RESEARCH

Economy Watch

17 August 2022

RBNZ Committed To Inflation's Death

- **RBNZ hikes OCR 50 basis points to 3.0%**
- **Signals two more to come**
- **We see no reason to doubt them**
- **Cash rate to peak at 4.0%**
- **As recession probability rises**

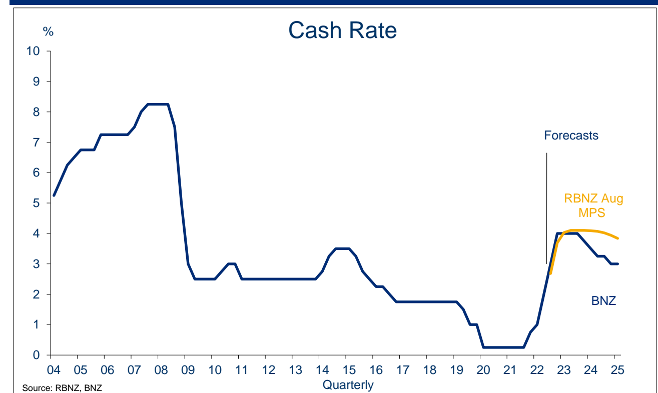
The RBNZ has decided it wants to put the nail in the coffin of inflation. It senses that the battle has nearly been won but is terrified that inflation might sneak away if given the slightest chance. Consequently, not only did it raise its cash rate by 50 basis points to 3.0% today but it also appeared to cement in a further 50 point rise in October and a very strong likelihood of yet another 50 points in November. Thereafter, it becomes a line ball call whether rates need to move any further, though the Bank sees the balance of risk being one last hike to cap things off.

We, along with everyone else, had expected the Reserve Bank to announce today's hike. We had also expected the peak in the RBNZ's cash rate track to be around 4.0% (it is, albeit 4.1% now compared to 3.9% in May). We were also looking for guidance to push our expected cash rate increase in October to 50 (from 25), which we have now done. But what we weren't expecting was a green light for the extra 50 in November, which we now concede to.

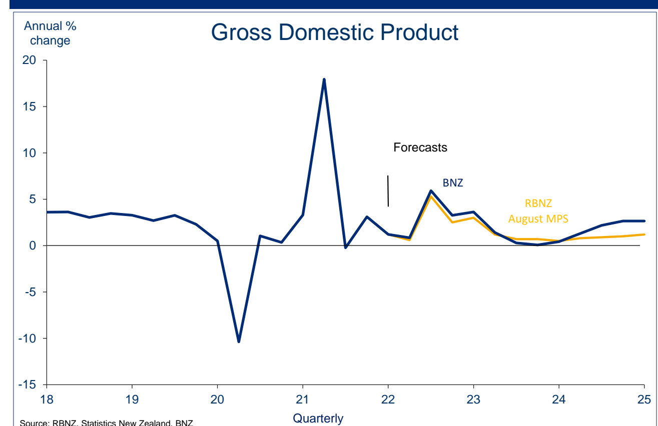
In hindsight, perhaps we should have worked this out. It's a long wait between November and the February 2023 meeting so what the Bank will have done, if it follows through with its published rate track, is grant itself time to see the impact of its actions on the economy before having to make any further decision. In our view 4.0% will be the peak in rates, as we believe the Reserve Bank's actions are almost guaranteeing a recession, its requisite pick up in the unemployment rate and the required drop in inflation. Indeed, we believe that Governor Orr thinks likewise given his press conference comment that the OCR at 4.0% is unambiguously above neutral and that getting the OCR to 4.0% would "buy the MPC some comfort". Reading between the lines we think that, at this stage, the MPC thinks that 4.0% would be enough to achieve its objectives.

The RBNZ will be quick to note that a recession is not its central forecast. But it is projecting zero growth in the June quarter 2023 and 0.1% in September followed by 0.2% in each of the next four quarters. This would be a wonderfully controlled slowdown were it to be proven correct. And, ironically, while the Bank won't use the word recession its medium term growth profile is actually weaker than our own.

