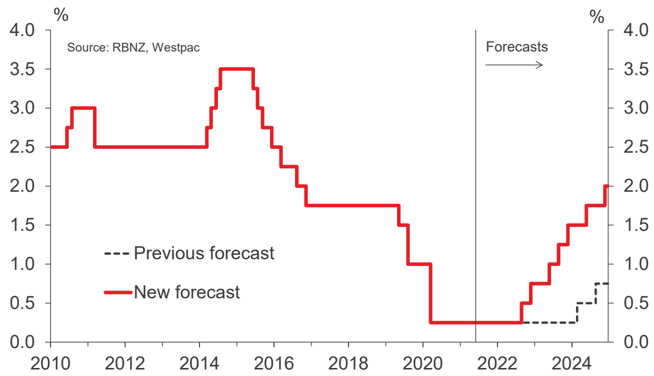
Economic Bulletin.

21 June 2021

Change of OCR call, June 2021.

- We now expect the Reserve Bank to start increasing the OCR from August 2022.
- Previously we expected interest rate hikes to be delayed until early 2024.
- However, with signs of solid momentum in domestic demand, we're now more confident that the economy can withstand a gradual normalisation of monetary policy settings.
- Our change of call is not motivated by inflation concerns. In fact, we think that the RBNZ has time on its side to deal with inflationary pressures.
- Covid-19 has proven to be a significant supply-side shock to the New Zealand economy, and it's well understood that monetary policy should not respond to supply shocks.
- We see little evidence that the economy is overheating. Activity is still running below its full potential, although the gap is closing.

Official Cash Rate forecasts



We are now forecasting the Reserve Bank to start raising the OCR from August next year. We expect the RBNZ to proceed cautiously, with a gradual series of hikes at three- or six-month intervals, reaching an OCR of 2% by the end of 2024.

Our forecast track over the next few years is similar to what the RBNZ laid out in its May *Monetary Policy Statement*. We're not fixed on the exact start date for rate hikes; when you're looking more than a year ahead, a few months either side is neither here nor there. But August seems like a reasonable

Financial forecasts

	2021			2022				2023			
	Latest (21 June)	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Cash	0.25	0.25	0.25	0.25	0.25	0.50	0.75	0.75	1.00	1.25	1.50
90 Day bill	0.33	0.35	0.35	0.35	0.45	0.70	0.85	0.95	1.20	1.45	1.60
2 Year Swap	0.70	0.60	0.70	0.80	0.90	1.05	1.20	1.35	1.50	1.60	1.70
10 Year Bond	1.76	1.90	2.05	2.20	2.35	2.50	2.60	2.70	2.80	2.85	2.90
NZD/USD	0.6937	0.72	0.74	0.76	0.78	0.78	0.77	0.76	0.75	0.74	0.72

starting point, since it will serve as an anchor for the RBNZ's thinking as it assesses the incoming data.

Previously we expected OCR hikes to be delayed until early 2024. Our concern was that rate hikes as early as next year would lead to unacceptably low inflation and employment outcomes for the RBNZ. But we're now growing more confident that the New Zealand economy will be able to absorb higher interest rates:

- The economy appears to have endured the 'touristless summer' better than we expected, and has come out of that phase with considerable momentum.
- March quarter GDP was much higher than forecast. While we have questions about how much of this surprise will be sustained, we think at least some of it was genuine.
- We've improved our modelling of mortgage rates, which suggests less upward pressure on them from OCR hikes. That has consequences for our house price forecasts – we still expect them to cool significantly over the next year, but we don't expect them to tip over into outright declines until late 2022, once OCR hikes are already under way.
- We've brought forward our rate hike forecasts for the US Federal Reserve (late 2022) and the Reserve Bank of Australia (early 2023). That removes the risk of a sharp rise in the New Zealand dollar if the RBNZ hiked rates well ahead of its peers. In fact, we've revised down our NZD/USD forecast a little, though we still expect it to rise over the next year.

Importantly, our change of call is not motivated by the inflation concerns that have gripped financial markets in recent months. On the contrary, we think that the RBNZ has plenty of time on its side when it comes to keeping inflation on target.

There's no disagreement that inflation will spike higher this year. That's partly because of base effects – some prices are much higher than they were at the same time last year, when the world was in Covid-19 lockdown conditions – and partly because of supply chain disruptions, which have seen a spike in prices for things such as raw materials and machinery parts, as well as shipping costs.

