ANZ Research

RBNZ Monetary Policy Review

5 October 2022

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Sticking to the plan, keeping options open

- The RBNZ raised the OCR by 50bps to 3.50% today, as expected, maintaining that "it remains appropriate to continue to tighten monetary conditions at pace".
- We continue to expect another 50bp hike at the November Monetary Policy Statement, with 25bp moves in each of the first three meetings of 2023, taking the OCR to a peak of 4.75%.
- We see risks on both sides of that. On the downside, current global market volatility could quickly turn into something uglier; on the upside, core inflation may not fall as fast or as far as projected.
- Interestingly, the Summary Record of Meeting showed the Committee discussed the merits of 50bps vs 75bps. That possibly reflects where the Committee see the skew of risks, and is a very different vibe to the RBA's 25bp hike yesterday.

In brief

As was widely anticipated, the RBNZ today raised the Official Cash Rate (OCR) by 50bps to 3.50%, and confirmed there's more where that came from.

The RBNZ, like central banks everywhere, faces a challenge balancing ongoing wage-price spiral risks against hard-landing risks". Unfortunately, both of these still appear to be going the wrong way. But for now it's the inflation side that demands action, whereas hard landing risks are a case of 'we'll cross that bridge when we come to it.'

In fact, the RBNZ put a little less emphasis on escalating global risks in their statement today than we expected. Of course, this in no way implies that it is ignoring key developments, and the market will, appropriately, make up its own mind about what the evolving situation means for the monetary policy outlook as the situation unfolds. But here and now, the RBNZ's focus remains squarely on inflation, and the weaker NZD associated with the global backdrop is only adding to risks on that score.

The 'vibe' of the accompanying statement and Summary Record of Meeting was also largely in line with our expectations – the statement was almost a carbon copy of that in August. If anything, the fact that the Committee discussed the merits of 75bps vs 50bps possibly reflects where the Committee currently see the skew of risks. We concur, but as we've stated before, if the global picture goes truly off the rails and sabotages the New Zealand economic outlook via a nasty terms of trade shock, our 'sticky-inflation, higher-peak-OCR' risk would pivot to a 'sticky-inflation limited-ability-to-cut' risk. Assuming no step-change to the outlook, it's always been our expectation that it'll take time for stronger-for-longer inflation dynamics to be incorporated into the RBNZ's outlook, so the RBNZ's tone today was always going to have limited implications for our OCR call. We're all in wait-and-see mode!

Key quotes:

- **Global: "**Headline inflation has declined slightly in some countries, but core measures of inflation have proved more persistent". "Recent indicators suggest the global growth outlook has weakened".
- **Labour market:** "New Zealand's productive capacity is still being constrained by labour shortages and wage pressures are heightened." "Some members noted that there may be changes in wage setting behaviour in an environment of higher headline inflation"
- **Domestic Activity:** "Other more recent indicators suggest that domestic activity in the September quarter may have been slightly stronger than previously assumed."
- **Consumer spending:** "Consumption remains resilient overall, but spending on durable goods, which may be more sensitive to interest rates, has continued to decline". "the level of domestic spending has remained resilient to date, in the face of slowing global growth and higher domestic interest rates. Employment levels are high, and household balance sheets remain resilient despite the fall in house prices"
- **OCR outlook:** "The Committee considered whether to increase the OCR by 50 or 75 basis points at this meeting."
- **Exchange rate:** "Higher global interest rates and increased risk aversion in global markets have placed downward pressure on the New Zealand dollar". "A lower New Zealand dollar, if sustained, poses further upside risk to inflation over the forecast horizon."
- **Housing**: "Members agreed that falling house prices and declines in other asset prices will negatively impact household consumption". "The impact of higher debt servicing requirements are an important channel of monetary policy transmission".
- **Getting traction**: "The Committee considered whether to increase the OCR by 50 or 75 basis points at this meeting. Some members highlighted that a larger increase in the OCR now would reduce the likelihood of a higher peak in the OCR being required. Other members emphasised the degree of policy tightening delivered to date. Members also noted the lags in monetary policy transmission and a slow pass-through to retail interest rates. On balance, the Committee agreed that a 50 basis point increase was appropriate at this meeting."

Our take

Today's decision to raise the OCR by 50bps to 3.50% appears to have been relatively straightforward, despite the dovish surprise from the Reserve Bank of Australia yesterday. Domestic data have evolved broadly in line with the RBNZ's August forecasts (when they signalled a 50bp hike for October and November), analysts were expecting it, and it was the closest option to market pricing.

