ECONOMIC BULLETIN

Change in OCR call.

6 Oct 2023 | **Kelly Eckhold**, Chief Economist | +64 21 786 758 | kelly.eckhold@westpac.co.nz | X: @kellyenz

High for longer; probably still higher too.

- **We continue to expect a rate hike to 5.75% at the November 2023 Monetary Policy Statement.**
- **We now don't see OCR reductions until early 2025, with a slow decline from there to 4.0% in 2026 and 3.5% from 2027 onwards.**
- **Inflation remains persistent in New Zealand, requiring the RBNZ to keep interest rates high for a sustained period to return inflation to the target range.**
- **The impact of the current 5.5% OCR is being blunted by strong migration and expansionary fiscal policy.**
- **The RBNZ has taken the approach of pushing out rate cuts as inflation pressures mount compared to moving rates up. This approach has risks.**
- **The steeper yield curve reflects the risk that inflation may be hard to manage.**
- **We have adjusted our longer term interest rate forecasts to reflect our higher for longer OCR profile.**

We are revising our forecasts for the Official Cash Rate (OCR). We still expect the RBNZ to increase the cash rate by 25bps to 5.75% in November, but now think that the OCR will remain at that level for longer. We now don't expect OCR cuts until early 2025.

Since late 2022, the RBNZ has executed a consistent strategy to move the OCR relatively quickly to 5.5% and then hold the OCR steady at that level until inflation pressures subside. This strategy has been effective in significantly tightening financial conditions, especially in recent months as markets embraced the "high for longer" message.

Tightening has mainly been felt by leveraged households and businesses who are increasingly paying markedly higher financing costs. For households, a significant proportion of past rate increases is still to hit budgets as borrowers roll onto higher rates. There has been less (indeed no) tightening in financial conditions coming from the exchange rate. This is unusual in a tightening cycle.

Tighter financial conditions are clearly weighing on economic activity. Household discretionary spending has reduced, and gauges of business sector activity (such as the PMI and PSI) are at depressed levels, consistent with either low or negative growth. The labour market has started to slacken, with businesses reporting that that is now much easier to source staff.

Putting that altogether, monetary policy is working as intended. The challenge for the Reserve Bank is that the starting point from which financial conditions started to tighten was very stimulatory and the magnitude of the related inflation surge was unprecedented in the inflation targeting era. Interest rates and financial conditions needed to tighten – and by a very long way – to correct the significant imbalances that were created in the Covid-19 period.

But nevertheless, inflation has proved persistent and resilient to tightening in the post Covid-19 period. Many factors have been at play including:

- A tougher geopolitical environment.
- Ongoing frictions in global supply chains and volatility in oil prices which are add significantly to inflation now.
- Ongoing resilience as many, perhaps even most, households and businesses did much better than feared through Covid-19 and built-up significant buffers.
- The rise in interest rates is also having an uneven impact on the economy. Some households and businesses really are struggling with the lift in borrowing costs, while others are largely unaffected because they are not as leveraged (perhaps 60-70% of households) or because job security has remained high.
- Unusual strength in population growth and the housing market when the lift in interest rates should have really been gaining leverage on the economy.
- Ongoing fiscal stimulus. In the 2023/24 fiscal year the government opted to deliver yet more stimulus – estimated at around 2% GDP based on Treasury estimates – even while the RBNZ was trying to get on top of inflation.

The upshot of these factors has been persistent inflation and relatively resilient growth in the face of monetary tightening. Aggregate supply and demand are being lifted by the explosion in population growth. This means that growth has continued to hold up in defiance of the usual cyclical indicators pointing to what should be recessionary conditions. We saw this with the most recent GDP report that showed growth in the year to June running at 1.8%, with the size of the economy about 0.5% larger than the RBNZ forecast as late as August 2023.

Similarly, while high frequency data suggests that employment growth is now slowing, the labour market remains tight. Yes, the labour market is easing, as it has globally after the Covid-19 period, but the easing is gradual while inflation is still white hot and falling slowly. And that firmness in the labour market is helping moderate the decline in households' spending appetites that might otherwise have occurred.

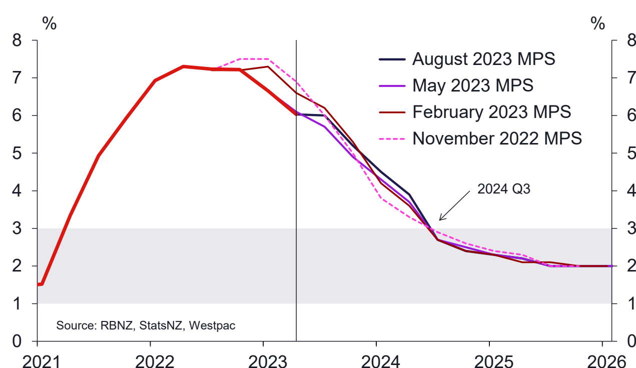
Change in RBNZ forecasts of the economy, November 2022 MPS vs August 2023 MPS

	Forecast horizon		
	June 2023	June 2024	June 2025
Annual Net Migration	+64.9 k	+45.5 k	+ 26.7 k
GDP growth	-0.2 %	+0.6 %	+1.3 %
Unemployment rate	-0.3 %	-0.2 %	-0.4 %

