Economic Alert

MONETARY POLICY REVIEW — OCTOBER 2021

Wednesday, 6 October 2021

The Monetary Policy Committee agreed to increase the Official Cash Rate ("OCR") to 0.50 per cent.

Key Point:

- *"The Monetary Policy Committee agreed to increase the Official Cash Rate ("OCR") to 0.50 per cent. Consistent with their assessment at the time of the August Statement, it is appropriate to continue reducing the level of monetary stimulus so as to maintain low inflation and support maximum sustainable employment."*

The positives:

"The level of global economic activity has continued to recover, supported by accommodative monetary and fiscal settings, and rising vaccination rates enabling a relaxation of mobility restrictions."

"Capacity pressures remain evident in the economy, particularly in the labour market. A broad range of economic indicators highlight that the New Zealand economy has been performing strongly in aggregate."

But these days, there is always a warning:

"However, the Committee is aware that the latest COVID-19 restrictions have badly affected some businesses in Auckland and a range of service industries more broadly. There will be longer-term implications for economic activity both domestically and internationally from the pandemic."

"The near-term outlook for global growth has weakened somewhat due to the spread of the Delta variant, fuel shortages, and rising risks to the Chinese economy. Considerable uncertainty exists regarding the longer-run economic impacts of COVID-19."

In summary:

"On Wednesday 6 October, the Committee reached a consensus to increase the OCR to 0.5 percent."

"The Committee noted that further removal of monetary policy stimulus is expected over time, with future moves contingent on the medium-term outlook for inflation and employment."

Comment:

Definitely not a surprise and, if anything, a bit of a non-event! To some extent, the statement was quite well balanced with a strong inflation theme running through it, a reference to the unsustainability of the local housing market, with a note of caution around the potential long-term impact of the delta strain on the domestic and international environment.

The Reserve Bank of New Zealand ("RBNZ") also noted that capacity pressures are becoming more persistent implying inflation is no longer looking transitory and that headline inflation will rise above 4.0% in the near term before easing. Furthermore, the central bank is being very clear on residential property prices, saying that the level of house prices is unsustainable, and that high vaccination rates are crucial in reducing the *"virus-related disruption."*

Strap yourself in and expect further reductions of monetary stimulus in due course.

Market Implications:

Simply put, the anticipation was better than the event! And while it looks like there will be another hike in November, the market is not getting carried away.

The New Zealand dollar is slightly weaker than the pre-announcement levels, having popped 25 points initially. Short-dated implied volatility continues to ease, and even hit a 1-week low after the announcement, which is dropping like a stone and for a third day as NZD/USD fails to break out of this week's 0.6927/82 range. Swap rates have firmed a touch after the announcement, but only at the peripheral, up a point or so.

Simply put, the market is taking this statement at face value acknowledging the inflationary pressures that are building within the economy, while also being cognisant of the Covid related risks. More hikes to come, but certainly not at a more aggressive rate than previously expected.