WESTPAC ECONOMIC BULLETIN

Preview of RBNZ November 2022 Monetary Policy Statement.

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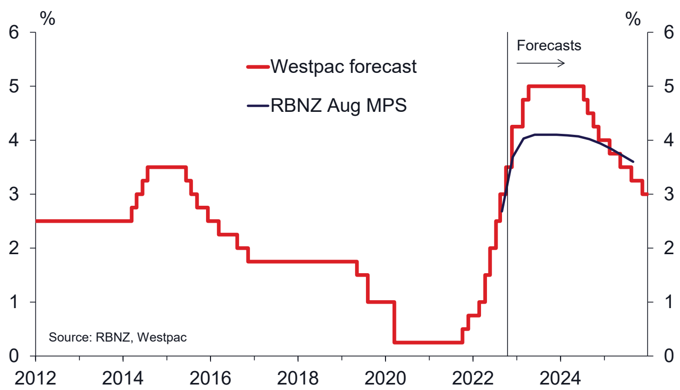
Peak practice.

- We expect the Reserve Bank to raise the Official Cash Rate by 75 basis points to 4.25% at next Wednesday's *Monetary Policy Statement*.
- Recent data has pointed to mounting inflation pressures, raising concerns that the Reserve Bank has fallen behind the pace despite its relatively early start to rate hikes.
- We expect the OCR to peak at 5% by early next year.
- And the Reserve Bank's preferred 'stitch in time' approach means that it will be looking to head off the risk of an even higher peak.

OCR forecasts



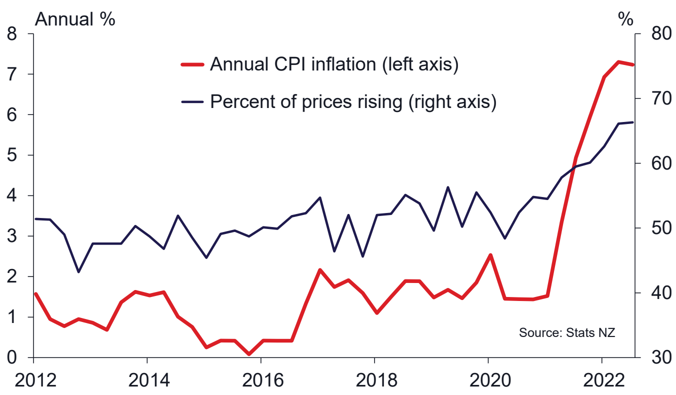
As it prepares next week's *Monetary Policy Statement*, the Reserve Bank finds itself facing the real risk of an inflationary spiral – the very situation it had hoped to prevent with its relatively early start on hiking interest rates. But given the momentum in domestic demand, and the cautious initial pace of rate hikes, the economy has become increasingly overheated and the advantage appears to have been lost. Now a much higher level of interest rates will be needed to bring inflation under control.

As we detailed in our CPI review last month, we now expect the Official Cash Rate to reach a peak of 5%, most likely in the early part of next year. With the cash rate at 3.5% today, that implies the RBNZ is still some way from where it needs to be. And with little room for delay, we think that the RBNZ will deliver a larger 75 basis point increase in the OCR this time, taking it up to 4.25%.

Our pick is in line with the majority of local forecasters. Interest rate markets are priced roughly halfway between a 50 point and a 75 point move, so a larger move would see a modest rise in rates on the day. However, the greater interest is likely to be in what the RBNZ signals for the months ahead. It's not certain whether their projected OCR track will go all the way up to 5% this time, but it is likely to be substantially higher than the 4.1% peak that they projected in August.

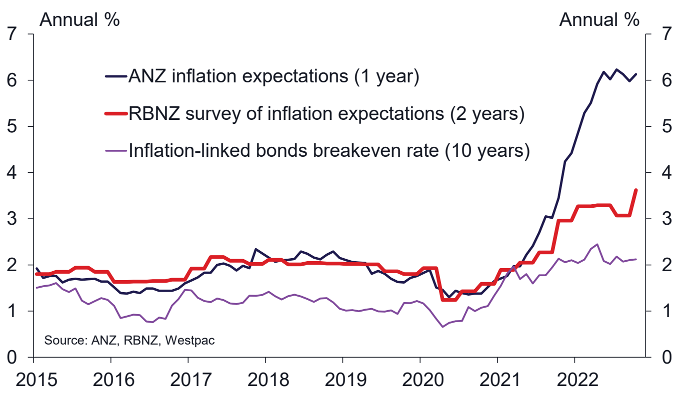
Since the last OCR review in October, the economic data has been a stream of uncomfortable news on the inflation front. The September quarter CPI showed that price rises are becoming more widespread, and are increasingly being driven by local forces. The annual inflation rate of 7.2% was down a touch from the peak of 7.3% in the previous quarter, but it was well above the RBNZ's forecast of 6.4%.

Consumer price inflation



The CPI release was followed by a sharp rise in surveyed expectations of inflation, particularly for two years ahead which is essentially the medium-term horizon for monetary policy. While those expectations had actually fallen in the previous survey, that now appears to have been a head-fake; high inflation is steadily eroding people's faith in the medium-term inflation target.

Measures of inflation expectations



Finally, there is now clear evidence that high inflation is feeding into wage-setting. A growing share of workers are getting cost-of-living increases or more, and employers are willing to pay because they believe they can pass it through into their prices. The RBNZ was already braced for some strong wage figures in the coming quarters, but the September quarter results either met or exceeded even those forecasts.

While we're picking a 75 basis point increase next week, we acknowledge that both a 50 point and a 100 point increase are genuine possibilities as well. In our view, there are a few factors that favour a step up from the 50 basis point increases we've seen at the last few reviews.

First, while the size of any one OCR move isn't crucial for the economy, it does serve as a signal of the central bank's intentions: how far it thinks it needs to go, and how committed it is to meeting its inflation target. The relentless rise in prices is clearly rattling people's confidence in a return to low and stable inflation in the years ahead. A show of force by the RBNZ could help to restore that confidence.

The second issue is that the Monetary Policy Committee's schedule means that there is an unusual three-month gap between next week's review and the following one in February. If the RBNZ is seen as being too timid, the opportunity for a course-correction is some time away. Indeed, even a 75 basis point rise next week would be a slowdown from the RBNZ's recent pace – they have effectively been delivering 100 basis points every three months. It's not ideal that scheduling should play such a role, but nevertheless it is a factor.

Finally, and perhaps most importantly, the Committee has already opened the door to a larger move, revealing that it had debated between a 50 and a 75 point increase in its October review (though it settled on the smaller of the two options that time).

What really piqued our interest was that the Committee again invoked the 'stitch in time' argument: a larger increase in the OCR now would reduce the risk of an even higher peak being needed in the future. This is the same reasoning that led the RBNZ to step up the pace from 25 point to 50 point moves in April this year. The case for this approach was actually laid out in a speech last September, but wasn't acted on until months later – a delay that the RBNZ now regrets.

As we detailed in our latest *Economic Overview*, many households will be refixing at substantially higher mortgage rates in the coming months. That might suggest that now is the wrong time to be piling on with further rises in interest rates. But the 'stitch in time' approach is actually the lesser of the evils. If you're worried about whether households can handle mortgage rates with a 6 in front, you would definitely want to get in front of inflation now and head off the risk that those rates could end up at 7% or more down the line.

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