ANZ Research

RBNZ Monetary Policy Review

13 April 2022

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Contact

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Giving inflation no quarter

- As we expected, the RBNZ raised the OCR 50bp to 1.50% today, saying "it is appropriate to continue to tighten monetary conditions at pace".
- We continue to expect a follow-up 50bp hike at the May Monetary Policy Statement, with more cautious 25bp moves from there.
- The comment that this move was a "stitch in time" approach suggests a trade-off with the endpoint for the OCR, which we'd agree with.

In brief

As we anticipated, the RBNZ today raised the Official Cash Rate (OCR) by 50bp to 1.50%, and confirmed there's more to come.

The RBNZ assessed that "underlying strength remains" in the economy, "supported by sound balance sheets, continued fiscal support, and strong export earnings." All up, "inflation pressures [are] ongoing". The Committee has its eyes firmly on the medium term, and in particular the need to ensure that inflation expectations remain well anchored.

As expected, the "least regrets" approach underpinned the decision to raise the OCR 50bp today: "The Committee will remain focused on ensuring that current high consumer price inflation does not become embedded into longer-term inflation expectations."

Somewhat surprisingly, there was very little discussion of downside growth risks. While we agree with the RBNZ that "the OCR is stimulatory at its current level", the change in rates has been very rapid. The housing market is in full retreat, and consumers are very wary indeed.

In other points:

- Global activity is slowing, but the level "continues to generate rising inflation pressures, exacerbated by ongoing supply disruptions".
- Omicron is causing "some economic disruption".
- No sympathy on falling house prices: "the Committee viewed this as a sign that house prices are moving towards a more sustainable level".
- Employment is "above its maximum sustainable level".
- Broader financial conditions have tightened, "with higher interest rates, a stronger New Zealand dollar exchange rate, and lower asset prices".
- Higher domestic inflation was seen as due to "both international and domestic factors", including commodity prices and capacity pressures.
- Weaker consumer confidence was ascribed primarily to the rising cost of living and global uncertainty, rather than the rise in interest rates seen thus far. The fact that an (admittedly unscientific) Stuff poll this week showed a clear majority in favour of a 50bp hike supports this contention.
- As in February, "net immigration is assumed to increase only slowly, eventually leading to a gradual easing in skill shortages".
- Inflation is forecast to peak "around 7 percent" in H1. There's upside risk to that – we're forecasting 7.4% inflation in the March quarter.

As regards the outlook for the OCR from here, "The Committee agreed that their policy 'path of least regret' is to increase the OCR by more now, rather than later." We'd view this more as a comment on the likely forecast endpoint of the OCR, rather than on the likelihood or otherwise of further 50bp moves. Indeed, while the comment "it is appropriate to continue to tighten monetary conditions at pace" may simply have referred to today's move, it's not inconsistent with our long-held expectation of a follow-up 50bp hike in May before the RBNZ takes things down a gear to more cautious 25bp steps while it gauges the impact of its actions thus far.

The key data between now and the 25 May Monetary Policy Statement is Q1 CPI (next Thursday), labour market data on 4 May, and the Budget on 19 May. Also key will be the usual monthly reads on pricing intentions, inflation expectations, and the housing market.

Our take

There were no easy policy choices for the RBNZ today. Even though the OCR is still very low, the pace of change in mortgage rates has been rapid, and with the housing market cooling more quickly than the RBNZ anticipated, oversteering the slowdown is a genuine risk. On the other hand, not authoritatively moving against broad-based inflation pressures that are miles out of line with the target – and yet to show any signs of turning – would risk giving a further leg up to inflation expectations, making the job of reining in inflation that much harder. That would exacerbate risks to the medium-term economic outlook. There's no free lunch.

It was a brave decision by the RBNZ Monetary Policy Committee today, but the right one in our view. The decision will no doubt come under scrutiny as evidence of a retreating housing market and a more cautious consumer continues to accumulate.

Because of the lags inherent in how monetary policy works, and the uncertainty inevitable in economic forecasting (let alone pandemic forecasting), getting the amount of tightening exactly right is likely to require a hefty dose of good luck as well as good management. The uncertainty around where the OCR will (or should) peak could hardly be greater. But promptly getting the OCR closer to neutral – lifting the foot pretty quickly off the accelerator – is a prudent step at this stage.

Market reaction

Broadly speaking, markets reacted as we expected they would, with the Kiwi spiking higher and very short end rates adjusting to the outsized hike (which was mostly, but not fully, priced in). We think today's move and the tone of the press release and record of meeting make it clear that the RBNZ is eager to get on top of inflation expectations, rather than address them once they have become unstuck, and that should, all else equal, benefit the NZD. But the global environment remains volatile and uncertain, and this decision might soon fade into the background.

Markets continue to price in around 80% odds of another 50bp hike in May; that seems entirely appropriate given where we expect CPI to print next week, and today's action. But the market is likely to tame its view of what is needed beyond May. That's because, encouragingly, the RBNZ has characterised today's outsized hike as the bringing forward of tightening, buying them optionality in future. Alongside their belief that the outlook remains broadly as outlined in February (which seems reasonable), the idea that doing more now might lessen the need to keep leaning into inflation should see longer-dated OCR expectations come back down to earth.

Indeed, before today's decision, expectations for where the OCR would be in late 2023 were approaching 4¼%; they have moderated and have scope to gravitate back towards 3½%, which is where we see the OCR topping out.

As this happens, we should see further moderation in 2-5 year interest rates. That said, liquidity has been an issue at times, and it would be too simple to assume that observed rates are a fair representation of true expectations.

