Significant move by New Zealand central bank to lift interest rate

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In what could be an indication of moves by major central banks, the Reserve Bank of New Zealand (RBNZ) lifted its interest rate on Wednesday to 0.75 percent from 0.5 percent with indications that further rises may be coming.

The RBNZ decision was the second such increase in two months and was taken in response to a sharp rise in the rate of inflation.

Reflecting the global inflation surge, NZ prices rose by 4.9 percent on an annualised basis in the third quarter, well above the central bank's forecast of 4.1 percent. House prices, which are included in the calculation of inflation, were up by 30 percent in the year to October.

Announcing its latest decision, the RBNZ forecast that inflation would run above 5 percent for the next three quarters, citing higher oil prices, rising transport costs and supply problems. It said these "immediate price shocks risk generating more generalised price rises given the current domestic capacity constraints."

Market forecasts are that further interest rate increases are in the pipeline.

Ben Udy, an economist at Capital Economics, told the *Australian Financial Review*: "Given the heat in the economy, we think the RBNZ is far from done. We expect the bank to continue to hike rates next year to around 2 percent by the middle of next year."

Normally moves by the RBNZ attract little international attention because of the relatively small size of the NZ economy and its financial system. But over the past months its actions have been closely followed because of what they may indicate about the future actions of much larger central banks—the Bank of England, the European Central Bank and, in particular, the US Federal Reserve.

With headline inflation in the US now running at more than 6 percent and showing no signs of abating, the key question is when and by how much the Fed may start to move. At its last meeting the Fed decided to taper its asset purchases, running at $120 billion a month, by $15 billion meaning they would cease by next June.

But there is pressure to accelerate tapering to $30 billion a month and bring the asset purchasing program to a conclusion sooner, possibly by March. This would clear the way for an interest rate rise because Fed chair Jerome Powell has insisted that any move will only come once the bond-buying program is ended.

The minutes of the Fed's November 2-3 meeting, released on Wednesday, indicated that "some officials" felt inflationary pressures were broadening and there may be a need to end the asset purchasing program sooner in case there was a need to lift interest rates.

Fed officials judged that while price increases reflected factors that were likely to be transitory, "inflation pressures would take longer to subside than they had previously assessed."

At his press conference on November 3 Powell did not indicate the conditions under which the Fed might speed up the tapering process.

Since then, some Fed officials have indicated they are in favour of it being accelerated at the next scheduled meeting to be held December 14–15.

Last week, Fed vice chair Richard Clarida said he would be looking closely at the data and it "may well be appropriate at that meeting to have a discussion about increasing the pace at which we are reducing" asset purchases.

San Francisco Fed president Mary Daly, generally regarded as a "dove" among Fed officials, has now indicated she may support reducing bond purchases after saying two weeks ago she considered any increase

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in the pace of tapering to be premature.

In an interview with Yahoo Finance on Wednesday, she said that with obviously "eye-popping and too high inflation" adding support to an "already robustly growing economy just isn't what we want to do."

The focus by Biden on inflation in remarks on his decision to renominate Powell as Fed chair earlier this week and Powell's response, in which he indicated the Fed would act "to prevent higher inflation from becoming entrenched," have been interpreted as signs the Fed is moving to a tighter monetary policy.

This sentiment was reflected in this week's two-day fall in the tech-heavy NASDAQ index where stock valuations are considered to be more sensitive to interest rate rises.

While it is not often mentioned, as the Fed and government officials couch their remarks in terms of what is good for the "economy," the central concern over inflation is to what extent it will fuel the growing surge by the working class for wage increases and the impact this will have on the vastly inflated stock market bubble.

In the past, under what were once regarded as "normal" conditions, the Fed and other central banks, faced with a global surge of inflation and the prospect of a wages push, would have moved to tighten monetary policy. But conditions have vastly changed.

In a comment published in the *Financial Times* (FT) on Monday, Ruchir Sharma, Morgan Stanley's chief global strategist, said the world was now in a "debt trap" which explained why, despite rising inflation, interest rates remained low.

He noted that over the past four decades total debt had more than tripled and now stood at 350 percent of global gross domestic product. With cheap money flowing into stocks, bonds and other financial assets, the scale of global financial markets has gone from being the same size as global GDP to four times larger.

These increases mean that financial markets become increasingly fragile and whereas in the past major central banks could increase rates by significant amounts, today "much milder tightening could tip many countries into economic trouble."

Sharma clearly included the US in that category, noting that it was among a growing list of countries where total debt had risen to more than 300 percent of GDP over the past two decades.

The $22 trillion US Treasury market is where, so to speak, the rubber hits the road.

FT commentator Gillian Tett noted in a recent column that a "frightening question" was "haunting" the Fed as it sought to engineer a smooth exit from quantitative easing and change its monetary policy.

This was whether the Treasury market was "robust enough to handle the shocks" that might arise. It had been assumed that US Treasuries traded in the world's most liquid and deepest market.

But in March 2020, when the market froze, "that cosy assumption was smashed apart" with New York Fed president John Williams reporting at a recent conference that "staggering" amounts of liquidity support had to be provided, reaching at one stage almost $1 trillion a day.

The assumption now prevailing in bond markets is that interest rates will remain indefinitely low. This was "bizarre," Tett wrote, given the outlook for prices and that a bond repricing was therefore overdue. But the key problem for the Fed was whether this adjustment could occur "without another 2020-style freeze."

The Fed, she claimed, understood that a source of the problem was that the Treasury market was characterised by the rise of high frequency trading funds that account for 50-60 percent of activity. When market conditions are calm, they create liquid circumstances for trading. However, in a crisis they flee, with the problems becoming exacerbated because some hedge funds are involved in huge derivatives trades.

But while the problems were understood, Tett concluded, there was "no easy way or swift fix" for them.

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