Our OCR forecast remains unchanged: we expect another 50bp hike in November, with 25bp hikes in each of the first three meetings of 2023, taking the OCR to 4.75%.

We see risks on both sides of this.

On the one hand, data continue to suggest high core inflation will be difficult to tame, and that monetary tightening isn't yet getting the traction it needs to get core inflation down quickly. If capacity (particularly in the labour market) doesn't open up, the OCR could easily have a 5-handle by the end of 2023.

But going the other way, the global outlook seems to be growing more fragile by the day as financial markets wobble. Clearly, there are some very significant high-impact risks bubbling away out there. On top of that uncertainty, there are question marks around how central banks would respond if faced with a nasty trade-off between stabilising inflation and financial stability. The Bank of England has already been confronted with that. There are plausible scenarios, in short, with a nasty combo of higher-than-expected global inflation at the same time as lower-than-expected global growth, that make the appropriate policy response a matter of debate here too.

Certainly recent developments have done nothing to dissuade us that there is a pretty high risk that inflation will prove stickier than expected, both in New Zealand and offshore. Certainly, as long as the RBNZ is prioritising getting inflation down to 2%, OCR cuts wouldn't be appropriate until it's crystal clear the economic outlook is disinflationary – eg with significant job losses on the cards.

So on the one hand, we have heightened big-impact, but difficult-to-forecast downside economic risks that may or may not materialise (and may or may not be disinflationary if they do), while on the other hand, the domestic wage-price spiral is looking more developed than previously feared.

The challenge for the Monetary Policy Committee is that they can't set the OCR for the average outcome across this risk distribution, as then they're guaranteed to fall between two stools. Rather, the OCR needs to be set for what's deemed the single most likely outcome. And right here right now, that's a tighter-for-longer labour market and stronger-for-longer core CPI inflation.

The November Monetary Policy Statement (on 23 November) is the next cab off the rank. We think this meeting has the potential to be a lot more interesting, as the Committee will have a full suite of economic forecasts from which to be able to reassess the risk of persistently higher core inflation (and global markets will have kept evolving!). Key economic data before the November MPS include the Q3 CPI (18 October), and the Q3 labour market data (2 November). A further significant acceleration in core inflation and wages could feed into a higher terminal OCR in the RBNZ's updated forecast. But whether this turns out to be enough to meet the 4½% peak the market had priced in going in today's meeting remains an open question – it may take more than one MPS for the RBNZ to come around to the view that an OCR closer to 5% than 4% is what's needed.

Market reaction

Markets have rightly latched onto the fact that the RBNZ "considered whether to increase the OCR by 50 or 75 basis points". That was the key sentence in the Summary Record of Meeting, and it effectively underwrites the recent run-up in market expectations for hikes going forward. That, alongside the Bank's decision to maintain verbatim every other hawkish phrase from August (tightening "at pace", demand remaining "resilient" to headwinds, "indicators continuing to highlight broad-based pricing pressures" and the Committee remaining "resolute") leave you under no illusion as to what the Committee is thinking. As such, it was as hawkish as anyone could have expected, and the RBNZ's tone stands in stark contrast to the RBA's tone yesterday. Even if markets are yearning for a central bank "pivot" to a slower pace of tightening, the RBNZ clearly isn't of that view (yet).

Short-end rates may not reach last week's stressed highs in coming days given the pull-back in global rates. But we do expect them to continue grinding gradually higher, and for expectations for the November decision to settle a little above 50bps. The Kiwi bounced on the news, and with the RBNZ back in the top spot in the G10 policy rate stakes, the Kiwi just got a little bit more expensive to short. That should limit further downside.

Continued monetary tightening

The Monetary Policy Committee today increased the Official Cash Rate (OCR) to 3.5 percent from 3.0 percent.

The Committee agreed it remains appropriate to continue to tighten monetary conditions at pace to maintain price stability and contribute to maximum sustainable employment. Core consumer price inflation is too high and labour resources are scarce.

Global consumer price pressures remain heightened. The global demand for goods and services is exceeding supply capacity, putting upward pressure on prices. Food and energy prices are being particularly exacerbated by the war in Ukraine.

A recent decline in oil prices and an easing in some supply-chain constraints have seen headline inflation measures fall in some countries. However, core measures of inflation have risen and persist. Central banks are tightening monetary conditions, implying a weaker growth outlook for New Zealand's trading partners.

In New Zealand, the level of domestic spending has remained resilient to date, in the face of slowing global growth and higher domestic interest rates. Employment levels are high, and household balance sheets remain resilient despite the fall in house prices.

