New Zealand: The hawkish bias is on

The Reserve Bank of New Zealand delivered a hawkish surprise by forecasting a rate hike in 2022. Economic projections also indicate the outlook for the economy is brighter, and the next move could be to signal tapering of its QE programme. This is translating into an even more attractive rate profile which should assist further appreciation in the currency

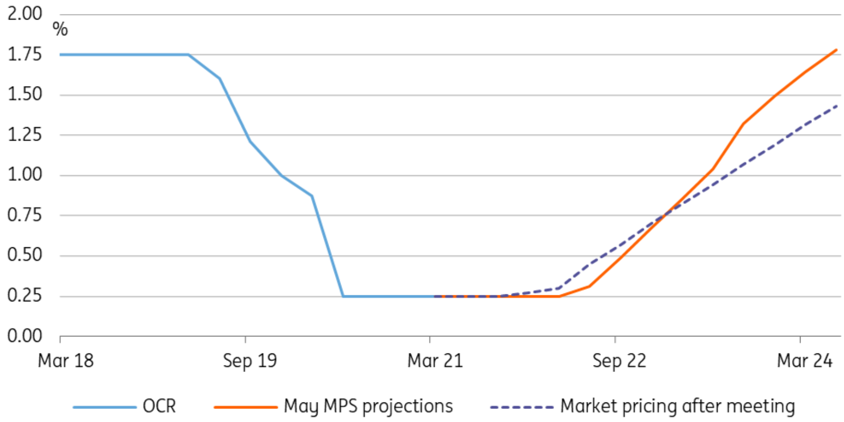
RBNZ delivers a surprising hawkish signal

The RBNZ announced monetary policy overnight, leaving rates at 0.25% and both its NZ$ 100bn asset purchase programme and the Funding for Lending facility unchanged. Markets had probably built up some expectations that the Bank would start to talk tapering due to bond lower issuance, although no strong direction was given in that sense.

All the surprises came from the monetary policy statement, where the Bank published its updated projection for some key economic indicators. For the first time in a year, the RBNZ published the projected path for the OCR (the Bank's policy rate). A market largely positioned for no change in rates until 2023 was taken off guard by forecasts of a rate hike in the second half of 2022.

Investors have moved to price in monetary tightening after the meeting, and the swap market is now pricing in around two 25bp rate hikes by the end of 2022.

Market adjusting to the new hawkish bias



Source: Refinitiv, ING

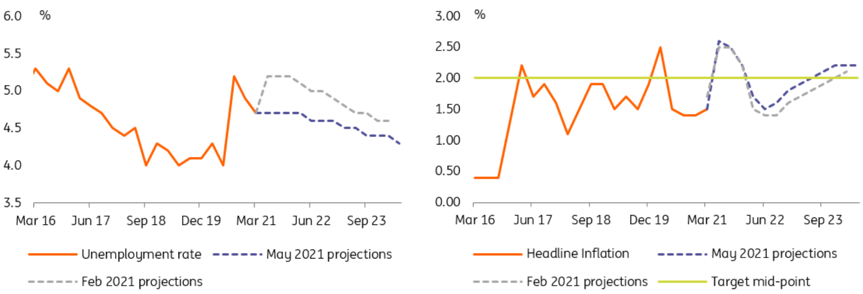
An upbeat tone on the economic recovery

RBNZ Governor Adrian Orr made clear that any projection or forward guidance remains heavily dependent on the path of the economic recovery in New Zealand, which is still highly uncertain. At the same time, the set of economic projections pointed to a clearly improved outlook for the economic recovery.

Growth projections for early 2022 were upgraded, with a strong rebound expected for 1Q22 next year (+3.4% year-on-year) after the 0.6% contraction registered in 1Q21, while a stronger expected performance in 4Q21 (1.9%) caused a revision of end-2022 forecasts to 3.5% from 3.7%.

Inflation and employment were, however, the two most interesting projections to watch on the economic side. After having consistently overestimated the unemployment rate over the past year, the RBNZ finally erased any temporary jump above 5.0%, with the rate now forecast to decline steadily from the current 4.7% to 4.4% in 2023.

Upgraded employment and inflation forecasts



Source: RBNZ, ING

A hawkish signal was also sent through the inflation projections, with a revision higher to the headline CPI for 2022 and 2023 of around 0.2%, and the Bank now expecting to achieve a stable 2.2% level in early 2023. The mid-point of the Bank's target range is 2.0%.

