

NZ Insight: The Middle East conflict – inflation and monetary policy scenarios

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Key points

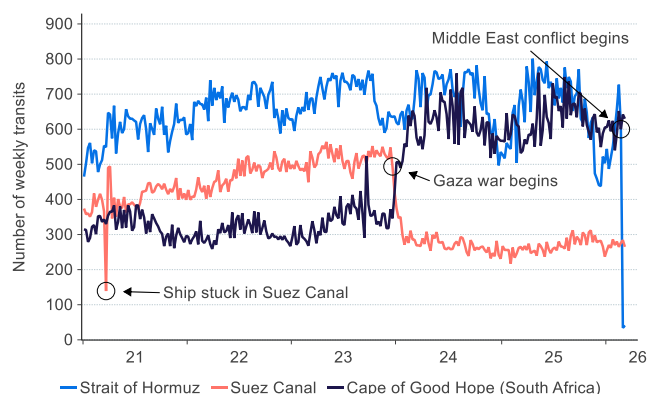
- We have [recently updated our CPI forecast](#) – our first attempt at centralising the impact of higher oil prices.
- This note challenges the many assumptions underpinning that forecast, and highlights how hard it is for the RBNZ to diagnose the medium-term inflation implications of this shock in real time.
- To clearly illustrate that point, we present two deliberately extreme scenarios (high impact, but low probability) that focus on the potential implications for medium-term inflation.
- Both scenarios have CPI inflation lifting sharply in the near term, but they differ significantly when it comes to the more lasting implications for inflation expectations and economic slack.
- Until there's clear evidence the economy is skewing towards one scenario over the other, we think the path of least regrets for the RBNZ is to maintain a similar trajectory for the OCR as envisioned before this shock. But in the meantime, the RBNZ's tone could quite rightly skew more towards leaning against the upside inflation risk.

No longer a short, sharp shock

The challenges facing the New Zealand economy as a result of the current Middle East conflict pale in comparison to the impact on the millions of people directly affected. But for as long as goods cannot enter or leave the Persian Gulf via the Strait of Hormuz, and global oil production is constrained, the New Zealand economy will be affected by this conflict.

While uncertainty is extreme, it's fair to conclude that the Middle East conflict has moved beyond a short-lived geopolitical shock into a phase where the risk of persistent oil supply losses is growing. Beyond the initial shock phase, oil markets tend to shift from pricing uncertainty to pricing endurance, where the key question is how long producers can physically sustain output under deteriorating operating conditions. Infrastructure damage, security risks, staffing constraints and logistics disruptions can linger long after headline tensions ease.

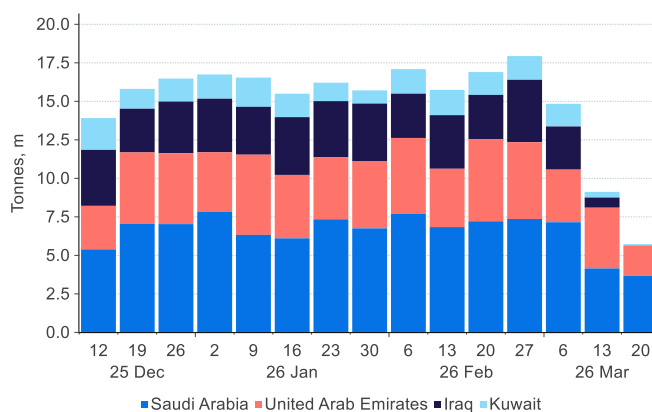
Figure 1. Disruption to Middle East shipping routes since 2021



Source: IMF, Macrobond, ANZ Research

Prolonged disruptions increase the risk that operators will shut-in wells to protect reservoir integrity and ensure worker safety. In that scenario, bringing them back online is neither immediate nor guaranteed. Restart risks mean that temporary disruptions can translate into longer-lasting supply losses, even if security conditions stabilise. Inventory releases can ease near-term pressure but are not a substitute for lost production. The longer the disruption persists, the higher is the oil price needed to restore balance. That keeps the skew of risks to the upside for oil prices and thus persistent oil-driven inflation pressures in New Zealand.

