ANZ Research

RBNZ Monetary Policy Statement

25 May 2022

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Contact

Sharon Zollner or David Croy for more details.

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On the warpath

- As was almost universally expected, the RBNZ lifted the Official Cash Rate (OCR) 50bp to 2.0% 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 3.95% in the second half of 2023, and then declines towards the end of the forecasts, being back at 3.51% in June 2025. This peak was higher than expected.
- The track is also consistent with more 50bp hikes to come. In our view, domestic growth momentum is cooling rapidly, and this is likely to be more evident by July. However, the RBNZ doesn't think it's done with 50s yet, and was happy to signal that clearly today. **Accordingly, we have changed our OCR forecast to include one more 50bp hike in July before the RBNZ reverts to a more normal pace of hiking. We maintain our OCR peak forecast of 3.5%.**

In brief

As was all but universally expected, the RBNZ today raised the Official Cash Rate (OCR) by 50bps to 2.0%, and indicated plenty more tightening to come. The MPS forecast track was more aggressive than expected: it sees the OCR reaching just shy of 4% by the second half of 2023, 65bp higher than in the February Monetary Policy Statement (MPS), before declining back to around 3.5% by mid-2025.

The overall tone of the Policy Assessment was hawkish. The RBNZ has its eyes firmly on the medium-term inflation outlook, rather than on near-term growth risks, while acknowledging these. The RBNZ simply can't treat those risks symmetrically, with inflation where it is. The RBNZ stated: "The Committee agreed that at present, with persistent cost pressures and rising inflation, the risk of moving too slowly and not far enough remained the most costly option." And to underline the point further: "The Committee agreed that stabilising inflation is its priority."

The risks around not getting on top of inflation are real: the starting point for CPI inflation is nearly 7%, and the RBNZ's forecast only returns to the 2% target midpoint in Q1 2025, similar to the February forecast (but with a much higher OCR required to achieve it). Inflation pressures couldn't be more broad-based, and the risks of a wage-price spiral were highlighted by a large upward revision to the RBNZ's wage forecast.

But the risks of an outright economic stall are real too, with consumer confidence outright recessionary, house prices falling, and growth in our largest trading partner under a lot of pressure. We expect sharply slowing momentum will become more evident in the data flow soon. However, the RBNZ's OCR track made it abundantly clear that the RBNZ expects to deliver more 50bp hikes. They expect subdued consumption, but note that "on average, household balance sheets are healthy" and "house prices are expected to remain above their pre-pandemic level."

While the RBNZ certainly talked tough today, we expect the RBNZ will revert to a more standard pace of tightening, of 25bp at each meeting, from August onwards, as hard landing risks demand attention.

The market reaction was swift, with the NZD up around half a cent and short end interest rates up 15-20bps.

Today's decision

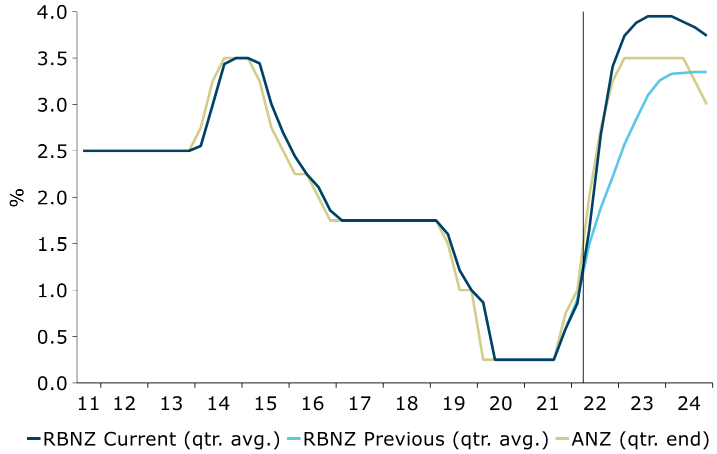
Today's OCR decision appears to have been very straightforward. Domestic commentators were united in expecting a 50bp hike, and market pricing made it the path of least resistance. There was certainly no suggestion of any equivocation in the Summary Record of Meeting RBNZ commented that "with persistent cost pressures and rising inflation, the risk of moving too slowly and not far enough remained the most costly option."