New Zealand's productive capacity is still being constrained by labour shortages and wage pressures are heightened. Overall, spending continues to outstrip the capacity to supply goods and services, with a range of indicators continuing to highlight broad-based pricing pressures.

Committee members agreed that monetary conditions needed to continue to tighten until they are confident there is sufficient restraint on spending to bring inflation back within its 1-3 percent per annum target range. The Committee remains resolute in achieving the Monetary Policy Remit.

Summary Record of Meeting – October 2022

The Monetary Policy Committee discussed developments affecting the outlook for inflation and employment in New Zealand. Inflation is currently too high and employment is beyond its maximum sustainable level. The Committee agreed to continue increasing the Official Cash Rate (OCR) at pace to maintain price stability and support maximum sustainable employment.

The Committee discussed recent international economic developments. Inflation remains high globally. Headline inflation has declined slightly in some countries, but core measures of inflation have proved more persistent. Recent indicators suggest the global growth outlook has weakened, in part due to tighter global financial conditions. In Europe, the war in Ukraine continues to pose downside risks to growth and upside risks to inflation. In China, containment of COVID-19 continues to adversely impact activity and there are financial stresses emanating from the property sector.

The Committee observed that global sovereign bond yields have increased significantly, consistent with a repricing of expectations for central bank policy rates. Some members believed that simultaneous and fast-paced monetary tightening in multiple countries was increasing downside risks to global growth. Members noted that large movements in wholesale interest rates and exchange rates were causing a deterioration in financial market liquidity, which can exacerbate market volatility.

Higher global interest rates and increased risk aversion in global markets have placed downward pressure on the New Zealand dollar. Members believed that this would contribute toward a rebalancing of New Zealand's current account over the long-term. However, a lower New Zealand dollar, if sustained, poses further upside risk to inflation over the forecast horizon.

The Committee discussed recent developments in the domestic economy. New Zealand GDP in the June quarter rebounded broadly as expected. This was supported by a resumption in international tourism following the reopening of New Zealand's borders, and an increase in domestic activity following the relaxation of pandemic restrictions. Other more recent indicators suggest that domestic activity in the September quarter may have been slightly stronger than previously assumed. Consumption remains resilient overall, but spending on durable goods, which may be more sensitive to interest rates, has continued to decline.

Household balance sheets are resilient despite recent declines in house prices. Members agreed that falling house prices and declines in other asset prices will negatively impact household consumption. Members noted that household debt servicing costs were rising and had further to increase on average as more fixed-rate mortgages are reset at higher interest rates. The impact of higher debt servicing requirements are an important channel of monetary policy transmission.

The Committee noted recent survey data showed that for businesses, cost pressures and labour scarcity remain the primary concerns. The construction industry faces ongoing capacity constraints. Building consents remain near historic highs, driven by growth in multi-unit dwellings, although there is uncertainty about the construction pipeline going forward.

The Committee agreed that the labour market remains very tight. Net migration remains negative and is yet to provide any sustained recovery in external labour supply. Members discussed the likelihood of further upside wage pressure given lags in the wage setting process. Some members noted that there may be changes in wage setting behaviour in an environment of higher headline inflation.

The Committee discussed domestic financial conditions. Members noted the strong funding position of banks and that as a result, recent increases in wholesale interest rates have yet to be fully reflected in retail interest rates. However, wholesale funding costs are rising and bank funding conditions are expected to become less accommodative. The Committee expects that higher wholesale interest rates will be reflected in higher retail interest rates, particularly deposit rates, as banks compete for funding.

The Committee discussed the pace and extent of monetary tightening required. Members agreed that the OCR needed to reach a level where the Committee could be confident it was sufficient to maintain expectations of low inflation in the longer term and bring consumer price inflation to within the target range.

The Committee considered whether to increase the OCR by 50 or 75 basis points at this meeting. Some members highlighted that a larger increase in the OCR now would reduce the likelihood of a higher peak in the OCR being required. Other members emphasised the degree of policy tightening delivered to date. Members also noted the lags in monetary policy transmission and a slow pass-through to retail interest rates. On balance, the Committee agreed that a 50 basis point increase was appropriate at this meeting.

On Wednesday 5 October, the Committee reached a consensus to increase the OCR to 3.5 percent from 3 percent.

Attendees:
Reserve Bank staff: Adrian Orr, Karen Silk, Christian Hawkesby, Paul Conway
External: Bob Buckle, Peter Harris, Caroline Saunders
Treasury Observer: Tim Ng
Secretary: David Craigie

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