ANZ Research

RBNZ Monetary Policy Statement & OCR Call Change

23 November 2022

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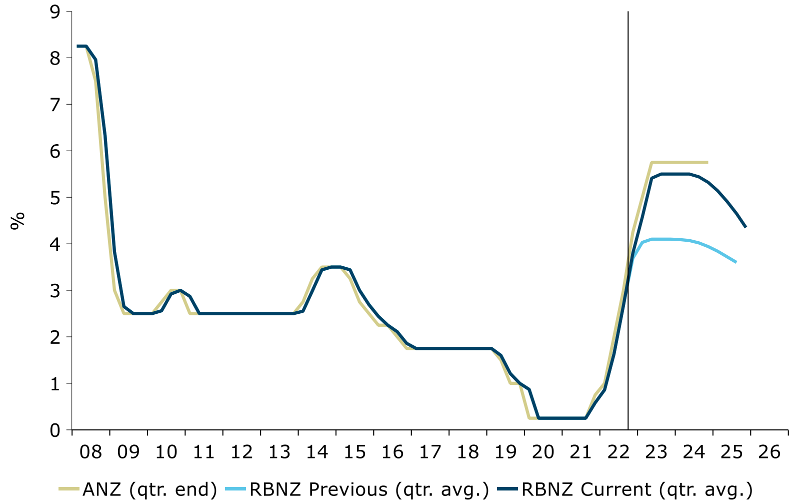
RBNZ: hope is not a strategy

- As was widely expected, the RBNZ lifted the Official Cash Rate (OCR) 75bp to 4.25% today with the release of its Monetary Policy Statement (MPS).
- The tone of the Statement was even more hawkish than we expected. **We have revised up our forecast OCR track, adding to our existing 75bp hike in February a 50bp hike in April and a 25bp hike in May, which would take the OCR to a peak of 5.75%.**
- The RBNZ noted that they "gave consideration to an increase in the OCR of 75 or 100 basis points."
- The RBNZ's updated OCR forecast reaches a peak of 5.5% by end-2023, a huge upgrade versus the August MPS forecast of a peak of 4.1%. Cuts are pencilled in for the second half of 2024 (endpoint: 4.35% at end-2025).
- The 140bp upward revision to the forecast OCR peak is massive, but so too have been the upside surprises to inflation, inflation expectations, and the wage outlook in recent months. The RBNZ estimates that the short term nominal neutral interest rate is 3.6%, reflecting high inflation expectations.
- The RBNZ is now forecasting a recession, with GDP to fall 1% peak to trough, with four consecutive quarters of negative growth – that appears to be what they now believe is unfortunately necessary to bring inflation down from what's looking like regrettably sustained highs.

In brief

As expected by most analysts, the RBNZ today raised the Official Cash Rate (OCR) by 75bps to 4.25%. The big surprise was in the forecast track, which now sees the OCR reaching a hefty 5.5% by end-2023 (a remarkable 140bp higher than in the August MPS), before declining back to 4.35% by end-2025.

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

The overall tone of the Policy Assessment was extremely hawkish. Although downside risks to growth exist and were acknowledged (particularly around global growth), it's all about getting inflation down as quickly as possible: "Members highlighted that the longer actual inflation remains above the target band, the more likely it is that higher inflation expectations become embedded".

But more important than the words is the OCR track, which, with a peak of 5.5%, sent a very clear message to the market – and mortgage holders: "Brace for impact."

The RBNZ has done some thinking on the neutral interest rate. While they note that their estimates of the long-run nominal neutral interest rate remains stable at around 2% (albeit drifting up slowly), if they feed through shorter-term measures of inflation expectations into their models, it produces an estimate of neutral of 3.6%. And if they feed inflation expectations at the two- to five-year horizon into their model, it spits out something closer to 3%. In essence, given the rise in inflation expectations that we've seen over the past year, the nominal OCR that is currently considered to be disinflationary has increased significantly above their longer-run estimate of 2%. That's a big driver of the lift in the OCR track.

The RBNZ is making policy in a haze of uncertainty, and continues to be commendably open about that unavoidable fact. In such an environment, it makes sense to look at the costs of being wrong in either direction - and these simply aren't comparable.

