13 April 2022

A Dovish Hike

- **RBNZ raises cash rate 50 basis points to 1.5%**
- **But states it is comfortable with Feb MPS rate track**
- **Implying terminal rate is 3.5% or less**
- **Market had priced a 4.0%+ terminal rate**
- **We make modest adjustments to our forecast rate track**

The world continues to get more bizarre by the day. We had never contemplated using the phrase a "dovish-hike" to describe a 50 basis points rate increase (the largest rate hike in 22 years!). But that is exactly what appears to be the case today.

We get the 50. The RBNZ simply decided it couldn't risk a slower move towards neutral. While we didn't have 50 pencilled in for this meeting, we did have one for the next. We see no need to change our May view given the clear message the Bank has given about where it wants rates to head near term. Moreover, the Bank, for all intents and purposes, acknowledged it was happy to follow market pricing for this meeting. With 46 basis points priced in for May, why would they do otherwise?

Hence, apart from incorporating the extra 25 bps from today's move, we have not changed our broader expectations thereafter. Following May's expected 50, we continue to expect 25 point increases in every meeting until the cash rate peaks at 3.0% in November, one meeting earlier than previously forecast.

Perhaps more importantly, the "Committee remained comfortable with the outlook for the OCR as outlined in their February Monetary Policy Statement". This, and the general tenor of the Review, leaves us with the feeling that the RBNZ does not believe the terminal cash rate should head any higher than it did when it produced its February missive. This is salient because the modelled peak in the RBNZ's interest rate track was 3.35%. In contrast, the market was pricing a peak approaching 4.25%. If the RBNZ is to be believed, this implies longer dated paper should rally and the curve flatten.

Committee "Members agreed that a larger rise in the OCR now is consistent with the forward path for interest rates outlined in their February Statement". It is technically correct to say this but a bit disingenuous. Given the 50 basis points move that has been delivered, maintaining

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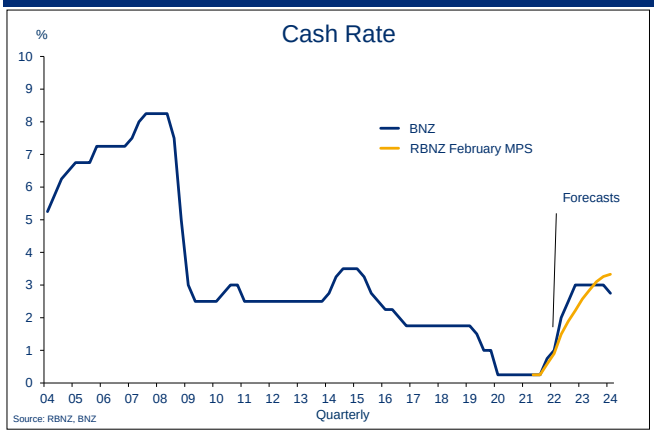

that consistency would also mean that the May increase should be just 25 basis points. This seems unlikely to be the Bank's central thinking given its urgency to get the cash rate above neutral, which it deems is around 2.0%.

Our interest rate track remains more aggressive than the central bank's in the near term. The RBNZ's February track implies pause(s) along the way. Ours does not. Our initially more aggressive track, and the fact that we believe the economy will struggle under the weight of rising interest rates, also sees us keeping our peak in the cash rate at 3.0%.

While we understand why the RBNZ has done what it has done, we are somewhat confused as to how it can justify its actions on a "least regrets basis" when uncertainty is so high. In its very short statement, the Bank referred to "the highly uncertain global economic environment", "an elevated level of uncertainty created by the persistent impacts of Covd-19", and "heightened global economic uncertainty". As we said in our previews, uncertainty does not seem consistent with aggression in a least regrets framework, as espoused by the Bank in an important policy framing speech last year.

We have long refuted the idea that Governor Orr should be boxed as a dove or a hawk. In our opinion he is an activist. While decisions are made by the Committee, not an individual, there are, nonetheless, signs of this activist intent in what was done today.

At least we can now look towards a suite of information that can help shape decisions around the next MPS. Amongst these are:

- indications of how the economy is performing as Covid restrictions are eased and borders open;
- further business and consumer confidence measures;
- more news on the extent of the housing market downturn;
- the March quarter CPI released on April 21;
- the May 4 labour market reports;
- the May 19, 2022 Budget that will indicate the degree of future fiscal stimulus; and
- we may even get greater confidence in how the Russia-Ukraine war is likely to pan out.

This is all very interesting but the biggest question of all is still unrelated to these data. The concern that dominates is: no matter what central banks do, do they have the right toolkit to deal with a massive negative supply shock. Arguably they didn't do so well through the deflationary period associated with positive supply shocks. Will they fare any better on the flip side?

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The full text of today's RBNZ OCR Review –

The Monetary Policy Committee today increased the Official Cash Rate (OCR) to 1.50 percent. The Committee agreed it is appropriate to continue to tighten monetary conditions at pace to best maintain price stability and support maximum sustainable employment.

The Committee remained comfortable with the outlook for the OCR as outlined in their February Monetary Policy Statement. They agreed that moving the OCR to a more neutral stance sooner will reduce the risks of rising inflation expectations. A larger move now also provides more policy flexibility ahead in light of the highly uncertain global economic environment.

