ANZ Research

RBNZ Monetary Policy Review

13 July 2022

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Contact

Sharon Zollner or David Croy for more details.

A copy-paste from the May MPS

- As expected, the RBNZ raised the OCR 50bps to 2.50% today, saying "it remains appropriate to continue to tighten monetary conditions at pace".
- The Committee "remains broadly comfortable" with the May MPS OCR track.
- We continue to expect another 50bp hike at the August Monetary Policy Statement, with more cautious 25bp moves from there as evidence mounts of a slowdown in consumption and construction.
- However, any upside surprises to inflation (eg in the Q2 CPI data next Monday) would up the odds of a continuation of 50bp hikes beyond August and/or a higher endpoint than the 3.5% peak we are forecasting.

In brief

As widely anticipated, the RBNZ today raised the Official Cash Rate (OCR) by 50bps to 2.50%, and confirmed there's more where that came from. The Committee's focus remains firmly on medium term inflation risks.

Although house prices, and business and consumer confidence continue to fall, contributing to "emerging medium-term downside risks to activity", inflation pressures are "pervasive". It's certainly hard to disagree with that. The fact is, soft activity and employment currently reflects supply constraints more than weakening demand. It doesn't necessarily imply easing inflation pressures. That will change, as the RBNZ will keep hiking until demand weakens such that it sits below supply-side capacity, but that's a story for down the road.

Key quotes:

- **The inflation/activity trade-off:** "The Committee acknowledged there is a near-term upside risk to consumer price inflation and emerging medium-term downside risks to economic activity."
- **Global**: "global inflationary pressures will likely persist in the near-term." "The pace of global economic growth is slowing."
- **Labour market:** "Labour shortages continue to be a major constraint for business activity, as are the ongoing impacts of global supply chain disruptions." "The recent removal of travel restrictions have also enabled a net outflow of labour in the near-term."
- **COVID:** "A resurgence in COVID-19 cases and a rise in other seasonal illnesses continues to constrain productive capacity."
- **Consumer spending:** "household spending has remained resilient despite a decline in consumer confidence."
- **OCR outlook:** "The Committee remains broadly comfortable with the projected path of the OCR outlined in the recent May Monetary Policy Statement."
- **Exchange rate:** "the weaker New Zealand dollar is continuing to have an impact on New Zealand dollar import prices."
- **Housing**: "Members agreed that the increase in mortgage interest rates will assist to bring house prices more in line with sustainable levels."

As regards the outlook for the OCR, "The Committee remains broadly comfortable with the projected path of the OCR outlined in the recent May Monetary Policy Statement." That track implied another 50bp hike in August, and a better-than-even chance of 50bp hikes in October and November as well.

The decision to lift the OCR 50bps appears to have been straightforward, in that other possibilities were not discussed in the summary record of meeting.

The key data between now and the 17 August Monetary Policy Statement is Q2 CPI next Monday (we will release our preview tomorrow), and labour market data on 3 August. The usual monthly reads on inflation pressures and labour demand remain important, given activity data is likely to remain volatile and unreflective of the state of demand due to the COVID winter surge. As the RBNZ said, "observing how households and firms are responding to … economic challenges will be important to understanding when monetary policy settings will be sufficient to achieve its remit objectives."

Our take

Today's decision to raise the OCR by 50bps to 2.5% was straightforward, in that it was consistent with the RBNZ's previous published forecast, analyst forecasts, and market pricing. The path of least resistance was a motorway. However, decisions are likely to get harder over the second half of the year as evidence mounts that tightening financial conditions are indeed dampening demand – and eventually inflation pressures – in the economy. The debate around "how much is too much?" will naturally get much louder. But that remains an issue for another day, with it remaining unclear whether inflation has even peaked, let alone how quickly it will come down.

