WESTPAC ECONOMIC BULLETIN

Review of RBNZ February 2023 Monetary Policy Statement.

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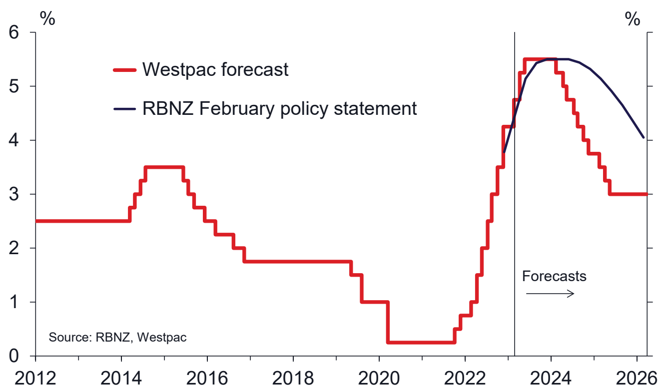
Back to the original plan.

- We now expect a peak of 5.5% in the OCR this year, up from our earlier forecast of 5.25%.
- The Reserve Bank remains committed to bringing inflation back under control, and sees the risks as being to the upside of its already-strong forecasts.
- As a result, we expect that it will carry through with its plans, at least in the near term.
- However, the RBNZ also recognises the downside risks to activity in the years ahead, as higher mortgage rates squeeze households' spending power.
- Cyclone Gabrielle will add to medium-term inflation pressures at the margin, but the scale of the impact is hard to gauge at this early point.

OCR forecasts



The Reserve Bank's decision to lift the Official Cash Rate by another 50 basis points was a well anticipated one. It's still the case that the RBNZ faces a momentous challenge in bringing inflation under control, one that will effectively require a recession in economic activity. But as we described in our preview, the most recent inflation results haven't quite lived up to the very strong assumptions that the RBNZ had made in its November forecasts. And, at the margin, that argued for something less than the 75 basis point hike that the RBNZ seemed to have in mind in November.

What surprised us, though, is that the RBNZ largely retained its projected path for monetary policy over the next couple of years. It still sees the cash rate peaking at 5.5% in the middle part of this year, and holding there until late next year. To be fair, we're getting down to fairly small increments at this point – the RBNZ has put a significant amount of monetary tightening in place already, and small differences in the peak rate would make very little difference to the economy. It does, however, play a role in signalling the RBNZ's intentions.

We had recently revised our OCR forecasts down slightly to a peak of 5.25% this year. However, after today's statement, we've decided to follow the principle of "don't fight the Fed" (or their local equivalent). When a central bank has something in mind, they're quite likely to do it, at least in the near term. And we suspect that there won't be enough in the upcoming data to persuade the RBNZ otherwise – not least because some of it will be impacted by Cyclone Gabrielle, rendering it less useful for gauging the strength of demand in the economy.

Hence, we've moved back to a 5.5% peak in our OCR forecast, which we think will be reached through a 50bp hike at the April review and a final 25bp hike in May. The RBNZ's own projections are ambiguous (probably intentionally so) about whether it favours 25bp or 50bp in April. But the RBNZ's tactic in recent times has been to move quickly towards where it thinks policy settings need to be, rather than spreading out rate hikes for the sake of spreading them out.

Despite the RBNZ's apparent confidence about the near-term direction of monetary policy, it is clearly grappling with some big uncertainties, even before considering the impact of the cyclone. On the inflation side, it still sees the risks as more to the upside – and that's over and above their already very strong inflation forecasts for the year ahead. The RBNZ expects the annual inflation rate to tick up to 7.3% in the March quarter, and only slowing as far as 5.3% by the end of this year. The longer that inflation remains high, the greater the risk that it becomes embedded in price- and wage-setting decisions in the years ahead.

On the other hand, the RBNZ is aware that the risks to activity are to the downside. Its forecasts imply that tighter monetary policy will allow it to engineer a shallow recession. But they recognise that history is against them on that front – recessions are typically more sudden and deeper than that.

The key issue is around how households will absorb the monetary tightening that we've seen to date. Mortgage rate fixing means that homeowners have been exposed to higher interest rates gradually, then suddenly. It's really in the months ahead that the tightening cycle that began in October 2021 will have its greatest bite. That bite could prove to be more effective in slowing consumer spending than the RBNZ has given it credit for.

Where we continue to differ from the RBNZ is on the timing of OCR cuts. The point that monetary policy works with a lag applies in both directions – mortgage fixing means that it will take some time just to stabilise the average rate that homeowners are paying, let alone provide some relief as the economy cools off. The RBNZ's proactive approach should extend to thinking about the appropriate time to start taking its foot off the brake.

Cyclone Gabrielle has provided an additional complication for the RBNZ. In today's statement it followed the standard view that natural disasters are a look-through for monetary policy, if the disruptions to prices and activity are temporary. However, there can be implications for monetary policy if the period of rebuilding extends over several years – as it did with the Christchurch earthquakes, and is likely to do in this case.

The RBNZ judged that at this point the cyclone did not materially alter the outlook for monetary policy over the medium term. However, it's still early days, and the estimates of the scale of the rebuild are quickly evolving (for instance, the Finance Minister's estimate of a $13bn cost may not have been available before the RBNZ finalised its forecasts). The recovery effort will draw on the nation's resources for an extended period; the implications for monetary policy are certainly not zero, it's just a matter of gauging the appropriate degree.

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