Figure 2. Persian Gulf oil exports



Source: Bloomberg, Macrobond, ANZ Research

But this is not the 1970s

While the world economy has faced oil supply shocks before, the transmission to inflation and monetary policy in New Zealand should be less severe than the shocks in the 1970s. The economy is less oil-intensive than it was in past decades, reflecting higher energy efficiency and a shift toward services, which dampens the growth hit from higher fuel prices. On the supply side, global oil production is more responsive and geographically dispersed than it once was, with shale and other flexible sources limiting the persistence of price spikes.

Crucially, there is far less wage indexation than in the 1970s, reducing the risk that a relative price shock to oil morphs into broad-based, self-sustaining inflation. That dynamic is reinforced by credible, independent inflation-targeting central banks and well-anchored inflation expectations. Finally, macro-stabilisation policy frameworks are more automatic and faster-moving, allowing fiscal and monetary policy to respond more nimbly and hopefully not in direct conflict with one another. Together, these factors suggest an oil shock today is more likely to be a painful relative price adjustment than an entrenched inflationary episode such as we've seen in history. But it's important to acknowledge the risks – and that's something scenarios can help with.

Beyond the near term: two relatively extreme scenarios

Thus far, attention has understandably gravitated toward the near-term CPI implications of the current shock (if oil prices rise to \$X, CPI inflation could peak at Y%). However, for central banks, it's the medium-term inflation implications that really matter. Is it a temporary supply shock that can be safely "looked through", or a shock that could well result in meaningfully higher or lower inflation than otherwise over the medium term, if you don't act against it? Telling the difference is unfortunately no easy feat – at least until you have 20/20 hindsight well after the fact.

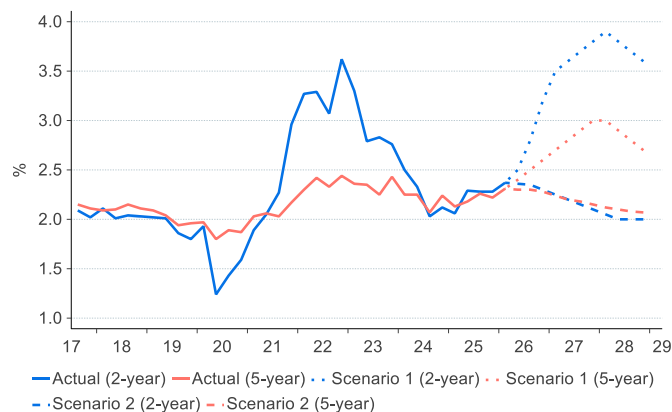
We set out two scenarios examining what could shift the medium-term inflation outlook and therefore require a significant response from the RBNZ. Crucially, it will take time before the RBNZ knows which scenario is unfolding (likely a much milder variant than we portray here!). And that raises the odds that monetary policy settings (and perhaps fiscal policy settings too) end up a bit off the mark for a time, adding to the problem – not a policy mistake *per se*, but the reality of policymaking under uncertainty.

Scenario one: too much inflation

This scenario has parallels to the post-pandemic inflation experience in that the inflation surge is initially diagnosed as “transitory”, but it broadens into medium-term non-tradable and core inflation that then demands a more aggressive monetary policy response than would have been necessary had it been accurately identified in real time. In this scenario:

- Economic demand is more robust than expected (e.g. confidence impacts prove smaller than expected, or our export prices go ballistic), and supply more constrained (e.g. global shipping is a mess). Policy makers (the RBNZ and Government) initially mis-diagnose the situation as a net negative demand shock over the medium term.
- The Government adopts an expansionary fiscal stance, including debt-funded transfers to households and/or broad-based tax relief (including fuel tax cuts).
- Unemployment stays fairly high, and this is initially misidentified as cyclical weakness when it actually turns out to be due to labour market scarring (“hysteresis”) from the previous downturn (in the lingo, a higher NAIRU) – for example, say, if we’ve lost many more skills than we’ve gained through the net migration slowdown, and firms have to compete hard for the skills they need. That means for a given unemployment rate, there’s more inflation in the system than otherwise – and more inflation than expected. We assume the mistake takes time to identify.
- Monetary policy is too accommodative for too long. This is not difficult to envisage: if economic demand remains robust and the OCR is held at 2.25% while CPI inflation accelerates well beyond that level, the *real* OCR becomes increasingly negative. This dynamic goes into overdrive when the near-term inflation spike ends up larger and more persistent than the RBNZ’s initial forecast. And because monetary policy impacts inflation with a lag, by the time the CPI data confirms the initial diagnosis was wrong, it’s too late – the RBNZ is now in catch-up mode!
- Medium-term inflation expectations push meaningfully higher, which combined with an assumption of no global market dislocation, robust demand, and ample credit availability leaves *effective* real interest rates across the economy in a very stimulatory position.
- Overall, we end up in 2027 with aggregate demand exceeding supply (a positive output gap) and unanchored inflation expectations causing non-tradable and core CPI inflation to accelerate well beyond our forecast and eroding the RBNZ’s inflation-fighting credibility. With high inflation now embedded, the RBNZ has to inflict significant pain on the economy to bring it back down to target in an acceptable timeframe.

