ANZ Research

RBNZ Monetary Policy Statement

23 February 2022

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A hawkish hike

- As widely expected, the RBNZ raised the OCR 25bp to 1.0% today.
- The RBNZ's OCR forecast cracks 3% by September 2023, and peaks at 3.35% at the end of the forecasts in March 2025 – about 75bp higher than in the November MPS. We'd characterise that as qualitatively similar to our own forecast.
- The tone of the Statement was hawkish. A 50bp move was seriously considered, and downside risks to growth got a lot less airplay than upside risks to inflation.

In brief

As expected, the RBNZ today raised the Official Cash Rate (OCR) by 25bp to 1.0%, and indicated that they expect it to go considerably higher yet. Their forecast shows that as things stand, they see the OCR reaching 3% by Q3 next year, and increasing more slowly from there to a peak of 3.35%. That's about 75bp more tightening than was foreseen at the November MPS.

The RBNZ acknowledged the near-term downside risks from the Omicron outbreak, but noted it will exacerbate resource constraints. It has its eyes firmly on the medium term, and that picture is all about broad-based inflation.

Indeed, the overall tone was hawkish. While there are downside risks to growth in the current environment, from both Omicron and global developments, a "least regrets" approach points firmly to steady hikes: "the most significant risk to be avoided at present was longer-term inflation expectations rising above the target and becoming embedded in future price setting."

Unless the wheels abruptly fall off, it's hard to disagree. The RBNZ's inflation forecast is higher throughout the projection and only returns to the 2% target midpoint in 2025, despite the higher forecast OCR.

A 50bp hike was discussed, with the Summary Record of Meeting noting that "many members saw this as a finely balanced decision." Advocating for a 50bp move were both the starting point for inflation and the inexorable rise in inflation expectations. But the arguments for 25bp won out: interest rates have already tightened significantly; the forecast OCR track is higher; and sales of LSAP bond holdings (ie QT) may put upward pressure on long-term interest rates.

In terms of the LSAP, the RBNZ indicated that they intend to do some "managed" bond sales, not just let bonds roll off their balance sheet as they mature. They intend to sell $5bn of NZGBs per year from July onwards.

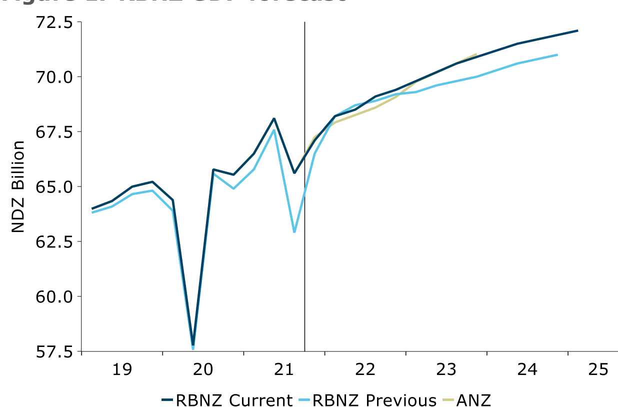
The market perceived the MPS as hawkish: both the NZD and short-end rates rose.

RBNZ forecasts

Recent data has continued to show an extremely stretched economy suffering intense cost and inflation pressures. The growth outlook continues to be distorted by COVID, but there is no question that the labour market is exceptionally tight, and inflation pressures intense.

The RBNZ has upgraded its GDP forecasts. Not only was the Q3 drop in GDP smaller than they (and we) anticipated back in November (falling 'just' 3.7% q/q due to lockdown), but the historical data were revised up significantly. The new projection brings the level of GDP bang in line with our forecast over 2023 – although we're expecting growth will be a little slower over 2022 than the RBNZ is forecasting, as Omicron disruption continues to weigh on activity.

