ANZ Research

RBNZ Monetary Policy Review Preview

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Summary

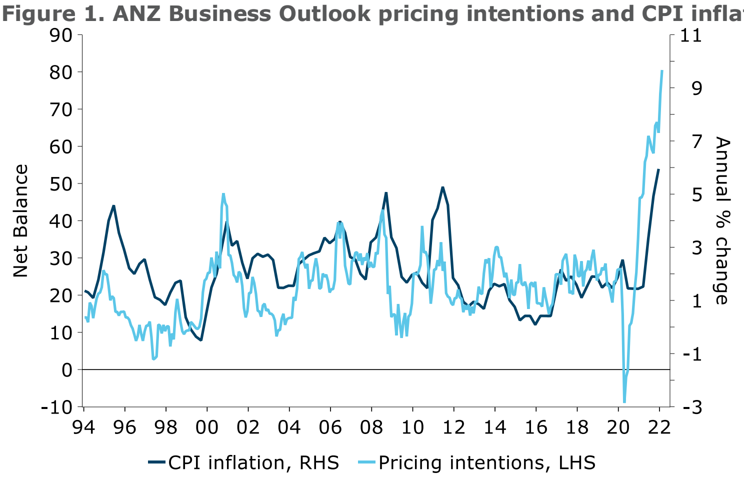
- We expect the RBNZ will raise the Official Cash Rate (OCR) 50bp to 1.50% at its Monetary Policy Review (MPR) next Wednesday.
- The RBNZ has a big job to do to rein in runaway inflation, and the sooner they rip into it, the lower the economic cost is likely to be.

No low-risk policy choices

The Reserve Bank is between something of a rock and a hard place. On the one hand, the path ahead for the economy is looking anything but smooth, with house prices falling and consumer confidence pummelled as household budgets are squeezed. On the other hand, the wall of inflation is vertical and so far, completely unyielding.

Normally, near-term downside growth risks are a recipe for at least caution on the part of central banks, if not outright largesse. But this time, one key thing is very, very different – inflation. We are forecasting it to peak around 7.5%. Uncertainty is rife and it's hard to know precisely where the RBNZ forecast might sit, or where the Q1 CPI outturn might land, but to some extent it's a moot point. Inflation is far too high. Core inflation is far too high. Inflation expectations are far too high. And firms' pricing intentions, which have been the best inflation indicator of all, are stratospheric and at this point, still rising (figure 1).

Figure 1. ANZ Business Outlook pricing intentions and CPI inflation



Source: Stats NZ, Macrobond, ANZ Research

What to do? The RBNZ describes its policy decisions in terms of "least regrets". Since COVID struck, and even before that, with inflation low (indeed too low, if anything), the biggest potential regret was seen to be unnecessarily high unemployment. Even when housing unexpectedly boomed, the COVID-related near-term downside risks to growth were very real, and it was perceived as best to therefore focus all efforts on warding off a potential near-term hard landing.

Not anymore. As Adrian Orr said in a speech following the February Monetary Policy Statement, "Our 'path of least regrets' has now become one where we must ensure that consumer price inflation and inflation expectations do not rise persistently above our target level. Anything less from the Committee risks spiralling long-term economic costs and reduced wellbeing for New Zealanders."

That is, the biggest regret from this starting point would be losing inflation-targeting credibility and seeing inflation expectations become truly unanchored. Fixing that would require far higher interest rates, and very likely a deep recession and sharp rise in unemployment, to solve – *a la* 1991. For now, it's still entirely reasonable to both hope and forecast that the inflation problem can be resolved with a "soft landing", a relatively gentle slowdown that doesn't involve an ugly unemployment rate. But the higher inflation expectations are allowed to go, the slimmer those hopes become.

In that context, near-term growth risks are very unfortunate, but are not a reason to tread cautiously with OCR hikes. The focus has shifted squarely to the medium term, where there are no trade-offs between the RBNZ's price stability target and its mandate to contribute to maximum sustainable employment. As Fed Chair Jerome Powell put it, "Without price stability, you really can't have a sustained period of maximum employment," given how damaging embedded high (and inevitably, volatile) inflation is.

Double-speed hikes are not without risks either, of course. The housing market in particular is vulnerable – it can't be anything else, after rising 40% in less than two years – and those two years being a period in which New Zealand Inc became poorer via the loss of tourism. There is no path of no potential regrets. But the RBNZ now has to play the hand it's got.

There were two key points to take out of the February Monetary Policy Statement as regards the likelihood of 50bp moves. First, the Summary Record of Meeting revealed that "many members saw [25bp vs 50bp] as a finely balanced decision." And second, the Committee "affirmed that it was willing to move the OCR in larger increments if required over coming quarters." That cleared the path for 50bp moves, in our view, and the market appears to be on board too (see the Markets section). In essence, we think the hurdle for a 50bp hike is pretty low.

