ANZ Research

RBNZ Monetary Policy Statement

17 August 2022

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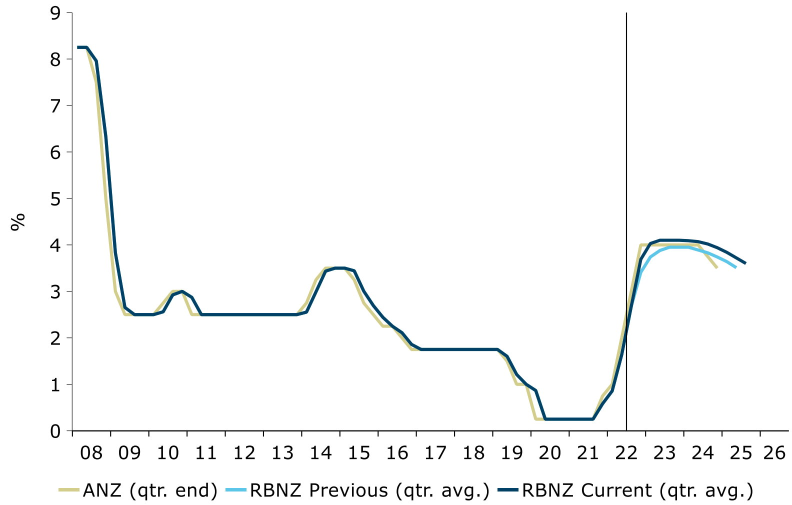
Toru

- As was universally expected, the RBNZ lifted the Official Cash Rate (OCR) 50bp to 3.0% today.
- The tone of the Statement was hawkish, while acknowledging both domestic and global downside risks to growth.
- The RBNZ's updated OCR forecast reaches a peak of 4.1% by mid-2023, versus the May MPS forecast of a peak of 3.95%. As before, cuts are pencilled in for 2024 (endpoint: 3.6%).
- The 15bp upward revision to the OCR peak is the bare minimum the RBNZ could have chosen in light of the very large upward revision to their non-tradable and wage inflation forecasts, in our view.
- The RBNZ is currently reassessing its estimates of the neutral OCR. Any upward revision will need to go 1:1 into the OCR track.

In brief

As expected, the RBNZ today raised the Official Cash Rate (OCR) by 50bps to 3.0%. The OCR forecast track now sees the OCR reaching 4.1% by mid-2023, 15bp higher than in the May Monetary Policy Statement (MPS), before declining back to 3.6% by September 2025. The RBNZ appears to also be coming around to the idea that the neutral OCR is creeping higher, but this has not been incorporated into these forecasts. But it might be by the November MPS. Accurately estimating the neutral OCR in real time is all but impossible, given the lags with which monetary policy operates, but the RBNZ can't afford to make optimistic assumptions.

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

The overall tone of the Policy Assessment was hawkish. Inflation remains the focus: "The Committee remains resolute in achieving the Monetary Policy Remit." Downside growth risks are real, particularly on the global front, but actual strong inflation demands attention.

RBNZ forecasts in brief

The RBNZ's CPI inflation forecast returns to the 2% target midpoint only in Q1 2025, as in May (but with a slightly higher OCR required to achieve it). The forecasts for both non-tradable inflation and wages were revised up significantly, as expected. By the end of the year, non-tradable inflation is expected to be 6.2% y/y (previously 4.6%), and QES average hourly earnings 8.3%% y/y (previously 6.2%).

In our view, the strong upward revisions to both wages and non-tradable inflation appear incongruous with only a 15bp upward revision to the OCR track. That said, there are offsets: the RBNZ revised down its forecasts for residential investment and overall business investment, as we expected. The terms of trade have also been revised down. The consumption outlook remains subdued, as in May, but the RBNZ notes that "household budgets have been bolstered by high levels of employment, savings built up during COVID-19 lockdowns, and government support payments." The unemployment rate peaks at 5.0% (4.8% previously).

See the graphical appendix on page 7 for more detail.

There are many reasons (some good, some bad) why interest rates may not get as far as we or the RBNZ expects. On the 'growth-friendly' side, a faster recovery in the supply side of the economy could remove some inflation pressure by relieving capacity constraints. This could come in a few forms, such as global supply chains recovering more rapidly, or a net inflow of migrants easing some of the severe labour shortages Kiwi firms are experiencing. On the 'bad side', recent data out of China highlights growth risks in our largest trading partner. Youth unemployment in China reached a record 19.9% in July, and the PBOC cut their policy interest rate by 10bps to 2% earlier this week as a weakening property sector and the ongoing zero-COVID approach continue to weigh on the economy. New Zealand is highly sensitive to global trade shocks, and a slowdown in China would undoubtedly be felt here.

