



More tightening needed

Release Date: 23 February 2022

The Monetary Policy Committee today increased the Official Cash Rate (OCR) to 1 percent. The Committee also agreed to commence the gradual reduction of the Reserve Bank's bond holdings under the Large Scale Asset Purchase (LSAP) programme - through both bond maturities and managed sales.

The Committee agreed it remains appropriate to continue reducing monetary stimulus so as to maintain price stability and support maximum sustainable employment.

The level of global economic activity is generating rising inflation pressures, exacerbated by ongoing supply disruptions. The pace of global economic growth has slowed however, due to the general elevated uncertainty created by the persistent impacts of COVID-19, and clear signals that monetary conditions will tighten over the course of 2022.

In New Zealand, underlying economic strength remains in the economy, supported by aggregate household and business balance sheet strength, fiscal policy support, and continued strong export returns. However, some short-term economic disruption is expected given the current growing COVID-19 health challenge. The high vaccination rates across New Zealand will assist significantly to reduce this disruption.

Economic capacity pressures have continued to tighten. Employment is now above its maximum sustainable level, with a broad range of economic indicators highlighting that the New Zealand economy continues to perform above its current potential.



Headline CPI inflation is well above the Reserve Bank's target range, but will return towards the 2 percent midpoint over coming years. The near-term rise in inflation is accentuated by higher oil prices, rising transport costs, and the impact of supply shortfalls. These immediate relative price movements risk generating more generalised price rises, especially given the current domestic capacity constraints.

The Committee agreed that further removal of monetary policy stimulus is expected over time given the medium-term outlook for growth and employment, and the upside risks to inflation.

More information:

- [Download the February 2022 Monetary Policy Statement \(PDF 7.3MB\)](#)

Summary Record of Meeting

The Monetary Policy Committee discussed developments affecting the outlook for monetary policy. Global economic activity experienced a robust recovery in 2021. The pace of growth is expected to slow, weighed down by resource and production constraints.

Global inflation is expected to peak during 2022 and then moderate, as supply disruptions are gradually resolved. However, global inflation is currently higher, and expected to ease more gradually than anticipated in the November *Statement*.

The Committee noted that central banks are now looking to increase interest rates sooner and by more than anticipated in the November *Statement*. The rise in global interest rates has resulted in a fall in the New Zealand dollar, as



interest rate differentials have narrowed. Bond and equity prices have been more volatile of late, in part due to the shift in monetary policy expectations and a rise in geopolitical tensions. The Committee noted that asset valuations had been boosted by very low interest rates, and that higher interest rates may dampen these valuations in future.

The New Zealand economy has been resilient in the face of the COVID-19 pandemic to date. Export prices have remained high, supported by the solid international economic recovery. Domestic spending and investment have also been robust. However, conditions have been very difficult for some businesses, especially in service industries.

The recent emergence and spread of the Omicron COVID-19 variant is expected to further disrupt economic activity in the near term. People's ability and willingness to work and spend will be strongly determined by near-term health outcomes.

The Committee reconfirmed that house prices in New Zealand are above their sustainable level, but are expected to ease over time. They noted that house prices had begun to ease, with monthly falls in December and January.

Mortgage lending growth has also slowed. Government regulatory and tax policy changes, and high rates of residential building are expected to slow house prices. Higher mortgage interest rates will also play a role in the transition of house prices toward a more sustainable level over coming years.

Resource constraints are evident in the economy, and will be exacerbated by further disruptions from the Omicron outbreak. Employment is above its maximum sustainable level. The Committee noted that there has been some



upward pressure on nominal wages, as expected, consistent with the tight labour market. They also noted that wage growth continues to lag CPI inflation.

The Committee discussed the outlook for net migration to New Zealand with the international borders being reopened in stages over coming months. The impact on labour supply is uncertain in the near term, but a positive inflow is expected over time as border flows return to normal. The Committee noted that net migration is assumed to increase slowly, helping to gradually ease skill shortages.

Annual CPI inflation has increased largely as expected in the November *Statement*, reflecting domestic capacity constraints and higher prices for imported goods, in particular oil. The Committee noted that annual inflation is expected to peak in early-2022, and then ease over the course of the year, returning to within their target range in mid-2023. The Committee agreed that further removal of monetary stimulus is necessary to achieve their Remit.

The OCR remains the Committee's preferred tool for implementing monetary policy, and the impact of additional monetary policy tools is considered when determining the level of the OCR. With regards to the latter, members noted that the Funding for Lending Programme (FLP) window closes this year. They also noted that the cost of bank funding from the FLP is rising in line with the OCR.

The Large Scale Asset Purchase (LSAP) programme was introduced in March 2020, providing significant stimulus and supporting the functioning of the bond market. Purchases under the programme were halted in July 2021.

The Committee agreed that managing down the Bank's holdings of these bonds was now consistent with their monetary policy objectives. Members also agreed



that managed sales of bond holdings, in addition to not investing the proceeds of maturities, was most consistent with achieving their mandate over time (further details below).

The Committee discussed the extent of monetary tightening required to meet their price stability and maximum sustainable employment mandate. In doing so, the Committee applied their least regrets framework, noting that the most significant risk to be avoided at present was longer-term inflation expectations rising above the target and becoming embedded in future price setting.

It was agreed that more monetary tightening was needed than signalled in the November *Statement*. The Committee confirmed that the outlook for a higher OCR at the end of the projection horizon was a balanced reflection of the likely path of interest rates.

