WESTPAC ECONOMIC BULLETIN

Preview of RBNZ February 2023 Monetary Policy Statement.

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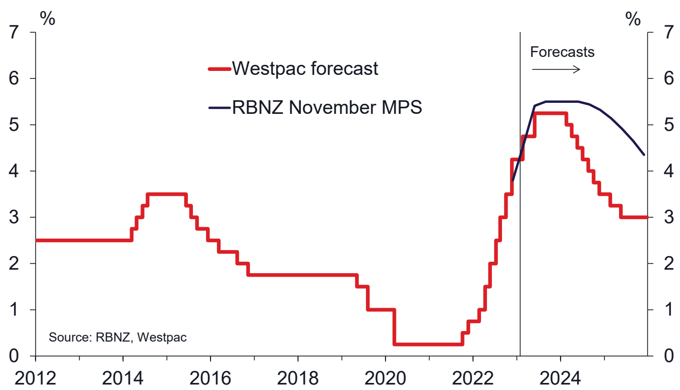
Michael Gordon, Acting Chief Economist
+64 9 336 5670
michael.gordon@westpac.co.nz

A matter of degree.

- We expect the Reserve Bank to lift the Official Cash Rate by 50 basis points to 4.75% next week.
- While still a large increase, it's less than the 75 basis point move that the RBNZ seemed to have in mind at its November *Monetary Policy Statement*.
- Inflation pressures have remained strong, but not quite to the degree that the RBNZ was bracing for.
- We expect the OCR to rise further to a peak of 5.25% this year. Borrowers will continue to roll onto higher interest rates for some time to come, even if the OCR is reduced over 2024 as we're forecasting.

OCR forecasts



The Reserve Bank will again use next Wednesday's *Monetary Policy Statement* to emphasise the scale of its battle against inflation. We're expecting a 50 basis point increase in the Official Cash Rate to 4.75%, and market opinion has also swung in that direction over recent weeks.

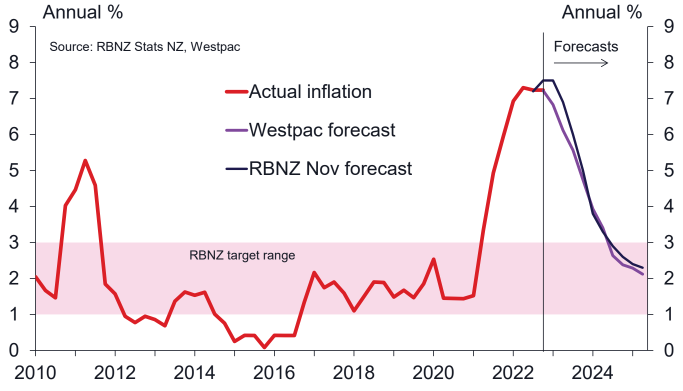
That's down from the 75 basis point rise that the market was widely expecting, and which the Reserve Bank seemed quite set on delivering, in the wake of the November *Monetary Policy Statement*. Part of that was no doubt about the RBNZ signalling its determination to get inflation under control. But it was also partly predicated on some forecasts of a surge in wage and price inflation in the near term. The data over the last few months, while strong, hasn't quite lived up to what the RBNZ was expecting. And when the facts change a little, you should change your mind a little.

We still expect the RBNZ's projections to show the cash rate rising further in the next few months, then holding at its peak for some time to come. The RBNZ will want to dissuade the market from pricing in rate cuts too soon, which would risk restimulating the economy before the inflation battle has been won. Indeed, for signalling purposes, we feel that the risks around next week's decision lean more towards a larger 75bp move than a smaller 25bp one.

Economic developments since the November statement have been mixed. The biggest upside surprise has perhaps been the GDP figures released at the end of last year. The reopening of the border and the return of overseas tourists has seen the economy grow by 4% in the last two quarters alone – and that was at a time when visitor numbers were only halfway back to pre-Covid levels. If there's more of that to come, it could be very difficult for the RBNZ to engineer the slowdown needed to bring inflation under control.

