WESTPAC ECONOMIC BULLETIN

Review of RBNZ May 2022 Monetary Policy Statement.

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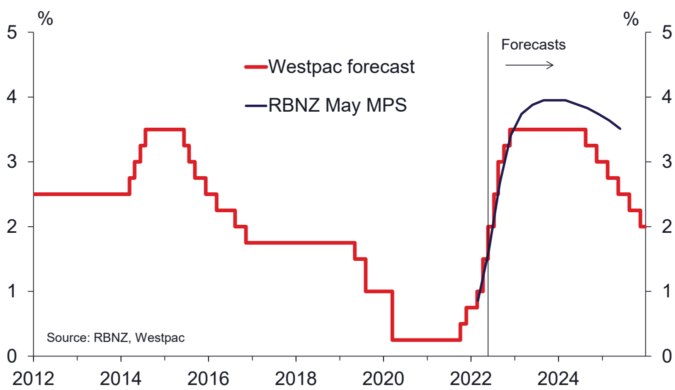
Behavioural change.

- The Reserve Bank increased the OCR by a further 50 basis points to 2% and signalled much more to come.
- The RBNZ now expects to reach a peak of almost 4% next year, with most of the increase occurring this year.
- This is exactly in line with our forecast for this year. We expect two further 50bp hikes at the July and August reviews, then two 25bp hikes in October and November to a peak of 3.5%.
- The RBNZ is increasingly concerned about the risk of higher inflation becoming embedded in people's thinking and actions.
- That means the OCR will need to be higher than 'neutral' for some time, until demand in the economy becomes more aligned with its capacity.
- The RBNZ appears to have realised that it was too cautious in its initial response to rising inflation, in spite of a relatively early start.

OCR forecasts



After increasing the Official Cash Rate by 50 basis points at its April policy review, it was clear that the Reserve Bank was open to more of the same. Consequently, today's decision to raise it by a further 50 basis points to 2% was widely anticipated, and the real interest was always going to be in what the RBNZ signalled for the path ahead.

That turned out to be even more assertive than we expected at this stage. The RBNZ projects the cash rate to reach a peak of close to 4% by the second half of next year, with most of the increase being front-loaded. That track implies that the OCR will reach 3.5% by the end of this year – and with just four more review dates this year, some of the upcoming moves will have to be 50-pointers as well.

Today's statement fully endorses the forecast track that we published in our *Economic Overview* last week. We argued that the need for a firmer response to inflation, and the value of early action, would prompt the RBNZ to lift the cash rate by 50 basis points four times in a row between April and August, on the way to a peak of 3.5% by November. Obviously we have no reason to change that view after today's statement.

However, what did surprise us was how quickly the RBNZ shifted to this view, in light of what it has said recently. In the February *Monetary Policy Statement* the OCR was expected to reach a peak of 3.4% by the end of 2024. The following policy review in April didn't include a new set of forecasts, but the RBNZ indicated verbally that it was comfortable with the peak in that February profile, but would look to get there sooner. Six weeks later, the Monetary Policy Committee has decided that earlier rate hikes alone won't cut it – the OCR will need to reach a higher peak as well.

So what's behind the RBNZ's change of view? As we noted in our preview, the economic news between April and now didn't seem to warrant such a response. Sure, the data highlighted the extent of the inflation challenge that lies ahead, but not to a degree that would have surprised the RBNZ relative to its forecasts three months ago. And as the RBNZ itself acknowledged in its statement, the risks around inflation aren't quite as one-sided as before, as the prospect of a slowing global economy has loomed into view.

The most succinct explanation came from Governor Orr at the following media conference: behavioural change within the policy committee has been the biggest factor in the evolution of the RBNZ's stance over recent months. While we can only guess at the conversations that would have gone on around the table, we suspect that the RBNZ has come to realise that it's fallen behind in its fight against inflation, and is now having to play catch-up.

As we discussed in our *Economic Overview*, the RBNZ's error was in not following its own reasoning. A speech last September set out the conditions under which the RBNZ would step up the pace of tightening – conditions that had arguably been met already at the time. Yet the RBNZ then proceeded with a series of more cautious 25 basis point moves, only stepping up the pace with a 50 basis point hike in April. While the RBNZ can take some pride in recognising the need for higher interest rates sooner than most of its overseas peers, it's not relative performance that it will ultimately be judged on.

The danger of acting too slowly is the risk that the RBNZ's target of 2% inflation over the medium term loses credibility with the public. If that happens and people start acting under the belief that inflation will consistently be higher than 2% in the future, then re-establishing the central bank's credibility will come at a serious cost to the economy. This is the lesson of the 'stagflation' era of the 1970s in particular, as well as the drawn-out tightening cycle in New Zealand between 2003 and 2007.

The RBNZ did emphasise that their projections are for a temporary peak in the OCR, rather than a permanently higher level. The intention is to keep monetary policy 'tight' for long enough to bring demand and supply in the economy into better alignment, before returning interest rates to more sustainable long-term levels.

That's been a feature of our forecasts for some time too. We expect the RBNZ to begin lowering the OCR by the second half of 2024, towards a more neutral long-run level of 2%. For any forecast that far ahead, neither the timing nor the level should be taken as gospel, but it's important to emphasise the idea that this is an old-fashioned economic cycle, not a new normal.

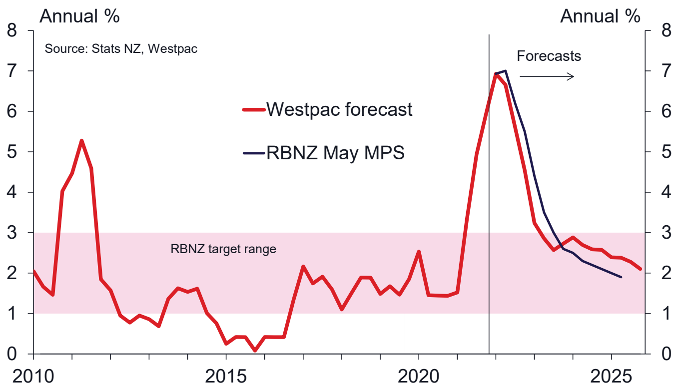
And just to be clear, a cash rate of 2% right now is not 'neutral'. The concept of a neutral interest rate applies when, among other things, expected inflation is settled at the midpoint of the central bank's target. That is not the case today; we might more reasonably expect it to be true a few years from now.

Interestingly, the RBNZ's cash rate projections were very much in line with what financial markets were pricing in – two weeks ago. But the mood in markets had soured in the interim, as concerns about faltering world growth kicked in. In that light, the market reaction today could have gone either way. Would traders jump back on the higher interest rate bandwagon? Or would they have considered the RBNZ to be out of touch with events, and at risk of sending the economy into recession?

It seems that the first response has prevailed. Two-year wholesale interest rates rose by more than 20 basis points after the announcement, and the New Zealand dollar rose from 0.644 to 0.650.

Today's decision probably won't do much for the interest rates that most borrowers and depositors face. Longer-term rates had already baked the idea of a substantial rise in the OCR over the next couple of years. But today's statement does serve to emphasise the point that the RBNZ won't be ending its campaign against inflation any soon.

Consumer price inflation forecasts



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