RESEARCH
Economy Watch

18 August 2021

COVID Clobbers Rate Hike

- **RBNZ was ready to start hiking rates today**
- **COVID's re-emergence stymied this**
- **But rate hikes will come**
- **As RBNZ acknowledges objectives have been met**
- **We leave our rate profile unchanged but delay it a meeting**

The biggest surprise, for many, in today's MPS will have been the Reserve Bank's strength in conviction that it needs to get interest rates above neutral, and relatively quickly. As we had anticipated, the RBNZ formally recognised it is meeting its inflation and employment objectives and so needs to see the removal of the emergency stimulus it put in place when New Zealand entered its first COVID lockdown.

With this in mind, the RBNZ brought forward the starting point for the tightening cycle it had first suggested in its May MPS and pushed higher the peak in the modelled OCR track to 2.14%, with 2.00% exceeded by end 2023.

In today's MPS, the RBNZ actually states that "Emergency levels of monetary stimulus are no longer warranted given the strength in employment and rising inflationary pressures. Our central projection implies that monetary stimulus should be reduced to ensure the MPC meets its objectives".

But then New Zealand managed to arrange its first COVID outbreak in months just before the RBNZ went to press. In years gone by this would have been very problematic as the MPS would have been printed ready for distribution. Now, the joys of technology mean the RBNZ was able to rewrite parts of its script, and modify the odd table or two, to provide recognition of its concerns about the aforesaid outbreak. Importantly it was able to change "hike" to "hold".

The last paragraph of the Board's minutes sums things up very nicely. "The Committee discussed the merits of an increase in the OCR at this meeting and considered the implications of alternative sequencing of OCR changes over time. The Committee agreed that their least regrets policy stance is to further reduce monetary policy stimulus to reduce the risk that inflation expectations become unanchored. However, in light of the current Level 4 lockdown and health uncertainty the Committee agreed to leave the OCR unchanged at this meeting."

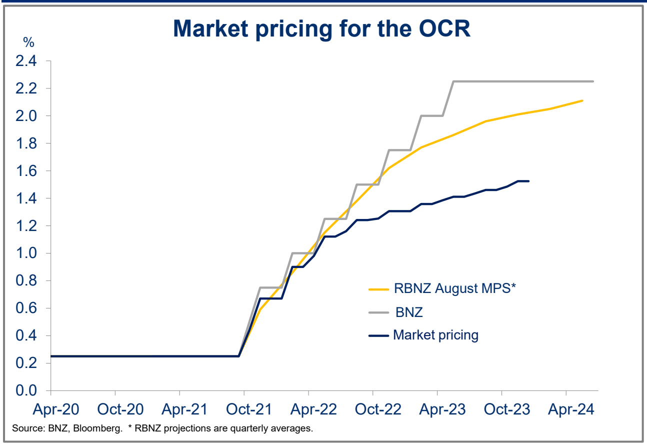
The problem we are now left with is that we need to be able to forecast the longevity of the current COVID outbreak in order to place where the first rate hike will be. And, of course, there is no way to do this. What we can say, however, is that if New Zealand successfully contains the current outbreak quickly then it is almost certain the cash rate will be raised in October. We can also say that it is likely that, even in the event of a protracted lockdown, the economy will progressively open up early in 2022 as vaccination rates reach "acceptable" levels. But it all depends on the progress of the virus and its economic impact.

As we don't know the answer to this question, we have simply moved the starting point for our forecast tightening cycle to the October meeting and then left the pathway unchanged from our previous forecasts. The implicit assumption is that New Zealand is successful in its management of COVID-19.

Moreover, when the RBNZ discussed the key risks to its outlook it noted that they "have learned from past experience that the economy is resilient to periods at higher alert levels if there is significant government support provided, and alert levels can be lowered relatively quickly". The former is a given, the latter is where there will be points of contention.

It also shouldn't be forgotten that many of our current inflation and employment issues stem from COVID having created a major supply shock. If this outbreak sees a further supply shock dominate the adverse impact on demand then the RBNZ may need to swing into hiking action even with COVID restrictions in place.

