focus

Interest rate rises: New Zealand racing for gold or silver

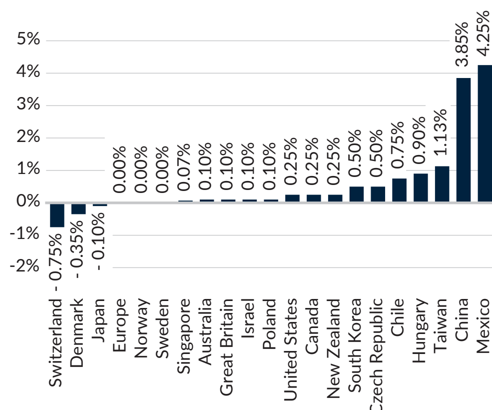
Last week market expectations for New Zealand interest rates shifted sharply. It now looks like a two-horse race over the next couple of months between our Reserve Bank and Norway's Norges Bank as to who will be the first developed market central bank to hike rates in a post-COVID world. In contrast, earlier this month, the Reserve Bank of Australia reiterated its "central scenario" remains that it doesn't expect to hike rates until 2024, while the United States Federal Reserve's projections are it will commence with hikes in 2023. **How has New Zealand found itself at the head of the pack to tighten monetary policy?**

FORSYTH BARR

Crisis policy settings

Around the world, the majority of developed market central bank cash rates sit, there-or-thereabouts, around 0%. When COVID-19 struck most didn't have much interest rate ammunition available – rates were generally already low, reflecting an extended period of low growth and low inflation following the Global Financial Crisis (GFC). To boost their firepower, they adopted (previously) unconventional policies en masse, collectively printing trillions of dollars through quantitative easing (QE) programmes and injecting these funds into economies.

SELECTED COUNTRIES CASH RATES: MOST DEVELOPED NATIONS ARE AT OR NEAR 0%



Source: Bloomberg, Forsyth Barr analysis

These measures worked. Economies today are dramatically better than what the vast majority of forecasters expected 16 or so months ago. Markets are now contemplating when and how central banks will extract themselves from the current crisis monetary settings.

A reminder: What central banks are trying to achieve

Most central banks have a similar mandate. In the cases of our Reserve Bank (RBNZ) and the US Federal Reserve it is effectively the same mandate: (1) keep inflation broadly stable, averaging around 2% over time, and (2) aiming for "maximum sustainable employment". Typically this is a balancing act – cutting interest rates boosts the economy and creates jobs, but if they're cut too far or held too low for too long inflation can emerge requiring rates to be lifted.

Most central banks' current policy settings are framed by the slow recovery and weak economic growth following the GFC. They are cautious about tightening policy too soon, and have put a heavy focus on achieving "maximum" employment. In many places where inflation is running at or above targets, central bankers are playing down the risk, saying they expect current pressures to be temporary or "transitory".

Why is New Zealand at the front of the race?

Last week two important pieces of news propelled New Zealand to the head of the pack in the race to raise cash rates.

Firstly, there was a marked shift in tone and policy from the RBNZ in its Monetary Policy Review. The RBNZ had previously stated it would take "considerable time and patience" to meet its inflation and employment targets. This language was dropped, and the RBNZ took its first step to reduce monetary stimulus. From today the RBNZ has ceased its "large-scale asset purchases" QE programme. Since March last year, under the programme, the RBNZ has purchased around NZ$55b of New Zealand Government and Local Government Funding Agency bonds.

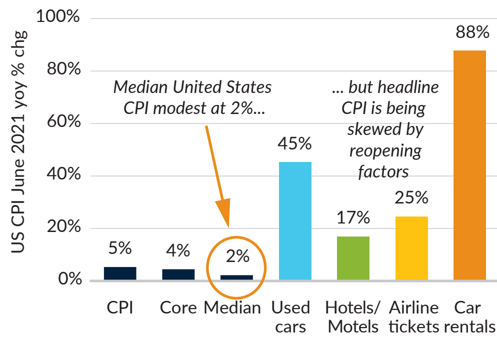
Secondly, New Zealand's measure of inflation, the consumer price index (CPI), came in at +3.3% yoy, the highest level since 2008 and well above the RBNZ's +2.6% expectation published in May. In other countries, when you delve into the detail it can be argued that current high inflation largely reflects "transitory" factors which will resolve themselves in time. In New Zealand, however, whilst there are some temporary factors at work, inflation appears more broad-based.

What does "transitory" mean?

Globally, most central bankers are singing from the same hymn sheet, saying they expect current inflationary pressures to be "transitory", reflecting price rebounds from lockdown slumps, and disruptions to production and supply chains around the world which eventually will be alleviated.

