WESTPAC ECONOMIC BULLETIN

RBNZ November 2022 Monetary Policy Statement.

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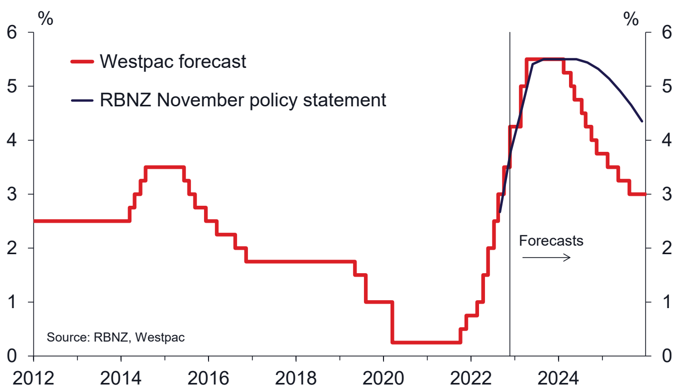
History doesn't repeat, but it rhymes.

- We have revised up our Official Cash Rate forecast to a peak of 5.5% by April next year.
- This incorporates a 75 basis point increase in February and a further 50 basis points in April.
- However, we have also brought forward the expected downleg of the cycle, with OCR cuts starting from early 2024.
- The Reserve Bank is firmly committed to breaking the dynamic of rapidly rising prices and wages.
- It is now openly forecasting that this will require a prolonged downturn in the economy.
- But history suggests that recessions can break the back of inflation fairly quickly.
- We think the risks lean towards inflation being a bit less persistent in the years ahead than the RBNZ is forecasting.

OCR forecasts



The Reserve Bank remains on the warpath against inflation, lifting the Official Cash Rate by a record 75 basis points to 4.25% today and signalling much more to come. The RBNZ is increasingly concerned that inflationary forces are becoming embedded in the New Zealand economy, and indeed is now openly predicting that a recession will be needed to bring inflation under control.

The size of today's increase was expected by the majority of forecasters. As we noted in our preview last week, there were good reasons to expect the RBNZ to pick up the pace this time, compared to the 50 basis point increases that we've seen at prior reviews.

What was more of a surprise was how much more the RBNZ thinks there is to come. Its projections point to a peak of 5.5% by the middle of next year, a massive upgrade from the 4.1% peak that was projected in the August *Monetary Policy*

Statement. And moving 'at pace' remains the watchword – a literal read of the published OCR track would require another 75 basis point hike at the next review in February, and a further 50 basis points in April.

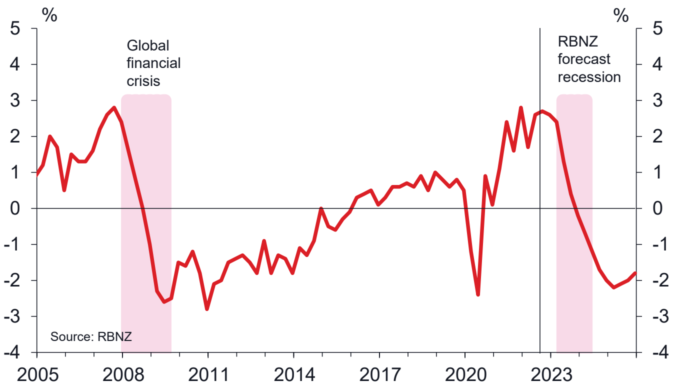
Given the RBNZ's inclinations (and it's not clear what would come along in the next few months to dissuade them from this) we've adopted the same forecast for the near term, with a peak OCR of 5.5% in April next year. We acknowledge the scale of the challenge that the RBNZ faces in breaking the cycle of rising prices and wages.

But for the first time in a while, we're also thinking about the risk that the RBNZ could end up overcooking it on the inflation front. We now expect OCR cuts to begin in early 2024, six months earlier than we did previously. Those rate cuts are both earlier and faster than what the RBNZ is projecting.

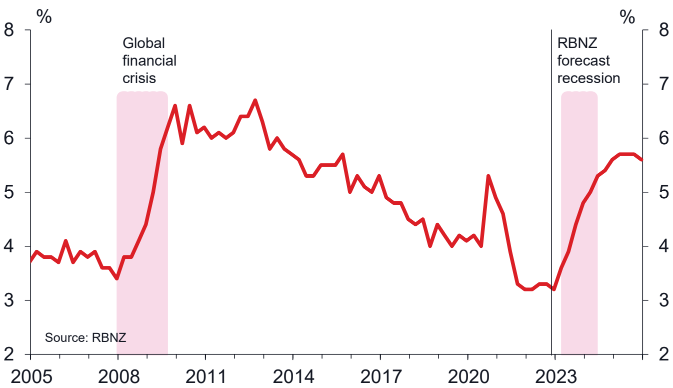
Make no mistake, the RBNZ is not just signalling a recession, it's forecasting a downturn on a similar scale to the Global Financial Crisis – different causes, but similar consequences. On the RBNZ's forecasts, economic activity continues to fall below its potential long after the recession has 'officially' ended. And the unemployment rate rises by several percentage points – albeit from a low starting point – just as it did in 2008-09.

Even so, the RBNZ expects wage and price inflation to remain stubbornly high in the coming years. Headline inflation is expected to rise further to a peak of 7.5% in the next two quarters, only receding to 5% by the end of next year and dropping back into the 1-3% target range in the second half of 2024.

RBNZ output gap estimate



RBNZ unemployment estimate



But the lesson of the Global Financial Crisis is that it actually broke the back of inflation fairly quickly. Non-tradables inflation – the portion that tends to be driven more by local conditions rather than offshore forces – slowed quite sharply, compared to where it had been running over much of the previous decade. Wage growth didn't even peak until 2009, but that is typically the last shoe to drop in the economic cycle. And once it turned, it remained stubbornly low for years to come.

Admittedly the scale of the inflation problem is greater now than it was in 2008, or indeed at any point in the last 30-odd years of inflation targeting. But we shouldn't lose sight of the fact that monetary policy works, eventually. As we detailed in our recent *Economic Overview*, a growing number of borrowers will be rolling onto substantially higher mortgage rates in the coming months, which will eat into households' spending power. The next 12 months will be much more telling than the past 12 months have been.

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