Domestically, too, downside growth risks remain very real. Indeed, we anticipate that the economy would be in recession in 2023 in the absence of a strong net exports recovery. But with domestic inflation not yet showing any signs of easing, and the nominal economy inflating, the RBNZ can't afford to let up with interest rate hikes. Just this morning, data from Stats NZ showed that median weekly earnings were up 8.8% y/y in Q2 2022 – the fastest increase since the data began in 1998.

Special topic: the neutral OCR

With headline inflation, inflation expectations, and wage growth now sitting well above year-ago levels and likely to remain elevated for some time, it's sensible to think that the nominal neutral OCR (the level of the OCR that is considered neither contractionary nor expansionary once all the dust has settled) will also be creeping higher.

To get high inflation down, the OCR needs to be taken above neutral for a time and then guided back to neutral once the inflation outlook is expected to be consistent the RBNZ's target. All else equal, therefore, any change to the RBNZ's estimate of neutral needs to go 1:1 into the OCR track.

But neutral isn't actually observable. It's estimated based on past inflation and economic outcomes, and it's time-varying. Given the uncertainty around neutral estimates, the RBNZ tends to present a central estimate with a wide confidence band around it, and revise current and past estimates regularly.

There are many factors that push and pull on the neutral OCR, including demographic change, productivity growth, and inflation expectations. Wage inflation is also a key ingredient, where all else equal, higher wage inflation will push the nominal neutral OCR higher. That's because strong wage growth erodes the impact of rising interest rates on households. And one of the most significant events since the May MPS is that wage inflation (measured by average hourly earnings in particular) has accelerated significantly.

This is clearly on the RBNZ's mind, highlighted in the Summary Record of Meeting: "the Committee discussed the possibility that neutral interest rates may be higher. For example, market-based estimates of neutral nominal interest rates have increased over the past year. Staff will be undertaking further work to review their estimates." An upward revision to the RBNZ's estimate of neutral therefore presents upside risk to the OCR track in the next MPS.

Indeed, to put upside risk in context, it's worth noting that unemployment is currently lower (and inflation higher) than in the mid-2000s, when the RBNZ estimated neutral was closer to 5%. So barring some global shock (a growing risk), there absolutely is a chance that the OCR may need to go higher still, and not by chump change, to deliver the real tightening required to get inflation back to 2%. To monitor this risk, we'll be watching for any developments that suggest that monetary policy is no longer getting the traction it was: confidence bouncing back strongly, job ads holding up, or green shoots in the housing market, for example.

Market implications

Short-end interest rates moved higher in reaction to today's MPS, with the bellwether 2-year swap rising around 6bps within 30mins of its release. We still see upside risks from here given the higher end-point in the RBNZ's OCR track (4.10%), which is consistent with two more 50bp hikes (in October and November) and the chance of a lesser hike in February. The RBNZ continuing to front-load hikes is also suggestive of flatter/more inverted yield curves, especially if global bond markets (which influence local longer-term interest rates more than the OCR does) remain more attuned to the recession risks narrative. The NZD reacted positively too, as one might expect given the renewed focus on short end rates in FX markets. But global themes remain all-powerful, and if the Fed maintains its hawkish rhetoric, that could eclipse the RBNZ's policy stance.

Policy Assessment

Tēnā koutou katoa, welcome all.

The Monetary Policy Committee today increased the Official Cash Rate (OCR) to 3 percent from 2.5 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 remains too high and labour resources remain scarce.

Global consumer price inflation has continued to rise, albeit with some recent reprieve from lower global oil prices. The war in Ukraine continues to underpin high commodity prices, with global production costs and constraints further exacerbated by supply-chain bottlenecks due to the ongoing COVID-19 health challenge. The outlook for global growth continues to weaken, reflecting the ongoing tightening in global monetary conditions.

In New Zealand, domestic spending has remained resilient to global and local headwinds to date. Spending levels are supported by a robust employment level, continued fiscal support, an elevated terms of trade, and sound household balance sheets in aggregate.

