

24 November 2021



RBNZ: On the way to neutral

- Cash rate raised 25 basis points to 0.75%
- Hike after hike pencilled in
- Terminal rate 2.50% to 2.75%
- RBNZ forecasts now match our own
- Our forecast profile is unchanged

Today the RBNZ raised its cash rate 0.25% to 0.75%. More importantly, it confirmed it will progressively raise that cash rate until monetary conditions are on the tighter side of neutral. And this will be achieved before the end of next year. To cap things off, the Bank also suggests the peak in the cash rate will eventually be between 2.50% and 2.75%.

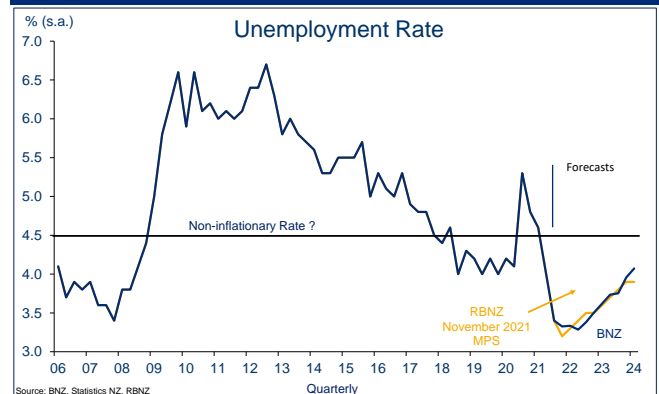
In what is a rarity, we really have nothing to question the RBNZ about. It's difficult to criticise when the Bank's forecasts for inflation, growth, unemployment and interest rates are now almost identical to our own.

Like us, the RBNZ sees Q3 GDP to be 7.0% below its Q2 level. It then sees a solid bounce over the next six months. It believes the anticipated Q4 bounce will be more aggressive than Q1 whereas we see this the opposite way around. Cumulatively, however, there is very little difference.

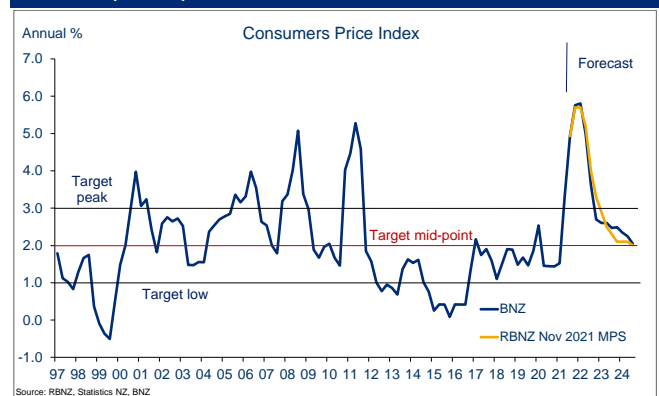
Our respective unemployment forecasts are now almost exactly the same. Importantly, at no point in the forecast horizon does the unemployment rate get up to the 4.5% level deemed to be the NAIRU.

With regard to the CPI, we have a 1.3% increase pencilled in for Q4, followed by 0.9% in Q1. The RBNZ now has 1.2% and 0.9% respectively. We both see it taking some time for annual inflation to get back to the mid-point of the RBNZ's target range. And, of course, it only gets there if interest rates are increased in the manner postulated.

