WESTPAC ECONOMIC BULLETIN

Preview of RBNZ February 2022 Monetary Policy Statement.

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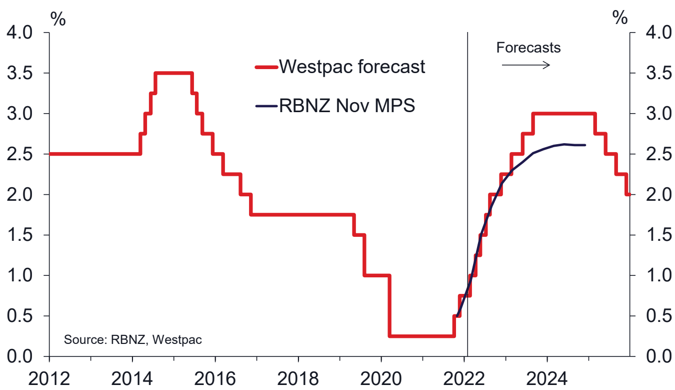
Stand and deliver.

- We expect the Reserve Bank to raise the Official Cash Rate by another 25 basis points to 1.00% next week.
- The RBNZ needs to take the heat out of domestic demand to rein in inflation pressures.
- But unlike many of its overseas peers, the RBNZ already has this process under way.
- Mortgage rates have already risen in anticipation of OCR hikes, and this is clearly having the desired effect on the housing market.
- To complete the job, the RBNZ will need to follow through on those rate hikes.
- Our forecast remains for the OCR to reach a peak of 3% by the second half of next year.
- That profile can be comfortably achieved in 25 basis point increments.

OCR forecasts



There will be a lot for the Reserve Bank to mull over ahead of next Wednesday's *Monetary Policy Statement*, not least because of the unusual three-month gap since the last policy review. Concerns about inflation, both here and overseas, have continued to escalate in that time. But there have also been other developments that give reason for a cautious approach. We expect that the RBNZ will lift the Official Cash Rate by a further 25 basis points to 1.00%, and continue to signal a series of rate hikes to come.

The direction for monetary policy is beyond doubt; the question now is the extent of tightening that will be needed to rein in inflation pressures. The RBNZ is well-placed in this regard compared to many of its overseas peers, having ended its bond-buying programme and started raising interest rates last year. But there is still more work to be done.

In November, the RBNZ's cash rate projections reached a peak of around 2.6% by the end of 2023 – broadly in line with what markets were pricing in at the time, but below our forecast of a 3% peak. We expect that the track this time will be lifted to something closer to our view, but not beyond that.

Developments over the last three months have been positive for the interest rate outlook on balance, but not overwhelmingly so. On the plus side, December quarter inflation was slightly higher than the RBNZ expected, and inflation expectations have continued to drift higher. A fall in the New Zealand dollar, even as commodity prices have continued to rise, will add further to inflation pressures in the near term.

But there have been some negatives as well, most significantly the housing market. Housing is a key channel for the transmission of monetary policy: interest rates affect house prices, which affect households' wealth and their willingness to spend, and ultimately the extent of demand-side inflation pressures.

Although we are still in the early stages of the hiking cycle, financial markets have already baked in a substantial number of hikes over the next couple of years. As a result, the most popular fixed-term mortgage rates have risen sharply from their lows since September. And we're now seeing the results of that: house price growth has slowed rapidly, and even turned negative in December and January. Curiously, the RBNZ upgraded its house price forecast in November, despite a higher interest rate track, and was expecting rapid house price gains through the second half of last year. Relative to that forecast, the housing market is falling well short.

This doesn't mean that the RBNZ's job is done, however. The housing market will only continue to cool off if mortgage rates remain at these levels. That means the RBNZ still has to deliver on the OCR hikes that the market is anticipating.

A peak of 3% by the second half of next year can be comfortably achieved in steps of 25 basis points. Financial markets also see 25bp as the most likely move next week, although they are factoring in a reasonable chance of a 50bp hike as well. We see this as unlikely. We've gone over the economic arguments for a larger move ahead of each of the last three policy reviews, and we won't rehash them here.

In our view, the case for a 50bp move was more compelling in November than it is today. Back then the OCR was further away from the expected peak than it is now, the RBNZ was facing some major upside surprises to its forecasts, and tactically, a 50bp move would have tided them over during the three-month gap between reviews. The fact that they didn't take up that option should tell us something about their preferences.

In November, the RBNZ singled out two factors that pushed it towards a smaller rate hike. The first was that fear of Covid in the community might dampen consumer spending and business investment going forward. Omicron hadn't made the headlines at that point, but the current outbreak plays right into that concern.

The second factor was uncertainty about how mortgage borrowers would cope with what had been a rapid rise in interest rates in a short space of time. We haven't had any direct evidence on that, but it's clear that higher interest rates have had an impact on the demand for new borrowing (with tighter lending regulations also playing a role). The RBNZ is getting the traction on the housing market that it would have wanted, and it doesn't need to step up the pace to get results.

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