In the US, used cars are the poster child for transitory inflation. In June used car prices were up +45% yoy, which alone accounted for one-third of the annual lift in US CPI. Prices have surged on a perfect storm of strong demand as the economy reopens, people remain reluctant to take public transport, and rental car companies restock, coupled with limited new car supply due to semiconductor shortages. (On average new cars use around 1,400 chips. Last year, with fears of a depressed car market, chip manufacturers switched production to chips for phones and other in-home devices. It's going to take time for them to transition back). We think it's reasonable to expect US used car inflation will be temporary.

US INFLATION: HIGH HEADLINE MEASURE DRIVEN BY "TRANSITORY" FACTORS



Source: Refinitiv, Forsyth Barr analysis

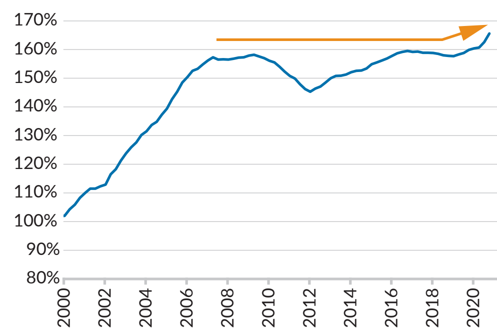
Such one-off price changes are not the kind of inflation central banks worry about. Central banks are concerned with imbalances in the economy that cause persistent price rises over time.

Why might New Zealand be different?

For a number of reasons we believe inflation could prove stickier in New Zealand (and therefore more concerning for the RBNZ) than in other countries:

1. Whilst the rest of the world has been grappling with restrictions and lockdowns, New Zealand has largely (with the exception of tourism and border movements) been in a post COVID-19 economy since the middle of last year. Consumers — without the burden of COVID lockdown fears — have responded to ultra-low interest rates by breaking out the credit cards. Much of New Zealand's strong economy is being funded by rising household debt.

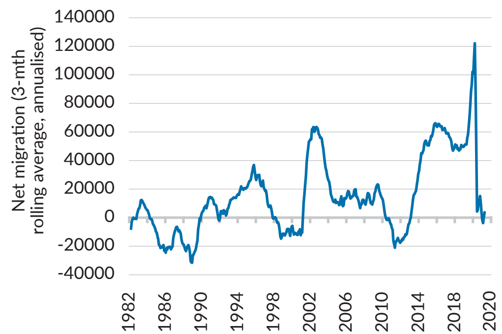
NEW ZEALANDERS BREAKING OUT THE CREDIT CARDS: HOUSEHOLD DEBT / GDP



Source: RBNZ, Forsyth Barr analysis

2. The New Zealand economy is facing pent-up demand and capacity constraints — the housing shortage being the most obvious example — from the tidal wave of migrants over the last eight years. In recent years, that same migration kept a lid on wages. But now, with borders shut, capacity pressures are biting. And they might yet get worse. New Zealanders are free to emigrate to Australia or the UK, but not the reverse. The impact of labour market tightness on businesses is being exacerbated by the +13% lift in the minimum wage over the past 18 months.

BOOM TO BUST: NEW ZEALAND NET MIGRATION



Source: Statistics NZ, Forsyth Barr analysis

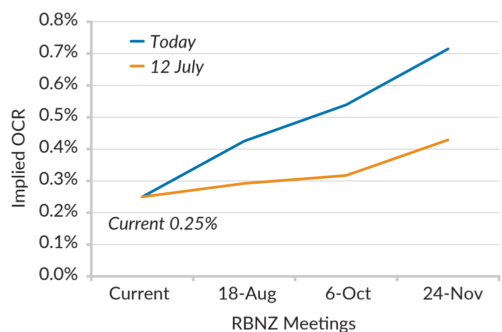
3. New Zealand is a small, open economy that is a long way from most trading partners. The delays in supply chains and dramatic jump in freight prices are disproportionately impacting import (and export) costs for our businesses. Furthermore, it is competition from imports which constrains prices across many industries. Many industries in New Zealand are concentrated, meaning price rises are likely be stickier even if costs fall.

