

RBNZ Monetary Policy Statement Preview

15 February 2022



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Hikes coming, “steady” or not...

Summary

- We expect the RBNZ will raise the Official Cash Rate (OCR) 25bp to 1.00% at its Monetary Policy Statement (MPS) next Wednesday.
- The RBNZ has a big job to do, and we would not rule out a 50bp hike. But as in November, there are lower-risk ways the RBNZ could tighten conditions more aggressively if they feel it's necessary.

Rate rise inevitable

There is no serious debate about the fact that the New Zealand economy needs higher interest rates to rein in persistent inflation pressures. The issue at hand, as it was in November, is whether the RBNZ will hike by 25bp or 50bp.

It's been a long time between drinks for the RBNZ, with no opportunity to move the Official Cash Rate since late November. If there hadn't been a hole in their meeting calendar in January, we'd certainly have another hike under the belt by now. So should the RBNZ make up for lost time?

Odds implied by market pricing are currently around 70/30 in favour of a 25bp, rather than 50bp hike. As in November, we can't rule it out, but on balance, we think the RBNZ will opt for 25bp. Let's go through the arguments.

Arguments for 25bp	Arguments for 50bp
<ul style="list-style-type: none"> • But you said: The RBNZ has made it clear they prefer to move in steady 25bp steps unless the risks are a landslide in one direction. See our November MPS Preview for a discussion of our interpretation of those comments in the current cyclical context. • Less risky alternatives: Beyond moving the OCR itself, the forecast track has a huge impact. A more aggressive OCR forecast delivers more tightening upfront – with less risk of a U-turn in actual policy. • Omicron chaos is just kicking off. Relatively short-lived it may be, but it's going to be intense and enormously stressful for many firms, and a double hike might look a little tone-deaf in that context. • Broader financial conditions have tightened materially. The CCCFA and LVR rules have tightened credit availability. Swap rates suggest mortgage rates will rise. Long yields are up. Our Financial Conditions Index has tightened rapidly. • The housing market is already in retreat, with house sales falling and annual house price inflation rapidly losing steam. That's very unusual so early in a hiking cycle, when more typically the RBNZ is struggling to get traction. It's quite a game changer. 	<ul style="list-style-type: none"> • Q4 CPI inflation came out at 5.9% (RBNZ exp: 5.7%), led by domestic inflation. Core measures are all outside the target band. • The Nike argument. If you're confident you have a big job to do, why not get going? A slower start means higher rates for longer, all else equal. • The Bank of England nearly kicked off their hiking cycle with 50bp. It was a close-run thing, with a 5-4 vote. The Fed's Bullard is in favour of a 50bp start in the US too. • The RBNZ has shown it doesn't mind surprising the market. And the market is on the fence anyway. • Omicron is going to be inflationary, if anything. The experience of the rest of the world means the RBNZ will be comfortable forecasting Omicron's negative impacts on demand to blow through fairly rapidly. • The NZD is sharply lower. That will add to imported inflation pressures. • Energy prices keep rising. Petrol prices have an outsized impact on household inflation expectations in particular, but also hit firms' costs.

In the “foot in each camp” category:

- **inflation expectations** in the RBNZ’s survey rose, with the 5-year measure lifting from 2.17% to 2.30%. A 0.3% deviation from the target midpoint is not insignificant at that time horizon, but it would be an exaggeration to suggest it’s into the danger zone.
- The **unemployment rate**, at 3.2%, was in line with RBNZ expectations but with slightly disappointing employment and wage growth. Still, unemployment is at a fresh record low.

Overall, while we can “never say never”, we don’t see any compelling reason for the RBNZ to change its approach from the November MPS, when they made it clear that steady steps were appropriate given the risks are decidedly to the downside for economic growth, even if inflation is to the upside.

Markets

The market’s immediate focus will be the OCR decision itself and the RBNZ’s revised OCR track. Market expectations are currently split as to whether we will see a 25bp or 50bp hike (roughly 70/30). Presuming market pricing doesn’t change too much between now and decision day, that implies we will see a knee-jerk reaction one way or the other, and some volatility is thus to be expected. However, we suspect volatility will be mostly confined to the very short end of the curve, out to perhaps 3 or 6 months. Other key short-end rates like the 1 and 2-year swap will be more responsive to the RBNZ’s OCR track, and if that gets revised up as we expect, we don’t see a lot of scope for downward movement in them.