But for the record, let's run through the key data since the February MPS:

- **Russia invaded Ukraine.** The full repercussions are yet to be felt, but the upshot is higher energy and food prices, and more disruption to global supply chains. In short, it's inflationary
- The **fuel tax was cut 25c** and public transport fees were halved. We estimate that this could knock half a percent off the CPI peak, but whether CPI inflation is 7 or 7½% is neither here nor there really. And given the plan is ostensibly to put the taxes back on in a phased fashion at some future date, it will potentially elongate the period of exceptionally high inflation, with associated risks for inflation expectations.
- Business confidence and activity indicators in our **Business Outlook** survey tanked in February but recovered somewhat in March, while key inflation indicators and inflation expectations continued to rise.
- NZ's **terms of trade fell** 1% in Q4 as import prices rose faster than export prices. The **ANZ Commodity Price Index surged** nearly 4% in February and again in March to hit fresh record highs.
- **Consumer confidence crashed** in February, and failed to bounce back in March even as the shock value of Omicron dissipated. Key indicators including whether it is perceived to be a good time to buy a major household item fell to recessionary levels.

- **GDP for Q4 rebounded 3%** versus the RBNZ's forecast of 2.3%. But it's full of lockdown noise.
- **REINZ** data for February showed a hat-trick of monthly house price falls. **Mortgage rates have risen** further.
- **The NZD** TWI is up around 3½%, but commodity prices are also broadly higher. However, **GlobalDairyTrade** prices have slipped slightly in the last two auctions.

On balance, this data is consistent with our view that the economy is looking likely to cool as consumers in particular pull their heads in. But since a large chunk of that pressure on household confidence and budgets is coming from the sharply higher cost of living, letting inflation go might not be much of a kindness to households either.

At this stage, it's a case of pick your poison. Yes, aggressive hikes now raise the odds of a hard landing for the economy in the near term, but going too slowly would raise the risks of an even harder landing further down the track. As we described in our OCR call change a month ago, the RBNZ was understandably but uncharacteristically late to the OCR hiking party due to the uncertainties COVID engendered.

Indeed, the real OCR (whether deflated by actual CPI or inflation expectations) is deeply negative – and still falling. We're certainly not suggesting there's any imminent danger of that causing a flurry of risk-schmisk exuberance, given the housing market is going backwards. But it's catch-up time, given what's known today. The picture could change abruptly, but here and now, cost and inflation pressures are rampant and broad-based, and until the RBNZ can conclude that the risk of a wage-price spiral has significantly abated, it's onwards and upwards for rates, quick march.

Markets

We think a 50bp hike is the "path of least resistance" for markets given what's priced in over the next 2-3 meetings (around 40bps for April, a further 46bps for May and another 40bps for June). Collectively that adds up to 126bps of hikes over the next three meetings, which aligns with our view of back-to-back 50bp hikes, followed by 25bp hikes. Technically then, if we do get a 50bp hike, all that really needs to adjust is the very, very short end (ie the front OIS contract and bank bills).

However, markets rarely respond in a purely technical manner, and it's not just what the RBNZ does that matters; it's also what they say. Offshore events matter too, and with rate hike expectations rising in the US and Australia, there would seem to be limited scope for pullbacks the whole way along the yield curve. That said, given where local rates are today (with an OCR of 3.17% priced in by year-end, the 1-year at around 2.9% and the 2-year at around 3.5%), there isn't much scope for more upside either. Taken together then, we think it'll be pretty much status quo on 50bps, with ongoing volatility and nervousness driven by offshore events.

If the RBNZ does only hike by 25bps, as some are predicting, it would cause some real volatility, and potentially confusion. It would likely see forward expectations concertina back in as the market recalibrates itself to a new 25bp per meeting speed limit, driving the short end lower. But it could also do some real damage at the longer end of the curve (ie 10 years and longer), where yields might rise as markets start to price in wider inflation and term premiums.

In the FX space, we think a 50bp hike poses mild upside risks for the NZD. Not only will it add to the NZD's appeal from a carry/interest rate spread perspective, but more importantly, it'll cement the RBNZ's inflation credibility, which is a key foundation for exchange rate strength. And to the extent that it should keep a lid on longer-term inflation outcomes and expectations, that should also be well received by FX markets. Markets don't like currencies with high inflation, or central banks that are behind the curve, and proactive hikes will ensure that New Zealand stays far away from the dangers of that.

We don't expect anything on the quantitative tightening ("QT") front. The RBNZ has already announced that QT will get underway in July, and be left on auto-pilot, so to speak. When we get to July, there will be some mild curiosity in markets about which bonds the RBNZ is selling back to the Treasury, but as those bonds are already out of the market, it'll be only of passing interest.

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