

Economic Bulletin.

24 November 2021

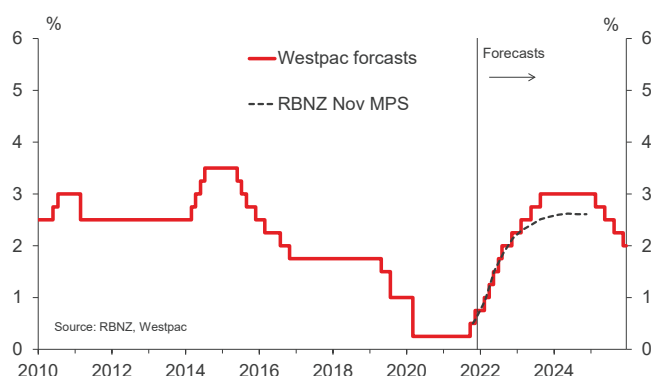
And many more – Review of the RBNZ Monetary Policy Statement, November 2021.

- The Reserve Bank increased the OCR by 25 basis points to 0.75%, and signalled substantial further tightening to come.
- Today's move was widely expected, although we and the market also saw a meaningful risk of a 50 basis point hike.
- The deciding factor for the RBNZ was uncertainty around how spending and investment would hold up as the country moved towards living with Covid.
- But beyond the impact of Covid, demand in the New Zealand economy has been running hot and the labour market is very tight.
- That raises the risk of a more sustained bout of inflation pressures.
- The RBNZ expects to lift the OCR above its estimate of the 'neutral' level and into tight territory over the next couple of years.
- This is consistent with our existing forecast of a 3% peak in the OCR in 2023.

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OCR forecasts



The Reserve Bank's decision on the Official Cash Rate today was no doubt a finely balanced one. The need for at least some reduction of monetary stimulus is self-evident, but the way that recent data has outpaced forecasts made a case for going beyond the usual 25 basis point moves and hiking by 50 basis points in one go. We've long seen that as a meaningful risk, and market pricing was close to evenly split between a 25bp and a 50bp move.

The fact that the RBNZ went for a 25bp hike led to some pullback in markets, with a sharp drop in short-term interest rates and a modest fall in the New Zealand dollar. We don't think this will extend much further, though. While the risk of a more aggressive policy tightening has been taken off the table for the near term, the RBNZ expects a sustained series of rate hikes over the coming years, broadly in line with what the market has been pricing in.

Our forecast remains for the OCR to reach a peak of 3% in around the third quarter of 2023. While that's a little higher than the 2.6% peak in the RBNZ's projections, the broad



contours of our forecast and the reasoning behind it are very much in line with the RBNZ's thinking. Strong domestic demand increases the risk of a sustained bout of inflation, and monetary policy settings will need to go not just back to 'neutral', but into 'tight' territory for a while at least.

The RBNZ recognises that inflation is being driven by both demand and supply factors. Indeed, much of the recent spike in the inflation rate to 4.9% reflects cost shocks that have largely emanated from overseas. Many of these price rises will be temporary, or at least non-repeating. However, there are also issues around capacity constraints, particularly in the labour market, and it's not clear how these will play out as we move towards living with Covid.

The more pertinent issue – especially for New Zealand – is that we're running up against these capacity constraints because demand is running hot. Fiscal and monetary stimulus, and a long stretch of operating largely without public health restrictions, allowed the economy to gather a head of steam over the last year or so. That's clearly been manifesting in the recent data, with GDP more than 4% above its pre-Covid level, and the unemployment rate dropping to a record-equalling low.

In these conditions, there's a greater risk that even a temporary price shock generates an ongoing cycle of domestic price increases. The RBNZ's inflation forecast peaks at 5.7% in the near term, but it takes some time beyond that to ease back within the 1-3% target range – and that's with higher interest rates acting to suppress demand.

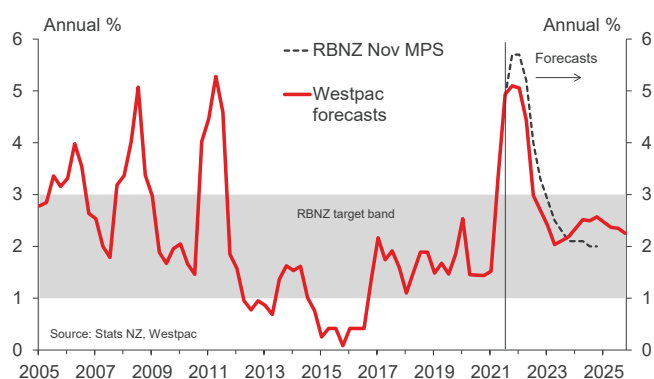
Of course, demand is already somewhat suppressed right now, due to the Covid restrictions that have been in place since August. While activity has picked up again as these restrictions have been eased, the shift from an elimination strategy to living with Covid means that we can't be confident that the rebound will be as strong as it was after previous lockdowns.

Indeed, this was one of the factors that pushed the Monetary Policy Committee towards a smaller rate hike today – fear of Covid in the community might dampen consumer spending and business investment going forward. We're probably more optimistic than the RBNZ on this front, but we recognise that it's a matter of degree. There is, for instance, some evidence that the US economy's recovery has gone faster or slower as Covid cases have waxed and waned. We'll have more of a sense of this by the next monetary policy review in February, by which time the country will be out of lockdowns and firmly into the 'traffic light' system of Covid management.

It's worth noting that the RBNZ's projected OCR track does imply a fairly rapid series of rate hikes as we move into next year – including a strong possibility of a 50bp hike at the February review. The projection includes an average OCR of 0.94% over the March quarter next year; with only one scheduled review in that quarter, they would have to go straight from 0.75% to 1.25% to get that kind of result.

The housing market is a key channel for how monetary policy affects the wider economy, and higher interest rates will have a significant impact on house prices over the coming years – like us, the RBNZ is forecasting a modest drop in house prices from the second half of next year. We don't expect that to be a source of distress in itself – the vast majority of property owners will still be well ahead of the game, given the recent pace of price rises. But it will have a meaningful impact on people's perceived wealth and their willingness to spend. (It also suggests that debt-to-income restrictions may not be the binding factor on the housing market by the time they become operational, probably not until late next year.)

Inflation forecasts



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