamental rethink. The longer NZ stays at Level 4 to ensure elimination, the greater the potential economic hit, and the more likely that any OCR increases get delayed and the overall tightening cycle is toned down.

The situation will shift – and the economic outlook could too

So far the number of community cases are up to 7, of which all are linked. One of the cases works at Auckland hospital, another at a school. Several people have attended crowded venues. The strain of the virus has been traced back to Australia, focusing the search for the source on recent arrivals back from Australia. And that is just 24 hours of revelations. With a surge in COVID testing, more cases are likely to be identified. At this point the risks are Level 4 restrictions get extended. We are all going to need to adapt to the unfolding situation as best we can, as we did last year.

Be prepared for volatility, in financial markets as well as economic views. The extent of the lockdown will heavily influence the near-term outlook. But, with NZ reacting quickly, and with a stretched economy remaining probable, NZ still looks set to experience rising interest rates to some degree over coming years.

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