The RBNZ's focus remains squarely on upside inflation risks, reiterating that under its "least regrets" approach that given "persistent cost pressures and rising inflation, the risk of moving too slowly and not far enough remained the most costly option." That's an entirely reasonable assessment when inflation-targeting credibility and anchoring long-run inflation expectations is on the line. While domestic and global inflation risks remain elevated, the RBNZ also notes downside risks to domestic activity – specifically, the risk that higher interest rates lead to a more rapid decline in house prices than expected, which would cause a larger decline in household spending and consumption than they assume. However, they also note that some slowdown in demand is needed to bring inflation in line.

RBNZ forecasts

A key signalling device for future policy choices is the RBNZ's forecast OCR track (figure 1). The track implies both more hikes, and faster, with an unprecedented steepness suggesting another 50bp hike not only in July, but in August as well.

Figure 1. OCR forecast

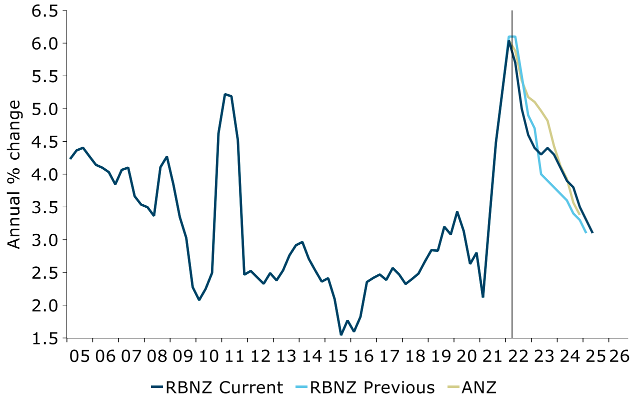


Source: RBNZ, Macrobond, ANZ Research

As has become commonplace in recent months, the RBNZ has revised down its forecasts for real economic activity, but upgraded its forecast for inflation. The RBNZ now expects inflation to peak at 7% in Q2, before easing. It's a similar forecast to ours – with inflation only just returning to target at the end of the forecast, as surging wage growth is expected to give domestic inflation pressures considerable momentum (figure 2).

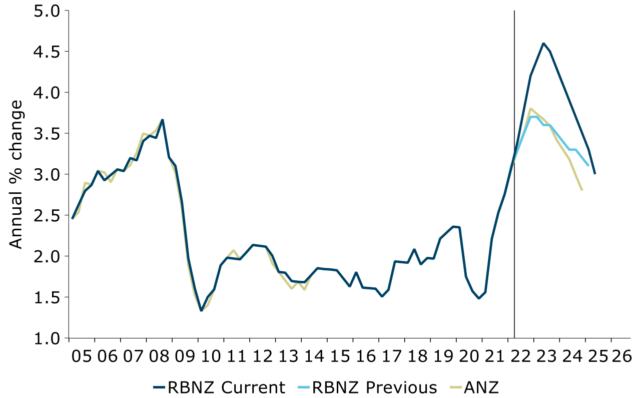
In fact, wage growth received a significant upgrade in the latest set of forecasts – with annual labour cost inflation picked to hit 4.6% in mid-2023, a record for the series (figure 3). Surging wages in a productivity-constrained environment like COVID are a recipe for spiralling inflation, and the RBNZ is cognisant that in a tight global labour market, people are "more willing and able to take up new roles for higher wages".

Figure 2. RBNZ non-tradable CPI inflation forecast



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

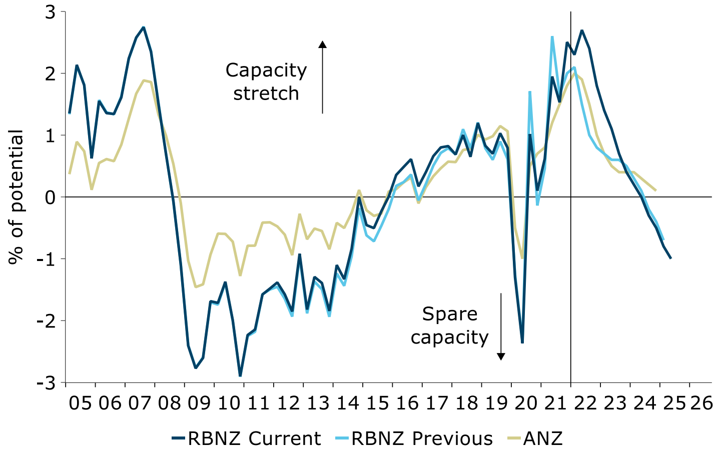
Figure 3. Wage forecasts



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The RBNZ's output gap estimate (and forecast) really highlights the pickle they are in (figure 4). Yes, growth risks are very much to the downside, but with supply constraints and strong demand (including government spending) continuing to drive up inflation, they have no choice but to drive the output gap into negative territory in order to bring inflation pressures down. It will significantly dent economic growth – and raises the risk of recession. But better to rip the band-aid off now than to let inflation spiral further out of control, if that's the choice.

