

# Economic Bulletin.

21 May 2021



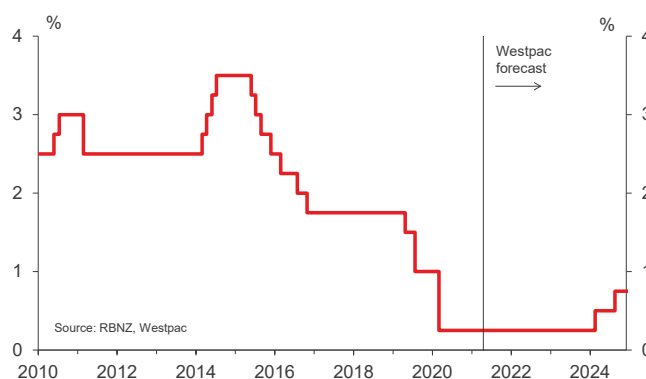
## A steady hand – Preview of RBNZ May 2021 Monetary Policy Statement.

- We expect the Reserve Bank will leave its monetary policy settings unchanged at next week's MPS.
- The economic outlook has improved on balance, despite a soft patch in growth over the summer period.
- Inflation is expected to rise well above 2% this year, but the RBNZ has already foreseen this and will regard it as temporary.
- The RBNZ's forward guidance will again emphasise the need for a sustained return to the inflation target, and employment at or above maximum sustainable levels.
- We expect OCR hikes will begin only in early 2024, although unconventional monetary policy measures will unwind before then.

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Westpac OCR forecast



We expect that next Wednesday's *Monetary Policy Statement* will largely stick to the line of previous policy reviews, with the Official Cash Rate expected to remain on hold for an extended period. With inflation set to jump higher in the near term, the Reserve Bank will need to manage its message carefully. But the rise in inflation itself won't come as a surprise to the RBNZ, and it will continue to regard this as temporary.

As we detailed in our latest *Economic Overview*, we don't expect the OCR to be increased until early 2024. That might seem like a long time to wait, but it's important to note that there will be an effective tightening of financial conditions between now and then. Longer-term interest rates are already rising around the world as the path out of the Covid-19 pandemic becomes clearer. And the RBNZ is likely to allow its unconventional policy measures to expire before returning to its normal policy tool.

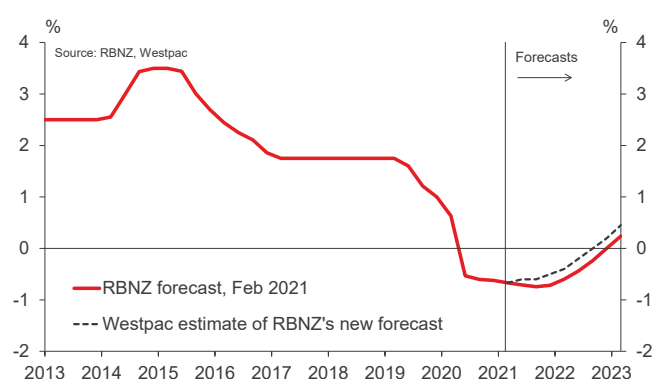
The RBNZ doesn't currently publish a projection of the OCR itself. Instead, it uses a measure termed the 'unconstrained OCR'. This is meant to represent the combined effects of the low OCR and the RBNZ's unconventional measures, namely



the Large-Scale Asset Purchase programme (LSAP) and the Funding for Lending Programme for banks (FLP). In February, the RBNZ estimated that the combined effect of these policies was equivalent to an OCR of minus 0.7%. That estimate moved higher from 2022 as the unconventional policy tools rolled off, and rose above zero in early 2023 – suggesting that the OCR itself wouldn't need to increase before that date.

We think the RBNZ will conclude that recent developments have been mildly positive on balance. This could mean a slightly less negative unconstrained OCR track, with an earlier move above the zero mark. Such a projection would be consistent with OCR hikes from 2023 – sooner than our own forecasts (we're more cautious on the extent of domestically-generated inflation pressures), but later than market expectations of an OCR hike by around August next year.

