WESTPAC ECONOMIC BULLETIN

Review of RBNZ August 2022 Monetary Policy Statement.

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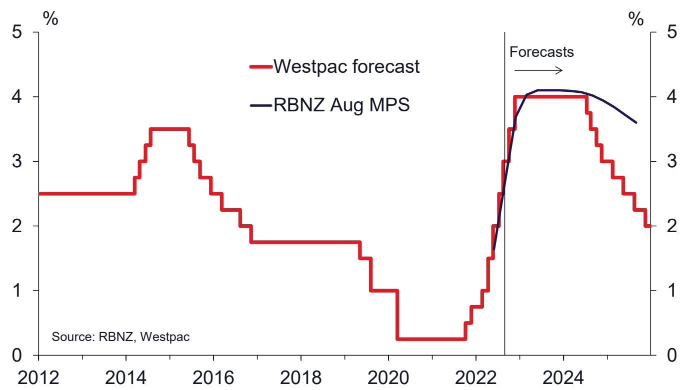
50 is the new 25.

- The Reserve Bank increased the OCR by a further 50 basis points to 3%, as was widely expected.
- The RBNZ statement focused heavily on inflation pressures and capacity constraints, particularly in the labour market.
- The projected peak in the cash rate was lifted slightly to 4.1%, and the expected pace of rate increases was brought forward.
- Given the already steep profile in their previous forecasts, that could only mean further 50 basis point hikes at the two remaining review dates this year.
- That's right in line with our forecasts for the near future.
- However, we see more scope than the RBNZ does for interest rates to ease back in the following years.
- There is growing evidence that higher interest rates are having the intended effect of slowing demand in the economy.

OCR forecasts



The Reserve Bank increased the Official Cash Rate by another 50 basis points to 3% in today's *Monetary Policy Statement*. This was the fourth larger-than-normal increase in a row, and the statement strongly hinted at more to come.

The size of today's increase itself was universally expected by economists and financial markets, so the interest was always going to be in what the RBNZ signalled about the path ahead. In its previous published forecasts in May, the RBNZ projected that the cash rate would peak at just below 4% in the second half of next year. We thought that could shift either way this time, depending on how the RBNZ saw the balance between stronger near-term inflation pressures and signs of softening activity in both the local and global economies.

The result was a slightly higher and earlier peak in the projected OCR, reaching 4.1% by the middle of next year. Moreover, the RBNZ dropped some strong hints that it intends to move towards that point quickly. The RBNZ repeated the language that it has used in recent months that it “remains appropriate” to continue to tighten monetary conditions “at pace”.

The record of the Monetary Policy Committee meeting was even more to the point, with an agreement “to further bring forward the timing of OCR increases.” The May OCR projection was itself notably less ambiguous than usual – achieving it would have required 50 basis point hikes up to August, then 25 basis point hikes at the two remaining reviews this year in October and November. Bringing this profile forward can only mean more 50 basis point hikes.

The RBNZ is viewing the world firmly through an inflationary lens. The statement gave short shrift to the idea of a softening in domestic demand, stating that “domestic spending has remained resilient to global and local headwinds to date”. Restrained growth was credited to labour shortages, which have also boosted wage growth and added to inflation pressures.

Like us, the RBNZ does think that annual inflation peaked at 7.3% in the June quarter. Even so, it’s a long road back to ‘low and stable’. The RBNZ still expects an inflation rate of 5.8% by the end of this year, and 3.8% by the end of next year, and it’s not expected to drop back into the 1-3% target range until the middle of 2024.

Interestingly, the Committee discussed whether raising the OCR even faster, in order to bring inflation back within the range sooner, would improve the credibility of the inflation target. The statement didn’t elaborate on which arguments won the day, but presumably the risk of driving the economy into recession was not seen as credibility-enhancing.

We recently revised up our own OCR forecasts, with two further 50 basis point hikes in October and November to reach a peak of 4%. Today’s RBNZ statement was very much in line with that near-term outlook. However, where the RBNZ sees the cash rate remaining close to this level for some years to come, we see more of a cyclical aspect to this, with more room to cut interest rates once inflation pressures have been brought to heel.

We’ve long been saying that a little will go a long way when it comes to higher interest rates, given the degree of leverage in the economy (and particularly for households). Term interest rates have been rising for more than a year now, and we can see they’re having the effects that the RBNZ would have been looking for. The surge in house prices is rapidly deflating, consumer spending is flattening out (in dollar terms; given the strength of inflation, that suggests that volumes are going backwards), and there are early signs that the edge is coming off the labour market. We don’t expect a recession, but we’re on track for some fairly lean growth in the years ahead.

As such, we’ll continue to watch the high-frequency data to gauge the extent of cooling in the domestic economy. And we think that by the end of this year, that evidence won’t have escaped the RBNZ’s attention either.

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