WESTPAC ECONOMIC BULLETIN

Review of RBNZ Monetary Policy Statement, February 2022.

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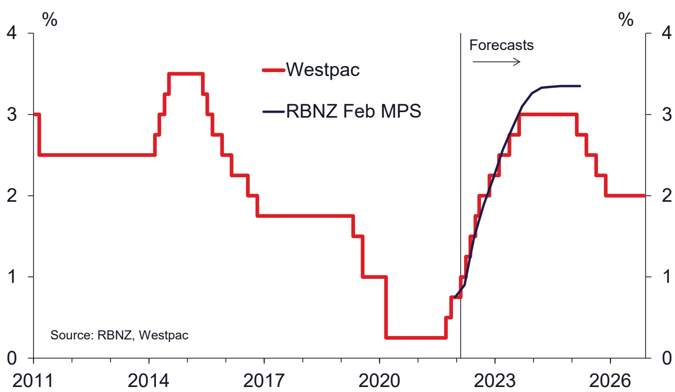
Heron there and everywhere.

- The Reserve Bank increased the OCR by a further 25 basis points to 1%, as expected.
- However, the statement showed a much greater concern about the build-up of inflation pressures in the domestic economy.
- The RBNZ now projects the OCR to rise above 3% over the next few years, higher even than our top-of-the-range forecast of 3%.
- We're not persuaded that it will ultimately need to go as high as the RBNZ expects, particularly given the signs that interest rates are already cooling the housing market.
- But for now, that does raise the odds of 'the heron taking flight' (to use the RBNZ's analogy) with a more aggressive 50 basis point move at future reviews.

Official Cash Rate



The Reserve Bank's decision today to lift the Official Cash Rate by 25 basis points, and signal more hikes to come, was well anticipated in the market. But the details of the statement revealed an even greater degree of concern about burgeoning inflation pressures than we had expected.

The Monetary Policy Committee noted (as it has on previous occasions) that the decision was finely balanced between a 25 or a 50 basis point move, and that the option of a larger move remains on the table for future reviews. It also announced that it would manage down its holdings of Government bonds – accumulated under the Large-Scale Asset Purchase (LSAP) programme in response to the Covid shock – by selling about $5bn per year, as well as allowing them to mature.

Most significantly, the RBNZ lifted its projections for the path of the OCR to a peak of 3.4% in 2024, compared to a 2.6% peak in the previous review in November. Not only is that higher than even our top-of-the-range forecast of 3%, it's a much bigger upgrade than we expected from the RBNZ given developments over the last three months.

On reflection, we probably underestimated how much the RBNZ would be unnerved by the rise in inflation expectations. Central bank credibility is hard-won and more easily lost; once expectations of above-target inflation become embedded, it can be economically costly to dislodge them.

The RBNZ's forecasts for activity and inflation are in many respects similar to our own, as we detailed in our latest quarterly *Economic Overview*. That suggests the difference lies in our respective views about what monetary policy settings will be needed to achieve those outcomes.

We agree that there's a substantial amount of work still to be done over the next couple of years to bring inflation pressures into check. But as we note in our *Overview*, some of the steam has already started to come out of the New Zealand economy, and the risks around demand pressures and the inflation outlook are starting to become more two-sided. For that reason, we're not ready to jump on board with the RBNZ's higher interest rate path just yet.

Most importantly, we've always put more weight than the RBNZ does on the role that interest rates play in house price cycles. And we're already getting evidence that current mortgage rates are having the desired cooling effect on the housing market. That in turn will affect people's willingness to spend, and ultimately the extent of demand pressures in the economy.

Nevertheless, if the RBNZ currently believes that it will need to lift the OCR that far, that raises the question of tactics. And here it's useful to refer back to what the RBNZ has said on this matter, in particular the speech last October by Assistant Governor Hawkesby.

Using the analogy of the kotuku (white heron), the speech noted that in normal times the RBNZ would most likely proceed in a series of small, steady steps. But under certain conditions, they may need to 'take flight' and move in larger steps. Those conditions were:

- How far away the RBNZ is from where it believes it needs to be;
- Whether the risks are becoming skewed in one direction;
- Whether there is a meaningful risk of not meeting their inflation and employment mandates over the medium term.

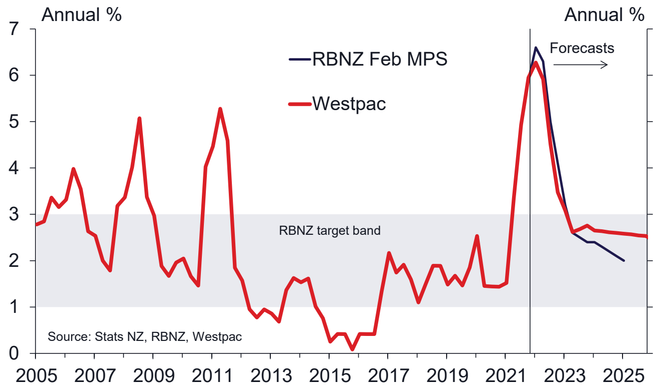
The first condition in particular is notable: compared to its forecasts last August, the RBNZ has increased its projected peak in the OCR by 120 basis points. So despite having put 75 basis points of hikes under its belt since then, the RBNZ sees itself as being further behind the curve now than it was in August or November.

Reaching an OCR of 3%, or even a bit higher, by 2024 can still be comfortably achieved in steps of 25bp at each review date. But tactically, there's surely a case for doing more of the heavy lifting up front, rather than spacing it out evenly over such a long period. The fact that the Committee wasn't able to get across the line for a 50bp hike today, or any of the previous occasions, suggests that the hurdle for heron-like behaviour is still quite high.

The decision to start selling down their Government bond holdings, while interesting in terms of how they'll manage this task, doesn't play much of a role in our thinking on monetary policy. Firstly, the RBNZ has noted that bond sales will not be actively used to remove monetary stimulus, and that they're looking to do this in a way that doesn't disrupt markets.

Secondly, our reading of the evidence suggests that the power of a bond purchase programme comes not so much from the purchases themselves, but from the signalling effect: buying bonds shows that the central bank is committed to keeping longer-term interest rates low, at a time when short-term rates may be running up against the zero lower bound. That doesn't apply in the other direction though – central banks are not constrained in their ability to signal higher interest rates in the future. So we suspect that whatever role the LSAP had in depressing longer-term interest rates has already played out.

Inflation forecasts



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