Headed for Neutral

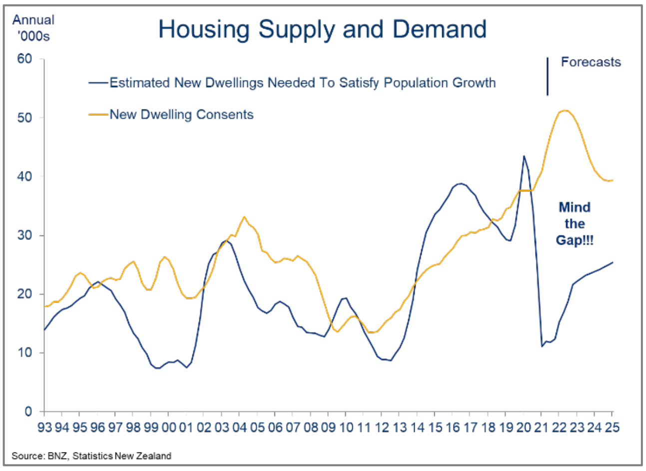


Interest rate and currency markets initially saw today's statement through dovish-tinted glasses as a rate hike (that some, a few days ago, had thought would be 50 basis points) never eventuated. But as the tea leaves were viewed more closely, it became obvious the general thrust of the document was in fact more hawkish than widely anticipated, so a grand reversal took place.

As things stand, we still think the market is underpricing the terminal cash rate but we can understand why this might be so given the risk profile surrounding the eventual outcome.

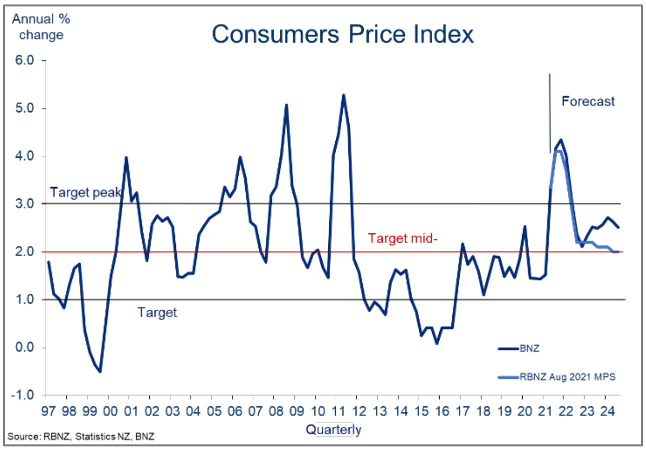
On another note, it was interesting to see the RBNZ reconfirm its view that "house prices appear to be above their sustainable level". From our perspective, it was nice to see the Bank using a chart that we have been deferring to for some time, which shows the marginal increase in housing supply exceeding the marginal increase in demand. This, we believe, is ultimately what will drive prices lower, especially as interest rates rise. Not surprisingly, the Bank's analysis does conclude with a reasonable drop in house prices from late 2022 through to 2024.

Our view on housing

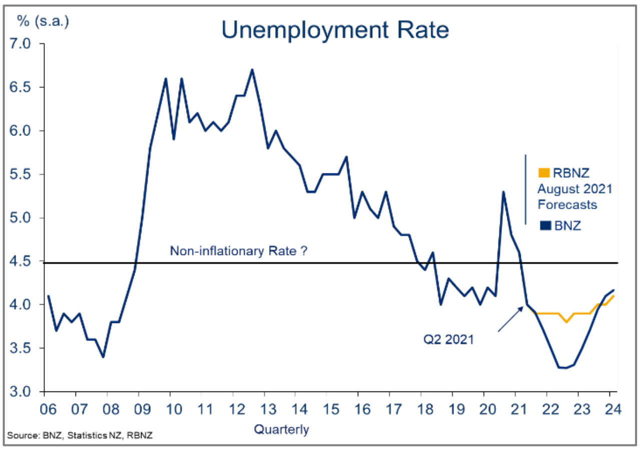


So putting it all together, we see nothing in today's MPS to change our broader view of the economy. We still see the economy as being stretched to breaking and believe that it will, in time, demand interest rates heading towards neutral. For now, though, COVID clouds that view and will remain problematic until such time the economy again emerges from lockdown.

Upside to CPI projections



Downside to unemployment



stephen_toplis@bnz.co.nz

The full text of today's RBNZ MPS

The Monetary Policy Committee agreed to retain the current stimulatory level of monetary settings, keeping the Official Cash Rate (OCR) at 0.25 per cent for now. Today's decision was made in the context of the Government's imposition of Level 4 COVID restrictions on activity across New Zealand.

The Committee will assess the inflation and employment outlook on an ongoing basis, with a view to continue to reduce the level of monetary stimulus over time so as to best meet their policy remit. This follows the recent halting of additional government bond purchases under the Large Scale Asset Purchase (LSAP) programme in July.

Global monetary and fiscal settings remain at accommodative levels, supporting international spending and investment. Rising vaccination rates across many countries have provided economic impetus. The rise in activity has continued to support demand and prices for New Zealand's export commodities.