However, production is being constrained by acute labour shortages, heightened by seasonal and COVID-19 related illnesses. In these circumstances, spending and investment continues to outstrip supply capacity, and wage pressures are heightened. A range of indicators highlight broad-based domestic 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 – August 2022

The Monetary Policy Committee discussed developments affecting the outlook for inflation and employment in New Zealand. Consumer price inflation is currently too high and labour remains scarce. The Committee agreed to continue increasing the Official Cash Rate (OCR) at pace to achieve price stability and to 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 Committee judged that the global economic outlook has weakened since May, reflecting tightening financial conditions, ongoing geopolitical tensions, and continued disruption to global supply of goods and services. The war in Ukraine has put upward pressure on global commodity prices, especially oil and food, and disrupted global trade. Lockdowns in some Chinese cities to combat the spread of COVID-19 has contributed to supply-chain bottlenecks and shipping times and costs remain elevated.

Inflation is at the highest level in many decades in most advanced economies, due to disrupted and curtailed global supply coupled with a strong recovery of demand following the disruptions and uncertainties caused by earlier phases of the pandemic. Most central banks are raising interest rates, in many cases at a much faster pace than has been seen in recent history. Higher interest rates abroad have placed downward pressure on New Zealand’s exchange rates, making our imports more expensive while supporting exporter returns.

Developments in the New Zealand economy were discussed by the Committee. Demand has remained resilient to global and domestic headwinds to date. However, output is being constrained by the disrupted global supply of goods and services and acute labour shortages, made worse by high levels of sickness from COVID-19 and other illnesses.

Members discussed the outlook for domestic demand. Residential construction activity has been strong, but the Committee discussed downside risks to future construction activity, with some construction firms reporting a fall in forward orders. Business surveys and direct reports from businesses suggest a more general slowing in business activity in the coming months. However, inbound international tourism is recovering from a low base and that is expected to provide some offset to weaker domestic spending.

Household balance sheets on the whole are strong, but higher interest rates and rising costs of living are putting pressure on household finances, and are expected to reduce household spending and house prices. House prices have steadily dropped from high levels since November last year, and are expected to keep falling over the coming year towards more sustainable levels.

Production capacity pressures remain. In particular, labour shortages are a major constraint on business activity. Wage growth has continued to pick up in line with tightness in the labour market, and there is some evidence from discussions with businesses that firms are increasing wages more frequently. However, hourly wage rates are rising more slowly than inflation. The Committee was encouraged by recent declines in survey measures of inflation expectations, but remains alert to the risk of a more pronounced change in wage and price setting behaviour.

The Committee discussed the outlook for fiscal policy, and noted upside risks to overall government spending due to the rising cost of delivering government services.

The Committee expects some easing of the rate of inflation in the near term due to falling petrol prices and stabilisation in international shipping costs. However, inflation pressures have broadened and measures of core inflation have increased. Nevertheless, inflation is expected to return to the Committee’s 1-3 percent target range by the middle of 2024, but this will require a better balance between supply and demand.

The Committee discussed changes in the level of commercial bank cash balances held at the central bank. Noting current high levels, the Committee discussed the factors influencing those balances, including the Large Scale Asset Purchases (LSAP) and Funding for Lending programmes (FLP). Both of these programmes provided monetary stimulus through lowering longer-term interest rates.

The Committee noted that the volume of commercial bank lending is determined by several factors including customer demand for loans, banks’ perception and appetite for risk, and prudential requirements on banks’ capital, cash and other liquid assets and funding. The LSAP and FLP programmes did support bank funding and liquidity positions, but there is no evidence that this is currently having a direct impact on lending activity over and above their impact on interest rates. Credit growth is modest in the context of rising interest rates. Settlement cash balances will gradually reduce as the Reserve Bank sells back government bonds to the government as the LSAP programme is unwound.

The drawdown window of the FLP will expire in early December, and some further usage of the programme is expected in the coming months. In total, the programme will fund no more than 6 percent of bank lending. The programme has lowered funding costs for banks, which has contributed to lower lending rates for borrowers and provided additional stimulus to the economy while the OCR was low. However, the Committee sets policy to achieve the overall desired level of monetary conditions, and has offset the impact of the FLP with a higher OCR as monetary policy stimulus has been removed. The Bank’s experience using monetary policy instruments such as LSAP and FLP will be reviewed as part of the five-yearly Review and Assessment of the Formulation and Implementation of Monetary Policy.

