6 October 2021

RBNZ Unfazed By COVID

- **Cash rate raised 25 basis points**
- **Bank says more to come**
- **Forecasts based on endemic-COVID**
- **Demand will need to match supply constraints**
- **House prices need to correct too**

The key news in today's RBNZ Monetary Policy Review is that the Reserve Bank is currently relatively comfortable the spread of COVID throughout New Zealand will unlikely prevent it delivering the tighter monetary conditions that the economy requires to keep in balance.

Not only did the RBNZ raise the cash rate 25 basis points, to 50 basis points, but it also reconfirmed its intent to keep raising interest rates, probably in line with its August Monetary Policy Statement. That statement indicated a measured increase in the cash rate to an average 2.0% in the September quarter 2023.

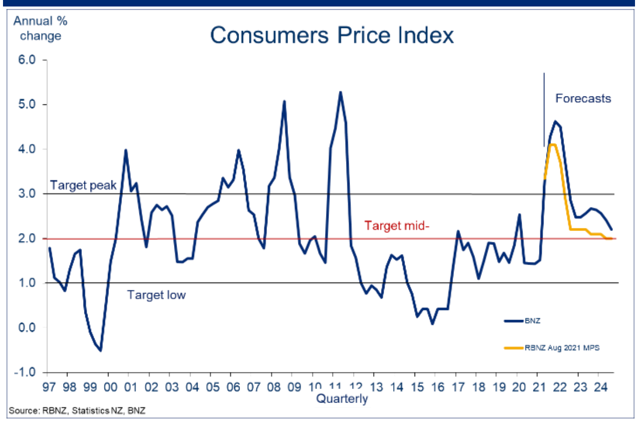
We had been concerned the RBNZ's August forecasts might have been based on the concept of New Zealand moving into a Level 1 type status based on the elimination of COVID. If this had been so, contemplating a COVID-endemic environment might well have caused the RBNZ to get nervous about future moves. But the RBNZ put this concern to bed by formally acknowledging it expects to see endemic COVID. On this basis, there is no need for folk to assume the Bank will hit the panic button if COVID spreads, as it inevitably will.

Of course, if COVID disruptions impact the Bank's medium-term view on inflation and employment then it will react but the key here, and the RBNZ highlighted this, is the medium term. No longer is the Bank on emergency settings, it's now back on the path of traditional central banking.

Traditional it may be, at one level, but not so traditional in another in that the Bank formally acknowledged it's supply issues that are dominating the inflationary landscape, not demand. This is a bit more problematic for central banks whose policy levers are better suited to influencing demand than supply. What it does mean is that if supply is desperately constrained it has no option but to drag demand down in line with those constraints.

Having made such a song and dance about least regrets, it was interesting the RBNZ didn't use the term anywhere in today's missive. That may be so but the least regrets message still bubbled away underneath the headlines. A number of times the Bank talked about considerable uncertainty. Under the least regrets framework, considerable uncertainty, in the current context, means 25 basis point rate moves. In our opinion, this was a clear statement from the Bank that, at this stage at least, it does not intend to raise its cash rate 50 basis points in November. To hammer that home, it also made sure market watchers realised the RBNZ already anticipates annual CPI inflation will push through 4.0% when the September quarter CPI is released on October 18. Accordingly, markets should not get overly excited by a big number when it is published unless, of course, it's a very big number, say approaching 5.0%, which certainly can't be ruled out.

Inflation spikes



To round things out, and as required by the Bank's remit, it passed comment on the state of the New Zealand housing market. In its assessment "the level of house prices is currently unsustainable". That either means wage growth has to exceed house price growth for it to start becoming more comfortable, or house prices have to fall. With this in mind, the Bank intimated that it hopes rising mortgage interest rates will help put a dent in house prices.

There was nothing in today's statement to change our view of the world. Broadly speaking it hasn't changed the market's either. We thus continue to forecast 25 basis point cash rate increases at both the November and February Monetary Policy Statements. We then expect the cash rate to rise progressively to 2.25% by mid-2023. Our view remains only modestly more aggressive than the Reserve Bank's August MPS projections and a tad more aggressive than market pricing.