Our OCR forecast remains unchanged: another 50bp hike in August, but then slowing to 25bp hikes as the balance between near-term downside risks and medium-term inflation pressures becomes more nuanced than it is currently. But any upside surprises to inflation, including at Monday's Q2 CPI data release, would have to go straight into the RBNZ's forecast OCR track. When inflation is sitting this far above target there is simply no leeway to allow it any oxygen whatsoever. The hurdle for continuing the run of 50bp hikes beyond August is fairly low in that context. That said, there's a lot of water to flow under the bridge between now and October; we expect signs of a slowdown to be more definitive by then.

Market reaction

The market reaction to today's decision was very muted. Having gone into today with about 54bps of hikes priced in, it was only the very short end of the interest rate curve that really needed to recalibrate to the decision, and with no discernible change to the RBNZ's language/tone, it's logical that 1-2year swap rates have not moved far. The 2yr swap was about 5bps lower about half an hour after the decision; we put that down to relief that the RBNZ simply held the line, and didn't ratchet up their hawkish rhetoric. NZD/USD spiked briefly higher when the hike was announced, but has since drifted off, probably due to the slow burn of hard landing fears. There was certainly nothing in today's decision to suggest that the RBNZ is about to blink in the face of downside growth risks – the reality is they can't afford to, given where inflation and inflation expectations sit. Given the high degree of continuity between May's decision and today's, market attention will quickly turn to US CPI data tonight, and NZ CPI data on Monday.

Monetary Tightening Continues

The Monetary Policy Committee today increased the Official Cash Rate (OCR) to 2.50 percent. The Committee agreed it remains appropriate to continue to tighten monetary conditions at pace to maintain price stability and support maximum sustainable employment. The Committee is resolute in its commitment to ensure consumer price inflation returns to within the 1 to 3 percent target range.

The level of global economic activity, combined with the ongoing supply disruptions largely driven by both COVID-19 persistence and the Russian invasion of Ukraine, continue to generate global inflation pressures. Food and energy prices are especially affected by geopolitical tension. However, the pace of global economic growth is slowing. The broad-based tightening in global monetary and financial conditions is acting to reduce spending growth. Asset prices have also declined due to higher interest rates and a weaker earnings outlook.

In New Zealand, domestic spending remains supported by high employment levels, resilient household balance sheets in aggregate, continued fiscal support, and a strong terms of trade. The reduction in COVID-19 health-related restrictions is also enabling increased demand. Labour and resource scarcity are also contributing to upward price pressures which are currently exacerbated by seasonal illness, a resurgence in COVID-19 cases, and a net outflow of labour abroad.

In these circumstances, spending and investment demand continues to outstrip supply capacity, with a broad range of indicators highlighting pervasive inflation pressures. Employment remains above its maximum sustainable level and the Reserve Bank's core inflation measures are around 4 percent. The Committee acknowledged there is a near-term upside risk to consumer price inflation and emerging medium-term downside risks to economic activity.

The Committee agreed to continue to lift the OCR to a level where it is confident consumer price inflation will settle within the target range. The Committee is comfortable that the projected path of the OCR outlined in the recent May *Monetary Policy Statement* remains broadly consistent with achieving its primary inflation and employment objectives - without causing unnecessary instability in output, interest rates and the exchange rate. Once aggregate supply and demand are more in balance, the OCR can then return to a lower, more neutral, level.

Summary Record of Meeting – July 2022

The Monetary Policy Committee discussed developments affecting the outlook for inflation and employment in New Zealand. Members agreed that developments were broadly in line with their assessment at the May *Monetary Policy Statement*. The Committee agreed it remains appropriate to continue to tighten monetary conditions at pace to maintain price stability and support maximum sustainable employment.

The Committee judged that the global economic outlook has continued to weaken, broadly as anticipated. The weaker outlook reflects a tightening of financial conditions, ongoing global supply disruptions, and rising geopolitical tensions. The Russian invasion of Ukraine continues to cause disruption to the supply of oil, gas and food commodities, resulting in continued high prices for food and energy. Ongoing health restrictions are exacerbating supply disruptions, as currently most notable in China.