The level of global economic activity continues to generate rising inflation pressures, exacerbated by ongoing supply disruptions in large part driven by COVID-19. The Russian invasion of Ukraine has significantly added to these supply disruptions, causing prices to spike in internationally traded commodities and energy.

However, the pace of global economic activity continues to slow. There is an elevated level of uncertainty created by the persistent impacts of COVID-19, and clear signals that monetary and broader financial conditions will tighten over the course of 2022. Added to this is the high level of geopolitical tension and related economic sanctions on Russia.

In New Zealand, underlying strength remains in the economy, supported by sound balance sheets, continued fiscal support, and strong export earnings. There has been some economic disruption due to the outbreak of Omicron. However, the high vaccination rates across New Zealand are assisting to reduce this disruption.

Heightened global economic uncertainty and inflation are dampening consumer confidence. The rise in mortgage interest rates – amongst other factors – have acted to reduce mortgage demand and house prices. However, economic capacity pressures remain, with a broad range of indicators highlighting domestic capacity constraints and ongoing inflation pressures. Employment is above its maximum sustainable level and labour shortages are impacting many businesses.

The Reserve Bank's core inflation measures are at or above 3 percent. Inflationary pressure is being further accentuated by current high imported energy and commodity prices, which are lifting headline CPI inflation. The Committee will remain focused on ensuring that current high consumer price inflation does not become embedded into longer-term inflation expectations.

Summary Record of Meeting

The Monetary Policy Committee discussed developments affecting the outlook for monetary policy.

It was noted that global consumer price inflation is high, well above most central banks' targets. This general inflation pressure is due to the recent recovery in global demand running up against severe supply shortages and trade disruption. The economic disruption caused by COVID-19 has been exacerbated by rising energy and food prices resulting from the Russian invasion of Ukraine

The full text of today's RBNZ OCR Review – cont'd

The Committee noted that global economic growth is slowing, given supply constraints, consumer price pressures cutting into real incomes, and heightened geopolitical tensions causing investment uncertainty. Central banks globally are also tightening, or looking to tighten, their monetary policy stances over 2022, in an effort to constrain consumer price inflation expectations consistent with their policy targets.

Members observed that financial conditions have tightened in New Zealand, with higher interest rates, a stronger New Zealand dollar exchange rate, and lower asset prices.

It was noted that mortgage interest rates have risen broadly consistent with the outlook for the Official Cash Rate (OCR) in the Reserve Bank's February Monetary Policy Statement. The Committee noted that the higher New Zealand dollar against trading-partner currencies has assisted to partly offset higher import prices for local consumers.

In discussing the underlying influences on higher domestic inflation, the Committee agreed that both international and domestic factors were important.

Headline inflation is rising largely as a result of disrupted supply chains and higher world commodity prices. These higher commodity prices are increasing both imported inflation and also the incomes of some New Zealand exporters. Domestic demand pressures, relative to supply capacity, are also pushing New Zealand's core inflation above the Bank's 1 to 3 percent target range.

Capacity pressures are apparent across a wide range of domestic indicators. In particular labour shortages remain heightened, impinging on domestic economic output. Nominal wages are rising in response to these shortages, as would be expected. However, the increasing cost of living is putting pressure on household budgets. Consumer confidence has been declining as domestic price pressures are outpacing nominal household income growth.

The Committee discussed the outlook for labour supply with the reopening of New Zealand's international border underway. Members agreed that while the medium-term outlook is for ongoing net inward migration, as is the historical norm, this level would take some time to rebuild. Near-term indicators highlight that New Zealanders are currently leaving in larger numbers than visitors are arriving, as the border is opened in stages. The Committee noted that net immigration is assumed to increase only slowly, eventually leading to a gradual easing in skill shortages.

House prices have fallen from their recent high levels. The Committee viewed this as a sign that house prices are moving towards a more sustainable level. Home building intentions remain at record levels, which will assist this adjustment. However, construction activity faces challenges, including access to land, rising building costs, ongoing supply chain bottlenecks, and limited access to labour. The construction sector is operating around peak capacity.

Members noted that inflation is above target and employment is above its maximum sustainable level. As such, the Committee confirmed that further increases in the OCR are needed in order to meet their mandate.

The Committee discussed the pace and extent to which the OCR needs to rise in order to meet their inflation and employment mandate.

Members noted that annual consumer price inflation is expected to peak around 7 percent in the first half of 2022. The risk of more persistent high inflation expectations has increased. The Committee agreed that their policy 'path of least regret' is to increase the OCR by more now, rather than later, to head off rising inflation expectations and minimise any unnecessary volatility in output, interest rates, and the exchange rate in the future. The Committee agreed to a 50 basis point rise in the OCR, consistent with this least regrets analysis.

The Committee noted that the OCR is stimulatory at its current level. Members agreed that a larger rise in the OCR now is consistent with the forward path for interest rates outlined in their February Statement. Members also agreed that this 'stitch in time' approach is consistent with near-term financial market pricing.

On Wednesday 13 April, the Committee reached a consensus to increase the OCR to 1.50 percent.

The full text of today's RBNZ OCR Review – cont'd

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