Unemployment remains below NAIRU

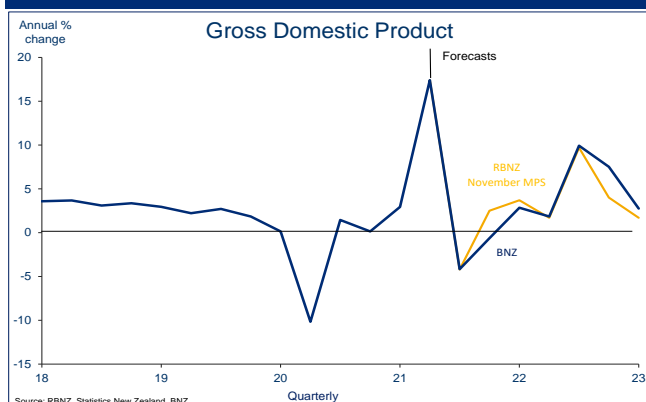


Inflation yet to peak

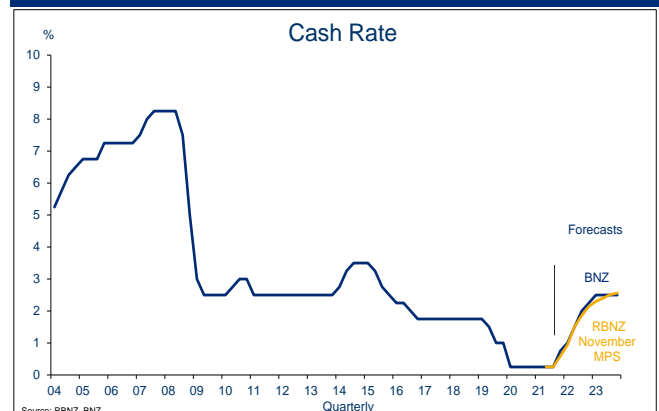


Even the RBNZ's interest rate track sits upon our own. The only exception is that our forecasts are discrete (i.e. we forecast rate changes as at given RBNZ meeting dates and publish an end quarter figure) whereas the central bank's forecasts display a modelled quarterly average track for the OCR.

Growth volatile



Cash rate to go through neutral



We, and the RBNZ, see the risks around our respective interest tracks as being evenly balanced.

It should thus come as no surprise that we will not be changing our views on the prospective cash rate track one iota following today's statement. To confirm, that means:

- The cash rate is raised a further 25 basis points at the February MPS taking it to 1.00%
- There are then rate increases in each of the April, May, July and August meetings. We then have one rate increase in each of Q4 2022 and Q1 2023. This takes the peak in the cash rate to 2.5%.
- The cash rate is then expected to stay there for a period of time until tighter than neutral conditions are no longer needed.

As we had anticipated, the Monetary Policy Committee acknowledged that near term risks suggest policy could be tightened more aggressively but elevated uncertainty about the future meant this would be an unwise approach at this juncture.

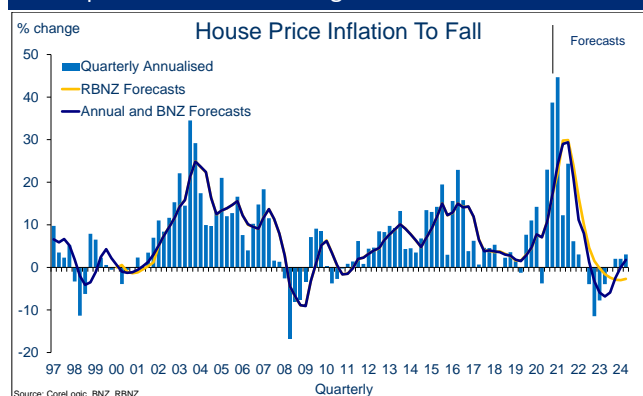
Of course, the RBNZ has two other monetary policy programmes in play: the Large Scale Asset Programme (LSAP) and Funding for Lending Programme (FLP). With regard to the LSAP, the RBNZ said it "expects to gradually manage LSAP bond holdings down, in a way that maintains the smooth functioning of financial markets". We interpret this as meaning the Reserve Bank is in no rush to do anything, it is unlikely to be selling bonds in the foreseeable future, but it may just let them roll off the books when their holdings mature. Whatever the case, the Bank is going to give us a heads up on how the holdings will be reduced "early next year".

As for the FLP, the Bank had said it would remain in place until the end of 2022 and so it will. Any removal of the programme is basically seen as being a breach of promise.

Naturally, though, as the cash rate rises, the FLP rate moves with it, so the tightening in conditions is not prevented.

Not surprisingly, the RBNZ reiterated it wants to see a correction in house prices. Accordingly, it forecast a cumulative correction of over 5.0%. We think the risk is that house prices will fall sooner and more than the RBNZ suggests but, unless that decline is precipitous, it will not bother the central bank.