### Unconstrained OCR forecasts



We expect the RBNZ to upgrade its economic growth forecasts for this year. December quarter GDP fell by 1%, which was much weaker than the RBNZ's forecast of a flat result. But we suspect that the drop was due to the absence of international tourists over the peak summer period (a point that the RBNZ itself has been highlighting since its August *Monetary Policy Statement*). Without the usual corresponding outflow of people through the middle of the year, we would expect to see stronger than usual growth indicators in the coming months.

Perhaps the most positive development in recent months has been the ongoing strength in New Zealand's export commodity prices. What's more, this hasn't been accompanied by a rise in the exchange rate, which might normally have played a 'buffering' role in commodity price movements.

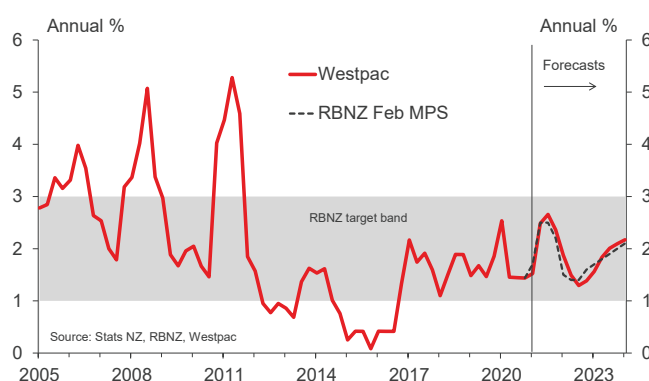
The housing policy changes that the Government announced in March may have only a modest impact on the RBNZ's forecasts, given their starting point. In February the RBNZ was already assuming that house price growth would slow sharply from the second half of this year. While we didn't agree with that assessment at the time, the changes around the tax treatment of property investors play well into the RBNZ's existing forecast.

The RBNZ's February and April policy reviews both concluded with:

*"The Committee agreed to maintain its current stimulatory monetary settings until it is confident that consumer price inflation will be sustained at the 2 percent per annum target midpoint, and that employment is at or above its maximum sustainable level. Meeting these requirements will necessitate considerable time and patience. The Committee agreed that it was prepared to lower the OCR if required."*

There's quite a bit to unpack here. First, the RBNZ is looking for evidence of a sustained return to the 2% midpoint of its inflation target. There's widespread agreement that inflation is going to rise substantially above 2% this year. That's partly due to year-ago comparisons – inflation was particularly weak in the June quarter last year, during the Covid-19 lockdown. And some of it is due to ongoing Covid-related impacts, such as disruptions to global manufacturing and shipping. But none of this will come as a surprise to the RBNZ.

### Inflation forecasts



The key question is whether the forces currently pushing prices higher will lead to a sustained bout of inflation. But despite all the recent market noise, there isn't really a stronger case for believing that now than there was three months ago. The RBNZ will likely conclude that the economy is still running below its full capacity, with the international borders remaining largely closed and unemployment above its pre-Covid levels.

We should note that while the economy is still below what the RBNZ would regard as maximum sustainable employment, the gap is closing faster than they (and indeed everyone) expected. The unemployment rate fell to 4.7% in the March quarter, against the RBNZ's forecast of a rise to 5.0%. But a 'neutral' unemployment rate is probably in the region of 4%; we'd need to get not just down to that level, but below it, before we would expect to see a substantial pickup in wage pressures.

Finally, we expect the RBNZ to retain the line that it is "prepared to lower the OCR if required". The RBNZ has done the work to ensure that banks' systems are equipped to handle a negative OCR, and its commitment to leave the OCR unchanged for 12 months expired in March. While it hasn't so far taken up the opportunity to cut the OCR below zero, that shouldn't be read as an unwillingness to do so. The RBNZ is well aware that the global economy remains precarious, with Covid-19 surging back in many parts of the world.

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