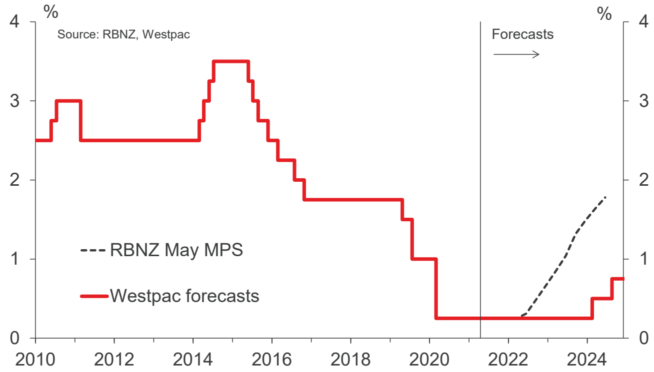
Economic Bulletin.

26 May 2021

Wouldn't it be nice – Review of the RBNZ Monetary Policy Statement, May 2021.

- The Reserve Bank left its monetary policy settings unchanged, to support the economy through its post-Covid recovery.
- However, it signalled that the Official Cash Rate could start to rise from the second half of next year, much earlier than our forecasts suggest.
- The RBNZ is concerned that the labour market is much tighter than previously thought, due to skill mismatches and the loss of migrant workers.
- It expects a significant lift in wage growth, even as the unemployment rate struggles to move lower.
- In time, higher wage growth is expected to add to the pickup in inflation pressures, requiring some monetary stimulus to be withdrawn.
- We're less convinced about the extent of wage and therefore price pressures.
- For now we maintain our forecast that OCR hikes will be delayed until early 2024.
- But we recognise that our point of difference with the RBNZ hinges on the degree of capacity in the labour market, something that's inherently difficult to judge.

Official Cash Rate



Today's *Monetary Policy Statement* was similar in tone to recent Reserve Bank statements. The New Zealand economy has rebounded strongly from last year's Covid-19 lockdowns, but it remains below its full potential, and policy support will be needed for some time. The Official Cash Rate remains at a record-low 0.25%, and the unconventional policy measures that the RBNZ introduced last year remain in place.

However, we were surprised by the RBNZ's guidance on future monetary policy settings. For one, the RBNZ published a forward track for the OCR for the first time in a year. The fact that multiple tools have been in play has made it harder to convey the overall stance of monetary policy over the last year. In previous statements the RBNZ has instead published an 'unconstrained OCR', which is meant to reflect the combined impact of these policy tools in OCR-equivalent terms (and assuming that the OCR was able to go below zero). With economic conditions improving, the RBNZ's unconstrained OCR track would have eventually risen above 0.25% anyway, so it makes sense to go back to expressing the policy stance purely in OCR terms.

The RBNZ's forward track suggested that OCR hikes could begin by the September quarter next year. That was about in line with the views of most analysts, and with financial market pricing – though markets, as is their wont, have leapfrogged today's RBNZ statement and have started to price a hike as early as next May.

That is, however, much earlier than our forecast of an early 2024 start to OCR hikes. That's despite some activity and inflation forecasts that look quite similar to our own. It's widely accepted that the inflation rate will spike higher this year, but the RBNZ continues to regard this as due to temporary factors, and by the middle of next year it expects inflation to drop to as low as 1.5%. GDP slowed over the summer period, reflecting the absence of international tourists, but is expected to pick up strongly over the rest of this year.

Our view for some time has been that the Monetary Policy Committee takes the employment side of its mandate seriously – more seriously than financial markets, which still tend to view the RBNZ as a straightforward inflation targeter. What surprised us is how hawkish the RBNZ has become in its assessment of the labour market.

There was a subtle but important change in the last paragraph of the RBNZ's media release:

"The Committee agreed to maintain its current stimulatory monetary settings until it is confident that consumer price inflation will be sustained near the 2 percent per annum target midpoint, and that employment is at its maximum sustainable level."

That last part was changed from "at or above its maximum sustainable level". Previously, it appeared that the RBNZ was willing to push the boat out on the employment side of its mandate, as long as inflation stayed well contained within the target range. Now, it seems concerned about the risk of pushing things too far.

That in turn reflects a concern about where 'maximum sustainable' lies. The current unemployment rate of 4.7% suggests that there is still some slack left in the labour market, compared to pre-Covid levels of around 4%. But at the same time, firms are talking about severe skills shortages, business surveys say that the difficulty of finding workers is back at previous highs, and job advertisements are far outstripping employment growth, suggesting some difficulty in filling positions.

