



# ECONOMIC BULLETIN

## Hawks, doves, and kiwis.



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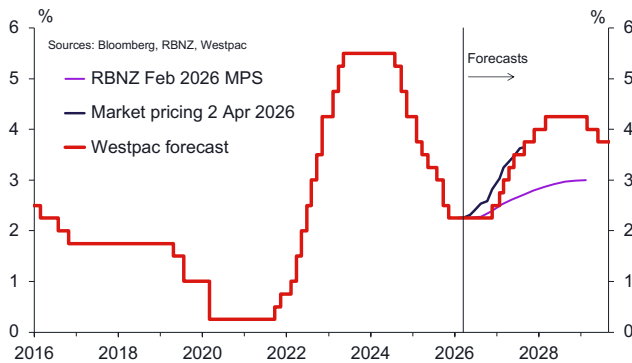
### Overview.

As discussed **in our preview this week**, the outcome of the upcoming Monetary Policy Review seems certain – an OCR maintained at 2.25%. However, looking further ahead, we think there is likely to be a diversity of views across the Monetary Policy Committee (MPC) about how the Middle East conflict is likely to play out; the likely impact on the economy and inflation; and the appropriate monetary policy response.

In this edition of our regular “Hawks, Doves and Kiwis” note, we survey some of the arguments that might be advanced by MPC members as they seek to tease out the implications of this shock. Some of those arguments would push the RBNZ in a more “hawkish” direction, while others would counsel a “dovish” response.

We expect to see at least some of these perspectives raised in the Record of Meeting that will be published after next week’s meeting. However, it will likely take some time before it becomes clear which path the economy and monetary policy will take.

### Official Cash Rate forecasts

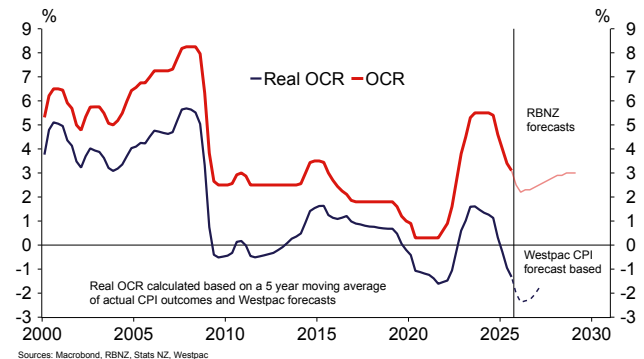


### The Hawk’s Eye View.

The Middle East conflict is both large and possibly long lasting. The current 2.25% nominal OCR was set with a view to a very different outlook. More neutral settings will soon be appropriate while we assess the size and duration of the inflation shock.

- Inflation is likely to rise to the 4-5% range at the very least. And the shock could be long lasting, reflecting the significant supply chain disruptions at play.
- The OCR was set based on a forecast of a high level of excess capacity which still seems relevant. But it also envisaged an inflation rate that would soon move back inside the inflation target range. This is unlikely now.
- Hence the real OCR is now much lower than was anticipated would be the case in late 2025/early 2026. Indeed, the real OCR is now likely in deeply negative territory and will fall a lot further as inflation rises.
- We would need to make heroic assumptions to think inflation expectations will remain low enough to think that real interest rates are not now low and falling.
- This inflation shock comes after a long period of above target inflation. This further challenges the idea that inflation expectations will remain unimpacted.

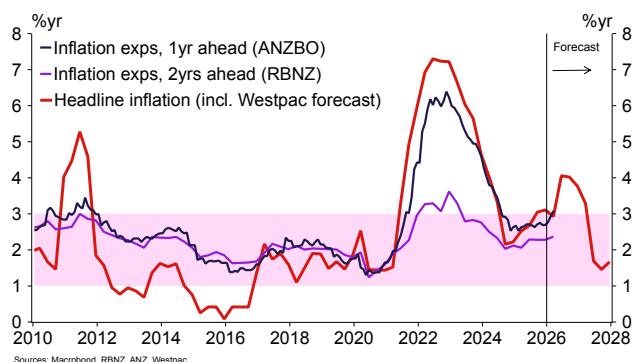
### RBNZ forecasts of the nominal OCR and estimated real OCR



Significant risks to inflation expectations and wage setting behaviour could result from the inflation shock. This requires a proactive response to avoid a later OCR overshoot.

- The shock to the inflation rate is extreme and the duration of the shock unknown.
- Price setting behaviour could quickly adjust to reflect the shock. Pricing intentions were already high, and costs are increasing in a visible way. Customers are likely to accept a price rise given the Iran war.
- Labour market conditions are not uniformly loose. Skilled labour remains hard to get and there are considerable costs for firms to replace lost skilled workers. These firms may opt to compensate those workers given the broad-based nature of the inflation shock.
- Given the risk of a lift in inflation expectations, it's no longer appropriate to retain stimulatory conditions. Policy should be at least neutral in the current circumstances. A quick adjustment of the OCR above 3% is appropriate.

**Inflation and inflation expectations**



Many central banks will likely be forced to tighten monetary policy in response to the inflation shock. The RBNZ will need to follow suit or exchange rate depreciation will be a significant risk.

