WESTPAC ECONOMIC BULLETIN

RBNZ Monetary Policy Review, April 2023.

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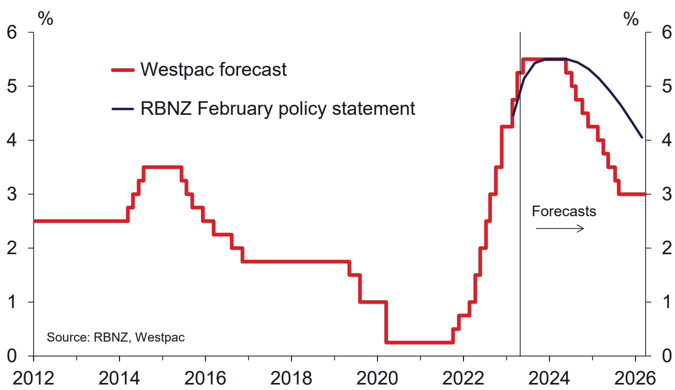
Aussie goes Lowe, we go high.

- The Reserve Bank delivered a larger than expected 50 basis point increase in the OCR, taking it up to 5.25%.
- This move reflects a determination to get to where it thinks it needs to be quickly.
- The RBNZ appears to be still eyeing a peak OCR of 5.5% this year.
- The RBNZ is wary of the additional pressures that the cyclone rebuild will place on an economy that is already overheated (though starting to cool off).
- We expect a further 25bp increase at the May review.
- The RBNZ is likely to retain a tightening bias beyond this, and the balance of risks is towards a peak higher than 5.5%.

OCR forecasts



The Reserve Bank lifted the Official Cash Rate by 50 basis points to 5.25% today, upending a near-consensus in the market for a 25 basis point rise. The tone of the accompanying statement was firmly focused on the challenge of bringing inflation, and inflation expectations, down from what are still very elevated levels.

Given that today's move already puts us above the 5% peak that we had in our OCR forecasts, we've revised our view accordingly. We now expect a further 25 basis point increase to 5.50% at the May *Monetary Policy Statement*, and the risks lean towards an even higher peak than that.

The RBNZ's move today was in contrast to many of its overseas peers, who have tended to look to slow the pace of increase after last year's flurry of rate hikes. In particular, the Reserve Bank of Australia decided to pause yesterday, with Governor Lowe noting that further tightening "may well be needed", a less emphatic statement than his previous "will be needed". The difference in approach is striking given that most developed countries are facing similar economic conditions and similar sources of inflation pressures.

So why did the RBNZ decide to go large? The first clue comes from a change of wording in its statement. Previously the Monetary Policy Committee had noted that monetary conditions "need to tighten further" – that is, focusing on the direction of change. However, in today's statement the Committee agreed that "the OCR needs to be at a *level* that will reduce inflation to within the target range over the medium term" (our emphasis). That suggests the 'stitch in time' logic at work again: once the RBNZ has a notion of where the OCR needs to be, it's better to get there quickly than to draw it out.

The second consideration was captured in the record of the Committee meeting, which noted that "wholesale interest rates have fallen significantly since the February statement, and this could put downward pressure on lending rates. As a result, a 50 basis point increase in the OCR was seen as helping to maintain the current lending rates faced by businesses and households." In other words, the RBNZ wanted to steer the market away from what it regards as prematurely pricing in OCR cuts.

As for where the RBNZ thinks the OCR needs to get to, the implication is that it sees the inflation outlook as relatively unchanged since February, when its projections pointed to a 5.50% peak in the OCR by the middle of this year. While there hasn't been a lot of new information on the economy since then, it seems that the pluses and minuses balanced each other out in the Committee's minds.

One of the key additions to today's statement is that the RBNZ has firmed up its view on the impact of the recent flooding and Cyclone Gabrielle. Beyond the initial disruptions to activity and prices, the rebuilding efforts over the years ahead will create an additional demand on the nation's resources, which "is expected to add to inflation pressure by more than assumed in the February statement". That's understandable since the February review was too close to the event to take a strong view on it. But it's interesting that the RBNZ has come to this view before seeing the May Budget, which will detail the Government's share of the cost of rebuilding and how it will be funded.

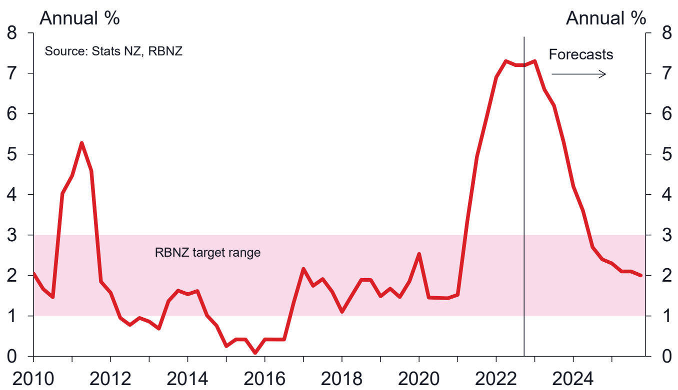
This statement suggests that, all else equal, the RBNZ would be looking at an OCR peaking higher than the 5.50% it had previously projected. But of course, not all else has been equal. As we noted in our preview, the December quarter GDP figures were well below what the RBNZ had assumed. That said, it doesn't overturn the fact that the economy is overheated and needs to be reined in to something more balanced – it's just a question of degree. Recent data has provided some comfort that that rebalancing is under way – for instance, labour shortages are now dropping down the list of businesses' major concerns. But there is a long way to go in the years ahead, and the RBNZ will have little tolerance for any upside shocks to inflation over that time.

We see the balance of risks around the expected 5.50% peak in the OCR as being to the upside. That reflects the high starting point for inflation and the RBNZ's clearly stated concerns about inflation expectations. Consequently, it's likely that the RBNZ will retain a tightening bias after May 2023, with the discussions at each subsequent meeting likely to be between no change and a 25 basis point increase, depending on the incoming data.

With this in mind, it will be increasingly important to think about the key risks that might push the RBNZ towards a higher (or lower) peak than we're forecasting. The key factors are likely to be:

- The RBNZ's assessment of the extent to which the fiscal stance will add to inflation pressures given the cyclone rebuild, an allowance for underlying cost pressures and any potential election-year policy initiatives.
- The extent to which additional government spending is financed through borrowing as opposed to re-prioritization or spending deferrals.
- The strength of net migration, which the RBNZ identifies as adding to net demand and hence inflation pressures. This is in fact how the RBNZ has traditionally viewed migration, but it's worth highlighting because the business community seems to be taking the opposite view at the moment – hoping that the return of migrant workers will ease labour shortages and bring wage inflation down.
- The evolution of global demand and offshore financial stability concerns and the extent of flow-through to domestic financial conditions and inflation.
- Finally, the RBNZ may change its assessment of the impact of previous OCR increases on growth, the output gap and medium-term inflation pressures as new data are released. The RBNZ has previously noted that much of the impact of rate hikes to date still lies ahead of us, and that there are uncertainties around how those hikes will affect economic conditions.

RBNZ Consumer price inflation forecast



Factors constraining business activity

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