WESTPAC ECONOMIC BULLETIN

Preview of RBNZ April 2023 Monetary Policy Review.

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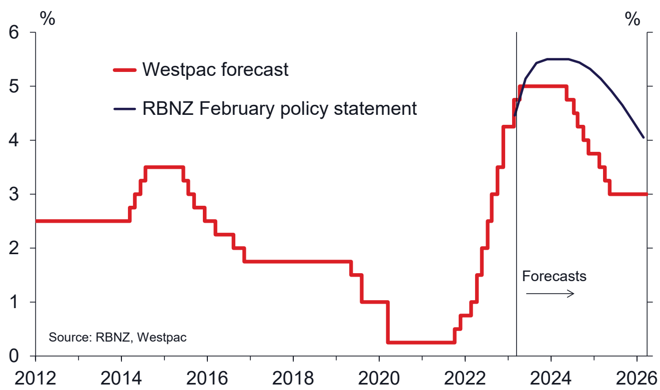
So close and yet so far.

- We expect the Reserve Bank to lift the Official Cash Rate by 25 basis points to 5% next week.
- For now, the RBNZ will leave the door open for further rate hikes.
- Monetary policy is now actively working to slow the economy.
- But it will still be a long and uncomfortable wait until we get back to low and stable inflation.

OCR forecasts



We expect the Reserve Bank to lift the Official Cash Rate by another 25 basis points to 5% at next Wednesday's monetary policy review. This has been more or less fully priced into the market, so the decision itself is unlikely to cause a stir on the day.

Where there will be more interest is in what the RBNZ signals about future moves. There's a growing sense that we're nearing the peak for this cycle, if not all the way there yet. Given the lingering risks around high inflation, it would make sense for the RBNZ to retain the option of further rate hikes in the months ahead. Whether it actually ends up delivering on that will depend on how some recent developments play out. We're currently forecasting a peak of 5% for this cycle, though we acknowledge that the risks are skewed towards a higher peak than a lower one.

The OCR has risen a long way in the last year and a half. By late 2022 it had finally reached what the Reserve Bank considers to be in 'contractionary' territory, where it's actively working to bring inflation down (rather than just giving the economy less of a boost). And that accumulated policy tightening is still working its way through the economy, particularly with many homeowners due to roll onto much higher mortgage rates in the year ahead.

While there hasn't been a great deal of economic data released since the February Monetary Policy Statement, the one big number that we've had – GDP – was a shocker. Output fell by 0.6% in the December quarter last year, against the RBNZ's forecast of a 0.7% rise. And after accounting for downward revisions to growth in the previous quarters, the level of activity is a whopping 2% below what the RBNZ had assumed.

On its own, the weak December quarter result seems to have been more of an air pocket than a crash landing – the higher-frequency data has actually been improving again in the first few months of this year. Still, the starting point matters. If the economy is not running as hot as thought, that will affect any calculation about how far it needs to slow in order to bring inflation under control.

In its February *Monetary Policy Statement* the RBNZ projected the OCR to reach a peak of 5.5% this year, most likely in the form of three further 25 basis point increases. We estimate that the GDP surprise alone would knock about 50 basis points off that profile. That would still make a 25 point hike next week a reasonable prospect, but would cast some doubt about the need for further moves.

However, there are other developments that the RBNZ will need to weigh up. The first is the impact of Cyclone Gabrielle and the subsequent recovery. In February the RBNZ noted that the rebuild – likely to be in the billions of dollars, spread over a few years – would add to economic activity and potentially to inflation pressures. But at that point it was too early to quantify the impact on monetary policy. That will probably remain the case for the April policy review. Indeed, our sense is that the RBNZ has deferred this issue until after the May Budget, where we'll get more detail on the fiscal impact of the rebuild, both in terms of how much the government will need to spend and how it will be funded.

The second issue is the heightened concerns about the global banking sector in recent weeks. No-one can say for certain whether the handful of bank failures so far is the start of something bigger, and the memories of the Global Financial Crisis are still fresh in many people's minds. On the other hand, the authorities have taken strong and proactive measures to preserve financial stability that seem to have been quite effective so far. Central banks that are closer to the situation, like the US Federal Reserve, haven't changed their monetary policy tack as a result, so it's hard to see why the RBNZ would take a different view.

Regardless of where the OCR peaks in this cycle, interest rates will likely need to stay high for some time, until inflation is clearly back on a path towards the 1-3% target range. Both the RBNZ and ourselves are projecting that the economy and the labour market will slow materially over the year ahead. But that weakness largely remains in the realm of the forecasts; the actual economic data up to now has been fairly robust. Until the RBNZ gets clear confirmation that the economy is slowing, it will continue to emphasise the potential for further rate hikes.

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