Preston Rowe Paterson
International Property Consultants and Valuers

Higher Interest Rates Necessary

Release Date: 23 November 2022

The Monetary Policy Committee today increased the Official Cash Rate (OCR) from 3.5 percent to 4.25 percent.

The Committee agreed that the OCR needs to reach a higher level, and sooner than previously indicated, to ensure inflation returns to within its target range over the medium-term. Core consumer price inflation is too high, employment is beyond its maximum sustainable level, and near-term inflation expectations have risen.

Global consumer price inflation is broad based and remains heightened. Food and energy prices, and persistent core inflation, have combined to create very high headline inflation in many countries. Central banks are tightening monetary conditions in an effort to slow spending and reduce inflation pressure. The ongoing slowdown in global growth will affect New Zealand through both financial and trade channels, and impact on people's confidence due to uncertainty.

In New Zealand, household spending remains resilient, especially considering the rise in debt servicing costs, the fall in house prices, and low levels of consumer confidence. Employment levels are high, and income growth and household savings are supporting spending. The rebound in tourism is also supporting domestic demand.

The productive capacity of the economy is being constrained by broad-based labour shortages, and wage pressures are evident. Aggregate demand continues to outstrip New Zealand's capacity to supply goods and services, with a range of indicators continuing to signify broad-based inflation pressure.

Committee members agreed that monetary conditions needed to continue to tighten further, so as to be 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.

More information:

Download the November 2022 *Monetary Policy Statement* (PDF 6.5MB)

Media contact:
Oliver Bates
Manager External Stakeholders | Communications and Stakeholder Engagement
Phone: 04 474 8627
Email: Oliver.Bates@rbnz.govt.nz

Summary Record of Meeting

The Monetary Policy Committee discussed developments affecting the outlook for inflation and employment in New Zealand. Inflation is currently too high and employment is beyond its maximum sustainable level. The Committee agreed it must continue to act decisively to return inflation to target and to fulfil its *Remit*.

The Committee discussed recent international economic developments. In many countries, elevated food and energy prices are contributing to high headline inflation, with high core inflation reflecting more broad based inflationary pressures. Most central banks have continued to tighten monetary conditions and to signal further interest rate increases in coming months. Financial market volatility remains high as central banks act to stem the rise in inflation in an environment of slowing and uncertain economic growth.

Expectations for global economic growth have declined further. For example, China's economy is facing headwinds emanating from the property sector, while measures to contain the spread of COVID-19 continue to cause production bottlenecks. The United States and Europe are, to varying degrees, experiencing the effects of high inflation, tighter financial conditions and associated economic uncertainty. The Committee agreed that the anticipated global growth slowdown will affect New Zealand through trade and financial channels, and increased economic uncertainty impacting on people's confidence.

The Committee observed that consumer price inflation in New Zealand in the September quarter was significantly stronger than expected. Measures of core inflation continued to rise and price pressures broadened. Survey measures and other high frequency data suggest that pricing pressure will be sustained over coming months. In addition, shorter term inflation expectations have increased as high inflation persists.

The Committee agreed that to achieve its *Remit* objectives, actual and expected inflation need to decline substantially. Members highlighted that the longer actual inflation remains above the target band, the more likely it is that higher inflation expectations become embedded.

The Committee discussed the labour market at length, given its importance in the current economic environment. Labour shortages remain a significant constraint on economic activity. Recent data highlight a material increase in employment, enabled by a strong lift in labour force participation to a record level. Measures of labour force utilisation are near record levels and firms continue to report severe difficulties finding labour.

High consumer price index (CPI) inflation and competition for workers are putting upward pressure on wages. The Committee observed that overall wage growth is not exceeding CPI inflation after accounting for productivity growth. While wage growth for people in the same job is generally not keeping pace with inflation, many people are changing jobs or increasing their hours worked to achieve real income growth. The Committee noted that public sector wage growth has lagged that in the private sector and agreed this lag represents an upside risk to wage pressure going forward.

The Committee observed the stronger than expected rebound in tourism since New Zealand's border reopened. Short-term visitor arrivals, international card spending data, and information gathered from recent business visits indicate that tourism spending will make a strong contribution to economic activity in coming months. However, some members noted that ongoing capacity constraints could, at some point, inhibit the tourism recovery and add to overall inflation pressures. In relation to New Zealand's goods exports, members observed that a lower New Zealand dollar is currently mitigating the impact of recent declines in international commodity prices.