Text of Monetary Policy Review

The Monetary Policy Committee today increased the Official Cash Rate (OCR) to 1.50 percent. The Committee agreed it is appropriate to continue to tighten monetary conditions at pace to best maintain price stability and support maximum sustainable employment.

The Committee remained comfortable with the outlook for the OCR as outlined in their February Monetary Policy Statement. They agreed that moving the OCR to a more neutral stance sooner will reduce the risks of rising inflation expectations. A larger move now also provides more policy flexibility ahead in light of the highly uncertain global economic environment.

The level of global economic activity continues to generate rising inflation pressures, exacerbated by ongoing supply disruptions in large part driven by COVID-19. The Russian invasion of Ukraine has significantly added to these supply disruptions, causing prices to spike in internationally traded commodities and energy.

However, the pace of global economic activity continues to slow. There is an elevated level of uncertainty created by the persistent impacts of COVID-19, and clear signals that monetary and broader financial conditions will tighten over the course of 2022. Added to this is the high level of geopolitical tension and related economic sanctions on Russia.

In New Zealand, underlying strength remains in the economy, supported by sound balance sheets, continued fiscal support, and strong export earnings. There has been some economic disruption due to the outbreak of Omicron. However, the high vaccination rates across New Zealand are assisting to reduce this disruption.

Heightened global economic uncertainty and inflation are dampening consumer confidence. The rise in mortgage interest rates – amongst other factors – have acted to reduce mortgage demand and house prices. However, economic capacity pressures remain, with a broad range of indicators highlighting domestic capacity constraints and ongoing inflation pressures. Employment is above its maximum sustainable level and labour shortages are impacting many businesses.

The Reserve Bank's core inflation measures are at or above 3 percent. Inflationary pressure is being further accentuated by current high imported energy and commodity prices, which are lifting headline CPI inflation. The Committee will remain focused on ensuring that current high consumer price inflation does not become embedded into longer-term inflation expectations.

Summary Record of Meeting

The Monetary Policy Committee discussed developments affecting the outlook for monetary policy.

It was noted that global consumer price inflation is high, well above most central banks' targets. This general inflation pressure is due to the recent recovery in global demand running up against severe supply shortages and trade disruption. The economic disruption caused by COVID-19 has been exacerbated by rising energy and food prices resulting from the Russian invasion of Ukraine.

The Committee noted that global economic growth is slowing, given supply constraints, consumer price pressures cutting into real incomes, and heightened geopolitical tensions causing investment uncertainty. Central banks globally are also tightening, or looking to tighten, their monetary policy stances over 2022, in an effort to constrain consumer price inflation expectations consistent with their policy targets.

Members observed that financial conditions have tightened in New Zealand, with higher interest rates, a stronger New Zealand dollar exchange rate, and lower asset prices.

It was noted that mortgage interest rates have risen broadly consistent with the outlook for the Official Cash Rate (OCR) in the Reserve Bank's February Monetary Policy Statement. The Committee noted that the higher New Zealand dollar against trading-partner currencies has assisted to partly offset higher import prices for local consumers.

In discussing the underlying influences on higher domestic inflation, the Committee agreed that both international and domestic factors were important.

Headline inflation is rising largely as a result of disrupted supply chains and higher world commodity prices. These higher commodity prices are increasing both imported inflation and also the incomes of some New Zealand exporters. Domestic demand pressures, relative to supply capacity, are also pushing New Zealand's core inflation above the Bank's 1 to 3 percent target range.

Capacity pressures are apparent across a wide range of domestic indicators. In particular labour shortages remain heightened, impinging on domestic economic output. Nominal wages are rising in response to these shortages, as would be expected. However, the increasing cost of living is putting pressure on household budgets. Consumer confidence has been declining as domestic price pressures are outpacing nominal household income growth.

The Committee discussed the outlook for labour supply with the reopening of New Zealand's international border underway. Members agreed that while the medium-term outlook is for ongoing net inward migration, as is the historical norm, this level would take some time to rebuild. Near-term indicators highlight that New Zealanders are currently leaving in larger numbers than visitors are arriving, as the border is opened in stages. The Committee noted that net immigration is assumed to increase only slowly, eventually leading to a gradual easing in skill shortages.

House prices have fallen from their recent high levels. The Committee viewed this as a sign that house prices are moving towards a more sustainable level. Home building intentions remain at record levels, which will assist this adjustment. However, construction activity faces challenges, including access to land, rising building costs, ongoing supply chain bottlenecks, and limited access to labour. The construction sector is operating around peak capacity.

Members noted that inflation is above target and employment is above its maximum sustainable level. As such, the Committee confirmed that further increases in the OCR are needed in order to meet their mandate.

The Committee discussed the pace and extent to which the OCR needs to rise in order to meet their inflation and employment mandate.

Members noted that annual consumer price inflation is expected to peak around 7 percent in the first half of 2022. The risk of more persistent high inflation expectations has increased. The Committee agreed that their policy 'path of least regret' is to increase the OCR by more now, rather than later, to head off rising inflation expectations and minimise any unnecessary volatility in output, interest rates, and the exchange rate in the future. The Committee agreed to a 50 basis point rise in the OCR, consistent with this least regrets analysis.

The Committee noted that the OCR is stimulatory at its current level. Members agreed that a larger rise in the OCR now is consistent with the forward path for interest rates outlined in their February Statement. Members also agreed that this 'stitch in time' approach is consistent with near-term financial market pricing.

On Wednesday 13 April, the Committee reached a consensus to increase the OCR to 1.50 percent.

Attendees

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

External: Bob Buckle, Peter Harris, Caroline Saunders

Observer: Caralee McLiesh

Secretary: Gael Price

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Last updated: 28 February 2022

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