Source: RBNZ and Westpac calculations

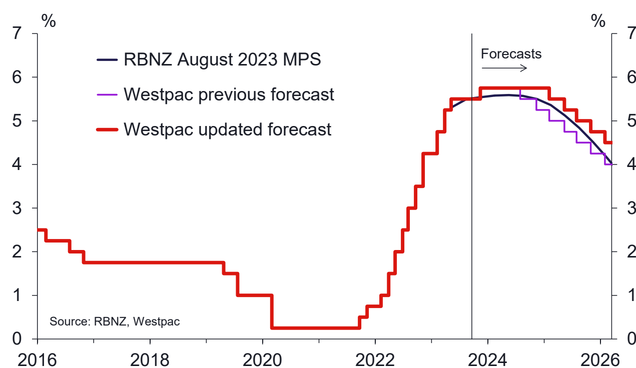
We are concerned that the RBNZ's interest rate strategy may not have been sufficiently adjusted to accommodate these factors. Since late 2022, the RBNZ's growth forecasts have been significantly revised up and unemployment rate forecasts revised down, while the RBNZ's inflation forecasts have remained well anchored around the idea that inflation will return to the 1-3 % target range by end 2024. While the RBNZ's assumptions might prove correct (for example if the growth potential of the economy has increased significantly with population growth), we are concerned that inflation might persist. It may be that an OCR of 5.5% is insufficient to bring inflation down fast enough without risking a rise in inflation expectations, which could compound the upward pressure on costs and wages.

RBNZ forecasts for consumer price inflation



To account for these risks, we are adjusting our medium-term view for the OCR. We continue to think that the RBNZ will opt to raise the OCR further in the November MPS to 5.75%. However, we now do not see an easing in the OCR until 2025. After that, we see a slow 25bps per quarter adjustment down in the OCR, and it is likely to take some time to reach an assumed terminal OCR of 3.5%.

Official Cash Rate forecasts

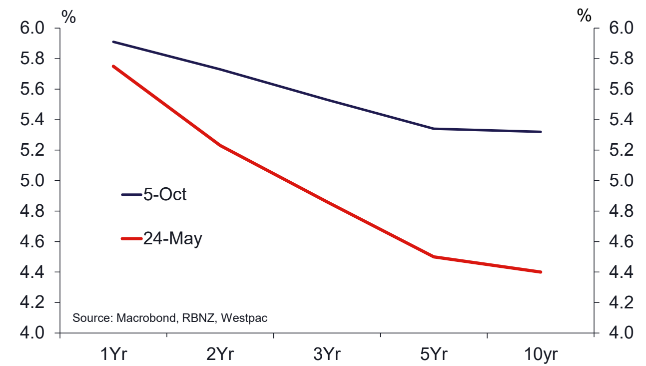


This revised profile is more consistent with the risks associated with the "high for longer" approach compared to moving proactively to tighten by more sooner to bring inflation down more quickly and thus allowing earlier easing. This profile is also more consistent with the

message coming from the yield curve and long-term interest rates which have steepened and significantly increased in recent months. At the least, the rise in long term interest rates may tell us that markets have scaled back recession concerns. At worst, higher long rates might be pointing to inflation risks. Either way, it is prudent to incorporate this information into our forecasts.

We have also slightly revised up our forecasts for longer-term interest rates to reflect our revised OCR view. It had become increasingly clear that market prices were seriously challenging our medium-term interest rate forecasts. We think this revised profile better reflects the risks here.

Swap curve – change since last OCR hike



Financial forecasts

	End of quarter				End of year			
	Jun-23	Sep-23	Dec-23	Mar-24	2021	2022	2023	2024
OCR	5.50	5.50	5.75	5.75	0.75	4.25	5.75	5.75
90 day bank bill	5.62	5.66	5.85	5.85	0.82	4.26	5.85	5.75
2 year swap	5.18	5.53	5.81	5.67	2.08	5.10	5.81	5.08
5 year swap	4.44	4.90	5.35	5.22	2.46	4.67	5.35	4.82
10 year bond	4.27	4.87	5.45	5.45	2.39	4.31	5.45	5.15

CONTACT

Westpac Economics Team | **westpac.co.nz/economics** | nzeconomics@westpac.co.nz

Kelly Eckhold, Chief Economist | +64 9 348 9382 | +64 21 786 758 | kelly.eckhold@westpac.co.nz

Satish Ranchhod, Senior Economist | +64 9 336 5668 | +64 21 710 852 | satish.ranchhod@westpac.co.nz

Darren Gibbs, Senior Economist | +64 9 367 3368 | +64 21 794 292 | darren.gibbs@westpac.co.nz

Nathan Penny, Senior Agri Economist | +64 9 348 9114 | +64 21 743 579 | nathan.penny@westpac.co.nz

Paul Clark, Industry Economist | +64 9 336 5656 | +64 21 713 704 | paul.clark@westpac.co.nz

Shania Bonenkamp, Graduate | +64 21 796 895 | shania.bonenkamp@westpac.co.nz

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