Globally, many central banks have increased policy rates in response to rising inflationary pressures, to realign economic demand with supply. Members agreed that global inflationary pressures will likely persist in the near-term, as reflected in ongoing high domestic import prices and elevated shipping costs.

Members noted that the New Zealand dollar exchange rate has depreciated since the May *Monetary Policy Statement*. A moderation in global commodity prices, amid a continued decline in investor risk appetite, and rising central bank policy rates globally have contributed to this depreciation. The Committee noted that the weaker New Zealand dollar is continuing to have an impact on New Zealand dollar import prices.

In New Zealand, GDP contracted modestly in the March 2022 quarter. However, these data remain volatile, with a catch-up in government spending and exports expected. Increased visitors to New Zealand are also supporting hospitality and tourism. Meanwhile, household spending has remained resilient despite a decline in consumer confidence.

Financial conditions have continued to tighten with mortgage rates rising in response to, and in anticipation of, increases to the Official Cash Rate (OCR). Asset prices, including house prices, continue to decline. Members agreed that the increase in mortgage interest rates will assist to bring house prices more in line with sustainable levels. The Committee also agreed that both high food and energy costs and rising mortgage interest rates will lead to more subdued household discretionary spending in coming quarters.

Members noted that while there are near-term upside risks to consumer price inflation, there are also medium-term downside risks to economic activity. Despite these risks, members agreed that capacity pressures remain pervasive. Labour shortages continue to be a major constraint for business activity, as are the ongoing impacts of global supply chain disruptions. A resurgence in COVID-19 cases and a rise in other seasonal illnesses continues to constrain productive capacity in New Zealand. The recent removal of travel restrictions have also enabled a net outflow of labour in the near-term. Members agreed that employment is above its maximum sustainable level, and that rising wage pressure remains an expected outcome. Meanwhile, core inflation measures are around 4 percent.

The Committee discussed the unique shocks the economy is currently facing relative to historical experience. These developments increase the uncertainty about how households and firms will respond to a tightening of monetary policy. The Committee agreed that observing how households and firms are responding to these economic challenges will be important to understanding when monetary policy settings will be sufficient to achieve its remit objectives.

The Committee agreed to maintain its approach of briskly lifting the OCR until it is confident that monetary conditions are sufficient to constrain inflation expectations and bring consumer price inflation to within the target range. The Committee remains broadly comfortable with the projected path of the OCR outlined in the recent May *Monetary Policy Statement*. Once aggregate supply and demand are more in balance, the OCR can then return to a lower, more neutral, level. The Committee viewed this strategy as consistent with achieving their primary inflation and employment objectives without causing unnecessary instability in output, interest rates and the exchange rate.

On Wednesday 13 July, the Committee reached a consensus to increase the OCR to 2.50 percent.

Attendees:

Reserve Bank staff: Adrian Orr, Karen Silk, Christian Hawkesby, Adam Richardson,

External: Bob Buckle, Peter Harris, Caroline Saunders

Treasury Observer: Tim Ng

Reserve Bank observer: Paul Conway

Secretary: Sandeep Parekh

Contact us

Meet the team

We welcome your questions and feedback. Click here for more information about our team.

Sharon Zollner
Chief Economist

Follow Sharon on Twitter
@sharon_zollner

Telephone: +64 27 664 3554
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

David Croy
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 4 576 1022
Email: david.croy@anz.com

Susan Kilsby
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

Miles Workman
Senior Economist

Macroeconomic forecast co-ordinator, fiscal policy, economic risk assessment and credit developments.

Telephone: +64 21 661 792
Email: miles.workman@anz.com

Finn Robinson
Economist

Macroeconomic forecasting, economic developments, labour market dynamics, inflation and monetary policy.

Telephone: +64 21 629 553
Email: finn.robinson@anz.com

Kyle Uerata
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

Natalie Denne
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist’s diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

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