Scotiabank

GLOBAL ECONOMICS

FLASH REPORT

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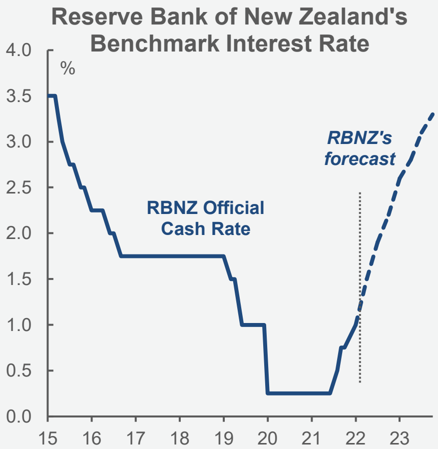
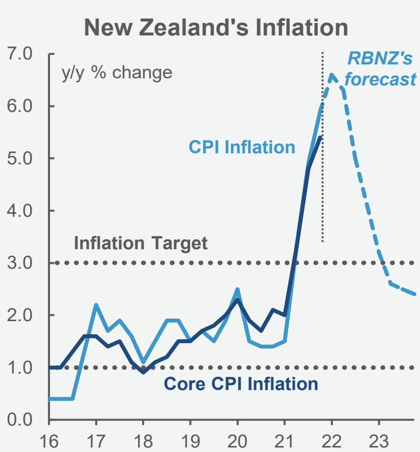
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Reserve Bank of New Zealand Raises Policy Rate Again

- **The Reserve Bank of New Zealand raised the Official Cash Rate by 25 basis points to 1.0%, marking the third hike in the current cycle. The central bank also announced that it will begin quantitative tightening in July.**
- **The New Zealand economy is performing strongly, causing notable tightness in labour and capital resources. Resulting inflationary pressures warrant faster monetary tightening through 2023.**

The Reserve Bank of New Zealand's (RBNZ) Monetary Policy Committee raised the Official Cash Rate (OCR) by 25 basis points to 1.0%—its pre-pandemic level—following the February 23 policy meeting (chart 1). Prior to this move, the central bank had lifted the policy rate by the same magnitude last October and November. The Committee also announced that the RBNZ's bond holdings under the Large Scale Asset Purchase programme will be gradually reduced through both bond maturities and managed sales, which may put some upward pressure on longer-term rates. The planned quantitative tightening of NZD5 bn per fiscal year will commence in July 2022.

Given strong inflation and tightness in the labour market, the RBNZ sees that further monetary tightening is needed. In fact, policymakers had a "finely balanced" discussion regarding the appropriate size of the rate increase (25 bps vs. 50 bps); while they opted for the 25 bps hike due to uncertainties related to the Omicron variant, the debate highlights the central bank's concerns about the economy running hot. The RBNZ revised its forecasts for the OCR up, foreseeing the policy rate to reach 3.25% by the end of 2023 (vs. 2.5% in the November projection). The next monetary policy decision is scheduled for April 13, when the OCR will likely be raised again by 25 bps to 1.25%. We expect the benchmark rate to be increased at each of the remaining six policy meetings in 2022, taking the OCR to 2.50% by the end of the year.

New Zealand's economy is performing strongly on the back of low interest rates, solid balance sheets of households and businesses, supportive fiscal policy, as well as high demand and elevated prices for the nation's exports. With the economy's activity being above its potential, pressure on available labour and capital resources is intensifying. Indeed, the RBNZ assesses that employment is above its maximum sustainable level. The country's unemployment rate—at 3.2% in Q4 2021—is at its lowest level on record and wage inflation is accelerating as firms are competing for workers. The labour cost index increased by 2.6% y/y in Q4 and is expected to show further acceleration through 2022. Another indicator, the country's average weekly wages, showed remuneration increasing by 5.7% y/y in Q4. While the central bank assesses that labour market tightness will peak in the first half of 2022, it expects net inward migration to increase (only) gradually over coming years as border restrictions are eased.

Inflationary pressures in New Zealand have continued to pick up, with the consumer price index rising by 5.9% y/y in Q4 (chart 2). Core inflation accelerated to 5.4% y/y in Q4. The RBNZ forecasts headline inflation to peak at 6.6% y/y in the current quarter before returning to the inflation target of 1–3% by mid-2023. Price pressures in New Zealand reflect both domestic and external factors, such as higher wage gains, rising capacity pressures, elevated inflation expectations, as well as global supply chain bottlenecks. The RBNZ notes that inflation risks continue to be skewed to the upside. We generally agree with the RBNZ's assessment of the economy and note that frontloading of interest rate hikes is needed to contain inflationary pressures. Nonetheless, we highlight that the outlook is surrounded by substantial uncertainties stemming from domestic and external developments. Indeed, we will closely monitor the domestic housing market, geopolitical tensions in Europe, and the evolving COVID–19 situation.

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