If the data turns seriously south in the next three months the market will adjust, effectively easing policy, and the RBNZ can corroborate this at February's Monetary Policy Statement, with little harm done.

But if upward surprises on inflation keep on coming – and they certainly have form – then the RBNZ would have regretted not going harder as they will be quite rightly worried that their inflation-targeting credibility is seriously on the line. Getting inflation down becomes much more difficult when households and firms just don't believe it's going to happen and start building that into their decision making.

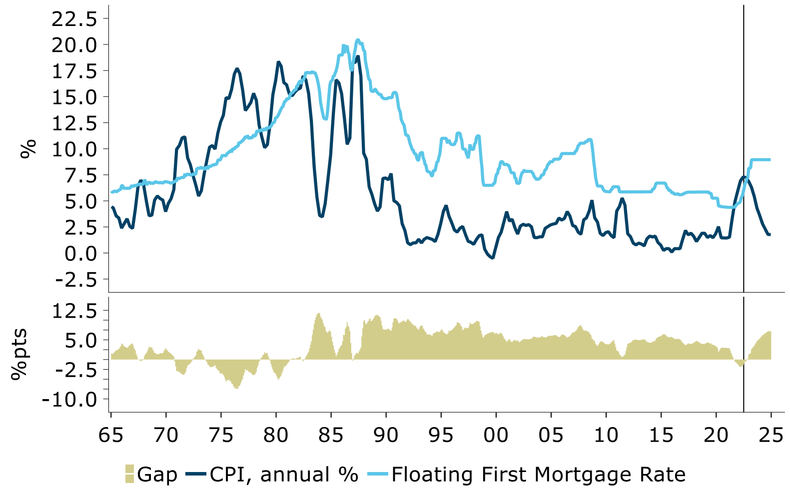
Hope is not a strategy. The RBNZ Monetary Policy Committee gets that, and deserves a pat on the back for facing the challenges head-on. If the facts change, they'll change their minds. But right now, the fact is that high inflation is looking increasingly entrenched, and dithering would only make the problem worse.

Our updated OCR forecast

The tone and forecasts in the MPS confirm that the RBNZ's gloves are off. We had already been talking about upside risk to our 5% forecast peak (made at the time of the upward CPI surprise) based on subsequent data. Now, with confirmation the RBNZ is seeing the risks the same way we do, we are now comfortable centralising that upside risk into our forecast. We now expect not only another 75bp hike in February as before, but now also a 50bp hike in April and a 25bp hike in May, taking the OCR to a peak of 5.75%. We see a bit more wage inflation than the RBNZ does, and think it will take longer for the unemployment rate to start rising meaningfully. But it's a big upgrade, and although revisions to everyone's OCR forecasts have been one-sided for a long time, we see the risks around a 5.75% peak as balanced.

As with every one of our previous forecast OCR peaks, the ability of the RBNZ to stop hiking the OCR at 5.75% depends on inflation falling soon. This inflation problem is unlikely to be beaten until retail interest rates have spent a decent amount of time sitting considerably higher than CPI inflation. That's our forecast, but we're not there yet (figure 1).

Figure 2. Floating mortgage rate and CPI inflation: a long-run view



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

RBNZ forecasts in brief

The RBNZ's CPI inflation forecast returns to the 2% target midpoint only in Q3 2025, (six months later than before, and with a much 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 accelerate to 7% y/y, peaking at 7.4% in Q1 2023 (previous peak 6.2%; ANZ forecast 6.6%), and QES average hourly earnings peak at 9.1% in Q4 2022 y/y (previous peak: 8.3%; ANZ: 9.3%). Note "The Committee noted that public sector wage growth has lagged that in the private sector and agreed this lag represents an upside risk to wage pressure going forward."

A recession is forecast from the second half of 2023, with no recovery in economic momentum until the latter half of 2025. We wouldn't call this a 'deep' downturn by any means, and as we noted in our recent Quarterly Economic Outlook, if a mild recession is the cost of transitioning the economy to a sustainable path, then it's probably a cost worth paying. The document includes a box on this, noting that this isn't your 'typical' recession caused by a global shock, it's a policy-induced recession required to get the economy back on an even keel. The unemployment rate is forecast to steadily lift to a peak of 5.7% in 2025 (5.0% previously)

See the graphical appendix on page 8 for more detail.