Figure 4. Output gap forecast



Source: RBNZ, Macrobond, ANZ Research

Growth headwinds are clearly building, especially with interest rates rising to sharply. That's reflected in a downwards revision to the RBNZ's real GDP forecasts (looking through Omicron rebound). This downgrade comes despite a significant upgrade to their forecast for real government spending, which they note is "very high". As growth headwinds continue to build over 2022, further sharp interest rate rises could significantly weigh on an already-slowing activity pulse. We suspect that will limit OCR hikes to a peak of 3.5%, as downside risks become increasingly apparent over the second half of the year.

The biggest support pillar for the economy in the face of slowing growth and high inflation has been the tight labour market. The RBNZ expects a small reduction in the unemployment rate to 3.1% in Q2, before it lifts gradually to just under 5% in 2025 as monetary tightening squeezes the labour market. It's clear that with inflation still overshooting their target, the Monetary Policy Committee will need to inflict some damage on the labour market in order to cool the domestic inflation impulse.

But they are getting traction in the housing market – with house prices already down almost 5% since November (sa, ANZ estimate). The RBNZ now expects house prices to fall 14% from the peak in November 2021, a slightly larger fall than our own forecast. They did note that shortages in the construction sector are likely to impact the delivery of new housing supply (which is still being consented at record levels). The falling rate of house construction was seen as "exacerbating the pressure on housing supply," though overall, cooling construction "is needed".

Supply issues are certainly inflationary – the RBNZ points out that the price of building a new home has been the largest contributor to non-tradable inflation in the past 12 months. However, the construction industry could be in for a challenging period. If the industry were to get into trouble, it could take wider economic momentum with it.

Underlying the RBNZ's forecasts are some key assumptions. One of the most important of these is the level of the neutral OCR, where it is neither stimulatory nor contractionary for the economy. We had flagged the risk that the RBNZ could reassess this estimate a little bit higher, therefore signalling a change in view of how much they may need to hike to achieve contractionary monetary conditions. In the end, it looks like their neutral assumption is little changed from February (around 2%), and that the bulk of the upgrade to their OCR track is due to perceived stronger domestic inflation momentum.

Fiscal and monetary policy interaction

Regarding Budget 2022, the RBNZ noted that Government spending is very high. That's certainly been acknowledged in their forecast for Government consumption (which includes a positive starting point surprise). The RBNZ expects the degree of fiscal stimulus to reduce in coming years, but as we noted in our Budget Review, there is plenty of scope in the Government's fiscal strategy to lift spending again from Budget 2023.

Reading between the lines, and given the RBNZ's assessment of extreme capacity stretch in the economy (which is hard to disagree with), it appears that the RBNZ does deem it necessary to "make room" for high Government spending. And if things pan out as forecast, that suggests the costs of fiscal expansion are not only the costs associated with servicing higher government debt, but also a higher-than-otherwise interest cost on private sector debt held by businesses and households.

What happens now with the OCR?

The main focus for the market today was not the OCR decision itself, which was seen as locked in, but rather any hints about future policy, and in particular whether July is likely to bring a 25bp or 50bp hike. The RBNZ laid its cards on the table on that front, with an OCR track that implied a 50bp hike in July and probably August as well.

For our part, we expect signs of faltering domestic momentum to become very clear over coming months. August and even July feel a very long way away in that context. Given the determination evident in the MPS forecasts today we are changing our OCR forecast to include another 50bp hike in July, but maintain that mounting evidence that monetary policy is "working" and domestic inflation pressures are waning will see the RBNZ revert to 25bp hikes thereafter. The odds of a hard landing grow with every 50bp hike, but the RBNZ's focus is the fact that the odds of a wage-price spiral would grow with every opportunity to hike 50bp that the RBNZ passes up.

We continue to forecast the OCR being raised to a peak of 3.5%, but stress again that this forecast assumes the wheels don't fall off the housing market, the labour market, nor New Zealand's commodity prices in the meantime. This feels like the kind of global environment where the picture could change very quickly.

Weighing it up

Today was a relatively straightforward decision for the RBNZ, as expected, but what was less expected was the "all guns blazing" approach to future inflation risks. Yes, inflation is far too high, but nonetheless, more nuanced policy choices lie ahead, as the OCR moves further into contractionary territory, and the implications of shooting the housing market in the back with a machine gun become more evident.