The Committee discussed the possibility that neutral interest rates may be higher. For example, market-based estimates of neutral nominal interest rates have increased over the past year. Staff will be undertaking further work to review their estimates.

The Committee agreed that further increases in the OCR were required in order to meet their Remit objectives, and discussed the appropriate pace at which to raise rates. The Committee discussed whether more rapid increases could improve the credibility of the inflation target and reduce the risk of a significant increase in inflation expectations. However, the Committee agreed that maintaining the recent pace of tightening remains the best means by which to meet their Remit.

The Committee noted that a number of central banks had increased interest rates by more than 50 basis points recently, but that most of these countries had started increasing interest rates later than New Zealand did and were often starting at a lower level of interest rates.

The Committee agreed that domestic inflationary pressures had increased since May and to further bring forward the timing of OCR increases. The Committee agreed to continue increasing the OCR until it is confident that monetary conditions are sufficient to maintain expectations of low inflation in the longer term and bring consumer price inflation to within the target range. 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 17 August, the Committee reached a consensus to increase the OCR to 3 percent from 2.5 percent.

Attendees:

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

External: Bob Buckle, Peter Harris, Caroline Saunders

Treasury Observer: Dominick Stephens

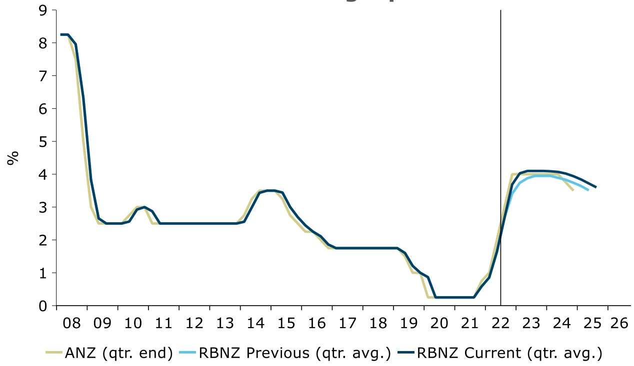
Reserve Bank Observer: Paul Conway

Secretary: Chris Bloor

Key forecasts

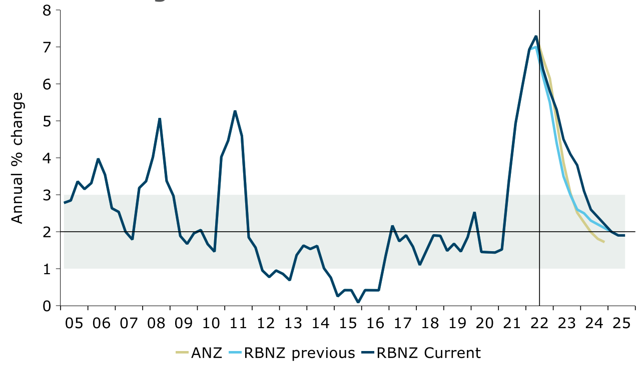
Overall, the RBNZ have a similar path for inflation and the labour market as we do, with a little less activity over the medium term. The latter is reflected in their expectation that capacity stretch will recede meaningfully over the next few years. The forecasts for wage and non-tradable inflation have been revised up significantly following the Q2 starting point surprise.

The RBNZ are now forecasting a peak OCR of 4.1%...



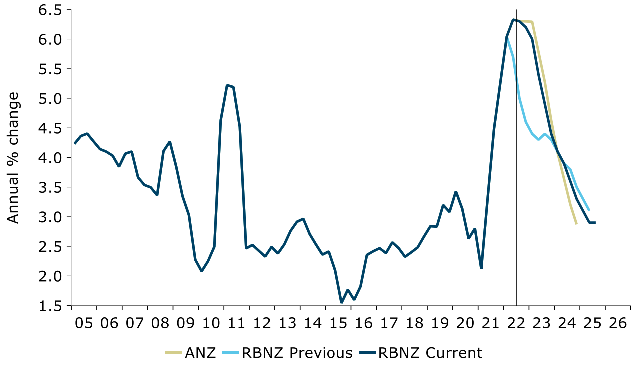
Source: RBNZ, Macrobond, ANZ Research

...and a smidge more inflation...