Market implications

Markets went into today's decision pricing in favour of a 75bp hike, and they got it. What they were unprepared for was the magnitude of the upgrade to the RBNZ's OCR track, which now peaks at 5.5%. That's not just a big step up from August's 4.1% peak; it is also way higher than markets were banking on going into the decision. Indeed, we put market expectations of where the OCR would peak at around 5.17% before the decision. The RBNZ's track is a technical projection, and it's not supposed to signal that policy is on a pre-set path, but if we try to back-solve what is implied at each decision by the track, it points to another 75bp hike in February, followed by 25bp hikes in April and May.

In terms of swap rates, the mechanical implication of the new, higher OCR track is that they need to go higher, and they have. But even from here, we see scope for further upside given the RBNZ's clearly resolute tone. We think the 2yr swap rate has scope to drift up to above 5½%, especially as we now see the OCR peaking at 5¾% next year.

FX markets responded well to the news, with the Kiwi spiking almost half a cent before retreating. We think this decision will ultimately be NZD supportive on the grounds that the RBNZ's track points to the OCR coming to rest above where markets expect the US Fed Funds rate to peak (markets are pricing in a 5.08% peak). Getting on top of inflation should also be positive for the NZD in that it should reduce the need for markets to price in an inflation discount to the real exchange rate. However, this decision will stoke recession fears, and that may weigh on the Kiwi.

Policy Assessment – Higher interest rates necessary

The Monetary Policy Committee today increased the Official Cash Rate (OCR) from 3.5 percent to 4.25 percent.

The Committee agreed that the OCR needs to reach a higher level, and sooner than previously indicated, to ensure inflation returns to within its target range over the medium term. Core consumer price inflation is too high, employment is beyond its maximum sustainable level, and near-term inflation expectations have risen.

Global consumer price inflation is broad based and remains heightened. Food and energy prices, and persistent core inflation, have combined to create very high headline inflation in many countries. Central banks are tightening monetary conditions in an effort to slow spending and reduce inflation pressure. The ongoing slowdown in global growth will affect New Zealand through both financial and trade channels, and impact on people's confidence due to uncertainty.

In New Zealand, household spending remains resilient, especially considering the rise in debt servicing costs, the fall in house prices, and low levels of consumer confidence. Employment levels are high, and income growth and household savings are supporting spending. The rebound in tourism is also supporting domestic demand.

The productive capacity of the economy is being constrained by broad-based labour shortages, and wage pressures are evident. Aggregate demand continues to outstrip New Zealand's capacity to supply goods and services, with a range of indicators continuing to signify broad-based inflation pressure.

Committee members agreed that monetary conditions needed to continue to tighten further, so as to be 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

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 it must continue to act decisively to return inflation to target and to fulfil its Remit.

The Committee discussed recent international economic developments. In many countries, elevated food and energy prices are contributing to high headline inflation, with high core inflation reflecting more broad based inflationary pressures. Most central banks have continued to tighten monetary conditions and to signal further interest rate increases in coming months. Financial market volatility remains high as central banks act to stem the rise in inflation in an environment of slowing and uncertain economic growth.

Expectations for global economic growth have declined further. For example, China's economy is facing headwinds emanating from the property sector, while measures to contain the spread of COVID-19 continue to cause production bottlenecks. The United States and Europe are, to varying degrees, experiencing the effects of high inflation, tighter financial conditions and associated economic uncertainty. The Committee agreed that the anticipated global growth slowdown will affect New Zealand through trade and financial channels, and increased economic uncertainty impacting on people's confidence.

The Committee observed that consumer price inflation in New Zealand in the September quarter was significantly stronger than expected. Measures of core inflation continued to rise and price pressures broadened. Survey measures and other high frequency data suggest that pricing pressure will be sustained over coming months. In addition, shorter term inflation expectations have increased as high inflation persists.

The Committee agreed that to achieve its Remit objectives, actual and expected inflation need to decline substantially. Members highlighted that the longer actual inflation remains above the target band, the more likely it is that higher inflation expectations become embedded.