Monetary policy is working. It's certainly difficult to disentangle all the drivers, with a mix of supply and demand factors constraining the growth outlook. But what is abundantly clear is that momentum is turning south abruptly. Residential construction intentions have plummeted in the ANZ Business Outlook survey; the best retail spending indicator out of the ANZ-Roy Morgan consumer confidence survey has absolutely tanked.

Given Covid uncertainty, the RBNZ was understandably late to kick off its hiking cycle, and has had to make up for lost time. But even if the real OCR is negative, it's hard to believe there are many people filling their boots with 6% lending because CPI inflation is 7%. We're just not at that stage of the business (nor housing) cycle – nor likely to be any time soon.

Most importantly, monetary policy from here on in is very likely exacerbating a slowdown, not taking the top off strong growth. The RBNZ states that "some slowing of domestic demand growth through household spending and construction is needed" to bring inflation down, as we concur. But this is not 2007, where the housing market was shrugging off hike after hike, credit growth was extremely strong, homeowners were sitting pretty on their 2-year fixed mortgages, and the RBNZ struggled to get traction.

The OCR is up 175bp (eight-fold, if you want to look at it that way) in eight months. And as the preferred fixed mortgage term has evolved towards 1 year, the lag for monetary policy transmission has shortened. Almost 40% of mortgages will roll over in the next 6 months, onto sharply higher rates (in addition to those that have already done so). The going may well still be good for another 50bp hike in July – certainly the tone of the MPS today makes it likelier than not, and we have changed our near-term OCR call accordingly. However, before long, we suspect the balance will tilt towards 25bp moves as a good balance between urgency and flexibility in a very uncertain world.

But as always, data between now and the OCR Review on 13 July will have the final say. If consumers express wariness but in actuality keep right on spending (as in 2021), or if any more upward surprises to inflation arrive, another 50-pointer absolutely remains a possibility. On the other hand, global central banks are attempting a hair-pin turn in a tight bunch while descending a debt mountain. The next six weeks may not be a smooth ride.

Market reaction

Markets take a lot of signal from the RBNZ's OCR track, and in that regard, the changes we saw were definitely on the high side of what most were expecting (we think the street was looking for a small increase from 3.35% to around 3.5%). The track does end at 3.51%, but it gets there in Q2 2025 having peaked at 3.95% over late 2023/early 2024, and it was that increase (which averages 105bps over the next 12months compared to the February track) that took markets by surprise.

While it's impossible to precisely back-solve an OCR profile that fits the quarterly averages of the RBNZ's OCR track (which is model driven, rather than calibrated to each meeting date), the track is consistent with at least two more 50bp hikes. In simple terms, if the RBNZ wants to get the OCR to average 3.74% over Q1 2023, it'll have to deliver at least 150bps of hikes at the remaining four meetings of 2022, and that in turn speaks to at least two more 50bp hikes. But as noted in the previous section, we suspect the tenor of the economic data (including the inflation pulse) will slow a little more rapidly than the RBNZ is assuming, and are therefore adding only one more 50bp hike to our forecast, in July.

However, if we take the RBNZ's OCR track as a given, that puts our measure of fair value for the 2yr swap at around 3¾%. That's not far from where we have levelled off this afternoon (the 2yr swap is up around 0.15%), and the degree to which it overshoots that will depend on whether the market takes the RBNZ at its word, or starts becoming fearful of a hard landing. On that score, while the NZD did pop around half a cent higher initially, given recent global market wobbles (which have hard landing fears at their core), once the dust settles, if local markets do arrive at the view that recession risks have increased, that's not a NZD-friendly backdrop.

Policy Assessment

Tēnā koutou katoa, welcome all.

The Monetary Policy Committee today increased the Official Cash Rate (OCR) to 2.0 percent. The Committee agreed it remains appropriate to continue to tighten monetary conditions at pace to maintain price stability and 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.

Consistent with the economic outlook and risks ahead, monetary conditions need to act as a constraint on demand until there is a better match with New Zealand's productive capacity. A larger and earlier increase in the OCR reduces the risk of inflation becoming persistent, while also providing more policy flexibility ahead in light of the highly uncertain global economic environment.

The level of global economic activity is generating rising inflation pressures, exacerbated by ongoing supply disruptions driven by both COVID-19 persistence and the Russian invasion of Ukraine. The latter continues to cause very high prices for food and energy commodities.