New Zealand at the front of the tightening queue

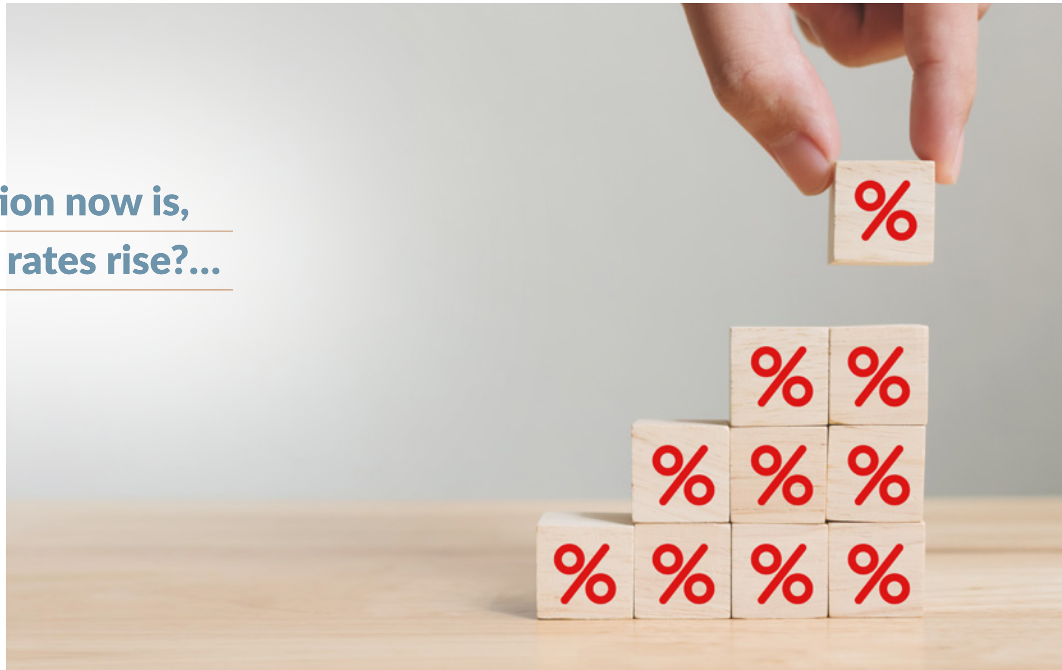
(Absent a shock such as an outbreak of the COVID-19 delta variant) the strength of the New Zealand economy and inflationary pressures are largely taking the choice of whether to tighten out of the RBNZ's hands.

Expectations of RBNZ rate hikes have been pulled forward and short-term interest rates have risen. The market has now priced in the RBNZ raising the Official Cash Rate (OCR) on 18 August and again in November and next April. A number of banks have already raised mortgage rates.

RATE HIKES PULLED FORWARD: OCR FORWARD PRICING

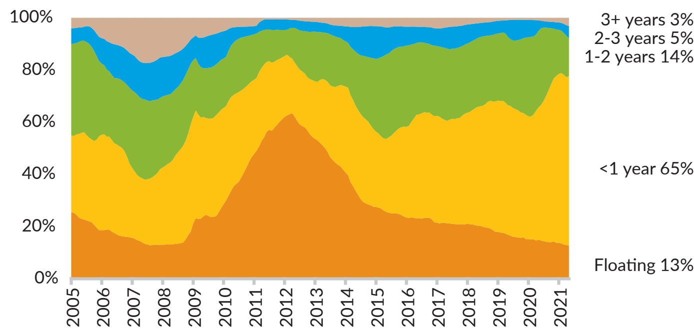


Source: RBNZ, Forsyth Barr analysis



...The question now is, how far will rates rise?...

MORTGAGE TENORS: BORROWERS EXPOSED TO RATE RISES



Source: RBNZ, Forsyth Barr analysis

The question now is, how far will rates rise? Our base case is we expect hikes will likely be measured and modest (relative to history). The market is pricing the RBNZ's cash rate at around 1.25% by the end of 2022 and around 1.50% by the end of 2023. High debt levels, plus 78% of mortgages being on terms of less than a year, means borrowers will almost immediately feel the cost of higher rates. The lack of migrants will also dampen growth in the years ahead. Further still, low interest rates internationally and concerns about the impact on the New Zealand dollar are likely to be an anchor for the RBNZ.

That said, we remain in a unique environment — the first global pandemic in over a century, an economy vulnerable to new virus variants and a slow vaccine rollout, interest rates at human-history lows, high debt levels, uncertainty around migration and trade flows. The risk to the outlook remains broad.

Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

Matt Henry
Head of Wealth Management Research

0800 367 227

forsythbarr.co.nz

Copyright Forsyth Barr Limited. You may not redistribute, copy, revise, amend, create a derivative work from, extract data from, or otherwise commercially exploit this publication in any way. This publication has been prepared in good faith based on information obtained from sources believed to be reliable and accurate. This publication does not contain financial advice – for financial advice, please speak to your Forsyth Barr Investment Adviser.