We are fairly certain inflation will print high for Q3. Indeed, an annual 4.3% is our pick. And we are equally convinced labour market data will confirm maximum sustainable employment. What we will be most interested in is the how the economy copes with the spread of COVID. Much of this will depend on the uptake of vaccines in New Zealand and their successfulness. No doubt playing its part in getting the message across, the RBNZ noted “achieving high vaccination rates will be crucial to reducing the ongoing disruption from endemic COVID-19 and the balance of pressure on demand and supply”. To that we say “here, here!”.

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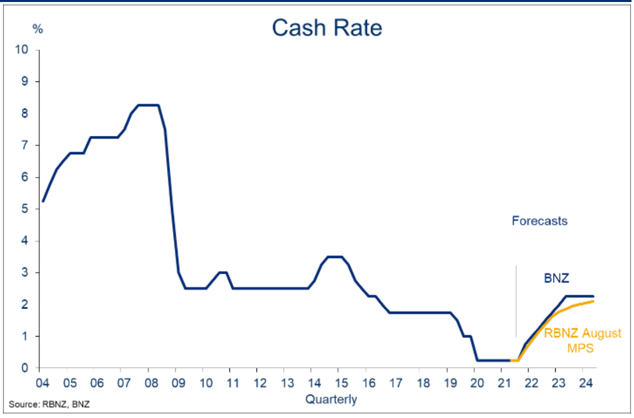
More rate hikes ahead



Full text of today’s RBNZ OCR Review

Monetary Stimulus Further Reduced - Official Cash rate raised to 0.50 percent

The Monetary Policy Committee agreed to increase the Official Cash Rate (OCR) to 0.50 per cent. Consistent with their assessment at the time of the August Statement, it is appropriate to continue reducing the level of monetary stimulus so as to maintain low inflation and support maximum sustainable employment.

The level of global economic activity has continued to recover, supported by accommodative monetary and fiscal settings, and rising vaccination rates enabling a relaxation of mobility restrictions. While economic uncertainty remains elevated due to the prevalent impact of COVID-19, cost pressures are becoming more persistent and some central banks have started the process of reducing monetary policy stimulus.

New Zealand’s public health settings are also evolving as domestic vaccination rates rise. The higher the vaccination rate, the less virus-related disruption there will be to New Zealand’s economic activity over coming years.

The current COVID-19-related restrictions have not materially changed the medium-term outlook for inflation and employment since the August *Statement*. Capacity pressures remain evident in the economy, particularly in the labour market. A broad range of economic indicators highlight that the New Zealand economy has been performing strongly in aggregate.

While the economy contracted sharply during the recent nationwide health-related lockdown, household and business balance sheet strength, ongoing fiscal policy support, and a strong terms of trade provide confidence that economic activity will recover quickly as alert level restrictions ease. Recent economic indicators support this picture.

However, the Committee is aware that the latest COVID-19 restrictions have badly affected some businesses in Auckland and a range of service industries more broadly. There will be longer-term implications for economic activity both domestically and internationally from the pandemic.

Headline CPI inflation is expected to increase above 4 percent in the near term before returning towards the 2 percent midpoint over the medium term. The near-term rise in inflation is accentuated by higher oil prices, rising transport costs and the impact of supply shortfalls. These immediate relative price shocks risk leading to more generalised price rises. At this time, measures of core inflation and medium-term inflation expectations remain close to 2 percent.

The Committee noted that further removal of monetary policy stimulus is expected over time, with future moves contingent on the medium-term outlook for inflation and employment.

Summary Record of Meeting

The Monetary Policy Committee discussed economic developments since the August *Statement.* The Committee noted that the level of global economic activity has continued to recover, supported by rising COVID-19 vaccination rates in many countries, a gradual relaxation of mobility restrictions, and continued monetary and fiscal support. However the near-term outlook for global growth has weakened somewhat due to the spread of the Delta variant, fuel shortages, and rising risks to the Chinese economy. Considerable uncertainty exists regarding the longer-run economic impacts of COVID-19.