The conclusion that the RBNZ has drawn is that 'maximum sustainable employment' could be much lower than previously thought (or put another way, the 'neutral' unemployment rate is higher). That's reflected in its labour market forecasts: it expects a rapid and sustained rise in wage growth, to a pace not seen since before the Global Financial Crisis, even as the unemployment rate struggles to move much below its current level.

Higher wage growth than we've seen in many years might sound like a good thing – indeed, it's a key part of the current Government's policy thrust. But in the RBNZ's forecasts, rising wage pressures (that aren't the result of productivity improvements) eventually lead to a sustained bout of inflation, requiring a monetary policy response in the coming years.

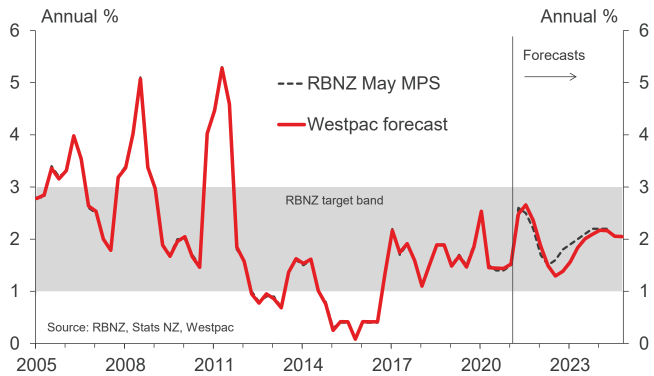
We're not convinced about the case for either a stubbornly high unemployment rate, or for a lift in wage growth as sharp as the RBNZ expects. But we recognise that this is the key point of difference between our view and the RBNZ's about how much monetary stimulus is appropriate.

We note that the perception of skill shortages and a tight labour is tied to the issue of immigration – with the international borders closed, the flow of both skilled and unskilled migrant workers that employers would normally have expected has been cut off. But debates about immigration often fall for the 'lump of labour' fallacy – the idea that there is a fixed amount of work to be shared across the workforce. In fact, the evidence is that migrants add to both labour supply and demand in roughly equal measure, with little net impact on wages. The absence of migrant workers might drive up wages in certain sectors, but it's far from clear that this would hold true economy-wide.

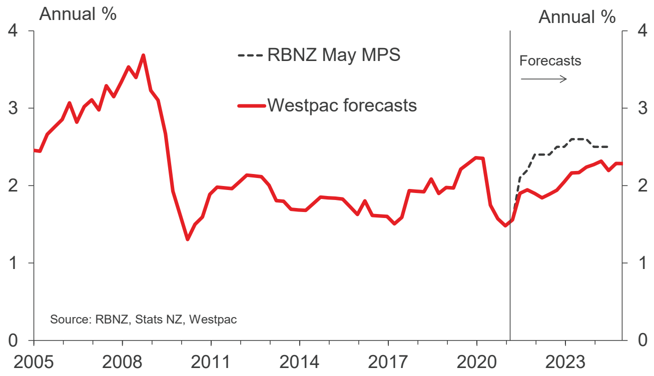
The persistence of wage growth also depends on how migration flows evolve. That's a question of both when we're able to open the borders more widely, and what immigration policy settings the Government will adopt once that happens. The RBNZ assumes that net inflows will gradually rise to around 23,000 working-age people per year, which is similar to our own assumption.

For now, we're sticking with our call that OCR hikes will be delayed until early 2024. Not because we're determined that we're right and the RBNZ is wrong, but because it hinges on an issue that needs much closer consideration. The question of whether 'maximum sustainable employment' has changed post-Covid is inherently difficult to judge in real-time – but we think the burden of proof lies with those who argue for a change.

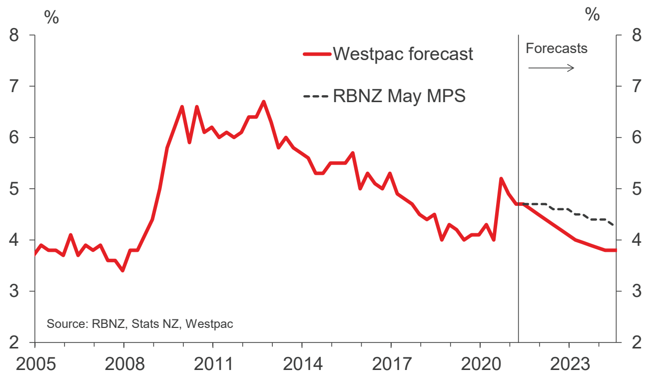
Consumer price inflation



Wage inflation



Unemployment



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