Economic Bulletin.

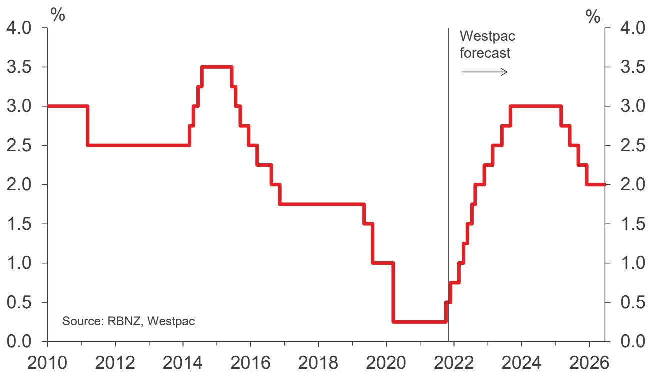
3 November 2021

Change of OCR forecast and Q3 labour market review.

- We now expect the Reserve Bank to raise the Official Cash Rate to a peak of 3% by mid-2023.
- This would see the cash rate going above 'neutral' and into 'tight' territory for a period of time, before easing back again.
- It looks increasingly unlikely that a smooth glide path towards a neutral cash rate of 2% would be enough to rein in inflation pressures.
- The starting point for the economy is wildly stronger than the RBNZ expected, and the upside risks for inflation are growing.
- Today's labour market surveys for the September quarter demonstrate that hot demand, rather than supply constraints, is the biggest challenge to the inflation outlook.
- The unemployment rate fell to a record-equalling low of 3.4%, and employment has grown by more than 4% in the last year.
- Wage growth has picked up, although it undershot our forecasts for the quarter. We expect it to accelerate in the coming quarters, in the face of both a tight labour market and rising inflation expectations.

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Official Cash Rate



Up, then down.

With today's labour market surveys, another major data point for the New Zealand economy has shot the lights out. The accumulated evidence is clear that demand is running very hot, and that the Reserve Bank will need to take more action to cool things down. What's more it's looking increasingly unlikely that the RBNZ will be able to achieve a smooth glide path towards a long-run 'neutral' level of the cash rate, and that interest rates will need to be meaningfully higher for some period of time.

We're now forecasting the Official Cash Rate to rise to a peak of 3% by mid-2023, from its current level of 0.5%. While that wouldn't be particularly high compared to history, it would represent much more than just an unwinding of the stimulus that was put in place in response to Covid-19. And it would be some way above where the 'neutral' cash rate is generally assessed to be (around 2%).

We'd emphasise that we're predicting that monetary policy will need to be 'tight' for some time in order to bring demand under control, before settling back towards a 'neutral' setting.

With that in mind, we've also pencilled in a series of OCR cuts back to 2% in 2025. But we're really trying to convey the general direction rather than the timing – predicting the next phase of interest rates is hard enough, let alone the next two phases.

25 or 50?

With so much monetary tightening factored in to our forecasts over the next couple of years, the question of tactics will naturally crop up. Will the RBNZ do this in 25 basis point steps, or could it step up the pace with a 50 basis point move at its *Monetary Policy Statement* later this month?

We've come down on the side of 25 basis point moves, but as we've noted before, the odds of a 50 basis point move are reasonably high. For one thing, the RBNZ itself said that it actively considered this option in its August review – and the economic case for it is stronger now than it was back then.

RBNZ Assistant Governor Hawkesby's speech last month set out a framework under which they might switch from cautious moves to a bolder response. The three criteria were:

- The starting point for the economy;
- Whether the risks to the economy were skewed one way or the other, and;
- Whether the RBNZ was at risk of not meeting its mandate over the medium term.

The first criteria has clearly been ticked off. The starting point for the economy is wildly different to what the RBNZ expected in August: GDP grew by 2.8% in the June quarter, annual inflation jumped to 4.9% in September, and now the unemployment rate has dropped to a record-equalling low of 3.4%.

The other two criteria are more subjective, but we'd judge that the risks are skewed to the upside – there's more chance of inflation overshooting than undershooting the target, if the RBNZ only gradually hikes the OCR to a peak of 2%.

So on the RBNZ's own framework, there's a reasonable case for a 50bp hike this month. But there's rarely a 'smoking gun' argument for these kinds of tactical decisions. And the uncertain impact of the current Covid outbreak offers a counter-argument for more cautious action. (Though as we've noted before, the outlook for 1-2 years ahead, where monetary policy should be focused, has not meaningfully changed as a result of this.)

Labour market review, September quarter 2021.

The unemployment rate fell from 4.0% to 3.4% in the September quarter, equalling the record low set in 2007. A drop in unemployment was widely expected, but this was a sharper fall than both we and the Reserve Bank predicted.

