WESTPAC ECONOMIC BULLETIN

Review of RBNZ April 2022 Monetary Policy Review.

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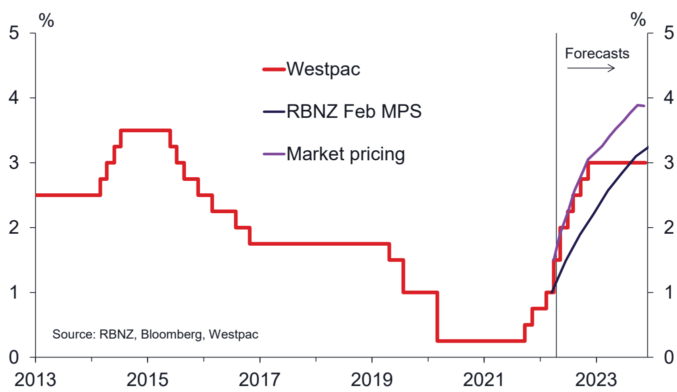
Fifty-fifty.

- The Reserve Bank increased the Official Cash Rate by 50 basis points to 1.50%. That was more than most economists (including us) were expecting, but was more in line with market pricing.
- We now expect a follow-up 50bp hike in May, with four more 25bp hikes to reach a peak of 3% by the end of this year.
- The RBNZ's primary concern is that the current surge in inflation could become embedded in local price-setting behaviour.
- To that end, it concluded that stronger action now would reduce the risk of having to do more work on interest rates in total.
- The RBNZ emphasised that its view of the peak in the OCR remains unchanged since February, in contrast to market pricing, which had been lurching towards a higher peak over recent weeks.
- Our view on the peak OCR for this cycle is slightly lower than the RBNZ's. We acknowledge that the risks are skewed towards a higher peak, but we think that by year-end the RBNZ will be pleasantly surprised at how much traction it's getting on the economy.

Official Cash Rate



The Reserve Bank's decision today to lift the OCR by 50 basis points in one go can be chalked up as a surprise to the extent that most economists (including us) judged that they would come down on the side of a smaller increase. But it's certainly no surprise that the option was on the table: 50 basis point moves are usually reserved for extraordinary conditions, and right now we're in the most challenging environment for inflation in decades.

Given the higher starting point for the OCR after today's decision, we've adjusted our forecasts accordingly. We now expect a follow-up 50 basis point hike at the May *Monetary Policy Statement*, with further 25 basis point hikes at the four remaining reviews this year. This would see the OCR reach a peak of 3% by November, instead of mid-2023 as in our previous forecast.

Our forecast for the May review reflects the fact that the RBNZ will have a lot of fresh data to contemplate before then (in contrast to the relative data drought ahead of the April review), and we expect that much of it will go in the direction of exacerbating the RBNZ's concerns about inflation. (The likely exception is the housing market, where prices are now falling as higher mortgage rates do their work.)

We've stuck with our forecast of a 3% peak in the OCR for this cycle, rather than aligning with the RBNZ's projection of a peak closer to 3.5%. While we acknowledge that the risks are skewed towards a higher peak, we tend to place more weight than the RBNZ does on the link from interest rates to house prices, and from house prices through to consumer spending. Our view is that by the end of this year, the RBNZ will be pleasantly surprised by how much traction it's getting on the economy.

Details.

Our prediction of a 25bp hike was largely based around the RBNZ's past observed behaviour. As we noted in our preview, the RBNZ's own stated conditions for stepping up the pace of rate hikes had arguably been met already in November, and again in February. Yet at every opportunity the RBNZ went for a smaller move, citing other considerations each time. That suggested to us that the hurdle for a 50bp move was reasonably high. Furthermore, that there was relatively little new information between February and April that would have tipped the balance one way or another.

That last part at least was correct. The primary factor that the RBNZ cited was a concern that inflation expectations could become unanchored, which would require a lot more work in the future to rein them in again. That's not a new concern though, in fact it featured strongly throughout the February *MPS*.

Instead, the change has been in terms of tactics. The RBNZ has decided that its "least regrets" approach now calls for assertive action today to avoid having to take more action over the longer term – that is, a stitch in time saves nine. There's a good argument for this – if the RBNZ is concerned about the degree of pain that it might inflict on homeowners, it would do them no favours by moving too cautiously and ending up with interest rates well above what it considered to be the pain threshold. (See the 2003-2007 tightening cycle for instance.) So the reasoning is sound, we're just left wondering why it didn't hold sway seven weeks ago.

Importantly, the RBNZ stated that it was comfortable with the projected OCR track from the February *MPS*, which peaked at around 3.4% by the end of 2024. That's a notable contrast with financial market pricing, which had been heading towards pricing in a peak in the OCR closer to 4% in recent weeks. In the absence of any substantial new data or any guidance from the RBNZ, the local market has been led around by offshore developments, where the trend has been towards more and faster interest rate hikes.

There's a crucial difference though: most overseas central banks are only just starting their tightening cycles, or have yet to begin. And to the extent that inflation is a globally shared problem, those central banks are at more risk of falling behind the curve and having to tighten much further than they intended.

The RBNZ's statement was meant as a reminder that it sets New Zealand policy for New Zealand conditions, and that it's already quite a way down the monetary tightening path. And that message has been heeded: beyond the next couple of reviews, market expectations for the OCR have been pegged back, and the two-year swap rate for instance is down by 11 basis points since the announcement.

The statement itself was focused on explaining today's decision rather than providing forward guidance, which is not uncommon when the RBNZ does change the OCR. That said, there was nothing in the statement to suggest that today's 50bp hike decision was a one-off. So, having now opened the door to bigger moves, and with a 1.5% OCR still considered to be stimulatory at a time when the economy really doesn't need stimulus, we're comfortable with anticipating a further 50bp move at the next meeting in May.

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