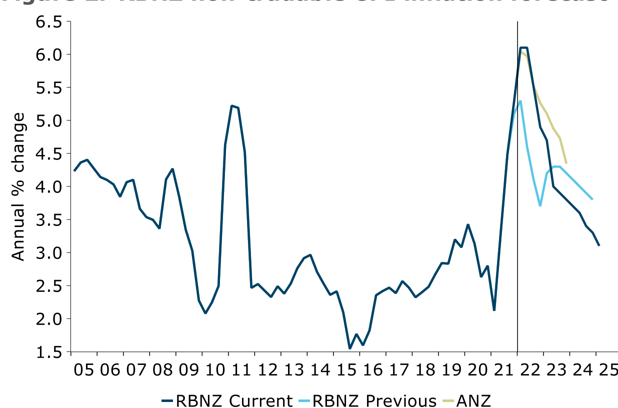
Figure 1. RBNZ GDP forecast



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The RBNZ has also, unsurprisingly, upgraded its inflation forecast after Q4's whopping 5.9% annual inflation print. It now expects inflation will peak at 6.6% in Q1 this year and remain well above the 1-3% target band over the rest of the year. While global factors account for much of the recent high inflation, domestic factors are also playing a large role – particularly the recent housing boom and the exceptionally tight labour market.

Figure 2. RBNZ non-tradable CPI inflation forecast



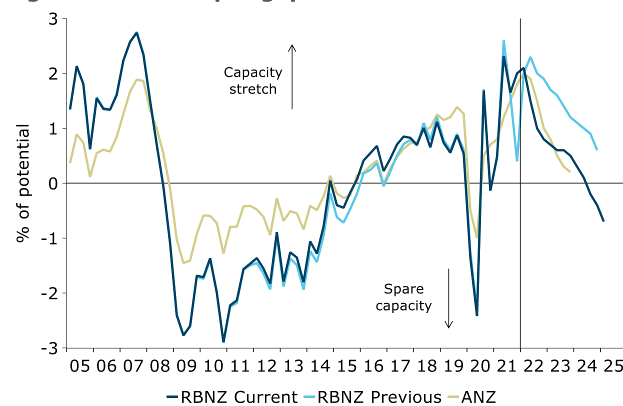
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

With inflation pressures so broad based (indeed the RBNZ had a special Box discussing just how broad-based it is), the RBNZ isn't actually forecasting CPI inflation to return to the 2% target range mid-point until Q1 2025 (ie the very last point in their forecast). That suggests they're now seeing inflation pressures as being so persistent that they expect inflation will be higher over all of 2023 and 2024 than their previous forecast, despite a 75bp lift in their OCR projection.

It's not all one-sided, though. Helping the RBNZ out is a waning of the fiscal stimulus, and an assumption that global inflationary pressures will ease this year. The latter is an assumption that may or may not prove right, with geopolitical tensions contributing to higher energy prices, in particular. However, the RBNZ did point out that inflation pressures in China and Australia, our two largest trading partners, are more subdued than elsewhere.

The New Zealand economy is clearly highly capacity constrained – and that's reflected in the RBNZ's estimate of the output gap, which shows pressures getting close to levels we saw in 2007. We concur! They see capacity pressures peaking early this year, as Omicron disruption washes through the economy. Over time, the RBNZ (and we) expect that a combination of tighter monetary policy and a general recovery in the supply side of the domestic and global economies should see capacity pressures start to ease.

Figure 3. The output gap



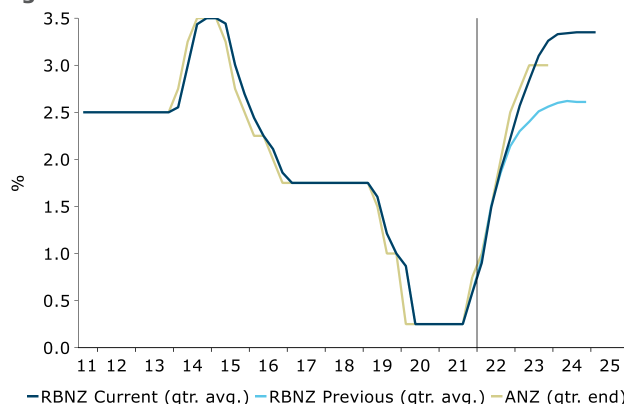
Source: RBNZ, Macrobond, ANZ Research

While the timing and magnitude of any supply side recovery is highly uncertain, the RBNZ is forecasting that the output gap will be negative for a time, starting in 2024. Given that they are forecasting an OCR track significantly above their estimate of neutral (about 2%) in order to get inflation back to target, it's no surprise that they think they need to take a lot of heat out of the economy achieve their targets.

Turning to the labour market, the RBNZ expects the unemployment rate will remain at the current record low of 3.2% over the first part of 2022, before rising to 4.3% in early 2025. That likely reflects a return of the unemployment rate to NAIRU – ie the level of unemployment that's consistent with low and stable inflation. We're still not convinced that unemployment will rise by that much (absent some unforecastable shock like a financial crisis). Demand and supply in the labour market are so out of sync right now that we think the labour market can weather a fairly chunky increase in the OCR before we really start to see significant job losses. Returning the labour market to maximum sustainable employment doesn't necessarily require higher unemployment – just a reduction in excess demand for labour.

The OCR track was lifted markedly versus November (figure 4). The 2022 profile is similar to their previous forecast, our own forecast, and current market pricing. However, beyond that they now see the OCR continuing upward to a peak of 3.35%, versus our own forecast of 3%. That's an implicit nod to current market pricing. Indeed, the Committee was clearly keen to see market pricing for future hikes hold up, given the comment in the Summary Record of Meeting that "many members" considered the 25 vs. 50 decision "finely balanced," and that larger moves were still in the toolkit "if required over coming quarters." That's a green light to the market to price in odds of a 50-pointer should CPI surprise on the upside, for example.

Figure 4. The OCR track

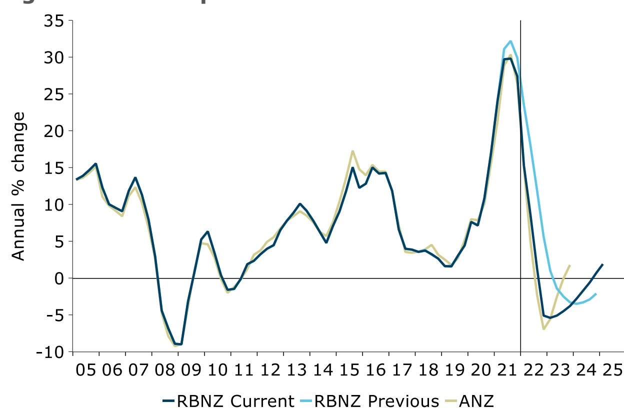


Source: RBNZ, Macrobond, ANZ Research

Stepping back and looking at the big picture, it's highly unusual for the RBNZ to be embarking on a hiking cycle at a time when the housing market appears to be in full retreat. It reflects that due to the volatility and uncertainty brought about by the pandemic, this hiking cycle was 'late' in kicking off. Annual house price inflation had already hit 30% by the time the OCR was first hiked in October 2021. More typically, New Zealand hiking cycles start when house price inflation is around 5-10%.

The upshot is, given the strength of inflation pressures, the RBNZ is going to have to keep on hiking into a falling housing market (figure 5). Like us, the RBNZ has been expecting to see the housing market slow, given the array of headwinds it was facing. It's just happened a little faster than anticipated in the November MPS. The RBNZ now expects annual house price inflation to fall from a peak of 29.8% in Q3 2021, to a low of -5.4% in Q1 of 2023. It's a slightly more persistent fall than we're expecting, but overall is consistent with our view of a soft landing in the housing market, with the tight labour market providing a buffer for household incomes.

Figure 5. House price inflation



Source: RBNZ, REINZ, CoreLogic, Macrobond, ANZ Research

In fact, the RBNZ is now expecting annual wage growth to accelerate to a peak of 5.2% y/y over the next few years – and so as long as the labour market remains tight, the housing market should muddle through. The RBNZ assumes that residential construction remains strong – there are enormous supply-side issues that are going to make that challenging, but there is clearly a long pipeline.

