Preston Rowe Paterson

International Property Consultants and Valuers

Reserve Bank increases Official Cash Rate

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The Committee agreed that the OCR still needs to increase, as indicated in the November Statement, to ensure inflation returns to within its target range over the medium term. While there are early signs of price pressure easing, core consumer price inflation remains too high, employment is still beyond its maximum sustainable level, and near-term inflation expectations remain elevated.

Cyclone Gabrielle and other recent severe weather events have had a devastating effect on the lives of many New Zealanders. It is too early to accurately assess the monetary policy implications of these weather events, given that the scale of destruction and economic disruption are only now becoming evident. The timing, size, and the nature of funding the Government's fiscal response are also yet to be determined.

The Committee's current assessment is that over coming weeks, prices for some goods are likely to spike and activity will be weaker than previously expected. Export revenues will be negatively impacted. Monetary policy is set with a medium-term focus, and the Committee will look through these short-term output variations and direct price effects. In time, the infrastructure and community rebuild will add to activity and inflationary pressures, especially given existing capacity constraints in the economy.

Internationally, core inflation remains high and inflationary pressures remain broad based. However, the outlook for global economic activity in 2023 remains subdued, which is acting to lower global consumer pricing pressures, as well as demand for New Zealand's key commodity exports. Continued growth in services exports will provide some export revenue offset.

Domestically, demand remained robust through 2022 underpinned by resilient household spending, construction activity, government spending, and a swift recovery in international tourism as the border reopened. Labour shortages remain a significant constraint on economic activity, contributing to heightened wage inflation. People are moving jobs at an elevated pace, consistent with labour shortages and strong demand.

While there are early signs of demand easing it continues to outpace supply, as reflected in strong domestic inflation. The Committee agreed that monetary conditions need to tighten further, as indicated in the November Statement, so as to be confident there is sufficient restraint on spending to bring inflation back within its 1 to 3% per annum target range. The Committee remains determined to achieve its Monetary Policy Remit.

More information:

Download the Monetary Policy Statement for February 2023 (PDF, 7 MB)

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. Overall, the economy has developed broadly in line with expectations at the time of the November Statement. Inflation is currently too high and employment is beyond its maximum sustainable level. The Committee agreed it must continue to increase the Official Cash Rate (OCR) to return inflation to target and to fulfil its Remit.

The Committee discussed recent international economic developments and their implications for New Zealand. In many countries, core inflation remains high, reflecting significant broad-based inflationary pressures. The outlook for global economic activity in 2023 remains relatively subdued. A weakening global economy is contributing to weaker demand for New Zealand's key commodity exports, such as dairy and meat, leading to a lower outlook for New Zealand's terms of trade. Continued growth in New Zealand's service exports, in particular tourism, is assumed to provide some offset to this drop in export revenue in the near term. As is an easing of travel and activity restrictions in China over the medium term.

Committee members discussed the effects of Cyclone Gabrielle and other recent severe weather events. These events have had a devastating effect on the lives of many New Zealanders. Economically, they represent a disruption to employment, trade and production, and damage to property. The economic impacts discussed by the Committee included the immediate upward pressure on some prices, the effect that higher CPI inflation could have on longer-term inflation expectations, the ability to resource and supply any increase in demand and investment in affected regions, and the longer-term impact these severe weather events will have on the productive capacity of New Zealand.

While it is too early to estimate the full economic impacts, near-term rebuilding and restocking are likely to lift the level of economic activity, and consumer prices for some goods and services will come under upward pressure given supply chain disruption and product scarcity. Weaker export volumes will impact negatively on export earnings as a result of these extreme weather events. It remains unclear how significant the impact of these events will be on New Zealand's longer-term productive capacity.

Monetary policy is set with a medium-term focus. Given this, the Committee decided to look through the short-term direct price pressures stemming from these extreme weather events, and focus on the medium-term impacts on inflation and maximum sustainable employment.

At this stage, the Committee agreed that the medium-term impacts of the severe weather events do not materially alter the outlook for monetary policy. However, significant uncertainty remains, and more accurate information on the scale of the events is becoming available by the day. Inflation remains high, employment is above its maximum sustainable level, and ongoing restrictive monetary policy settings are necessary. However, the Committee acknowledged the significant regional impacts that the severe weather events will have across New Zealand, and agreed that the Government's fiscal policy response would be more effective at addressing these, rather than any monetary policy activity.