House price correction coming



While the Reserve Bank won't say it so bluntly, it desperately needs a sharp softening in growth accompanied by an increase in the unemployment rate and a decline in house prices to achieve its objectives. We think it will achieve these goals in due course but the fact that it does so should not be seen as a failure of monetary policy but rather a sign of its success. Of course, if things go too far the tightening cycle will simply be aborted. This is a very real possibility but, equally, if tightening fails to provide the necessary traction the Reserve Bank will, likewise, have no hesitation in using the cash rate lever even more aggressively than is currently touted.

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The full text of today's RBNZ MPS

The Monetary Policy Committee agreed to raise the Official Cash Rate (OCR) to 0.75 per cent. The Committee agreed it remains appropriate to continue reducing monetary stimulus so as to maintain price stability and support maximum sustainable employment.

The level of global economic activity continues to rise, supported by accommodative monetary and fiscal policy settings, and the relaxation of COVID-19 health-restrictions. The pace of global economic growth has ebbed however, due to the elevated uncertainty created by the persistent COVID-19 virus.

Global supply-chain disruptions are causing both cost pressures and constraints on production, at a time when consumer demand remains strong. Central banks globally face the challenge of distinguishing between transitory price increases and underlying sustained inflation pressures to assess the need for, and timing of, reductions in the level of monetary policy stimulus.

New Zealand's public health restrictions are easing as the country transitions into the COVID-19 Protection Framework. The framework will enable greater mobility of people, and goods and services. With the easing of restrictions, it is anticipated that the COVID-19 virus will become more widespread geographically, albeit manageable for health authorities and less harmful for those vaccinated. However, household spending and business investment will be dampened in the near-term by these ongoing health uncertainties.

The recent nationwide health-related lockdown, the more prolonged restrictions in Auckland, Northland and the Waikato, and

the continued 'Level 2' restrictions elsewhere, resulted in a sharp contraction in economic activity. Despite these lockdowns, underlying economic strength remains supported by aggregate household and business balance sheet strength, fiscal policy support, and strong export returns.

Capacity pressures have continued to tighten. For example, employment is now above its maximum sustainable level. A broad range of economic indicators highlight that the New Zealand economy continues to perform above its current potential.

Headline CPI inflation is expected to measure above 5 percent in the near term before returning towards the 2 percent midpoint over the next two years. 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 generating more generalised price rises given the current domestic capacity constraints.

The Committee noted that further removal of monetary policy stimulus is expected over time given the medium term outlook for inflation and employment.

More information:

- [View the November 2021 Monetary Policy Statement](#)
- [Download the November 2021 Monetary Policy Statement \(PDF 7.4MB\)](#)

Summary Record of Meeting

The Monetary Policy Committee discussed economic developments since the *August Statement*. Global economic activity continues to recover, as public health restrictions ease and COVID-19 vaccine rates increase. However, the near-term outlook for global growth has weakened somewhat because of the continued spread of the Delta variant and related disruptions to production.

Global inflation has increased due to the rapid recovery in global demand combined with significant supply chain bottlenecks and labour shortages in some sectors. An ongoing boost from government spending and monetary policy stimulus in many countries is adding to strong demand. There is considerable uncertainty about the persistence of global inflationary pressures.

The New Zealand economy was in a strong position before the national lockdown in August, supported by resilient household spending, strong construction activity, and demand for our key dairy and meat exports. This had more than offset ongoing weakness in hospitality and sectors reliant on international tourism. While public health restrictions to control the spread of the Delta variant will result in a slowdown over the second half of the year, Government support for business and jobs has helped the economy weather the impact. Nevertheless, some customer-facing businesses in Auckland and a range of service sectors are suffering acute stress.

The Committee noted that the economy is expected to recover as public health restrictions are eased as the country moves into the COVID-19 Protection Framework. However, the Committee discussed the risk that consumer and business confidence weakens as COVID-19 becomes more widespread across the country, dampening household spending and investment in the near term.

Despite recent lockdowns, capacity pressures in the economy have continued to tighten. Employment is now assessed as being above its maximum sustainable level. Measures of labour market slack such as unemployment and underutilisation are at their lowest levels in over a decade. This has been reflected in stronger aggregate wage growth, albeit below the rate of CPI inflation.