The Committee discussed the recent *Financial Stability Report* and noted that the financial system remains resilient. In particular, members highlighted that recent stress tests demonstrate banks' resilience. The Committee was especially interested in the resilience of household balance sheets to scenarios of higher interest rates, reduced labour demand, and declining house prices. The Committee noted that while national house price indices have declined to mid-2021 levels, they are still above estimates of sustainable house prices and above levels that prevailed pre-COVID-19.

Household spending remains robust, especially considering the rise in debt servicing costs, the fall in house prices, and low levels of consumer confidence. Members observed that the large stock of household savings, in addition to income growth, may provide a buffer to support consumption now and in the future. However, members also noted that the ownership of savings is likely concentrated, leaving the majority of households exposed to high inflation and interest rates.

The Committee agreed that as debt servicing costs rise, spending decisions for many households will be increasingly constrained. These constraints would be most felt by recent home buyers with a high debt servicing commitment relative to their income. The Committee agreed that the impact of rising interest rates on households' spending and saving decisions is an important channel for monetary policy. In addition to constraining spending, higher interest rates also encourage saving and paying down of debt.

The Committee discussed domestic financial conditions, noting that wholesale interest rates have risen significantly since the August *Statement*, primarily due to higher-than-expected inflation in New Zealand and globally. Retail lending rates have also increased but remain lower than the levels wholesale rates might imply. Members observed that this reflects a combination of both the higher volume and the mix of current bank funding. Members noted that a gradual normalisation in bank funding conditions over the forecast period could result in sustained upward pressure on retail lending rates.

The Committee considered the economic projections. Members noted that a reduction in aggregate demand is projected to cause GDP in the New Zealand economy to temporarily contract by around 1% from 2023. Members noted that this reduction in aggregate demand was necessary to return inflation to target over the forecast period. Members agreed that the exact timing and extent of negative GDP growth was difficult to predict, but historical evidence suggests risks are skewed toward a likely short period of contraction. Members also agreed that the sooner supply and demand were better matched in the economy, the lower the overall cost of reducing inflation.

Members agreed that monetary policy primarily impacts on demand in the economy. However, any increase in the supply potential of the economy, such as through productivity improvements, would also assist in reducing inflation. However, members agreed that a significant increase in the economy's capacity to supply goods and services could not be relied on to reduce inflation pressures over the forecast horizon.

The Committee agreed that fiscal policy can also act to reduce demand in the economy. Members observed that in a higher inflation environment, a given level of government services would cost more to deliver. However, members noted that inflation would also lead to increased government revenues in nominal terms, potentially offsetting the rising cost of service delivery. On balance, members viewed the risks to inflation pressure from fiscal policies as skewed to the upside given the ongoing real demand for services.

The Committee received an update on the status of the Large Scale Asset Purchase (LSAP) portfolio and noted that sales of bonds in the LSAP portfolio to New Zealand Debt Management began in July. Members observed that the New Zealand government bond market continues to function normally under the current pace of LSAP sales and agreed to continue to evaluate this on an ongoing basis. The Committee agreed that the level of settlement cash balances is not a source of unexpected inflationary pressure and noted that overnight wholesale interest rates remain aligned to the OCR.

The Committee discussed the extent of additional monetary tightening required to achieve its *Remit*. Members agreed that the OCR needed to reach a level where the Committee could be confident it would reduce actual inflation to within the target range over the forecast horizon. Members agreed that this level had increased since the time of the August *Statement* due to the persistence of inflationary pressures resulting in a higher short-term nominal neutral interest rate.

The Committee discussed the size of the OCR increase to be delivered at this meeting. Increases of 50, 75 and 100 basis points were considered. The Committee discussed the relative merits of maintaining consistent increments in the OCR versus moving more quickly to reach the higher level of the OCR required. Members agreed that a larger increase in the OCR was appropriate, given the resilience of domestic spending, and the higher and more persistent actual and expected inflation outcomes.

The Committee gave consideration to an increase in the OCR of 75 or 100 basis points. On the balance of risks, the Committee agreed that a 75 basis point increase was appropriate at this meeting. Members highlighted that the cumulative tightening of monetary conditions delivered to date continues to pass through to the economy via the lagged transmission to effective retail interest rates.

On Wednesday 23 November, the Committee reached a consensus to increase the OCR from 3.5% to 4.25%.

Attendees:

Reserve Bank staff: Adrian Orr, Karen Silk, Christian Hawkesby, Paul Conway

External: Bob Buckle, Peter Harris, Caroline Saunders

Treasury Observer: Dominick Stephens

Secretary: David Craigie