The pace of global economic growth is slowing. The broad-based tightening in global monetary and financial conditions is acting to slow spending growth, accentuated by the high costs of basic food and energy staples. European geopolitical uncertainty is also weighing heavily on business confidence and investment intentions worldwide. Likewise, COVID-19 restrictions in significant regions of China are exacerbating supply chain disruptions and adding cost and complexity to trade.

In New Zealand, underlying strength remains in the economy, supported by a strong labour market, sound household balance sheets, continued fiscal support, and a strong terms of trade. The reduction in COVID-19 health-related restrictions is also enabling increased economic activity, including hospitality and tourism.

However, headwinds are strong. Heightened global economic uncertainty and higher inflation are dampening global and domestic consumer confidence. Asset prices, in particular house prices, have also declined, reflecting in part higher mortgage interest rates and increased supply of housing.

On balance, a broad range of indicators highlight that productive capacity constraints and ongoing inflation pressures remain prevalent. Employment remains above its maximum sustainable level, with labour shortages now the major constraint on production. The Reserve Bank's core inflation measures are above 3 percent.

The Committee agreed to continue to lift the OCR at pace to a level that will confidently bring consumer price inflation to within the target range. The Committee viewed the projected path of the OCR as consistent with achieving its primary inflation and employment objectives without causing unnecessary instability in output, interest rates and the exchange rate. Once aggregate supply and demand are more in balance, the OCR can then return to a lower, more neutral, level.

Summary Record of Meeting

The Monetary Policy Committee discussed developments affecting the outlook for inflation and employment in New Zealand. Members noted that current inflation and employment were above their target and sustainable levels respectively. Members agreed that while the direction of their monetary policy decision was clear, the extent and timing of future increases in the Official Cash Rate (OCR) still depends on the economic outlook and avoiding major risks.

The Committee agreed that global economic activity was slowing more than previously expected, and that further weakening in global economic growth was likely. Members noted that while international fiscal and monetary policy actions have partly cushioned the effect of the COVID-19 pandemic on household incomes and employment so far, significant and ongoing disruption is now being felt.

The recent rise in global inflation pressures has led central banks to raise their policy interest rates and signal further tightening to come. These measures have been aimed to deliberately slow demand to be more consistent with the current constrained supply capacity of goods and services.

The Committee noted that the disruption caused by the Russian invasion of Ukraine has added to the underlying global inflation pressures. The cost of living has risen significantly, in particular due to shortages of food and fuel. This rise in costs is necessitating lower non-essential spending in households globally. High global commodity prices are likely to persist for some time, creating long-lasting cost pressure for firms and households, even as general consumer price inflation slows.

Economic activity globally, and especially in China at present, is still being severely disrupted by COVID-19. Members agreed that China's regional health-related economic restrictions are having a direct impact on global growth, supply chain efficiency, and New Zealand's trade outlook. New Zealand's trade performance is strongly linked to China's economy.

The recent rise in central banks' policy interest rates, and forward guidance for more increases, has led to a significant fall in global equity prices, albeit from high levels. The Committee noted that a rise in official rates creates a higher hurdle for investment decisions.

Members discussed developments in the New Zealand economy. It was noted that rising global interest rates have narrowed interest rate differentials with New Zealand, adding to downward pressure on the New Zealand dollar exchange rate. The Committee noted that the lower New Zealand dollar raises import prices – exacerbating the effect of elevated global prices.

The Committee agreed that both high food and energy costs, and rising mortgage interest rates for those with debt, will affect household budget decisions and lead to less discretionary spending. Members noted that over the past year or so, wage growth has been less than consumer price inflation, adding further pressure on discretionary spending.

Recent and expected increases in mortgage interest rates are likely to contribute to falls in house prices, further reducing households' willingness to spend. It was agreed that household consumption was likely to be relatively subdued in coming quarters. The Committee noted that house prices are now headed toward a more sustainable level.

The Committee noted the Government's Budget announcements. It was agreed that fiscal policy is currently supporting economic activity, but that this stimulus is expected to reduce in coming years. The current level of fiscal spending is contributing to a modest increase in demand. This is expected to diminish over time as a result of the end to the large, broad based, fiscal support packages the Government delivered during the initial phase of the COVID-19 economic response.

The Committee noted that measures of core consumer price inflation are above their target range. Surveyed measures of near-term inflation expectations are also high, in line with actual consumer price inflation. It was noted, however, that the medium-term measures of inflation expectations have remained near the centre of the target range, albeit heightened somewhat. The Committee agreed that it was critical for these medium-term inflation expectations to remain around 2 per cent.

