

Economic Bulletin.

18 November 2021

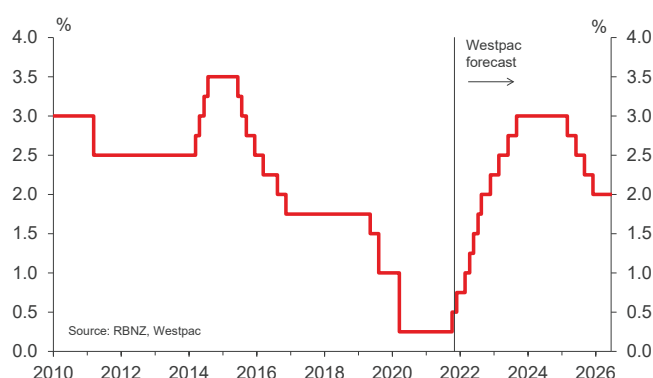
Onwards and upwards – Preview of RBNZ November 2021 Monetary Policy Statement.

- We expect the Reserve Bank to raise the Official Cash Rate by 25 basis points to 0.75% next week.
- Recent data has reinforced that demand in the New Zealand economy is running hot and that inflation pressures are building.
- We expect the RBNZ's projections to show a peak cash rate of close to 3% in the coming years, similar to our own forecast.
- That tightening profile could be comfortably achieved in 25 basis point increments.
- But we recognise that there is a meaningful risk of a 50 basis point move next week.
- Under the RBNZ's own framework, it's possible to argue that the conditions for bolder action have been met.

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Official Cash Rate



The Reserve Bank will unveil its latest *Monetary Policy Statement* next Wednesday. Even with Covid restrictions still weighing on the economy, there is ample evidence that interest rates will need to rise from their recent lows. We expect a 25 basis point increase in the OCR to 0.75% next week, and there's a meaningful risk of a 50 basis point move.

We think that the RBNZ will need to lift the OCR to a peak of 3% over the next couple of years. We've detailed the reasons for the view elsewhere, particularly in our quarterly *Economic Overview* released earlier this week. In short, we see excess demand as the greater challenge for New Zealand's inflation outlook, one that's likely to live on beyond the recent cost shocks that are emanating from overseas.

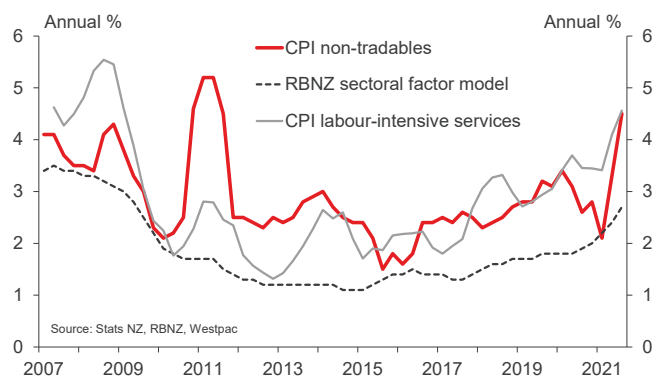
The data over recent weeks has only reinforced that view. We've learnt that the economy was running wildly ahead of what the RBNZ expected before the lockdown, with a 2.8% jump in GDP in the June quarter. Demand for workers has continued to run hot, with employment up more than 4% on



a year ago and the unemployment rate dropping to 3.4% in the September quarter. While the latest Covid restrictions have substantially dampened activity, indicators such as card spending, building consents and job advertisements suggest that activity is well-placed to rebound as restrictions are eased.

There's also been a sharp lift in inflation, which rose to 4.9% in the year to September. That was much higher than the RBNZ had expected in August, and it's likely to go even higher in the near term. That on its own is not cause for alarm for the central bank – many of the recent price increases are likely to be temporary or at least non-repeating. What's more striking is the evidence of more persistent forms of inflation emerging. No matter which metric of 'core' inflation you might use, they've all been heading higher – and were arguably doing so even before the pandemic.

Indicators of persistent inflation

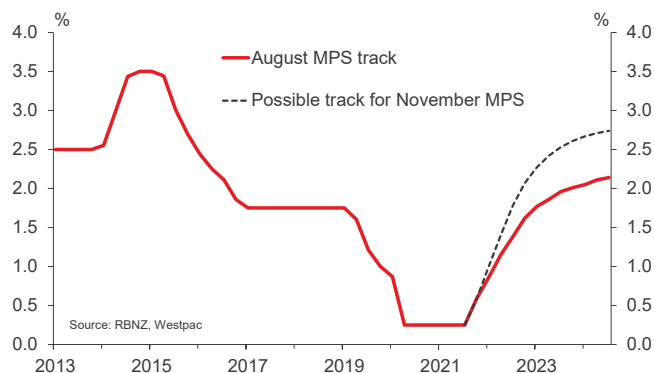


With all this in mind, we expect to see a sizeable lift in the RBNZ's projected OCR track compared to the August review. The previous track implied a steady series of OCR hikes, reaching a little above 2% by the end of the three-year forecast horizon. That's slightly higher than where the RBNZ estimates the 'neutral' level of the OCR to be. The reason given was that the OCR will need to be a little higher to offset the easing effect of measures such as large-scale bond purchases and the Funding for Lending Programme, which won't have been fully unwound three years from now.

We estimate that developments in the economy since then are worth at least an additional 50 basis points on the RBNZ's profile. That would see the projected OCR reach a peak in the high 2's, in line with what's baked into current market interest rates and close to our forecast of a 3% peak.

It's possible that the RBNZ could extend its projection beyond three years this time, to show a falling OCR in later years (as we've done with our own forecast). This would convey the idea that the higher OCR track is a temporary peak in the cycle, not a reassessment of where the long-run neutral level lies. It would also capture the idea that the OCR won't need to provide as much offset in later years, as the other policy measures run their natural course.

RBNZ OCR projections



With so much work ahead for monetary policy over the next couple of years, the question of tactics will naturally arise. We think that a 25 basis point hike is the more likely outcome at next Wednesday's policy review. But we also stress – and have done previously – that there is a meaningful risk that the Monetary Policy Committee decides to hike by 50 basis points in one go.

A recent RBNZ speech shed some important light on this matter. While some interpreted it as an attempt to hose down the possibility of a 50bp hike, that wasn't the case at all – it actually set out the conditions under which they would consider such a large move. And it's not hard to argue that those conditions have been met. The economy is coming from a much stronger starting point than the RBNZ expected, and the risks – relative to the RBNZ's previous forecasts – are skewed much more towards higher rather than lower inflation.

So why favour a 25bp move? Uncertainty around the impact of this longer-lasting Covid lockdown is certainly a factor. But the simplest argument is that it's not necessary – even our forecast of a 3% peak by August 2023, which is at the high end of the range of market forecasts, is completely achievable by moving in 25bp increments at each review. The Committee might prefer to get a head start by hiking 50bp this time, but it's not under pressure to do so.


Market pricing has been hovering around a 30-40% chance of a 50bp hike next week, and we wouldn't disagree with that assessment. So whichever way the RBNZ goes, there's going to be a sizeable move in short-term interest rates on the day. But we expect that impact to be short-lived, with the higher projected OCR track providing the more meaningful signal for the market.

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