Economic Bulletin.

13 August 2021

Breaking away from the pack – Preview of RBNZ August 2021 Monetary Policy Statement.

- We expect the Reserve Bank to lift the Official Cash Rate by 25 basis points to 0.5% next week.
- This would put it well ahead of its overseas peers. But that accurately reflects the local conditions that the RBNZ is facing.
- The New Zealand economy has built up a real head of steam, and ‘emergency’ monetary policy settings are no longer appropriate.
- The RBNZ has already signalled that the risk of waiting too long to keep inflation in check outweighs the risk of a Covid outbreak in its ‘least regrets’ framework.
- Markets are pricing at least a 25 basis point hike next week, with some chance of a 50 basis point move.
- We agree that the risks lie in that direction, but it’s more a question of tactics than economics.

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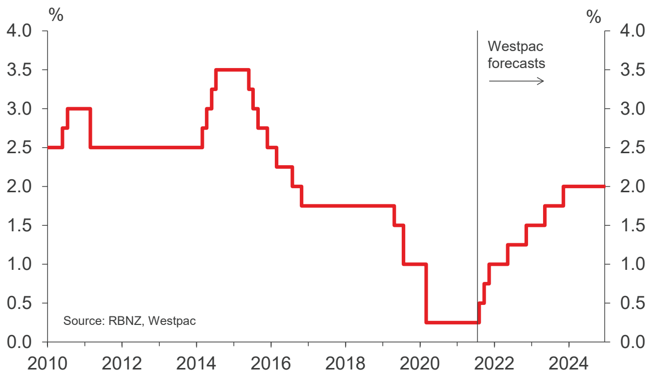
Official Cash Rate forecasts



With the New Zealand economy now clearly running hot, the Reserve Bank won’t be holding interest rates at their current low levels for much longer. We expect a 25 basis point increase in the Official Cash Rate at next Wednesday’s *Monetary Policy Statement*, and a projection for several more hikes over the next couple of years.

Raising interest rates now would put the RBNZ ahead of its overseas peers by quite some margin – we expect the US Federal Reserve to hold off until late 2022, and the Reserve Bank of Australia until early 2023. But that reflects the unique circumstances that the RBNZ faces. Eliminating the spread of Covid has allowed the domestic economy to build up a head of steam over the last year, and the ‘emergency’ monetary policy settings that were introduced last year are no longer needed. As Governor Orr reportedly said in a speech last month, this isn’t a conversation we’d be able to have in any other country.

The other aspect that has raised some eyebrows is how hiking rates now would fit with the RBNZ’s self-declared ‘least regrets' framework. Initially, 'least regrets' meant doing everything that it could to support the economy's recovery. By early this year, it meant waiting until it was certain that inflation and employment were on track before tightening. But by July the RBNZ had concluded that the risk of waiting too long, and letting inflation pressures get out of hand, outweighed the risk of another Covid shock in the near term.

The challenge here is that 'least regrets' is subjective. Waiting a few months would make little difference in terms of economic outcomes, but it would make a big difference in terms of our vaccination rate, and our ability to manage an outbreak of the more contagious Delta variant.

On the other hand, if New Zealand were forced into another lockdown, there is nothing to stop the RBNZ from immediately reversing any hikes it had made. The economic cost of a brief period of higher interest rates would also be minimal; the 'regret' would largely be felt by the RBNZ itself, in terms of the cost to its reputation. And the RBNZ has already indicated that it's willing to take that risk.

25 or 50?

We expect the OCR to be increased by 25 basis points at each of the next three reviews in August, October and November, to reach 1% by the end of this year. Market opinion has generally moved into line with our view since last week's strong labour market figures, and interest rate markets are even pricing in a reasonable chance of a 50 point move next week.

We don't see this as the most likely outcome, but we agree with the market's assessment. A 50 point move in one go would be very unusual – especially on the upside – but not unprecedented. And the RBNZ's Monetary Policy Committee has already shown itself to be an activist one, in both directions.

You may recall that in August 2019 the RBNZ shocked everyone by cutting the OCR by 50 basis points, when market opinion was strongly in favour of a 25 point move. Setting aside the economic rationale for this, what was most interesting was how the Committee explained its decision, which was essentially: "we thought that the OCR needed to be 50 basis points lower, so we did it".

What the Committee decides to do next week is ultimately this is a question of tactics; the economics alone won't resolve the issue. We think that the RBNZ's forecasts will show the OCR needing to reach about 2% by mid-2023. One way of looking at that is seven 25-point hikes over the course of 13 policy review dates – not that big an ask. In practice rate hikes are likely to be front-loaded rather than spread out evenly, but that still doesn't scream out for a 50 point move in one go.

It would be a different matter, however, if the Committee were presented with forecasts that suggested the OCR would need to go above 2% – that is, above their estimate of the 'neutral' cash rate – in order to bring inflation to heel. At this stage we don't think that will be necessary, but it depends on how effective the first few rate hikes are at dampening demand and house prices.

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