WESTPAC ECONOMIC BULLETIN

Preview of RBNZ April 2022 Monetary Policy Review.

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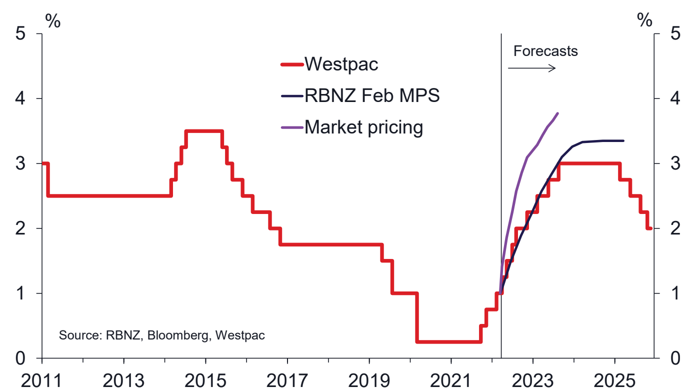
Flying blind.

- We expect the Reserve Bank to raise the Official Cash Rate by another 25 basis points to 1.25% next week.
- As in February, it's likely to be a tough call between a 25bp and a 50bp hike. That won't be helped by the unusually light data flow between reviews.
- The data that we have had suggests that near-term inflation is a growing headache for businesses and households.
- But it also shows that monetary policy moves to date are getting the intended traction via the housing market.
- The RBNZ has given little guidance as to how it might view recent developments. But its decisions to date suggest that the hurdle for larger OCR hikes is quite high.

Official Cash Rate



Next Wednesday's policy decision will be another difficult one for the Reserve Bank. As inflation concerns continue to mount among businesses and the public, the RBNZ will need to decide whether to continue on the path of steady 25 basis point interest rate hikes, or whether it will need to step up the pace with 50 basis point moves.

We come down on the side of a 25bp increase, for next week's review at least. We're certainly not dismissing the case for a 50bp hike – in fact we've given it a thorough airing ahead of every policy review since August last year. The trouble is that there's been a relative paucity of data since the last review for the RBNZ to make a judgement on whether it's on the right track or not. Moreover, the RBNZ has done little to shed a light on how it might view recent developments. In our view, the May *Monetary Policy Statement* would provide a better opportunity to explain a change of tack, if it were deemed necessary.

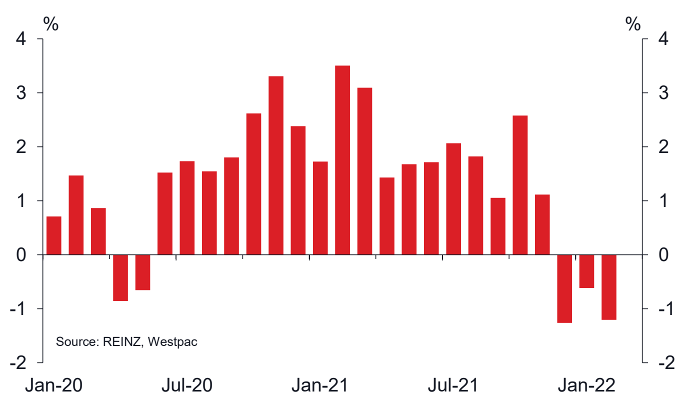
The split of market opinion means that the RBNZ is probably going to rattle financial markets no matter what it does. The majority of economists are with us in predicting a 25bp hike, with a few picking a 50bp move. However, interest rate markets are priced more strongly in favour of a 50bp move (and are getting towards pricing in a peak OCR of 4% of this cycle, which certainly would warrant faster action to reach that mark). A 25bp rate hike next week would clearly disappoint the market. Meanwhile a 50bp move could prompt traders to price in 50bp moves at subsequent reviews as well, which would push longer-term interest rates even higher than they've gone already.

Details.

