Economic Bulletin.

14 July 2021

Stand by for action – RBNZ Monetary Policy Review, July 2021.

- We now think that the Reserve Bank will start increasing the OCR at the August *Monetary Policy Statement*.
- Today's Monetary Policy Review was more hawkish than we expected.
- The RBNZ has significantly upgraded its assessment of economic activity, in keeping with the recent flow of data.
- It continues to see the upcoming spike in inflation as due to temporary factors.
- However, the strength of demand and rising capacity pressures have increased the risk that more persistent inflation pressures emerge.
- As a first step along the road to tightening, the RBNZ announced an end to its weekly purchases of Government bonds.
- Our view is that the reduction in purchases itself is less important than the signal that it sends – monetary policy is going to get tighter.

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Today's Reserve Bank statement demonstrates how quickly the ground is shifting on the New Zealand economy. Only three months ago, the RBNZ was still emphasising that "it was prepared to lower the OCR if required". Now, not only has the outlook for interest rates flipped in the other direction, but the RBNZ has already delivered its first tightening of sorts.

Overall, today's statement was more hawkish than we expected from the RBNZ at this point. We were previously forecasting the first OCR hike to come in November this year, but the odds have now shifted towards a hike as soon as the next *Monetary Policy Statement* in August.

The most notable change in the statement was that the RBNZ has called time on its Large-Scale Asset Purchase (LSAP) programme, with its weekly purchases of Government bonds set to end next week. This was explicitly described as a reduction of monetary stimulus, with the Monetary Policy Committee noting that the level of stimulus could be reduced now to minimise the risk of overshooting on its inflation and employment mandates.

What's notable is that this decision was elevated to the level of a Monetary Policy Review statement. The RBNZ has already run the weekly pace of purchases down to minimal levels over recent months – from $650m per week at the start of this year, to $200m per week now – and it hasn't felt the need to explain this as anything other than an operational decision. In that respect, going from $200m to zero is much less of a tightening than it has already delivered so far this year. However, the important issue here is not the reduction in purchases, but the message that it sends – namely, that monetary policy is going to get tighter from here.

The motivation behind this is that the RBNZ has significantly upgraded its assessment of economic activity, in keeping with the recent flow of data. It continues to regard the upcoming spike in inflation as being due to temporary factors. However, with demand running hot, there's a growing risk of more persistent inflation pressures emerging. This is very much in line with how our assessment of the economy has evolved in recent weeks.

The RBNZ’s media release did not give any guidance on future policy moves. That’s not unusual – when the RBNZ loosens or tightens monetary policy, it often focuses on explaining its latest decision rather than signalling what might come afterwards. The lack of a clear signal for an August OCR hike doesn’t rule it out, rather it suggests that it will be data-dependent. Between now and the August *MPS* we have quarterly releases on inflation and the labour market. We think these will be supportive of higher interest rates, but it’s not a fait accompli.

On a final note, while we think that the RBNZ is prepared to start hiking the OCR in August, we’re not entirely sure that this is the right move. New Zealand is a long way from reaching a satisfactory level of Covid-19 vaccination, and the possibility of border breaches and time spent in lockdowns still looms large. From a “least regrets” perspective, there’s plenty of room for regret if the RBNZ were to start tightening policy now, only to have to provide more stimulus (including, most likely, reopening the bond purchase programme) a few months down the track.

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