WESTPAC ECONOMIC BULLETIN

Preview of RBNZ August 2022 Monetary Policy Statement.

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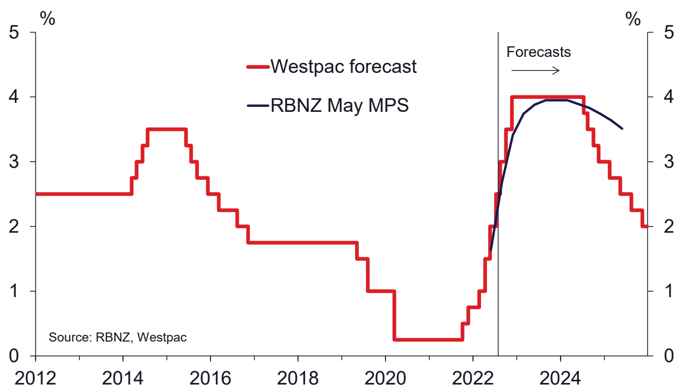
Pace setter.

- We expect the Reserve Bank to raise the Official Cash Rate by another 50 basis points to 3% at next Wednesday's *Monetary Policy Statement*.
- The RBNZ is likely to maintain a similar path for its OCR projections, in contrast to financial markets which have moved to pricing in a lower peak for this cycle and an earlier start to interest rate cuts.
- Continuing to tighten monetary policy "at pace" would send a message that while the fight against inflation is well under way, a declaration of victory is a long way off.

OCR forecasts



Both we and the market expect the Reserve Bank to increase the Official Cash Rate by another 50 basis points at next week's *Monetary Policy Statement*. That's been a settled matter for some time – even if the Reserve Bank hadn't repeated its wording around tightening monetary conditions "at pace" in its July review, the need for a continued strong response to inflation has been all too apparent.

The bigger question is around what the RBNZ signals for the path ahead. The outlook is becoming more mixed, with activity softening but inflation pressures even stronger than expected. What's more, financial markets are now trying to front-run the central bank in the other direction, pricing a lower peak in the OCR cycle and a turn to rate cuts as early as August next year.

With that in mind, we think that the RBNZ will want to keep emphasising its inflation-fighting credentials. Its task requires not just lifting interest rates to a certain level, but holding them there for long enough to do their job of bringing demand back into line. Any softening in the RBNZ's tone next week could see market interest rates fall even further, which would risk undermining the good work that the RBNZ has done so far.

We recently lifted our OCR forecast to a peak of 4% by the end of this year, from 3.5% previously. That was broadly in line with the track that the RBNZ published in its May *Monetary Policy Statement*, although a little more aggressive on the pace. We expect the RBNZ to run with something similar this time, in particular emphasising that interest rates will need to remain high for longer than the market is factoring in.

The language around moving "at pace" is arguably becoming more optional now. Successive large rate hikes mean that the gap between where the RBNZ is and where it needs to be has narrowed significantly, which could allow for a return to normal-sized 25 basis point OCR moves. However, we think that the RBNZ will favour getting the job done quickly rather than dragging it out into next year. Retaining the phrase "at pace" would keep the door open for further 50 basis point hikes at future meetings.

Economic developments since the May statement have been mixed. The outlook for growth both here and overseas has softened, but there is also mounting evidence of some fairly stubborn homegrown inflation pressures.

Inflation rose to another three-decade high of 7.3% in the year to June, even higher than the RBNZ expected. What will be of most concern is the extent to which this was driven by prices that are determined by local forces (the portion that could be considered 'imported' inflation was actually softer than expected). Those domestic price pressures are what monetary policy can, and should, respond to.

This was reinforced by the June labour market surveys, where the measures of wage growth were also stronger than forecast – by a bit for the Labour Cost Index, and by quite a lot for the more volatile Quarterly Employment Survey. Admittedly the unemployment rate was weaker than forecast, recording a small rise rather than the expected small drop. But that combination of stagnant jobs growth and surging wages will reinforce to the RBNZ that the economy is operating well beyond the 'maximum sustainable' level of employment.

One thing that has gone more the RBNZ's way is expectations of future inflation. This week's survey showed that expectations for two years ahead fell from 3.29% to 3.07%. The drop itself isn't surprising – the reference period has moved forward by one quarter, which means three months further beyond the spike in imported inflation, and three months further into the period of tighter monetary policy. But it will give the RBNZ some comfort that expectations are genuinely forward-looking – businesses aren't simply assuming that future inflation will look like the recent past.

The slowing in the world economy is in part by design, as central banks have ramped up their own fights against inflation. But it has also been driven by a series of other shocks: ongoing supply chain disruptions, the Russia-Ukraine war, and the return of Covid restrictions in China. The impact of these shocks will be felt in New Zealand, particularly through the demand for our exports – commodity prices have fallen in the last three months. That will take some of the heat out of the RBNZ's inflation battle, but it won't be the dominant factor.

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