- Most of the move up in market interest rates has reflected global dynamics.
- Global rates are rising reflecting the inflation shock and an expectation that central banks won't accommodate the shock.
- If the RBNZ retains relatively low short-term rates then downward pressure on the exchange rate will occur. This will add to inflation pressures.
- Some rise in the OCR to compensate for rising foreign rates is thus appropriate – likely towards the 3.5-4.5% range now likely for the US and Australia.

Even if the Iran war is quickly resolved, a legacy of high inflation will remain. It would be better for the OCR to

be positioned much closer to neutral levels to bring that inflation down to 2%.

- Even if the war ended tomorrow, inflation would be much higher than thought when the 2.25% OCR was last considered by the MPC.
- While doves can argue that accumulating excess capacity means an accommodative stance is appropriate, growth could quickly be restored if the war ended.
- The uncertain situation argues for a more neutral policy stance. Certainly, the odds of an undershoot of core inflation in the next 2 years looks remote.

### The Dove's Tale.

Good central bank practice is to look through the direct impact of supply shocks.

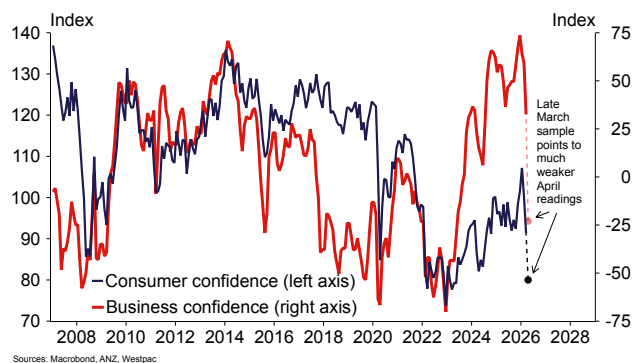
- The RBNZ cannot offset with higher interest rates the impact on near-term inflation of an increase in oil prices that's already occurred.
- As interest rates usually take around 12 to 18 months to have their full effects, interest rate hikes now could compound the downwards pressures on activity just as inflation will naturally be falling back, thus amplifying rather than dampening the cycle in inflation.
- Monetary policy tightening would only be appropriate if there were clear evidence of second-round inflation pressures that would not be addressed by the additional surplus productive capacity created by the shock.

The impacts on activity from the Middle East conflict are likely to be large, especially considering the fragility of New Zealand's recovery.

- GDP growth disappointed last year, with the recovery seemingly interrupted by uncertainty associated with US tariff policy. Many smaller firms will be poorly positioned to cope with a further year of disappointing growth.
- Consumer and business confidence has already taken a significant hit, and next month's surveys seem likely to be weaker again. Firms already report the curtailing of some activity.
- Uncertainty will lead to delays in making major decisions (such as hiring and investment proposals); a reduction in discretionary purchases due to a squeeze on household disposable incomes; and downward pressure on asset prices (including housing).
- In this environment, even a 2.25% OCR is unlikely to stimulate activity. While the real OCR this year will be lower than forecast previously, it is absurd to suggest that financial conditions have been eased by this shock.

- Long haul travel to New Zealand is likely to be lower than forecast previously due both increased costs associated with travel, physical disruptions through major hubs and perhaps travellers' reluctance to travel long distances.
- There is a risk that the conflict is protracted, and that the related disruptions cause a larger and more enduring lift in inflation than expected. However, in such circumstances, there is likely to be an even sharper downturn in economic activity. Tightening policy in such circumstances would be unnecessary.

### ANZ consumer and business confidence



The output gap is already sufficiently negative to place the required downward pressure on inflation over the medium term.

- Some countries will likely need to tighten monetary policy. This is because they will need to generate the excess capacity required to ensure that a near-term spike in inflation does not lead to persistent inflation over the medium-term.
- By contrast, New Zealand's economy already has significant spare capacity and that capacity is now unlikely to be absorbed this year given the weaker outlook for growth.
- The current level of spare capacity proved sufficient to normalise pricing setting behaviour – including wage growth – in the wake of the huge Covid inflation shock.
- It is unclear why even greater spare capacity would be required to dampen inflation this time, especially with fiscal policy providing a more supportive role than during the Covid shock.
- Tightening now will needlessly generate even greater spare capacity – probably including an unemployment rate over 6% – adding to the real cost of this shock to the New Zealand economy.

### Unemployment rate and wage growth



The oil price shock could expose other much-discussed weaknesses in the global economy, leading to a generalised tightening of financial conditions. The RBNZ needs to be wary of tightening into what could be a sharper global slowdown than currently assumed.

- Stresses caused by the oil shock could expose other vulnerabilities in the global economy, such as concerns about equity market valuations, private credit and structural weaknesses in China's economy.
- Some central banks will have little choice but to tighten policy (e.g., the RBA). This will weigh on trading partner growth and feed back into the outlook for both the demand for and prices of New Zealand's exports.
- The RBNZ needs to consider these risks especially given the weak starting point for the recovery.

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