While there's been some anecdotes and plenty of rhetoric since the last policy review in February, there's been a noticeable shortage of hard data. The most significant release was the December quarter GDP figures, which were stronger than the RBNZ expected, but not hugely so given the circumstances. The RBNZ judged that the economy's potential would take a couple of quarters to rebound from the Delta lockdown, given the ongoing Covid restrictions over that period. The GDP data suggests that rebound was faster than that, but higher potential output does not mean higher inflation pressures.

The other data of note is that house prices have continued to fall, with the REINZ price index down for a third month in February. (We expect the March figures will be released after the RBNZ's decision.) This is important, as housing is the biggest channel through which monetary policy works to dampen inflation pressures. The sharp rises in mortgage rates in recent months are clearly having their intended impact and will continue to do so. This will, however, take time and patience. Nonetheless, what we've seen so far doesn't point to the RBNZ falling behind the curve.

REINZ house price index monthly change, s.a.



Inflation has featured prominently in the news recently, and there's a strong sense that it's weighing heavily on both business and consumer confidence. We don't have fresh data on this – the quarterly CPI release is usually scheduled ahead of the RBNZ decision, but not this time. But the RBNZ will certainly be revising up its near-term inflation forecasts, even with the ameliorating effect of the cuts to petrol excise and public transport fares.

Near-term inflation matters for monetary policy to the extent that it feeds into people's inflation expectations over the longer term. Expectations are a crucial factor for the RBNZ right now, featuring prominently throughout the February *MPS*. Yet again, there's little in the way of new data here. The only survey information is from the ANZ's measure for expectations one year ahead, which have risen sharply – and understandably so – but these carry less weight given the relatively short time horizon. Inflation-linked bonds suggest that market expectations for longer-term inflation have picked up a bit since February, though they're still broadly in the 2% range.

Of course, it's not just about data. The RBNZ also needs to consider wider developments in the economic environment. Top of that list is the Russia-Ukraine conflict, which will affect global activity and inflation in ways that we can't fully predict. As we've noted before, the direct effects on New Zealand are likely to be inflationary ones, via higher prices for oil and other commodities.

That means yet another inflation shock in the near term. However, the appropriate monetary policy response to this isn't straightforward. A cost shock such as an oil price spike adds to inflation in the near term, but it also acts like a tax on activity, weighing on demand in other parts of the economy and reducing inflation pressures over the medium term. Indeed, in the past the RBNZ has deemed that the net impact on monetary policy is zero.

Whether that holds true in every situation is debatable. But the key point is that the rise in oil prices is not simply "more of the same" when it comes to interest rates. The problem that the RBNZ has been responding to so far has been one of excess *demand*, that is, the need to unwind the stimulus that was put in place in response to Covid. We've now added a *supply* shock on top of that, and it's well-known that monetary policy is not suited for dealing with those.

Aside from the difficulty of making sense of current economic conditions, there's the question of the RBNZ's tactics from meeting to meeting. The RBNZ certainly attempted to set out a framework for their thinking in a speech last September, which detailed the conditions under which they would move in small, steady steps – and by implication, the conditions under which they would step up the pace. We'd argue that the latter conditions had been met by November, and again in February, but the Committee's decisions suggest otherwise. In a speech in February, RBNZ Governor Orr referred to current conditions as "business as usual", which suggests a remarkably high threshold for what is "unusual".

So in light of previous decisions, a slowing housing market, falling real wages, an escalating international conflict, uncertainty around how the economy will cope with having to live with Covid for the first time, and a general gap in the data, is now the time to step up the pace of interest rate hikes? We're certainly not ruling out a 50bp hike next week, but we think a 25bp move would be more consistent with the RBNZ's past reasoning.

The May *Monetary Policy Statement* presents a better opportunity to make the case for bigger interest rate hikes, if needed. Not only will the RBNZ have the benefit of a full forecast round, it will also have fresh reads on inflation (actual and expected), the labour market, two more months' worth of housing data, and at least some notion of how the economy fared as the Omicron wave passed its peak.

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