However, the need to reinstate COVID-19 containment measures in some regions highlights the serious health and economic risks posed by the virus. Persistent and elevated health risks are promoting ongoing global supply chain disruptions, and are acting to constrain productive capacity and prolong inflationary pressures. Today's re-introduction of Level 4 restrictions to activity across New Zealand is a stark example of how unpredictable and disruptive the virus is proving to be.

The Committee noted that the New Zealand economy had rebounded more strongly than most countries, with less domestic disruption caused by COVID-19 to date. Employment is currently at or above its maximum sustainable level, and consumer price inflation expectations remain anchored near 2 percent, the midpoint of the target range.

Recent data for the New Zealand economy suggest demand is robust and the economic recovery has broadened, despite some weakness persisting in the sectors most exposed to international tourism. Household spending and construction activity are at high levels and continue to grow, and business investment is responding to increased demand.

Capacity pressures are now evident in the economy, particularly in the labour market where job vacancies remain high despite the recent decline in unemployment and underemployment. Wages are rising consistent with the tight labour market conditions.

Broader inflation pressures are being accentuated in the near-term by one-off price rises such as higher oil prices, and temporary factors such as supply shortfalls and higher transport costs. Near-term consumer price inflation is expected to rise above the Committee's target range before returning towards the 2 percent midpoint around mid-2022.

The Committee agreed they are confident of meeting their inflation and employment remit with less need for the existing level of monetary stimulus. However, the Committee remains alert to the supply disruptions that COVID-19 can create, and the dampening effect this can have on confidence. House prices are also above their sustainable level, heightening the risk of a price correction as supply increases.

The Committee agreed that their least regrets policy stance is to further reduce the level of monetary stimulus so as to anchor inflation expectations and continue to contribute to maximum sustainable employment. They agreed, however, to keep the OCR unchanged at this meeting given the heightened uncertainty with the country in a lockdown.

More information:

- Download the August 2021 Monetary Policy Statement (PDF 8MB)

Summary Record of Meeting

The Monetary Policy Committee discussed economic developments since the May Statement. The Committee noted that the global economy has continued to recover, supported by rising vaccination rates in many countries, a gradual relaxation of mobility restrictions, and continued monetary and fiscal support.

The Committee noted the considerable uncertainty that exists regarding the longer-run impacts of COVID-19, particularly with the emergence of new variants. Globally, periods of health-related mobility restriction are likely to continue for some time, creating ongoing short-term economic disruptions, supply cost pressures, and lower productive capacity.

The Committee agreed that in New Zealand the recent economic data suggest domestic demand is robust and that the economic recovery has broadened in recent months. While weakness still persists in sectors most heavily exposed to international tourism, activity in most industries now exceeds pre-COVID levels.

Domestic economic activity has been underpinned by strong household spending, high levels of construction, and strong demand for New Zealand's commodity exports. Recent data has also shown a pick-up in business investment, which broadens the base of aggregate demand and suggests businesses are responding to emerging capacity constraints.

The Committee noted uncertainty related to the emergence of new cases of COVID-19 in the community and the move back into Alert Level 4. The reinstatement of the Government Wage Subsidy Scheme and COVID-19 Resurgence Support Payments is expected to significantly buffer the loss of income associated with the lockdown.

The Committee agreed that capacity constraints were building in the economy. Pressures are particularly acute in the labour market, where job vacancies remain high alongside declines in unemployment. Falling underemployment provides a greater level of confidence that spare capacity is being absorbed. Employment is assessed as being at or above its maximum sustainable level in the current environment.

Wage inflation has increased in line with the tightening in the labour market, but the Committee expressed uncertainty about whether higher wage growth will be sustained.

The Committee noted that capacity constraints are contributing to rising headline inflation. Mirroring global developments, inflationary pressure in New Zealand has been accentuated in the near term by one-off factors such as higher oil prices, and temporary factors such as supply shortfalls and rising transport costs. This is expected to push inflation above 4 percent in the near-term, before returning towards the 2 percent midpoint of the target band from mid-2022. Medium and long-term inflation expectations remain anchored at 2 percent.

The Committee reflected that experience over the past 12 months has provided more confidence about the resilience of domestic demand in the face of health-related restrictions. The Government Wage Subsidy proved effective in supporting domestic incomes and providing job security through periods of lockdown, which has enabled a rapid recovery in consumer spending. This scheme has been rapidly reinstated in light of the current lockdown. While some households suffered income losses and accumulated debt, many households retain a larger buffer of savings, which could provide ongoing support to consumption.