The pace at which monetary stimulus should be reduced was discussed by the Committee. Members agreed there were many factors to assess, balancing the need to reduce monetary stimulus with many uncertainties. They considered the balance of risks and noted that the behavioural responses of household and businesses in the face of higher interest rates would be important for the appropriate pace of tightening.

The Committee agreed that while higher interest rates are necessary, households and firms may have become more sensitive to interest rate changes as their debt levels have risen. Members also noted that a significant proportion of mortgages will be reset at higher interest rates over calendar 2022.

The current Omicron outbreak will lead to economic disruption and may weigh on consumer and investor confidence in the near term. Health outcomes will be



important, in particular how these impact the supply capacity of the economy and level of demand.

While government spending and investment remains strong, the impulse to growth from fiscal support is now ebbing and will wane.

The recent signs of slowing in demand for housing was discussed by the Committee, which noted that house prices may fall further. The Committee agreed that higher interest rates were consistent with house prices becoming more sustainable. They also noted the Bank's recent policy adjustments to support the stability of the financial system, including tightening of loan-to-value ratio restrictions last year and ongoing changes to improve the capital adequacy of banks. The Committee acknowledged that some recent, more highly-leveraged, borrowers may be financially stretched in a higher interest rate environment.

When deciding whether to move the OCR up by 25 or 50 basis points, many members saw this as a finely balanced decision.

When considering the case for a 50 basis point increase, the Committee noted the high starting point for inflation and the drift upwards in measures of inflation expectations. The Committee agreed that maintaining stable longer-term inflation expectations near the mid-point of their target would greatly assist their purpose.

When considering the case for a 25 basis point increase, members noted that interest rates had already increased significantly late last year, and are expected to continue rising as the OCR is progressively increased. They also noted that conditional on the outlook, the OCR is expected to peak at a higher level than assumed at the November *Statement*. In addition, sales of the Bank's LSAP bond



holdings may put some upward pressure on longer-term interest rates.

Members of the Committee were conscious of broader uncertainty in the midst of the current Omicron wave.

Weighing the options, the Committee came to a consensus to increase the OCR by 25 basis points. The Committee also affirmed that it was willing to move the OCR in larger increments if required over coming quarters.

On Wednesday 23 February, the Committee reached a consensus to:

- Increase the OCR to 1 percent.
- Not reinvest the proceeds of any upcoming LSAP bond maturities.
- In addition, direct the Reserve Bank to sell nominal New Zealand Government Bonds and Inflation-indexed New Zealand Government Bonds to New Zealand Debt Management at a rate of \$5 billion per fiscal year, commencing in July 2022, provided it remained consistent with the Bank's monetary policy objectives, and subject to market conditions.
- Hold the Local Government Funding Agency bonds until maturity.

Attendees:

Reserve Bank staff: Adrian Orr, Christian Hawkesby, Yuong Ha

External: Bob Buckle, Peter Harris, Caroline Saunders

Observer: Bryan Chapple

Secretary: Elizabeth Kendal



The Committee discussed options for gradually managing down the size of the LSAP portfolio, guided by its principles for monetary policy tools (see Chapter 2, Box B). The Committee agreed that gradual reduction in the LSAP portfolio should seek to achieve three objectives:

- Have minimal impact on monetary stimulus – the bond holdings will not be actively used to remove monetary stimulus;
- Avoid harming the efficient functioning of financial markets which is essential for the functioning of the economy and the transmission of monetary policy; and
- Ensure that the MPC have the capacity to use the LSAP tool effectively, if economic and financial conditions deteriorate.

Reducing bond holdings will provide the Committee more scope to use LSAPs in the future and will support the management of liquidity in the financial system. Some members noted that some longer-term interest rates may change as the market analyses the net effect on bond supply. However, bond holdings will be gradually reduced to minimise unnecessary volatility in interest rates, consistent with the Committee's Remit.

The Committee considered whether selling bonds back into the secondary market would be appropriate and noted that selling bonds to New Zealand Debt Management (NZDM) would be the most efficient approach, providing the market with clarity around net bond supply.

The Committee agreed not to reinvest the proceeds of any upcoming bond maturities and directed the Reserve Bank to sell the nominal New Zealand Government Bonds and Inflation-indexed New Zealand Government Bonds to NZDM at a rate of \$5 billion per fiscal year. The Committee agreed to hold the



Local Government Funding Agency Bonds until maturity, as the holdings of these bonds are comparatively small.

This pace of sales would continue provided it remained consistent with the Reserve Bank's monetary policy objectives, and subject to market conditions. The Committee reserves the right to change the rate of sales or halt sales should conditions change, but do not foresee such changes to be common. The Reserve Bank intends to commence bonds sales in July following further consultation with the NZDM, and will issue a market announcement in coming months outlining operational details prior to commencement.

In accordance with the LSAP indemnity, staff consulted the NZDM on a range of options for reducing the LSAP portfolio. The Committee's decision to sell bonds back to the NZDM will have implications for the NZDM's funding programme and the NZDM will provide updated issuance guidance at the Budget in May.

Members noted that the bond holdings would continue to provide a small amount of ongoing marginal monetary stimulus, which would gradually reduce over time as bonds holdings are reduced. Members reiterated that the OCR remains the most effective and efficient way of adjusting monetary stimulus in either direction. Therefore, the stance of monetary policy will continue to be communicated primarily via changes to the OCR and conditional forward guidance through the published OCR track.