Figure 3. Inflation expectations under each scenario



Source: RBNZ, Macrobond, ANZ Research

Scenario two: a sizable net demand shock

Scenario two is for the doves. Inflation still rises sharply in the near term – that’s looking unavoidable – but the damage it causes to aggregate demand persists much longer than the initial supply disruption does. Policy makers initially misdiagnose the medium-term implications in this scenario too:

- As a net importer of petroleum products, the hit to New Zealand’s terms of trade dominates any offset from a lower NZD – it’s a negative national income shock.
- Uncertainty weighs on global demand, and that weighs on New Zealand’s export prices more than cost-push factors might boost them. Export prices fall, adding to the terms of trade pain.
- However, the RBNZ is worried about the potential implications for inflation expectations and decides it would be safer to have the OCR at a more neutral level – they start hiking the OCR from April 2026 with the intention of getting the OCR back in line with its assumed long-run neutral level of 3%. This compounds the negative impact on economic confidence and signals to the market that even more hikes should be priced in (pushing up swap rates).
- Discretionary fiscal policy settings are maintained at current levels, with the Government reluctant to use its balance sheet in fear of repeating the inflation-fuelling pro-cyclical expansion that followed the pandemic.
- CPI inflation surges in the near term, but its impact on an already-stretched household sector, combined with heightened uncertainty, causes households to tighten their belts significantly. That deepens the net demand shock.
- Uncertainty causes firms to pull back on investment and hiring, compounding the weakness in demand and leaving the labour market in a disinflationary state for longer.
- Medium-term inflation expectations (and price-setting behaviour) remain anchored around 2% throughout the shock. Firms’ ability to pass on cost increases is limited throughout.
- Risk premia rise sharply, independent of the policy rate, as investors demand greater compensation for duration and credit risk. This pushes up swap rates further and leaves *effective* real interest rates far more contractionary than otherwise. Mortgage rates increase more than otherwise, contributing to declines in house prices.
- Overall, the shock to aggregate demand over the medium term exceeds that to supply, with the output gap drifting further into negative territory.
- While not necessary for our dovish scenario, other global vulnerabilities could certainly exacerbate this one. For example, the current shock could spill over into global asset prices vulnerable to correction; private credit risks could materialise and become systemic across the global financial system; fiscal sustainability concerns in some economies could cause significant volatility in global bond markets, eventually forcing a sharp adjustment in fiscal settings (e.g. sharply higher taxes and/or lower government spending) slowing global growth further (and the New Zealand bond market wouldn’t be immune).
- The RBNZ then faces a significant risk of medium-term inflation being too low, and ultimately cuts the OCR far more aggressively than it raised it initially.

Figure 4. Non-tradable inflation



Source: Stats NZ, Macrobond, ANZ Research

Figure 5. OCR



Source: RBNZ, Macrobond, ANZ Research

Which scenario is more likely?

First, both scenarios have been designed to be “extreme” for story-telling purposes, so we wouldn’t characterise either of them as “likely”. In fact, the details of the scenarios aren’t even mutually exclusive – elements of both could come to pass.

On the one hand, we see a very real risk that inflation expectations push higher alongside actual inflation over the next few quarters, and a very real risk that NAIRU is drifting higher – wage expectations in [our latest Business Outlook](#) have started lifting even with unemployment still high. We also see a risk that the Government adds to aggregate demand with its response.

But the net negative demand risks stemming from the terms of trade implications, the impact on already-stressed households, and the potential impact on business investment and hiring should not be discounted, particularly given New Zealand’s economy is currently out of synch with most of our trading partners and is relatively early in a recovery from recession, implying confidence could be fragile. At this stage, it’s difficult to have strong conviction on whether this shock is a net upside or downside risk to the OCR. The market has opted for the former, and understandably so. As inflation data rolls in, that’s an obvious conclusion to draw. But it’s more complicated than that.