The housing market has of course made fools of all forecasters in recent years, and economic forecasting generally remains something of a mug's game in these unusual times. Two risks were given special attention:

- The global outlook was discussed at length, with risks on both sides around the central assumption that the pace of growth expected to moderate this year. It was noted that both ongoing supply-chain disruptions and geopolitical risks provided upside risks to inflation, though the latter was negative for growth.
- The importance of inflation expectations was underlined. "The increases in longer-term expectations in New Zealand since the November Statement remain within the range of changes in recent decades. However, there is a risk that persistently high inflation will lead to a change in wage- and price-setting behaviour and influence how prices are set."

The RBNZ's forecasts assume that COVID restrictions become less onerous over the projection, and that the Dubai oil price eases gradually towards USD80/barrel. Potential output is seen as constrained by COVID restrictions, with higher structural unemployment. Regarding credit conditions, the RBNZ concluded that "It is unclear at this stage whether the CCCFA changes will have persistent and widespread impacts on mortgage lending in light of other policies and factors (such as higher interest rates)."

Weighing it up

Overall, the economic picture is similar to November: upside risks to inflation are clear, but so too are downside risks to growth. Headwinds for economic activity are clear (and in particular for the housing market), but the OCR nonetheless needs to be raised in a pretty relentless fashion if the credibility of the inflation target is to be maintained. Buckle up; it could be a rough ride.

Where to now with QE?

The RBNZ had a Box in the MPS on the future of the Large-Scale Asset Purchase programme (LSAP), ie QE, in which it announced the sale of $5bn of government bonds (NZGBs) per year from July (ie next fiscal year) onwards. LGFA bonds won't be sold at all.

Depending on which bonds are sold, the NZGB part of the LSAP portfolio could be fully unwound by the end of the 2026/27 fiscal year (and there is a chart in the MPS showing exactly that). That's still a while away, and things could clearly change. Even though these transactions will be off-market, they will have a direct impact on NZDM bond issuance. So in that sense they may as well be considered to be a sell-down to the market (just with NZDM acting as go-between) as it will translate to additional supply over coming fiscal years. That will, in turn, put upward pressure on longer-term bond yields. We say that because we suspect the RBNZ will be keener to sell longer bonds, rather than shorter bonds that will roll off within the sell-down period. But that is of course something to which NZDM will need to agree.

The decision to run down the LSAP portfolio (ie to engage in quantitative tightening, or "QT") was not particularly surprising. We could see arguments both for and against it – with one of the key questions being, what impact will it have on the economy and financial conditions? That is, what does $5bn of QT per year equate to in terms of "equivalent" OCR hikes?

We don't know and we don't suspect the RBNZ does either, though the Committee did note that the intention to start QT was seen as a reason to hike 25bp rather than 50bp. That said, in the press conference, it was emphasised that the OCR will be the primary monetary policy tool going forward – and the RBNZ doesn't expect to be tweaking the pace of QT as a monetary policy tool.

QT was always coming, it's just being accelerated. For clarity, both the RBNZ and NZDM separately reiterated that any changes to Crown funding requirements will be announced at the Budget in May.

Market reaction

Markets took the view right from the get-go that today's MPS was hawkish, with the NZD and short end rates both up (the NZD has settled about 20bps higher, and the 2yr swap is around 10bps higher). And fair enough too, because we think it was pretty hawkish. While you could say that the Bank "only" hiked the OCR by 25bps today, that was about all that was "dovish". Indeed, the title of the MPS read "more tightening needed", and in the fine print the RBNZ noted that this decision was "finely balanced" and that it was "willing to move the OCR in larger increments if required over coming quarters". That's clearly far more hawkish than earlier talk of moving in "measured steps" and gives the green light for the market to all but forget about last year's Kotuku speech.

That said, we are mindful that the 0.75% lift in the RBNZ's OCR track end-point (which was lifted from 2.6% to 3.35%) was mostly a 2023 and 2024 story, so in a sense it is more conditional, remembering that a lot can still go wrong. But in the interim, with "larger increments" still on the table, there is no natural cap on where expectations can go if we do get another bout of strong inflation or employment data, and that means getting used to more of the volatility seen of late (in both rates and FX).

Policy Assessment

Tēnā koutou katoa, welcome all.