The Committee discussed the labour market at length, given its importance in the current economic environment. Labour shortages remain a significant constraint on economic activity. Recent data highlight a material increase in employment, enabled by a strong lift in labour force participation to a record level. Measures of labour force utilisation are near record levels and firms continue to report severe difficulties finding labour.

High consumer price index (CPI) inflation and competition for workers are putting upward pressure on wages. The Committee observed that overall wage growth is not exceeding CPI inflation after accounting for productivity growth. While wage growth for people in the same job is generally not keeping pace with inflation, many people are changing jobs or increasing their hours worked to achieve real income growth. The Committee noted that public sector wage growth has lagged that in the private sector and agreed this lag represents an upside risk to wage pressure going forward.

The Committee observed the stronger than expected rebound in tourism since New Zealand's border reopened. Short-term visitor arrivals, international card spending data, and information gathered from recent business visits indicate that tourism spending will make a strong contribution to economic activity in coming months. However, some members noted that ongoing capacity constraints could, at some point, inhibit the tourism recovery and add to overall inflation pressures. In relation to New Zealand's goods exports, members observed that a lower New Zealand dollar is currently mitigating the impact of recent declines in international commodity prices.

The Committee discussed the recent Financial Stability Report and noted that the financial system remains resilient. In particular, members highlighted that recent stress tests demonstrate banks' resilience. The Committee was especially interested in the resilience of household balance sheets to scenarios of higher interest rates, reduced labour demand, and declining house prices. The Committee noted that while national house price indices have declined to mid-2021 levels, they are still above estimates of sustainable house prices and above levels that prevailed pre-COVID-19.

Household spending remains robust, especially considering the rise in debt servicing costs, the fall in house prices, and low levels of consumer confidence. Members observed that the large stock of household savings, in addition to income growth, may provide a buffer to support consumption now and in the future. However, members also noted that the ownership of savings is likely concentrated, leaving the majority of households exposed to high inflation and interest rates.

The Committee agreed that as debt servicing costs rise, spending decisions for many households will be increasingly constrained. These constraints would be most felt by recent home buyers with a high debt servicing commitment relative to their income. The Committee agreed that the impact of rising interest rates on households' spending and saving decisions is an important channel for monetary policy. In addition to constraining spending, higher interest rates also encourage saving and paying down of debt.

The Committee discussed domestic financial conditions, noting that wholesale interest rates have risen significantly since the August Statement, primarily due to higher-than-expected inflation in New Zealand and globally. Retail lending rates have also increased but remain lower than the levels wholesale rates might imply. Members observed that this reflects a combination of both the higher volume and the mix of current bank funding. Members noted that a gradual normalisation in bank funding conditions over the forecast period could result in sustained upward pressure on retail lending rates.

The Committee considered the economic projections. Members noted that a reduction in aggregate demand is projected to cause GDP in the New Zealand economy to temporarily contract by around 1% from 2023. Members noted that this reduction in aggregate demand was necessary to return inflation to target over the forecast period. Members agreed that the exact timing and extent of negative GDP growth was difficult to predict, but historical evidence suggests risks are skewed toward a likely short period of contraction. Members also agreed that the sooner supply and demand were better matched in the economy, the lower the overall cost of reducing inflation.

Members agreed that monetary policy primarily impacts on demand in the economy. However, any increase in the supply potential of the economy, such as through productivity improvements, would also assist in reducing inflation. However, members agreed that a significant increase in the economy's capacity to supply goods and services could not be relied on to reduce inflation pressures over the forecast horizon.

The Committee agreed that fiscal policy can also act to reduce demand in the economy. Members observed that in a higher inflation environment, a given level of government services would cost more to deliver. However, members noted that inflation would also lead to increased government revenues in nominal terms, potentially offsetting the rising cost of service delivery. On balance, members viewed the risks to inflation pressure from fiscal policies as skewed to the upside given the ongoing real demand for services.

The Committee received an update on the status of the Large Scale Asset Purchase (LSAP) portfolio and noted that sales of bonds in the LSAP portfolio to New Zealand Debt Management began in July. Members observed that the New Zealand government bond market continues to function normally under the current pace of LSAP sales and agreed to continue to evaluate this on an ongoing basis. The Committee agreed that the level of settlement cash balances is not a source of unexpected inflationary pressure and noted that overnight wholesale interest rates remain aligned to the OCR.