Global inflation has increased due to ongoing supply bottlenecks, resulting in higher costs. These supply disruptions and labour shortages are affecting productive capacity. At the same time demand is recovering causing pressure on prices. Global inflation has also been pushed higher in the near-term by rising energy prices. In part this reflects transition costs associated with climate change. In response to signs that inflation pressures are becoming more persistent, some central banks have started the process of reducing monetary policy stimulus.

The Committee noted that recent domestic economic data suggest that prior to the country re-entering lockdown in August, the New Zealand economy was starting from a strong aggregate position, and capacity pressures were building. The economy is expected to have contracted sharply as a result of the recent COVID-related restrictions, although by less than the first national lockdown in the second quarter of 2020.

The Committee noted that near-term growth will remain volatile, and will depend on the speed and extent to which public health restrictions are eased. However, the experience of last year suggests that timely Government support for business and jobs is effective at cushioning the near-term impact on economic activity.

Early data suggest that business and consumer confidence remained robust during the latest lockdown. Some customer-facing businesses in Auckland and a range of service sectors are experiencing more acute stress. Reflecting the tightness of the labour market, firms have sought to hold on to employees, in some cases supported by wage subsidies. Employment opportunities appear to have remained firm.

As in the global economy, rising demand alongside capacity constraints is contributing to higher domestic inflation. Cost pressure in New Zealand has been accentuated in the near term by higher oil prices, supply shortfalls and rising transport costs. This is expected to result in CPI inflation rising above 4 percent in the near term, before returning towards the 2 percent midpoint of the target band over the medium term. Core inflation remains near the target mid-point.

The Committee noted significant uncertainty about how changes to public health settings, border restrictions, and rising incidence of COVID-19 in the community will impact on economic outcomes as the response to the pandemic evolves. Achieving high vaccination rates will be crucial to reducing the ongoing disruption that COVID-19 has on people and the economy.

The Committee agreed that there will be longer-term implications for economic activity both domestically and internationally from the pandemic. The Committee will be watching closely how the economy adjusts to the ongoing disruption from endemic COVID-19 and the balance of pressure on demand and supply.

As required by their Remit, members assessed the impact of monetary policy on the Government's objective to support more sustainable house prices. The Committee noted the Reserve Bank's assessment is that the level of house prices is currently unsustainable. Members noted that a number of factors are expected to constrain house prices over the medium term. These include a high rate of house building, slower population growth, changes to tax settings, and tighter bank lending rules. Rising mortgage interest rates, as monetary stimulus is reduced, would also constrain house prices to a more sustainable level. Members noted a risk that any continued near-term price growth could lead to sharper falls in house prices in the future.

With regard to the stance of monetary policy, the Committee noted that the current restrictions are creating a different set of policy challenges than in 2020. Demand shortfalls are less of an issue than the economy hitting capacity constraints given the effectiveness of Government support and resilience of household and business balance sheets. While some capacity bottlenecks are likely to be short term, there is a risk that these become more persistent as we transition to a COVID-19 endemic state of the world.

The Committee agreed that rising capacity pressures would feed through into inflation. Employment is expected to remain at around its maximum sustainable level. Members concluded that monetary policy stimulus will need to be reduced to maintain price stability and maximum sustainable employment over the medium term.

The Committee agreed to further reduce the level of monetary stimulus at this meeting by increasing the Official Cash Rate (OCR) to 0.5 percent. The Committee noted that further removal of monetary policy stimulus is expected over time, with future moves contingent on the medium-term outlook for inflation and employment.

On Wednesday 6 October, the Committee reached a consensus to increase the OCR to 0.5 percent.

Attendees:

Reserve Bank staff: Adrian Orr, Geoff Bascand, Christian Hawkesby, Yuong Ha
External: Bob Buckle, Peter Harris, Caroline Saunders
Observer: Caralee McLiesh
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