Border policy and house prices remain in focus

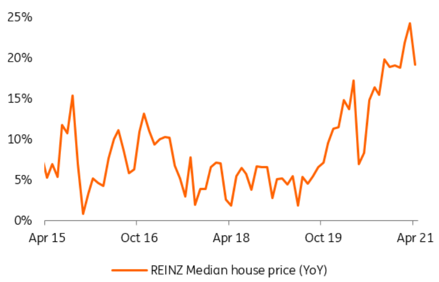
In the policy statement, the Bank highlighted concerns about the tourism sector, whose recovery remains tied to the timeline for a reopening of New Zealand borders. The government has so far said that strict border rules will remain in place until the local population has been vaccinated, although a travel bubble with Australia might have signalled a somewhat less strict approach is on the way.

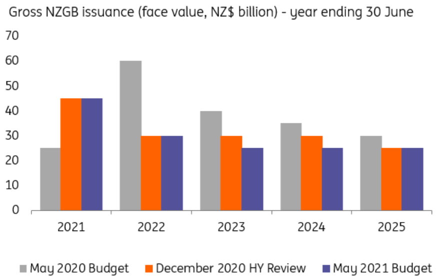
> *Signs that the government's measures are not enough to curb the housing bubble may well prompt markets to price in an even earlier rate hike by the RBNZ.*

Housing remains a key factor, and it is likely that the hawkish turn is partly motivated by the will to assist the government's efforts to curb surging house prices in New Zealand. Only 20 days ago, the RBNZ published a note titled: "Why the Reserve Bank is concerned about New Zealand's rising house prices". Despite having steered away from admitting that housing is now an important input in monetary policy decisions (remember that the NZ government changed the RBNZ remit to include housing considerations), it is hard to imagine government measures being able to counter house inflation on their own while rates remain exceptionally low.

Moving forward, the dynamics in house prices will be watched carefully by the market, and any signs that the government's measures are not enough to curb the housing bubble may well prompt markets to price in an even earlier rate hike by the RBNZ. In April, house prices grew at a slower pace, but still around 19% YoY.

House prices and bond issuance both set to be a factor





Source: Refinitiv, NZ Treasury, ING

NZD: Attractive rate profile to provide extended support

While little mention was made about the prospect of tapering, it was highlighted that the Bank will likely fall short of completing all NZ$ 100bn worth of purchases under its quantitative easing programme by June 2022. The RBNZ mentioned lower bond issuance by the government as a key reason, although the 100bn target appeared to be hard to reach regardless of issuance. So far, only around NZ$ 50bn worth of government bonds have been purchased under the programme.

We think the next step from the RBNZ will be to start talking tapering

We think the next step from the RBNZ will be to start talking tapering. Regardless of whether this will ultimately be a monetary policy related move, we are inclined to think the bank will continue to stress this is due to reduced bond issuance, in an attempt to avoid the unwanted consequences (like a stronger NZD) of sounding too hawkish. In the 2020 Budget (as shown in the chart above), the Treasury revised lower its bond issuance forecasts for 2023 and 2024, after having already cut its forecasts for the period 2022-2025 in the December half-year review.

At this point, we could start hearing discussions about ending the asset purchase programme earlier and/or reducing its size. Any tapering signal should not come as a major surprise for markets after the hawkish bias was put in place via the forward guidance tool, but it may all the same continue to support rate expectations.

NZD is set to reap the benefits of an improved rate profile

From an FX perspective, we suspect that the jump in NZD seen in the aftermath of the meeting may be the start of a broader cycle of appreciation. With the RBNZ now having joined the likes of the Bank of Canada and Norway's Norges Bank in the group of hawkish central banks in the G10, NZD is set to reap the benefits of an improved rate profile.

Hawkish pricing set to support NZD

Source: Refinitiv, ING

With inflationary pressures eroding the real rate attractiveness across developed countries, we continue to expect markets to reward those currencies that can count on more orthodox (i.e. less dovish) domestic monetary policy. It is worth noting that the relatively low inflation in New Zealand (1.5%) compared to the likes of Canada (3.4%) or Norway (3.0%), makes NZD even attractive than CAD and NOK from a real rate perspective.

We think the RBNZ policy divergence with the Fed (which we expect to stay dovish for longer) is likely to keep generating upward pressure on NZD/USD, pushing it above 0.75 this summer. We also see risks tilted to the upside compared to our latest NZD/USD year-end forecasts of 0.77, as long as our bearish USD view for 2022 materialises.

There is a possibility that the RBNZ's hawkish shift may prompt the Reserve Bank of Australia to follow with a less dovish tone. However, the policy divergence between New Zealand and Australia is set to stay in place for longer (Australia's policy rate is already lower, at 0.10%) and we expect this to keep putting pressure on AUD/NZD, which may drift towards 1.04 in the coming months.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer