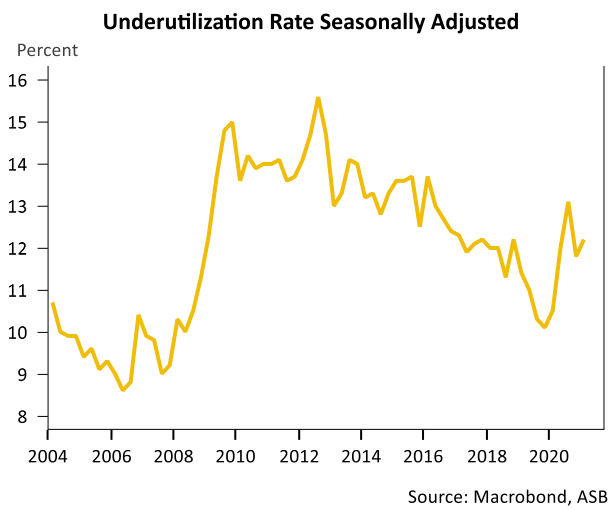
Economic Note

RBNZ July Monetary Policy Review

14 July 2021

RBNZ ready for rates take-off

- The RBNZ kept the OCR unchanged (as expected) but – significantly – will halt asset purchases by July 23rd.
- The RBNZ has agreed that "stimulus could now be reduced to minimise the risk of not meeting its mandate".
- An August rate hike looks more likely than not – if key upcoming data confirm that pressures are building.



The RBNZ has clearly changed tack to decide that the time for reducing monetary stimulus is very near. The risk of inflation and employment undershooting its objectives has switched to a risk of overshooting should the current level of stimulus remain in place. Lifting the OCR before too much longer will give the RBNZ a better balance of the various risks.

It's a fine line but we now expect the RBNZ will lift the OCR in August – provided key data between now and then are sufficiently strong to support the need for earlier removal of stimulus.

Key data that will determine the timing (and pace) of OCR increases will be: the extent of cost pass-through to inflation; the degree of labour underutilisation (see our chart above); wage inflation, and; inflation expectations. Indications that these gauges are tightening up sharply would be enough to prompt an August OCR increase. Data on the above will be what determines how soon the RBNZ acts. Essentially, though, every OCR decision from now on should be considered 'live'. Ending of Large Scale Asset Purchases i.e. quantitative easing by the end of next week opens the door to hiking as soon as August.

Imminent OCR increases are based also on events going smoothly over the coming months. But uncertainties remain huge: Australia is showing how quickly a benign situation can change; the Delta COVID variant is causing a further surge in global infections, and; NZ is still vulnerable through having only a small portion of the population vaccinated. A lot can go wrong, even as NZ's economy has hit growing pains so quickly. Gingerly removing some of the stimulus soon does seem to be the path of least regret, particularly as low interest rates have already played a strong role in boosting the economy back up and contributed to an overheating housing market in the process.

RBNZ now sees inflation pressures as more persistent

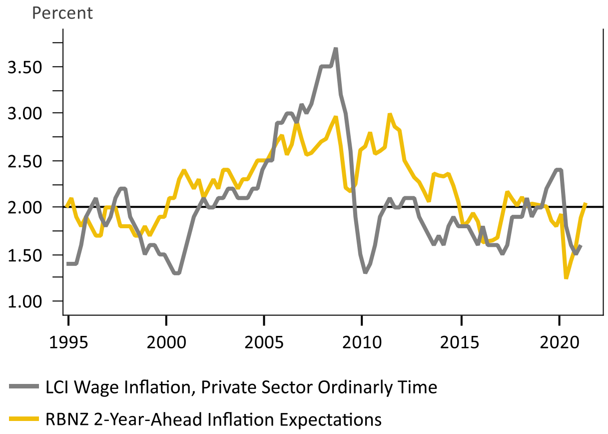
The RBNZ's policy assessment has changed to acknowledge that **inflation pressures are set to be more persistent than previously anticipated**. The most significant shift is the RBNZ's move to seeing removal of some monetary policy as prudent, away from needing "considerable time and patience" before meeting set conditions for reducing stimulus.

Nick Tuffley – Chief Economist – 021 891 881 (649) 301 5659 nick.tuffley@asb.co.nz
Mark Smith – Senior Economist (649) 301-5657 mark.smith4@asb.co.nz
Nathaniel Keall – Economist – (649) 301 5720 nathaniel.keall@asb.co.nz

As expected, the RBNZ started to highlight the more persistent nature of capacity pressures and labour shortages.

In contrast, back in May the RBNZ was still assuming that inflation pressures were largely temporary. Labour pressures were less in the limelight: in May the RBNZ talked of specific pockets of shortages having "the potential to put upward pressure on some wage costs", while employment was assessed to still be below estimates of the maximum sustainable level.

Wage Inflation and Inflation Expectations



Source: Macrobond, ASB

Least regrets says 'up', but still some things to worry about

Despite the clear ongoing shift towards a tightening bias, the RBNZ continues to emphasise its commitment to a 'least-regrets approach' (in the Bank's parlance). While some of the more extreme downside scenarios feared at the beginning of the pandemic have all but disappeared (think widespread deflation and mass unemployment), risks to the outlook remain.

Most obviously, the Bank highlighted that further COVID outbreaks remain a live possibility with the potential to slow the pace of recovery, noting "the need to reinstate COVID-19 containment measures in some regions highlights the ongoing global health and economic risks posed by the virus". Since the last Monetary Policy Statement in May, Wellington has had to undergo a short period of alert levels and, offshore, Sydney has struggled to contain an outbreak of the 'delta' COVID variant despite the reintroduction of a number of containment measures.

While the RBNZ avoided explicit mention of the delta variant in its summary of record, the new strain is more transmissible than previous variants and stricter and/or lengthier lockdowns may be necessary to respond to outbreaks, with all the attendant economic implications. A community outbreak of the variant within NZ, might therefore delay the RBNZ's timeframe for reducing stimulus and hiking the OCR.

LSAP to halt

The RBNZ signalled that the Large-Scale Asset Purchase (LSAP) programme will be halted by 23rd July 2021, with this tool "no longer necessary for monetary policy purposes". This is a frank admission that with market functioning now much, much better than in the depths of the COVID-19 gloom, a shift to more conventional policy tools is on the cards. The MPC reiterated that the OCR is the preferred tool when responding to economic conditions in the future. We concur.

However, the RBNZ did not close to door to restarting asset purchases completely, noting that it remained an important tool for supporting New Zealand debt market efficiency "if required", and an important monetary policy tool "if needed". Moreover, the RBNZ did not signal when, if at all, it planned to sell its current LSAP holdings.

The signal to cease weekly asset purchases towards the end of this month will be coming at a time when the NZ Debt Management Office has stepped up NZ government bond issuance (currently $500-$550m weekly to hit their $30bn 2021/22 issuance target) and will pressure yields higher at the margin.

It will also provide the RBNZ with more flexibility to bring OCR hikes forward, if needed. We had earlier expected the RBNZ to have ceased weekly LSAP prior to hiking the OCR in November – the door is open to act earlier, as we now think is likely on balance.

Being prepared

As we noted in our Preview last week, it's a prudent time for households and businesses to review their interest rate exposures, to make sure they are appropriate and start thinking about what higher interest rates mean for you.

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.

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.

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5957
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853
Senior Economist	Mike Jones	mike.jones@asb.co.nz	(649) 301 5660
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Economist	Nat Keall	nathaniel.keall@asb.co.nz	(649) 301 5720
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

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