The Monetary Policy Committee today increased the Official Cash Rate (OCR) to 1 percent. The Committee also agreed to commence the gradual reduction of the Reserve Bank's bond holdings under the Large Scale Asset Purchase (LSAP) programme - through both bond maturities and managed sales.

The Committee agreed it remains appropriate to continue reducing monetary stimulus so as to maintain price stability and support maximum sustainable employment.

The level of global economic activity is generating rising inflation pressures, exacerbated by ongoing supply disruptions. The pace of global economic growth has slowed however, due to the general elevated uncertainty created by the persistent impacts of COVID-19, and clear signals that monetary conditions will tighten over the course of 2022.

In New Zealand, underlying economic strength remains in the economy, supported by aggregate household and business balance sheet strength, fiscal policy support, and continued strong export returns. However, some short-term economic disruption is expected given the current growing COVID-19 health challenge. The high vaccination rates across New Zealand will assist significantly to reduce this disruption.

Economic capacity pressures have continued to tighten. Employment is now above its maximum sustainable level, with a broad range of economic indicators highlighting that the New Zealand economy continues to perform above its current potential.

Headline CPI inflation is well above the Reserve Bank's target range, but will return towards the 2 percent midpoint over coming years. The near-term rise in inflation is accentuated by higher oil prices, rising transport costs, and the impact of supply shortfalls. These immediate relative price movements risk generating more generalised price rises, especially given the current domestic capacity constraints.

The Committee agreed that further removal of monetary policy stimulus is expected over time given the medium-term outlook for growth and employment, and the upside risks to inflation.

Meitaki, thanks.

Adrian Orr
Governor

Summary record of meeting

The Monetary Policy Committee discussed developments affecting the outlook for monetary policy. Global economic activity experienced a robust recovery in 2021. The pace of growth is expected to slow, weighed down by resource and production constraints.

Global inflation is expected to peak during 2022 and then moderate, as supply disruptions are gradually resolved. However, global inflation is currently higher, and expected to ease more gradually than anticipated in the November *Statement*.

The Committee noted that central banks are now looking to increase interest rates sooner and by more than anticipated in the November *Statement*. The rise in global interest rates has resulted in a fall in the New Zealand dollar, as interest rate differentials have narrowed. Bond and equity prices have been more volatile of late, in part due to the shift in monetary policy expectations and a rise in geopolitical tensions. The Committee noted that asset valuations had been boosted by very low interest rates, and that higher interest rates may dampen these valuations in future.

The New Zealand economy has been resilient in the face of the COVID-19 pandemic to date. Export prices have remained high, supported by the solid international economic recovery. Domestic spending and investment have also been robust. However, conditions have been very difficult for some businesses, especially in service industries.

The recent emergence and spread of the Omicron COVID-19 variant is expected to further disrupt economic activity in the near term. People's ability and willingness to work and spend will be strongly determined by near-term health outcomes.

The Committee reconfirmed that house prices in New Zealand are above their sustainable level, but are expected to ease over time. They noted that house prices had begun to ease, with monthly falls in December and January. Mortgage lending growth has also slowed. Government regulatory and tax policy changes, and high rates of residential building are expected to slow house prices. Higher mortgage interest rates will also play a role in the transition of house prices toward a more sustainable level over coming years.

Resource constraints are evident in the economy, and will be exacerbated by further disruptions from the Omicron outbreak. Employment is above its maximum sustainable level. The Committee noted that there has been some upward pressure on nominal wages, as expected, consistent with the tight labour market. They also noted that wage growth continues to lag CPI inflation.

The Committee discussed the outlook for net migration to New Zealand with the international borders being reopened in stages over coming months. The impact on labour supply is uncertain in the near term, but a positive inflow is expected over time as border flows return to normal. The Committee noted that net migration is assumed to increase slowly, helping to gradually ease skill shortages.

Annual CPI inflation has increased largely as expected in the November *Statement*, reflecting domestic capacity constraints and higher prices for imported goods, in particular oil. The Committee noted that annual inflation is expected to peak in early-2022, and then ease over the course of the year, returning to within their target range in mid-2023. The Committee agreed that further removal of monetary stimulus is necessary to achieve their Remit.