The Committee discussed the outlook for net migration and how this could affect labour supply. For example, it is currently easier to leave New Zealand than arrive, so there could be a net loss of labour in the near term. There will be ongoing uncertainty as to the relative impact net migration will have on overall supply and demand in the economy.

Rising capacity pressures have led to an increase in domestic inflation. At the same time, continued bottlenecks in global and local supply chains and further increases in global oil prices have added to inflationary pressures. Annual CPI inflation has increased to 4.9 percent in New Zealand, above the Committee's 1 to 3 percent Remit target band. Measures of core inflation have also increased into the top half of the target band. The Committee noted that inflation is expected to remain high in the near term, and return to the midpoint of the target band over the next two years.

The Committee assessed that near-term risks to inflation are skewed to the upside, and discussed the risk that higher near-term inflation could become embedded in price setting behaviour. The Committee noted that near-term inflation expectations tend to move with actual inflation. Medium-term measures provide a better gauge of whether inflation expectations remain anchored, and these remain close to the target midpoint.

The Committee discussed the Reserve Bank's assessment that the level of house prices are unsustainable. Members noted that higher mortgage interest rates, continued strong home building, tighter lending rules and changes in tax settings should all act to moderate house prices over the medium term. The Committee discussed the risk that house prices could keep rising in the near term, increasing the risk of a sharper fall later. Continued increases in the OCR are expected to support more sustainable house prices.

The importance of overall monetary conditions was considered by the Committee, including medium-term borrowing rates

for households and businesses, to achieving its price stability and maximum sustainable employment objectives. In 2020, additional monetary policy tools were used to support the economy by further lowering interest rates when the OCR was near zero. The Committee agreed that higher interest rates are now needed to maintain price stability and maximum sustainable employment, and that the OCR remains their preferred tool to do this.

The Committee noted that the Large Scale Asset Purchase (LSAP) programme provided significant monetary stimulus and supported bond market functioning through 2020 as the Reserve Bank bought government bonds as an additional monetary policy tool. As bond market functioning has improved, the impact of the LSAP programme on monetary stimulus has fallen, and it is assessed that current bond holdings are providing a small amount of ongoing stimulus.

The Committee expects to gradually manage LSAP bond holdings down, in a way that maintains the smooth functioning of financial markets. More details on how bond holdings will be reduced will be provided early next year.

The Committee discussed that funding remains available to banks under the Funding for Lending Programme (FLP) until the end of 2022, as another part of the Bank's additional monetary policy toolkit. The programme provides banks with assured access to some medium-term funding at the OCR. This commitment has been factored into banks' funding plans. Any adjustment to the terms of the programme would increase funding and operational risks for banks, and would undermine future effectiveness if a similar programme is required in the future. The Committee agreed that changing the terms of the programme would not be consistent with its risk appetite.

As the OCR is increased, the cost to banks of borrowing through the FLP will rise, helping to remove monetary stimulus. Since banks have provided assets as collateral to access funding under the FLP, the scheme does not pose material financial risk to the Crown.

The Committee discussed how much monetary stimulus needed to be removed over the next 12-18 months to meet their price stability and maximum sustainable employment Remit. The Committee expected that the OCR would need to be progressively increased and, conditional on the economy evolving as expected, the OCR would likely need to be raised above its neutral rate.

The Committee discussed how fast interest rates need to be increased, taking into account primary and secondary objectives of its Remit. Higher starting point inflation and capacity pressures, and the risk that higher near-term inflation becomes embedded in price setting behaviour were discussed as factors arguing for a more rapid removal of monetary stimulus.

However, the Committee expressed uncertainty about the resilience of consumer spending and business investment as the country adapts to living with the COVID-19 virus in the community. The Committee also noted that increases in interest rates to households and businesses had already tightened monetary conditions. High levels of household debt, and a large share of fixed-rate mortgages re-pricing in coming months, could increase the sensitivity of consumer spending to these interest rate increases.

Weighing these factors, the Committee assessed risks to their price stability and maximum sustainable employment objectives as being broadly balanced over the medium term. The Committee judged that considered steps in the OCR were the most appropriate way to continue reducing monetary stimulus for now.

On Wednesday 24 November, the Committee reached a consensus to increase the OCR to 0.75 percent.

Attendees:

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