WESTPAC ECONOMIC BULLETIN

Preview of RBNZ July 2022 Monetary Policy Review.

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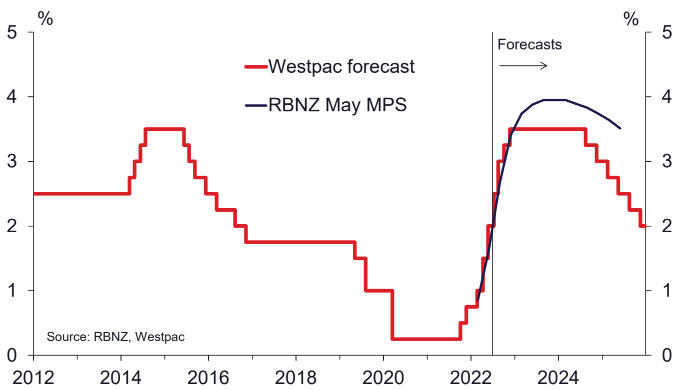
Michael Gordon, Acting Chief Economist
+64 9 336 5670
michael.gordon@westpac.co.nz

Keep on keeping on.

- We expect the Reserve Bank to raise the Official Cash Rate by another 50 basis points to 2.50% next week.
- Developments since the May statement have been mixed for the monetary policy outlook. Near-term inflation is still running hot, but the risks of a global slowdown have increased and early signs of a cooling in domestic activity have started to emerge.
- For now, the RBNZ will need to carry through with the interest rate hikes it has signalled, or risk undoing its good work so far on bringing inflation pressures under control.
- But at some point in the coming months it will be appropriate to signal that the end of the tightening cycle is near.

OCR forecasts



We expect the Reserve Bank to deliver a third consecutive 50 basis point increase in the Official Cash Rate at next Wednesday's review. That's more or less a unanimous view in the market, although pricing has flirted with the idea of a 75 basis point increase at times. It's also in line with the path that the RBNZ projected in its May *Monetary Policy Statement*, which saw the OCR reach about 3.5% by the end of this year, on the way to a peak of almost 4% next year.

The RBNZ's shift in its last two reviews to larger OCR hikes and a higher expected peak came as something of a surprise, as it didn't seem to be prompted by the flow of economic data at the time. Instead it was, as described by Governor Orr in the May press conference, a "behavioural change" within the RBNZ itself. In other words, it was a belated recognition that small, steady OCR hikes were the wrong way to deal with a problem of this scale. The OCR was a long way below where it needed to end up, and the risks around the medium-term inflation target were becoming heavily skewed to the upside.

Of course, we can't rule out further "behavioural change" in the future. But for now we have to assume that it has run its course, and that any future changes in the RBNZ's stance will be driven by how the economy evolves.

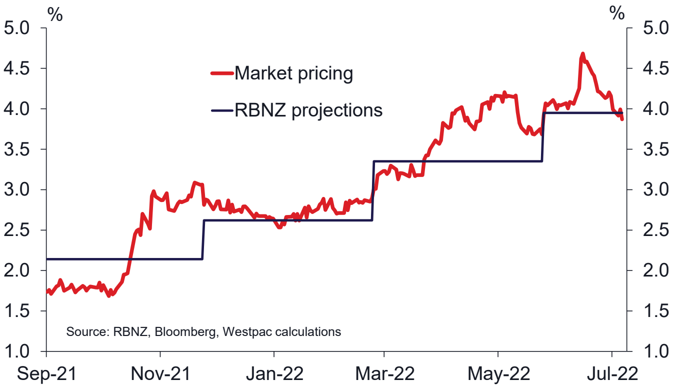
On that note, developments since the May statement have been mixed. The risks around near-term inflation look to be to the upside of the RBNZ's already-hefty forecasts, largely due to the second wave of fuel price rises. However, the surprise for the RBNZ hasn't been from crude oil prices but from a blowout in refining margins, which is even more likely to fall into the 'transitory' camp.

On the other hand, near-term activity is looking softer than the RBNZ expected. March quarter GDP fell by 0.2%, well below the RBNZ's estimate of a 0.7% rise. While Omicron disruptions were the likely suspect behind the March quarter decline, it doesn't look like June quarter activity will make up that lost ground to the extent that the RBNZ was forecasting.

Looking further ahead, the evidence for a softening in activity is more anecdotal than definitive at this stage. Certainly there needs to be some kind of slowdown in order to bring inflation pressures into line. But the lags involved with monetary policy – many borrowers are only just starting to feel the impact of the OCR hikes to date – mean that the risk of overdoing it is genuine.

Indeed, market thinking on this has been on quite a journey in a short space of time. Little more than a month ago, the concerns were all around inflation getting out of control, and central banks having to lift their policy rates even higher than they thought. That was egged on by the US Federal Reserve's decision to lift its policy rate by 75bps in June, having effectively dismissed the idea just weeks earlier. By that point, New Zealand interest rate markets were pricing in an OCR peak of 4.5% or more, against the RBNZ's projection of a 3.9% peak.

Evolution of the expected OCR peak



But in the last few weeks we've seen sharp declines in share prices and interest rates around the world, as markets have come to worry that rapid monetary policy tightening could drive the economy into recession. (Of course you can argue that an efficient market would have come to this conclusion immediately, not weeks later.) But while the speed of the adjustment has been dramatic, bear in mind that market expectations of the OCR have simply come back to be in line with the RBNZ's projections, and are close to where they were at the time of the May *MPS*.

Given where market pricing currently lies, if the RBNZ did become concerned about the risk of recession, it has a very powerful tool at its disposal: it could stop. For example, if it signalled that it was likely to stop hiking the OCR once it had reached 3%, we think that would see wholesale interest rates drop by as much as 50 basis points immediately (and as much as 100 basis points from their recent peaks). Mortgage rates would follow in turn.

But doing that now would risk undermining the work that the RBNZ has done to bring inflation pressures under control. For that reason, we think that for now the RBNZ will carry through with the OCR tightening path that it laid out in May, without bowing to the speculation about recession risks.

The August *Monetary Policy Statement* could be a different matter. We expect a fourth 50bp hike at that date, which would bring the OCR up to 3%. That's getting much closer to the RBNZ's projected peak of 3.9% (and our forecast of a 3.5% peak), and is more plausibly in the range of 'tight' monetary policy settings. At that point, we think the RBNZ could signal that it's getting on top of the situation, and that further OCR hikes are likely but will be data-dependent.

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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