What’s the appropriate monetary policy response?

As our scenarios highlight, the Monetary Policy Committee has its work cut out. Because monetary policy acts on the economy with a lag, their job is to pre-empt the future state of the economy, setting policy today in order to achieve their inflation target over the medium term. But in the midst of a risk-off supply shock like this, that’s not easy to do. As is often the case with monetary policy making under uncertainty, it’s the “path of least regrets” that guides the Committee’s decisions. And for now, we think that path is to assume that the surge in oil prices will temporarily add to inflation, but that any lasting implications for inflation expectations and economic slack will be minimal and broadly offsetting¹. And for now (until the data or situation changes our mind) we think that speaks to sticking to a similar path for the OCR as envisioned before this shock. But the RBNZ’s tone at the upcoming Monetary Policy Review (8 April) could quite rightly skew more towards leaning against the inflation expectation risks.

Would having a dual mandate (an additional full-employment target) make a difference? The short answer is no. It would change how the RBNZ communicates policy, but if we want low, stable and predictable inflation

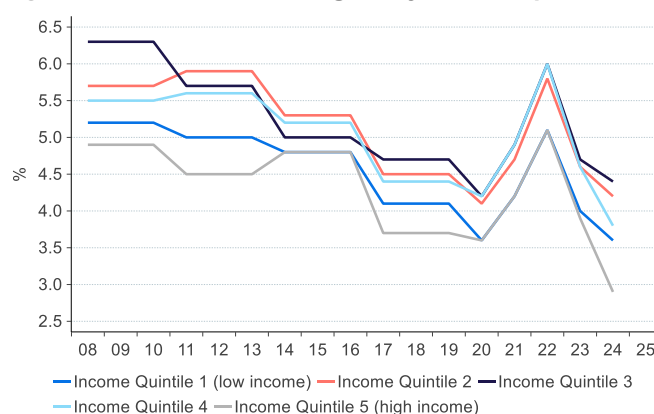
¹ In central bank speak, it’s the shock term of the Phillips Curve driving the initial inflation spike – and initially, that can be looked through. However, the potentially offsetting and longer-lasting impacts on the inflation expectations and economic slack terms are an unknown. The working assumption, at least initially, is likely to be that the shock term fades back toward zero over coming quarters. Meanwhile, attention will remain fixated on how the other components of the Phillips Curve are evolving – that’ll take time to work out.

over the long run (which we certainly do), short-term labour market outcomes would be a sacrificial lamb either way. It's a key part of how monetary policy works, and the wording of a mandate doesn't change that.

Gauging the magnitude and threat to New Zealand's nascent recovery

The first thing to highlight is that this shock is not going to impact everyone evenly – but shocks never do! Figure 6 shows that according to the household living-costs price indexes (HLPs), the highest and lowest income quintiles are least exposed to higher fuel prices. That is, fuel is a smaller share of income at the higher end (and these households also have the option to buy more fuel-efficient or electric vehicles), while low-income households likely have lower rates of vehicle ownership (but will still be affected by hikes in public transport fares, for example). According to the latest data, it's second- and third-income quintile households that have the largest direct exposure to higher petrol prices. But what figure 6 also shows is that when petrol prices surged in 2022, all income quintiles felt it. Lastly, it's important to note that spillovers into other parts of the CPI basket, such as food prices, will have an outsized impact on low-income households. This is more than a fuel price shock.

Figure 6. Petrol income weights by income quintile



Source: Stats NZ, Macrobond, ANZ Research

Turning back to the aggregate impacts, and based on what we currently know (and the assumptions we are having to make to put our forecasts together), we'd say the magnitude of this shock on the New Zealand economy is likely to be more significant than that following the outbreak of war in Ukraine in 2022, but much less significant than following the COVID-19 pandemic. But when it comes to geopolitics, we're cognisant that things can escalate quickly.

We will be updating our GDP forecasts once we've had a chance to incorporate the Q4 data, but in general the impact on growth can be expected to be smaller than the impact on inflation, meaning that while annual average growth is likely to be lower than otherwise in 2026, we don't think it'll go negative. We'll have more to say on that in tomorrow's Data Wrap. More broadly, we will update our forecasts as new information continues to come to light.

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