Members also noted the factors responsible for the current elevated consumer price inflation. New Zealand's inflation rate reflects a relatively similar contribution of global imported price pressures and domestic price pressures. They observed that a key factor contributing to domestic inflation pressure is housing – including both the cost of construction and the operating costs of dwellings in general.

On the costs of construction, members noted that the growing delay in accessing key building materials is significantly slowing activity, and increasing the financial risks associated with construction. The Committee observed that these delays, cost pressures, and associated uncertainty could limit the conversion of building permits into dwellings, exacerbating the pressure on housing supply.

Members agreed that employment is above its maximum sustainable level, as highlighted by a suite of indicators. They agreed that rising wage pressures are an expected outcome, with access to labour the key constraint on firms' productive capacity. With the global labour market tight, people are also more willing and able to take up new roles for higher wages.

The Committee noted that the reopening of the border should see a return to a net inflow of migrants into New Zealand over the next two years. Over time, this net immigration will help to ease New Zealand's labour shortages. More immediately there is an outflow of New Zealanders creating supply capacity constraints. With the international border reopening, more immigrants will also bolster demand ahead of supply capacity as they settle. It was agreed that these patterns of migration will have an uncertain net effect on inflation pressure, as they will affect both supply and demand in the economy. As a result, these dynamics do not play a key role in determining monetary policy at present.

The Committee noted the weaker outlook for employment growth in New Zealand, which is likely to be outpaced by labour force growth. As a result of the increase in labour supply, measured unemployment is expected to rise to around levels more consistent with maximum sustainable employment.

The Committee discussed the future path of the OCR based on the outlook for inflation and employment pressures. Members noted that both inflation and employment are currently higher than previously expected, and that this strength is broad-based, arising from a range of economic factors.

Members agreed that a higher level of the OCR is necessary to ensure annual consumer price inflation returns to within its target range over the next two years. They agreed this was also consistent with ensuring employment remained near its maximum sustainable level.

Members discussed their 'least regrets' framework which in the current context amounted to the risk of tightening policy 'too little, too late' versus 'too much, too soon'. The Committee agreed that at present, with persistent cost pressures and rising inflation, the risk of moving too slowly and not far enough remained the most costly option.

On the risk of doing too much too soon, the Committee acknowledged that raising the OCR steeply puts pressure on some households' spending decisions, especially those that are highly indebted.

However, members noted that, on average, household balance sheets are healthy. Banks have been testing mortgage lending for higher interest rate possibilities – consistent with current projected levels – before recent home loans were made. They also noted that house prices are expected to remain above their pre-pandemic level. The Committee also noted that while higher interest rates will increase firms' hurdle to investing, recent business surveys suggest labour shortages are the main constraint preventing an increase in production.

The Committee agreed that stabilising inflation is its priority. Members agreed that raising the OCR by more and sooner was consistent with avoiding higher future costs to employment and the economy in general as a result of high inflation. Stable inflation expectations will be a key indicator that the current monetary policy strategy is working.

The Committee agreed to maintain its approach of briskly lifting the OCR until convinced that monetary conditions were sufficient to constrain inflation expectations and bring consumer price inflation to within the target range. Once aggregate supply and demand are more in balance, the OCR can then return to a lower, more neutral, level. The Committee viewed the projected path of the OCR as consistent with achieving their primary inflation and employment objectives without causing unnecessary instability in output, interest rates and the exchange rate.

On Wednesday 25 May, the Committee reached a consensus to increase the OCR to 2.0 percent.

Attendees

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

External: Bob Buckle, Peter Harris, Caroline Saunders

Reserve Bank observer: Paul Conway

Treasury observer: Dominick Stephens

Secretary: Gael Price

Contact us

Meet the team

We welcome your questions and feedback. Click here for more information about our team.

Sharon Zollner
Chief Economist

Follow Sharon on Twitter
@sharon_zollner

Telephone: +64 9 357 4094
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

David Croy
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 4 576 1022
Email: david.croy@anz.com

Susan Kilsby
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

Miles Workman
Senior Economist

Macroeconomic forecast co-ordinator, fiscal policy, economic risk assessment and credit developments.

Telephone: +64 21 661 792
Email: miles.workman@anz.com

Finn Robinson
Economist

Macroeconomic forecasting, economic developments, labour market dynamics, inflation and monetary policy.

Telephone: +64 21 629 553
Email: finn.robinson@anz.com

Kyle Uerata
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

Natalie Denne
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist's diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

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