The Committee acknowledged that restrictions on the movement of people across the New Zealand border will only be removed gradually, and subject to ongoing health-related uncertainty. However, they also agreed that, to date, increased domestic spending has provided a significant offset to the loss of international tourism earnings. The closure of the border has also reduced international labour mobility, creating capacity shortages in some industries that have traditionally been reliant on migrant labour.

In light of this experience, members expressed caution about the level of remaining supply capacity in the New Zealand economy. The economic disruption caused by the ongoing global health issues has increased skill mismatches, which has likely reduced maximum sustainable employment in the near term. The Committee discussed the risk that the productive capacity of the economy is lagging domestic demand, which could lead to more persistent inflation pressure.

The Committee discussed the current, and risk of future, outbreaks of COVID-19 in New Zealand, and how monetary policy should respond. The Committee agreed that fiscal policy (government spending and transfer payments) has proved to be a very effective tool to respond to any immediate reduction in demand in the event of outbreaks. A monetary policy response may be required if a health-related lockdown has a more enduring impact on inflation and employment.

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 that the level of house prices is currently unsustainable. Members noted that the Reserve Bank is currently consulting on further bank lending restrictions to help mitigate the financial stability risks associated with unsustainable house prices.

The Committee noted that a number of factors are expected to weigh on house prices over the medium term. These include strong house building, slower population growth, changes to tax settings, and the ongoing impacts of tighter bank lending rules. Rising mortgage interest rates, as monetary stimulus is reduced, would also constrain house prices to a more sustainable level. Members expressed uncertainty about how quickly momentum in the housing market will recede and noted a risk that any continued near-term price growth could lead to sharper falls in house prices in the future.

The Committee reiterated that the OCR is currently the preferred tool to adjust the level of stimulus in the economy. The principles governing the suite of monetary policy tools will continue to guide their use. In line with those principles, the Funding for Lending Programme (FLP) will remain in place under its current terms until the drawdown window expires next year. The Committee directed staff to develop an operational strategy to help inform decisions regarding the management of Government and Local Government Funding Agency (LGFA) bonds purchased under the Large Scale Asset Purchase (LSAP) programme, consistent with the Committee's desired stance of policy and supporting the functioning of markets.

The Committee discussed the stance of monetary policy. Members noted that they now had more confidence that rising capacity pressures will feed through into inflation, and that employment is at its maximum sustainable level. Members concluded that they could continue removing monetary stimulus, following their decision to halt additional purchases of Government bonds under the LSAP programme at their July meeting.

The Committee discussed the merits of an increase in the OCR at this meeting and considered the implications of alternative sequencing of OCR changes over time. The Committee agreed that their least regrets policy stance is to further reduce monetary policy stimulus to reduce the risk that inflation expectations become unanchored. However in light of the current Level 4 lockdown and health uncertainty the Committee agreed to leave the OCR unchanged at this meeting.

On Wednesday 18 August, the Committee reached a consensus to:

- Maintain the OCR at 0.25 percent;
- Direct staff to develop an operational strategy to inform decisions on the management of Government and LGFA bonds purchased under theLSAP programme; and
- Maintain the existing Funding for Lending Programme conditions.

Attendees:

Reserve Bank staff: Adrian Orr, Geoff Bascand, Christian Hawkesby, Yuong Ha

External: Bob Buckle, Peter Harris, Caroline Saunders

Observer: Bryan Chapple

Secretary: Chris Bloor

Contact Details

BNZ Research

Stephen Toplis	Craig Ebert	Doug Steel	Jason Wong	Nick Smyth
Head of Research	Senior Economist	Senior Economist	Senior Markets Strategist	Senior Interest Rates Strategist
+64 4 474 6905	+64 4 474 6799	+64 4 474 6923	+64 4 924 7652	+64 4 924 7653

Main Offices

Wellington
Level 4, Spark Central
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Toll Free: 0800 854 854

National Australia Bank

Ivan Colhoun	Alan Oster	Ray Attrill	Skye Masters
Global Head of Research	Group Chief Economist	Head of FX Strategy	Head of Fixed Income Research
+61 2 9237 1836	+61 3 8634 2927	+61 2 9237 1848	+61 2 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+61 2 9295 1100
Fixed Income/Derivatives	+61 2 9295 1166

London

Foreign Exchange	+44 20 7796 3091
Fixed Income/Derivatives	+44 20 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+85 2 2526 5891
Fixed Income/Derivatives	+85 2 2526 5891