In the FX space, we expect the Kiwi to respond to the overall vibe – essentially, whether it is judged to be hawkish, which might ironically weigh on the NZD on the perception that a hard landing is more likely. We actually think a more cautious approach would likely be welcomed by currency markets, which have become less focussed on interest rates and interest rate differentials, and more focused on risk.

Beyond the OCR decision, we also expect the RBNZ to provide details on how it intends to manage down its LSAP bond holdings. While the RBNZ has not committed to provide that this month, they did say in November that “details on how bond holdings will be reduced will be provided early next year”, and we take that to mean next week. Running down the LSAP portfolio represents an unwinding of quantitative easing or “QE”, and can thus be thought of as quantitative tightening, or “QT”.

We expect the Bank to say that it intends to be pragmatic and flexible around QT, and be responsive to how the economic outlook and market functioning evolves, rather than pre-committing to, for example, getting the portfolio down to a specific size by a specific date. Within that, we expect the Bank to clarify things like how it intends to sell down its bond holdings (if it decides to do so), and to explain what it intends to achieve by running its portfolio down.

With regard to the former, we assume that the Bank remains committed to not selling bonds in the open market (which would effectively see them competing with the Treasury for funding), and instead be restricted to selling bonds to the Treasury, as outlined in [the Governor’s letter to the Finance Minister in August 2020](#). With regard to the latter, we’re not exactly sure what would be achieved by running down the LSAP portfolio ahead of its natural

maturity profile, if that brings forward the burden on fiscal policy. Long-term bond yields are already significantly higher than they were a few months ago, and even if the RBNZ wanted them higher, it's not clear that they could effect that through QT (especially if they can't sell bonds in the open market, as we assume). Bottom line – if the RBNZ do look to accelerate the run-off, we'd expect them to explain what impact they think it will have on the economy and markets, and how that might impact future OCR decisions.

Presuming the RBNZ is only able to sell its holdings to the Treasury, there would only be an impact on markets and fiscal policy if the Treasury had to issue extra bonds to fund these purchases. However, we doubt the Treasury is planning to issue more bonds (remember, the Treasury holds all the cards here, and they only just cut their bond issuance projections in December). It is possible that the Treasury have already earmarked a portion of its cash and liquid assets to be able to fund an earlier run-down of the LSAP portfolio than is implied by the maturity profile of the portfolio. But if they have already done that, then it's already in issuance projections (as, incidentally, is the repayment of all maturing bonds, including those held by the RBNZ), so it won't have a knock-on impact. Further out, any sales of LSAP bonds ahead of their maturity will shift the timing of when those liabilities need to be funded by the Treasury.

Markets may well get spooked by the idea that QT is coming, but they shouldn't if it is gradual and off-market, as we expect. And remember, if the economy sours or market functioning falters, the RBNZ can always hold off, or elect to slow the run-off rate of the portfolio by reinvesting a portion of its maturing bonds, as the US Federal Reserve did post-GFC/pre-COVID.

At some stage in the future, the RBNZ may also look to tweak the way it remunerates ESAS balances (the balances of accounts that settlement banks like ANZ hold with the RBNZ). At the moment, all balances are remunerated at the OCR. That wasn't how it was before QE was introduced – back then, banks were remunerated up to the level of their individual cash tier (based on their size), and remunerated at a lesser rate on balances in excess of that, to discourage cash hoarding. But because the settlement cash level (SCL) was projected to (and did) rise rapidly as a result of QE, the RBNZ abandoned cash tiering when it embarked on QE, as it would have amounted to an unavoidable tax on banks.

However, now that the system is flooded (SCL is forecast to be around \$45bn this week), cash often trades below the OCR, especially in the FX forwards market. That's not necessarily desirable as the RBNZ embarks on a tightening cycle. The RBNZ may look to re-introduce cash tiers and conduct large-scale open market operations ("OMOs") in a bid to soak up what it might view as excess liquidity. While this is likely to only be of passing interest to most observers, it would likely have an upward impact on where cash trades in the forwards, drive short-end basis swap spreads higher, and at the margin, slightly reduce how much work the OCR might need to do.

The merits of doing this sooner rather than later are debatable – we note, for example, that this would be going in the opposite direction to the FLP. But of course, so too is the OCR at the moment, and at some stage, it probably makes sense to restore things to how they were pre-COVID. And given any attempt to do so would represent another step towards tightening, albeit a minor one, doing it now might have appeal.



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Last updated: 27 January 2022

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