The Covid lockdown that began mid-August distorted the result to some degree, although less so than during last year's lockdown. Since some people wouldn't have been able to actively look for work under lockdown conditions, they weren't counted as officially unemployed. Based on more detailed questioning, Stats NZ estimates that this reduced the unemployment rate by 0.2 percentage points. That implies a 'true' measure closer to 3.6% - still much lower than anyone predicted.

The demand for workers has strengthened considerably over the course of this year. Employment surged by 2% in the quarter, and was up 4.2% on a year ago. This was higher than our forecast, although the risks were certainly in this direction. Other measures such as the Monthly Employment Indicator, which is drawn from tax data, have also pointed to a strong lift in jobs in recent months.

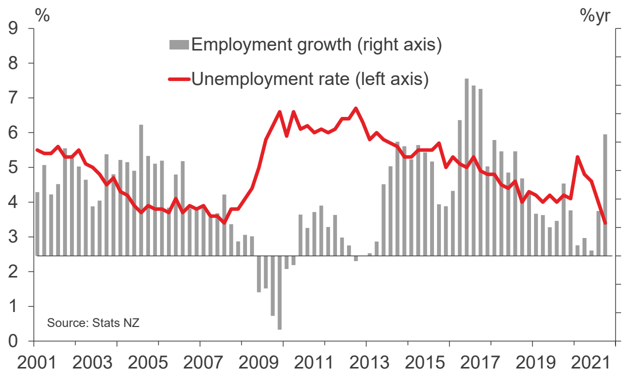
These results reinforce what we've been saying for months: the defining feature of the labour market right now is not a lack of supply, but strong demand. Individual employers will no doubt perceive this as a labour shortage, if they have vacancies that are difficult to fill. But at the macro level, that story doesn't stack up: if worker shortages were the main issue, we'd expect to see a stagnation in growth. What we're seeing is just the opposite – employment growth has rarely been higher than 4% a year, and always at times when the population has been growing much faster than it is today.

With a labour market this tight, we'd expect to see an acceleration in wage growth. And while it has picked up in the last couple of quarters, it wasn't as strong as we expected in the September quarter. The Labour Cost Index (LCI) rose by 0.8% overall, with a 0.7% rise in the private sector.

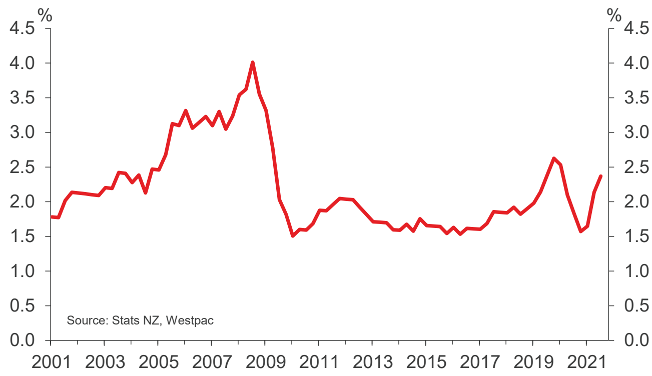
The 1% rise in public sector wages was more surprising, given the partial pay freeze announced earlier this year. That said, there was an exemption for roles that were deemed difficult to fill – and in this market, every role would be difficult to fill without offering a pay increase.

The smaller than expected rise in the LCI balances out the strength in employment in our view. (However, both employment and wages were stronger than the RBNZ's forecasts.) It may be a hint that the labour market isn't quite as stretched as we thought – that is, the 'sustainable' rate of unemployment is lower now than it was in the past. Or it could be that the upward pressures on wage growth are simply a matter of time. At the least, demand for cost-of-living increases is only going to ramp up as concerns about inflation rise.

Unemployment rate and employment growth



Labour Cost Index (all sectors, ordinary time)



	Quarterly actual		Quarterly expected		Annual
	Q2	Q3	Market	Westpac	Q3
Household Labour Force Survey					
Unemployment rate	4.0	3.4	3.9	3.8	-
Underutilisation rate	10.5	9.2	-	-	-
Employment growth	1.0	2.0	0.4	0.8	4.2
Participation rate	70.5	71.2	70.5	70.7	-
Quarterly Employment Survey					
FTE employment	1.7	1.1	-	1.0	3.2
Hours paid	3.1	1.2	-	1.0	6.8
Private average hourly earnings	0.7	1.2	1.5	1.7	3.6
Labour Cost Index					
All sectors, ordinary time	0.7	0.8	-	0.9	2.4
Private sector, ordinary time	0.9	0.7	0.8	1.0	2.5
Private sector, all salary & wage rates	0.9	0.7	0.8	1.0	2.5

Contact the Westpac economics team.

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Gregorius Steven, Economist
+64 9 367 3978

Any questions email:
economics@westpac.co.nz

Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Disclaimer.