The OCR remains the Committee's preferred tool for implementing monetary policy, and the impact of additional monetary policy tools is considered when determining the level of the OCR. With regards to the latter, members noted that the Funding for Lending Programme (FLP) window closes this year. They also noted that the cost of bank funding from the FLP is rising in line with the OCR.

The Large Scale Asset Purchase (LSAP) programme was introduced in March 2020, providing significant stimulus and supporting the functioning of the bond market. Purchases under the programme were halted in July 2021.

The Committee agreed that managing down the Bank's holdings of these bonds was now consistent with their monetary policy objectives. Members also agreed that managed sales of bond holdings, in addition to not investing the proceeds of maturities, was most consistent with achieving their mandate over time (further details below).

The Committee discussed the extent of monetary tightening required to meet their price stability and maximum sustainable employment mandate. In doing so, the Committee applied their least regrets framework, noting that the most significant risk to be avoided at present was longer-term inflation expectations rising above the target and becoming embedded in future price setting.

It was agreed that more monetary tightening was needed than signalled in the November *Statement*. The Committee confirmed that the outlook for a higher OCR at the end of the projection horizon was a balanced reflection of the likely path of interest rates.

The pace at which monetary stimulus should be reduced was discussed by the Committee. Members agreed there were many factors to assess, balancing the need to reduce monetary stimulus with many uncertainties. They considered the balance of risks and noted that the behavioural responses of household and businesses in the face of higher interest rates would be important for the appropriate pace of tightening.

The Committee agreed that while higher interest rates are necessary, households and firms may have become more sensitive to interest rate changes as their debt levels have risen. Members also noted that a significant proportion of mortgages will be reset at higher interest rates over calendar 2022.

The current Omicron outbreak will lead to economic disruption and may weigh on consumer and investor confidence in the near term. Health outcomes will be important, in particular how these impact the supply capacity of the economy and level of demand.

While government spending and investment remains strong, the impulse to growth from fiscal support is now ebbing and will wane.

The recent signs of slowing in demand for housing was discussed by the Committee, which noted that house prices may fall further. The Committee agreed that higher interest rates were consistent with house prices becoming more sustainable. They also noted the Bank's recent policy adjustments to support the stability of the financial system, including tightening of loan-to-value ratio restrictions last year and ongoing changes to improve the capital

adequacy of banks. The Committee acknowledged that some recent, more highly-leveraged, borrowers may be financially stretched in a higher interest rate environment.

When deciding whether to move the OCR up by 25 or 50 basis points, many members saw this as a finely balanced decision.

When considering the case for a 50 basis point increase, the Committee noted the high starting point for inflation and the drift upwards in measures of inflation expectations. The Committee agreed that maintaining stable longer-term inflation expectations near the mid-point of their target would greatly assist their purpose.

When considering the case for a 25 basis point increase, members noted that interest rates had already increased significantly late last year, and are expected to continue rising as the OCR is progressively increased. They also noted that conditional on the outlook, the OCR is expected to peak at a higher level than assumed at the November *Statement.* In addition, sales of the Bank's LSAP bond holdings may put some upward pressure on longer-term interest rates. Members of the Committee were conscious of broader uncertainty in the midst of the current Omicron wave.

Weighing the options, the Committee came to a consensus to increase the OCR by 25 basis points. The Committee also affirmed that it was willing to move the OCR in larger increments if required over coming quarters.

On Wednesday 23 February, the Committee reached a consensus to:

- Increase the OCR to 1 percent.
- Not reinvest the proceeds of any upcoming LSAP bond maturities.
- In addition, direct the Reserve Bank to sell nominal New Zealand Government Bonds and Inflation-indexed New Zealand Government Bonds to New Zealand Debt Management at a rate of $5 billion per fiscal year, commencing in July 2022, provided it remained consistent with the Bank's monetary policy objectives, and subject to market conditions.
- Hold the Local Government Funding Agency bonds until maturity.

Attendees

Reserve Bank staff: Adrian Orr, Christian Hawkesby, Yuong Ha

External: Bob Buckle, Peter Harris, Caroline Saunders

Observer: Bryan Chapple

Secretary: Elizabeth Kendall

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