The Committee noted that demand in the New Zealand economy remained robust through 2022, despite significant global and domestic challenges. Economic growth has been underpinned by resilient household spending, construction activity, government spending, and a swift recovery in international tourism as the border reopened. High frequency surveys of economic activity suggest domestic demand may be starting to ease. This moderation is in line with expectations outlined at the November Statement. However, demand continues to outpace supply, and this continues to be reflected in high domestic inflation.

The Committee observed that consumer price inflation in New Zealand in the December quarter remained high. Encouragingly, there was a slightly larger-than-forecast slowing in non-tradable inflation. However, CPI inflation, at 7.2 percent in the year to the December 2022 quarter, remains well above the 1 to 3 percent target range set out in the Remit. Measures of persistent or 'core' inflation have remained very high, indicating that high inflation remains broad-based. Medium- and longer-term inflation expectations have stabilised recently, but remain elevated. The potential for a persistent continuation of global and domestic supply constraints, greater persistence in core inflation and elevated inflation expectations were seen as upside risks to the economic projections.

The Committee noted that a range of measures indicated that labour shortages continue to be a significant constraint on economic activity, contributing to strong wage inflation. Measures of labour force utilisation are near record levels and firms continue to report severe difficulties finding labour. Private sector employees are also transitioning between jobs at an elevated pace, consistent with significant labour shortages and strong demand in the economy.

The Committee discussed financial conditions noting that increases in both shorter term wholesale and mortgage rates have exceeded longer term maturities. It was also noted that deposit rate increases continue to lag the increases in wholesale and mortgage rates resulting in a further widening of bank margins between lending and deposit rates. The Committee expect deposit rates to increase over the coming year incentivising savings, further dampening inflation and supporting the maintenance of current mortgage rates for a longer period.

The Committee also discussed the functioning of the New Zealand Government bond market, in the context of sales of bonds in the Large Scale Asset Purchase Programme portfolio. Measures of secondary market liquidity were generally in line with historic norms and observed volatility was consistent with trends seen in international interest rate markets.

The Committee considered the economic projections. As in the November Statement, the central projections show a decline in GDP this year. 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 more concentrated 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.

The Committee discussed the resilience of household balance sheets in the context of rising interest rates and the outlook for reduced labour demand. This was seen as a downside risk – with the potential for monetary policy to have larger effects on the economy in an environment of elevated debt levels. However, it was noted that while measures of financial stress have increased marginally, they remain low. The Committee agreed that as debt servicing costs rise, spending decisions for many households will become increasingly constrained. These constraints would be felt most 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. The Committee also agreed that housing market related activity was a downside risk. Projections incorporate a substantial decline in construction. However, there are significant uncertainties. Feedback from the construction industry points to a significant lack of forward activity. In contrast, rebuilding in the wake of Cyclone Gabrielle will support construction activity.

The Committee agreed that fiscal policy can also act to reduce demand in the economy. The current projection assumes government consumption and investment will fall as a share of the economy in coming years. However, members viewed the risks to inflation pressure from fiscal policy as skewed to the upside, particularly given the ongoing demand for government services in an environment of rising costs of provision. In addition, the economic impact of the Government response to recent severe weather events will depend on the scale of damage, fiscal reprioritisation decisions, timing of activity and how the fiscal costs are funded.

The Committee discussed the extent of additional monetary tightening required to achieve its Remit. Members noted the rapid pace and extent of tightening to date implies monetary policy is now contractionary. The Committee noted the long lags of monetary transmission to the economy means the impact of this tightening is still to be fully seen. Committee 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 of the OCR was broadly consistent with expectations at the time of the November Statement.

The Committee discussed the size of the OCR increase to be delivered at this meeting. Increases of 50 and 75 basis points were considered. The Committee assessed that, while the balance of risks around inflation remain skewed to the upside, the extent of this risk had moderated somewhat since the November Statement. As a result, a 50 basis point move balanced the need to ensure core inflation and inflation expectations fall, against the early signs that demand was beginning to moderate towards the economy's productive capacity.

On Wednesday 22 February, the Committee reached a consensus to raise the OCR by 50 basis points from 4.25% to 4.75%.

Attendees:

Reserve Bank members of MPC: Adrian Orr, Karen Silk, Christian Hawkesby, Paul Conway

External MPC members: Bob Buckle, Peter Harris, Caroline Saunders

Treasury Observer: Dominick Stephens

MPC Secretary: Adam Richardson

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