On the flipside, the inflation figures themselves haven't quite lived up to the RBNZ's very strong forecasts. The inflation rate held at 7.2% in the year to December, against the RBNZ's forecast of an acceleration to 7.5%. Importantly, the surprise for them was mostly on domestically-driven prices, which tend to be both more persistent and more closely related to the stance of monetary policy.

Consumer price inflation



Similarly, wage growth was on the lower side of the RBNZ's expectations. The Labour Cost Index was slightly lower with a 1.1% rise for the quarter. Average hourly earnings were substantially below forecast, but this wage measure is much choppier and the divergence between the two measures was already something of a puzzle. There's no doubt that wage growth is picking up – just not quite to the degree that the RBNZ was bracing for.

Incidentally, the announced 7% increase in the minimum wage is unlikely to present an upside risk to the RBNZ's forecasts. The RBNZ was already projecting a 1.8% rise in labour costs in the June quarter, the period in which the minimum wage increase takes effect. A 1.8% rise would be the largest quarterly increase in history by a wide margin.

The evidence is, again, mixed as to whether consumer demand is moderating in the way that the RBNZ is aiming for. Card spending data suggests that the usual Christmas splurge was smaller than usual, but that January was more like normal. There's also a shift in spending patterns going on, towards more on travel at the expense of retail – unwinding the shift that we saw during the era of Covid restrictions.

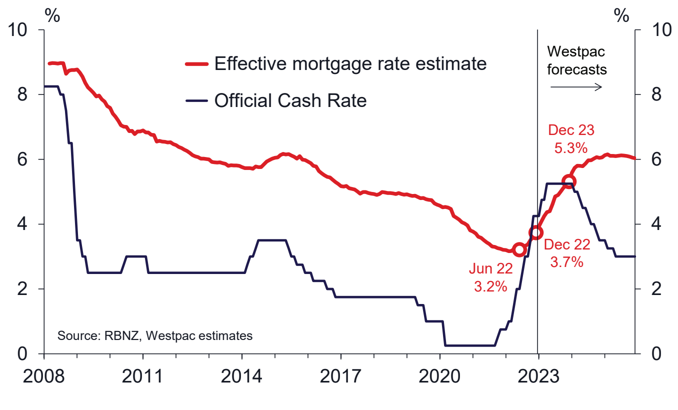
The economic impact of this year's flooding and Cyclone Gabrielle is hard to pin down at the moment. There will be some loss of business activity in the short term, followed by a boost from clean-up work and rebuilding – though with the building industry already running at full capacity, that may mean that some existing plans are delayed or even scrapped instead.

What seems more certain is that it will add further to inflation, at least in the short term. That ranges from the additional demands on the building industry, to supply chain disruptions, to ruined crops, to higher insurance premiums. However, some of these price rises should recede over time. And for those that don't, they represent a supply-side shock to the economy, rather than additional demand that would warrant a monetary policy response. All up, this should be a 'look through' event for the RBNZ – but it will require even more patience before we see some hard evidence that inflation is heading back towards the target range.

We expect the RBNZ's projections to show a further lift in the OCR to a peak of around 5.25% this year, again down slightly from the 5.5% that was signalled in the November projections. At this point, the RBNZ's task is largely around locking in its successes – longer-term market interest rates are already pricing in a higher OCR, and the RBNZ won't want to undo that good work by letting those rates fall. For that reason, we think the RBNZ will continue to signal that an easing in monetary policy is some way off.

Behind the scenes, though, the RBNZ should be turning its mind to the appropriate timing of rate cuts. Monetary policy works with a lag – and this applies in both directions. Mortgage fixing means that the effective average rate that borrowers are paying will continue to rise over the next couple of years, long after the OCR itself has peaked. The OCR cuts that we have in our forecasts through 2024 are what would be needed just to stabilise the effective average mortgage rate in 2025, let alone provide any relief to the average homeowner. The RBNZ has been notably proactive this time on the way up; it will need to be proactive on the way down too.

Effective average mortgage rate



Contact the Westpac economics team

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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