Peaking at 4.0%?



No recession?!



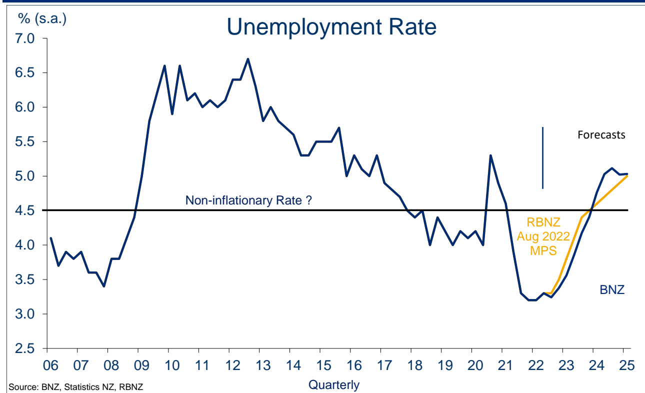
Whichever way you look at it, the RBNZ now projects activity to be lower than was previously the case aided largely by a sharp downward revision to its residential investment forecasts, which accompany a weaker house price projection.

With weaker growth also comes a weaker employment profile and, in turn, more rapidly rising unemployment. The RBNZ now forecasts the unemployment rate to be at its non-inflationary rate in September 2023.

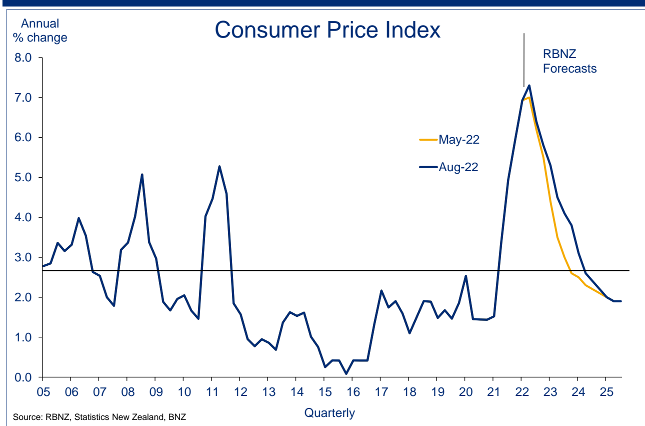
With the labour market weaker, growth weaker and the housing market weaker it thus seems a little incongruous that the RBNZ's CPI inflation forecasts have not been lowered, especially given that commodity prices are declining aggressively and global growth expectations have

fallen. It would appear the RBNZ has been spooked by the degree of wage inflation in the economy and the potential for elevated core inflation to keep overall CPI elevated.

Labour market on track



Inflation headed lower

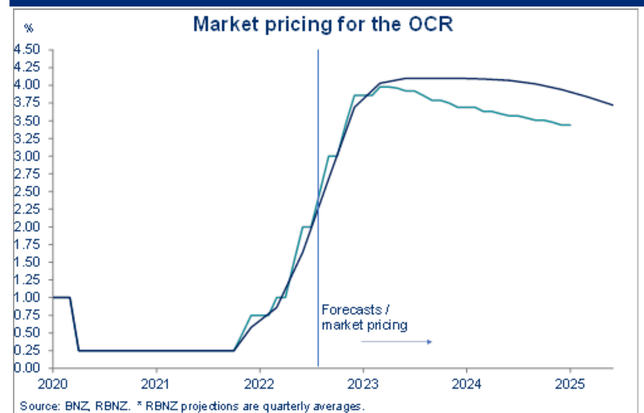


We had wondered whether the RBNZ would place more weight on the medium term downside to inflation from the softening labour market or the more immediate starting point surprises in inflation. Our questions appear to have been answered, the short term inflation surprises have won the day.

