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Record rate hike highlights central bank's quandary in fighting inflation

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Record rate hike underscores RBNZ's focus on beating inflation

On 23 November, the Reserve Bank of New Zealand (RBNZ) hiked rates by a record 75 basis points, providing a strong signal that its first priority is fighting inflation. The Official Cash Rate (OCR), now at 4.25% following the hike, is set to rise further still with the RBNZ projecting a terminal rate of 5.5%. Given that the latest consumers price index (CPI) released by Stats NZ, New Zealand's statistics agency, showed that inflation was still elevated in the September 2022 quarter at 7.2%, the RNBZ is seeking to head off a wage-price spiral driven by persistent price and wage rises. In a sign of the quandary it faces, the central bank pointed out in its November Monetary Policy Statement that New Zealand's economy looks set to enter a recession in 2023, with the downturn likely to be spread over several quarters. Furthermore, based on our belief that long-term interest rates will be more stable than short-term rates going forward, we feel that New Zealand is likely to see an inverted yield curve. This is another indicator that a recession is on the horizon, as short-term bond yields moving above yields on longer-dated debt is typically thought to signal economic contraction.

RBNZ to continue curbing demand, but impact of monetary policy difficult to predict

Despite the signs of a downturn, one of the only tools for curbing inflation available to the RBNZ is hiking rates in order to suppress demand until the supply side of the economy improves. It is now doing so with the largest and quickest monetary tightening cycle seen in New Zealand since the OCR's introduction in March 1999. This will inevitably entail lower spending, softer consumption, lower real wages, higher unemployment and weaker economic growth at a time when the economy is already suffering. The difficulty of this balancing act is highlighted by past experience of the way the time lag between interest rate movements and their effects can complicate the jobs of central banks. In New Zealand's case, the OCR previously saw significant upward movement between 2004 and 2007, when progressive hikes in response to strength in the economy pushed the rate up to 8.25%, where it was held until July 2008. However, after a round of swift rate cuts in order to support the economy and financial system during the Global Financial Crisis, the OCR had plunged to 2.5% by the summer of 2009. Although central banks base their actions on surveys of expectations of future activity, survey respondents tend to focus on current conditions on the assumption that they will continue indefinitely. This inevitably complicates the task of anticipating future events. The bluntness of the tools available is one of the reasons New Zealand is now facing both elevated inflation and the cumulative impact of prior interest rate rises.

Higher bond yields providing silver lining through income generation

Although New Zealand's November 2022 rate hike was larger than expected, markets had been pricing in aggressive tightening for quite some time. This may soften the impact of the current challenges. Given that yields on some bonds are now approaching 6%, we feel that stronger income generation opportunities are also providing a silver lining in the fixed income market.

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