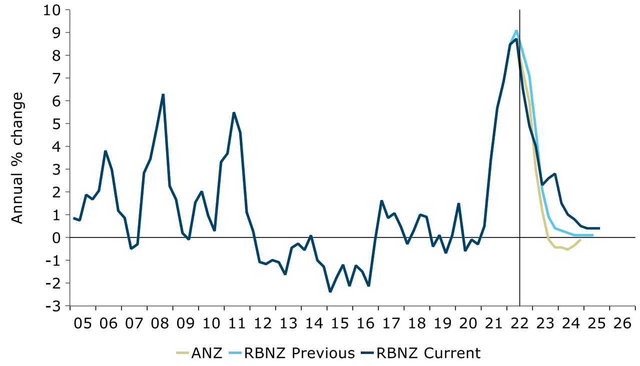
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

...with more persistence in non-tradable inflation...



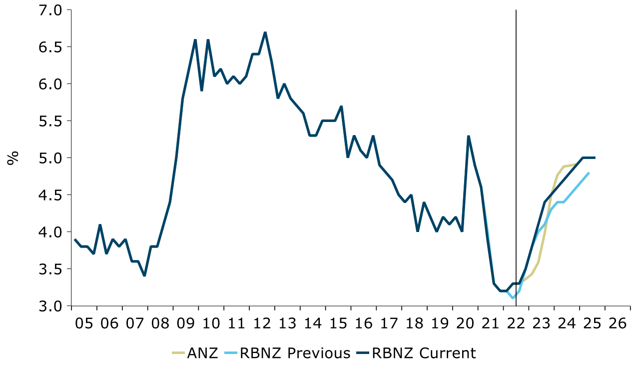
Source: RBNZ, Macrobond, ANZ Research

...and a kink in the expected decline in tradables



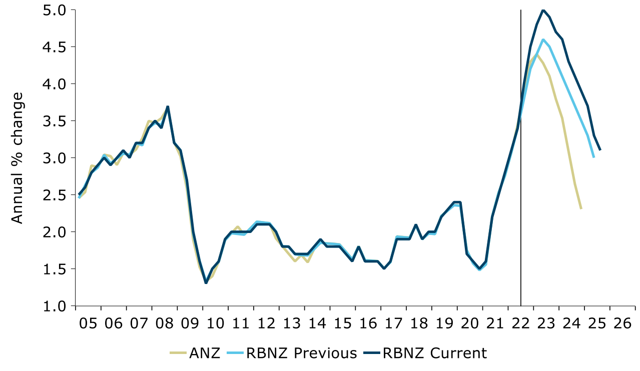
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

A higher unemployment rate will take some heat out of domestic inflation...



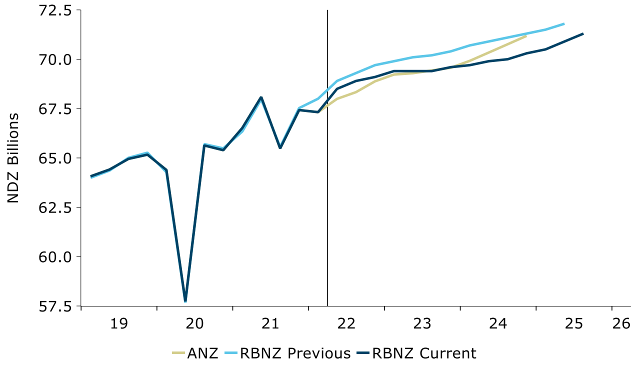
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

...but wage growth is higher throughout the forecast



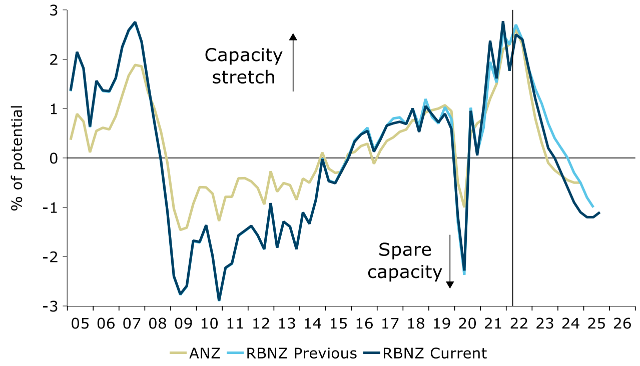
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The outlook for real GDP has been downgraded...



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

...which will help ease capacity stretch (output gap)



Source: RBNZ, Macrobond, ANZ Research

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