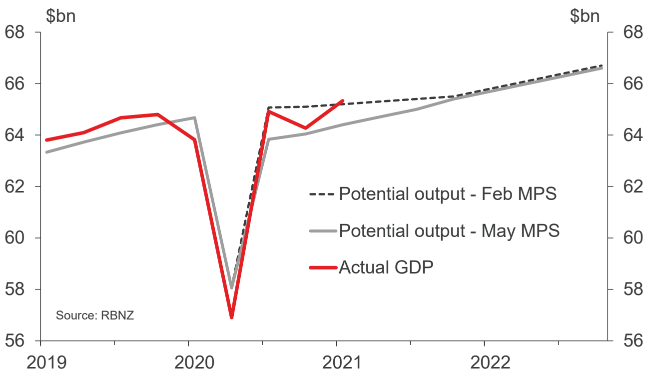
In many ways, Covid-19 has been a supply-side shock to the economy – especially in New Zealand's case, as the demand shock proved to be relatively brief. It's long been recognised that central banks should not tighten monetary policy in response to supply shocks (though nor should they try to soften the blow to activity by easing further).

The key for the RBNZ, in terms of its medium-term inflation target, is whether the initial spike translates into an ongoing series of price increases. And we're just not convinced that the conditions are in place for that. The economy is still operating some way below its non-inflationary potential, with domestic demand not fully compensating for the loss of overseas travel. Unemployment is above its pre-Covid level, wage inflation is subdued, and if anything the evidence is that retailers are finding it quite a difficult environment to pass on cost increases.

How will the RBNZ view the balance of conditions? The 1.6% rise in March quarter GDP was a huge surprise relative to the RBNZ's forecast of a 0.6% drop. And at face value that might suggest a major revision of the RBNZ's estimate of the output gap (the degree of spare capacity in the economy).

But the RBNZ has struggled with assessing the economy's potential output in recent times. In the May *MPS* it substantially lowered its estimate of potential output, which was probably influenced by the most recent GDP data – in this case, the 1% drop in December quarter GDP. The March quarter figures actually demonstrate that the economy had much more room to expand than the RBNZ had assumed.

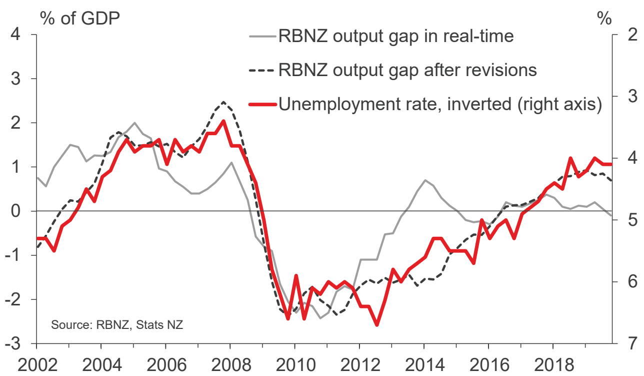
Quarterly GDP vs potential output estimates



More generally, estimating the output gap in real time is always fraught with problems. Calculations done years later will often find that the output gap was quite different from what was estimated at the time.

A much more reliable real-time indicator of the economy's spare capacity is the unemployment rate. At a current rate of 4.7%, it still hasn't reached what we would consider to be the 'maximum sustainable employment' mark, although the gap is narrowing.

Output gap estimates vs unemployment rate



The RBNZ has assumed that progress on reducing unemployment will stall as a result of skills mismatches. The evidence doesn't support this. More than 20,000 people have come off the Jobseeker Support benefit since the start of the year, a reduction of around 10%, which strongly indicates that job vacancies are being filled. There are still 45,000 more people receiving the benefit than there were before last year's lockdown. And the unusual nature of the Covid shock has meant that those people have come out of a much wider range of jobs and industries than we normally see in a downturn.

So we still think that the RBNZ can take a gradual path towards reducing stimulus. A year from now, the initial spike in inflation will have passed, and if anything there's more chance that inflation will be in the lower half of the RBNZ's target range. However, we expect the economy will be running closer to full capacity at that point, making it appropriate to start withdrawing stimulus in order to keep inflation in check in the years ahead.

We'll provide a full set of updated economic forecasts on our website later this week.

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