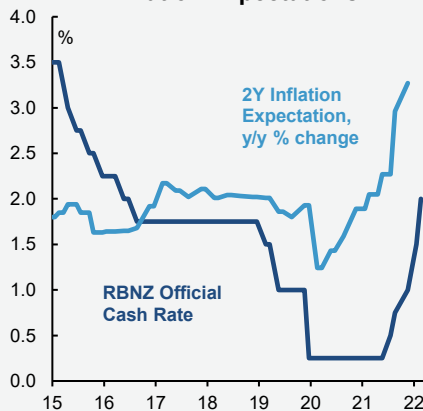


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Chart 1

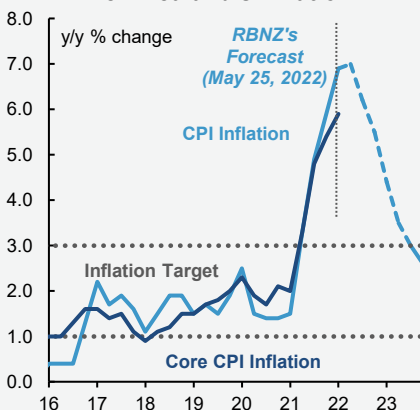
Benchmark Interest Rate and Inflation Expectations



Sources: Scotiabank Economics, Bloomberg.

Chart 2

New Zealand's Inflation



Sources: Scotiabank Economics, RBNZ, Bloomberg.

New Zealand's Benchmark Interest Rate to be Raised More and Sooner to Curb Inflation

- The Reserve Bank of New Zealand raised the Official Cash Rate by 50 basis points to 2.0% and pointed to swift monetary tightening ahead.
- Stabilizing inflation is the central bank's priority as rising inflation expectations risk triggering persistent price pressures.
- The central bank expects the policy rate to reach 3.4% by the end of the year; we foresee another 50 bps increase in July, followed by a more gradual hiking path through the rest of the year.

The Reserve Bank of New Zealand's (RBNZ) Monetary Policy Committee increased the Official Cash Rate (OCR) by 50 basis points to 2.00% following the May 25 policy meeting (chart 1), in line with expectations. The RBNZ has raised the benchmark interest rate by a total of 175 bps since the beginning of the hiking cycle in October 2021, and more rate increases are in sight. The Committee highlighted that monetary conditions need to be tightened "more and sooner" to meet the central bank's goals of price stability and maximum sustainable employment. Moreover, the RBNZ sees that hiking more aggressively now builds policy buffers for the future given global economic uncertainties.

The RBNZ published an updated Monetary Policy Statement today and revised the forecast for the OCR notably higher. It foresees the key rate reaching 3.4% by the end of this year vs. the February projection of 2.2%. The policy rate is expected to rise further in the first half of 2023, reaching the cyclical peak of 3.9% by June. In contrast, the RBNZ's February assessment depicted the OCR reaching a peak of 3.4% in Q3 2024. The main driver of the RBNZ's shift to a more aggressive monetary tightening trajectory is the country's inflation outlook. Indeed, RBNZ Governor Adrian Orr noted that in the context of rising inflation expectations and the risk of inflation becoming persistent, "we have to risk doing too much too soon, rather than risk doing too little too late". Accordingly, we assess that another 50 bps hike will be implemented in July.

New Zealand's inflation has been accelerating notably and is exceeding the RBNZ's 1–3% inflation target by a significant margin (chart 2). Headline prices rose 6.9% y/y in Q1 following a 5.9% gain in Q4 2021. Price pressures have intensified also at the core level, with the CPI excluding food, household energy, and vehicle fuels increasing by 5.9% y/y in Q1. Prices are rising rapidly on the back of an even contribution of imported inflationary pressures—caused by global commodity prices and supply chain bottlenecks—and domestic price pressures. According to the central bank, tight labour market conditions and associated wage gains, as well as rising housing-related costs are the key sources of domestic inflation. We expect inflation to remain elevated in the medium-term. Tighter monetary conditions and some cooling in economic activity will allow demand-driven price pressures to start easing in the second half of the year, with headline inflation forecasted to close 2022 at slightly above 5% y/y.

New Zealand's economy is still performing strongly on the back of solid balance sheets of households and businesses, supportive fiscal policy, as well as elevated prices for the nation's exports. Nevertheless, economic activity is expected to soften somewhat due to global uncertainties, weaker consumer confidence, elevated inflation that is dampening consumers' spending power, rising interest rates, and lower house prices. We expect New Zealand's real GDP to grow by around 3% in 2022 following a 5.4% gain last year. Such cooling is welcome, as the RBNZ assesses that employment is currently above its maximum sustainable level. The economy is facing labour shortages, with access to labour being the key constraint on firms' productive capacity. Accordingly, wage inflation is expected to accelerate further from the 5.3% y/y pace recorded in Q1.

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