The Committee discussed the extent of additional monetary tightening required to achieve its Remit. Members agreed that the OCR needed to reach a level where the Committee could be confident it would reduce actual inflation to within the target range over the forecast horizon. Members agreed that this level had increased since the time of the August Statement due to the persistence of inflationary pressures resulting in a higher short-term nominal neutral interest rate.

The Committee discussed the size of the OCR increase to be delivered at this meeting. Increases of 50, 75 and 100 basis points were considered. The Committee discussed the relative merits of maintaining consistent increments in the OCR versus moving more quickly to reach the higher level of the OCR required. Members agreed that a larger increase in the OCR was appropriate, given the resilience of domestic spending, and the higher and more persistent actual and expected inflation outcomes.

The Committee gave consideration to an increase in the OCR of 75 or 100 basis points. On the balance of risks, the Committee agreed that a 75 basis point increase was appropriate at this meeting. Members highlighted that the cumulative tightening of monetary conditions delivered to date continues to pass through to the economy via the lagged transmission to effective retail interest rates.

On Wednesday 23 November, the Committee reached a consensus to increase the OCR from 3.5% to 4.25%.

Attendees:

Reserve Bank staff: Adrian Orr, Karen Silk, Christian Hawkesby, Paul Conway

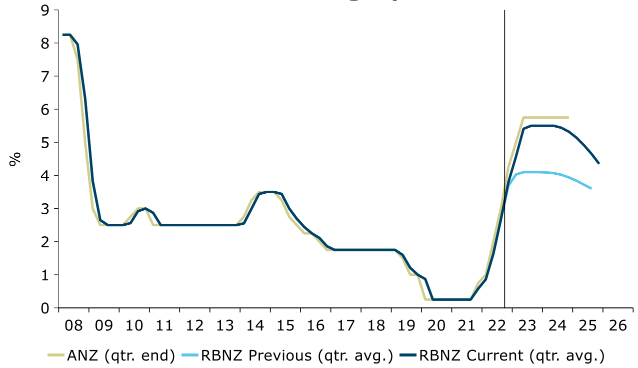
External: Bob Buckle, Peter Harris, Caroline Saunders

Treasury Observer: Dominick Stephens

Secretary: David Craigie

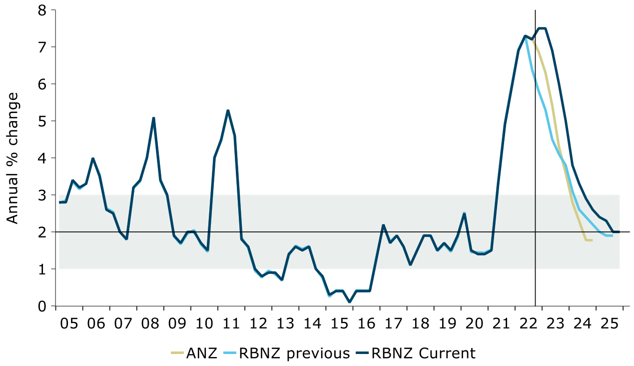
Key forecasts: More inflation less activity

The RBNZ are now forecasting a peak OCR of 5.5%...



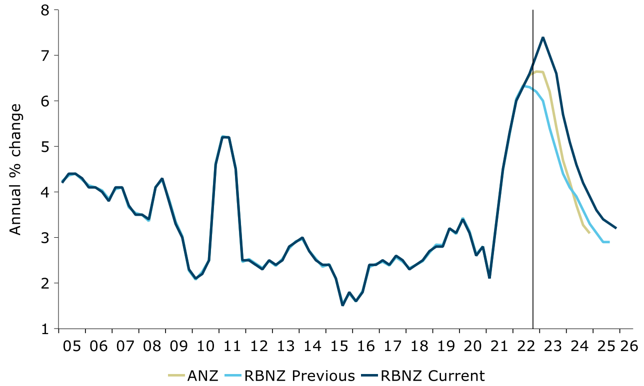
Source: RBNZ, Macrobond, ANZ Research

...and more inflation...