Of course, it's not only interest rates that define overall monetary conditions. So too does the Large Scale Asset Purchase Programme (LSAP) and the Funding For Lending Programme (FLP). The LSAP is in the process of being reversed but the FLP doesn't expire until December. The RBNZ has said it has an obligation to continue this programme through until the end of the year because that's what it told the banking sector it would do. We recognise that commitment. Nonetheless, it was interesting to see the Committee seemingly indicate that the OCR is probably higher than it would otherwise be had the FLP not been in place. The fact that the FLP expires in December might be further reason to pause in the rate hike process, over the festive season, and the effective tightening the FLP removal will entail may also help confirm the end to the tightening cycle.

Overall the "Committee agreed that domestic inflationary pressures had increased since May". We beg to differ on this front. Inflation has certainly increased but relative to past expectations we believe inflationary pressures have moderated since May, as evidenced by the Bank's own reduced demand forecasts and international developments. Be that as it may, Governor Orr in his "post-match" press conference stated that the Bank "is in a strong position to get on top of inflation". We couldn't agree more. It went earlier than most, and monetary settings are now definitively tight. Despite believing the Bank does not need to go as hard as it says it will, we have no beef with the idea that its actions will achieve its objectives and, after all, that is, ultimately, what the Bank should be judged on.

Market rate cut expectations overdone



From a market perspective there was nothing in today's RBNZ statement to get excited about so, not surprisingly, there was very little sustained movement in yields or the currency. That said, the market is still keen to price in relatively early rate cuts, which the RBNZ has clearly disavowed. We think cuts are likely to be quicker than the Bank assumes because we do think the economic response will be more aggressive than its central view. But our expectation is much closer to the Bank's than market pricing.

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Full text of today's RBNZ OCR Review:

The Monetary Policy Committee today increased the Official Cash Rate (OCR) to 3 percent from 2.5 percent. The Committee agreed it remains appropriate to continue to tighten monetary conditions at pace to maintain price stability and contribute to maximum sustainable employment. Core consumer price inflation remains too high and labour resources remain scarce.

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

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

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

Committee members agreed that monetary conditions needed to continue to tighten until they are confident there is sufficient restraint on spending to bring inflation back within its 1-3 percent per annum target range. The Committee remains resolute in achieving the Monetary Policy Remit.

Summary Record of Meeting – August 2022

The Monetary Policy Committee discussed developments affecting the outlook for inflation and employment in New Zealand. Consumer price inflation is currently too high and labour remains scarce. The Committee agreed to continue increasing the Official Cash Rate (OCR) at pace to achieve price stability and to support maximum sustainable employment. The Committee is resolute in its commitment to ensure consumer price inflation returns to within the 1 to 3 percent target range.

The Committee judged that the global economic outlook has weakened since May, reflecting tightening financial conditions, ongoing geopolitical tensions, and continued disruption to global supply of goods and services. The war in Ukraine has put upward pressure on global commodity prices, especially oil and food, and disrupted global trade. Lockdowns in some Chinese cities to combat the spread of COVID-19 has contributed to supply-chain bottlenecks and shipping times and costs remain elevated.

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

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

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

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

Production capacity pressures remain. In particular, labour shortages are a major constraint on business activity. Wage growth has continued to pick up in line with tightness in the labour market, and there is some evidence from discussions with businesses that firms are increasing wages more frequently. However, hourly wage rates are rising

more slowly than inflation. The Committee was encouraged by recent declines in survey measures of inflation expectations, but remains alert to the risk of a more pronounced change in wage and price setting behaviour.

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

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

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

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

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

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

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

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

The Committee agreed that domestic inflationary pressures had increased since May and to further bring forward the timing of OCR increases. The Committee agreed to continue increasing the OCR until it is confident that monetary conditions are sufficient to maintain expectations of low inflation in the longer term and bring consumer price inflation to within the target range. The Committee viewed this strategy as consistent with achieving their primary inflation and employment objectives without causing unnecessary instability in output, interest rates and the exchange rate.

On Wednesday 17 August, the Committee reached a consensus to increase the OCR to 3 percent from 2.5 percent.

Attendees:
Reserve Bank staff: Adrian Orr, Karen Silk, Christian Hawkesby, Adam Richardson
External: Bob Buckle, Peter Harris, Caroline Saunders
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