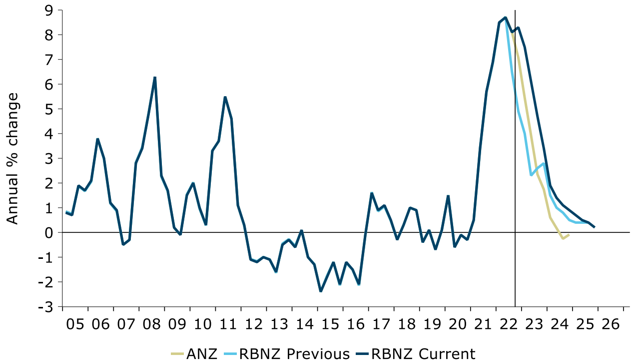


Source: RBNZ, Stats NZ, Macrobond, ANZ Research

...with a lot more non-tradable inflation...

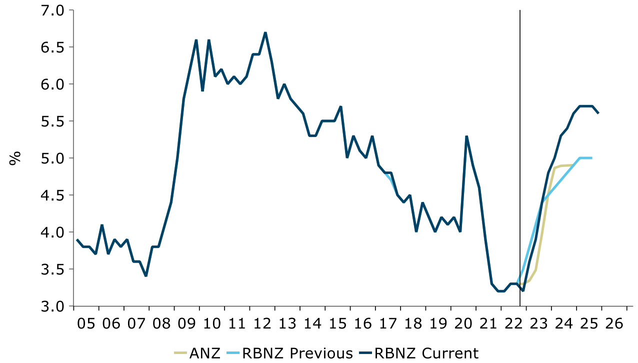


...and a touch more tradables



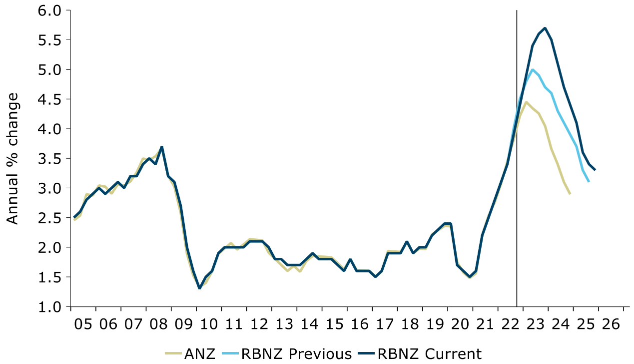
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The unemployment rate peaks at 5.7%...



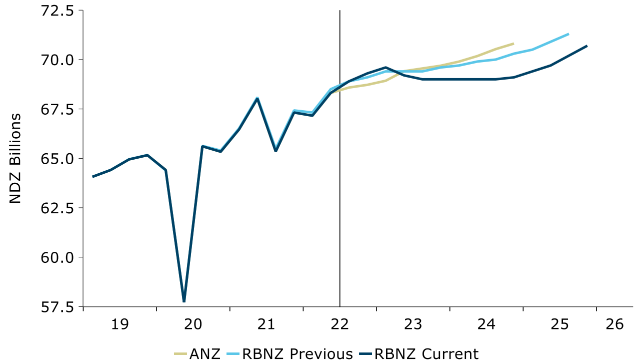
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

...but LCI wage growth is higher throughout the forecast



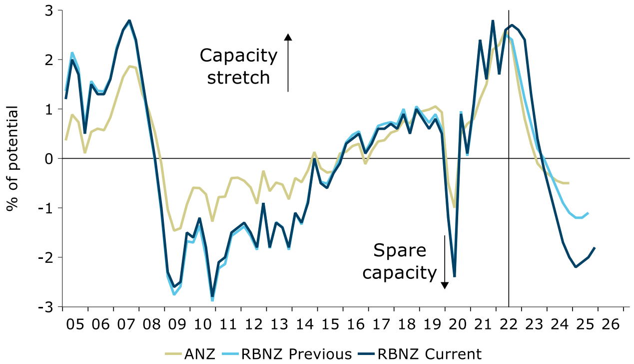
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The outlook for real GDP has been downgraded materially...



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

...which will help open up spare capacity (output gap)



Source: RBNZ, Macrobond, ANZ Research

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