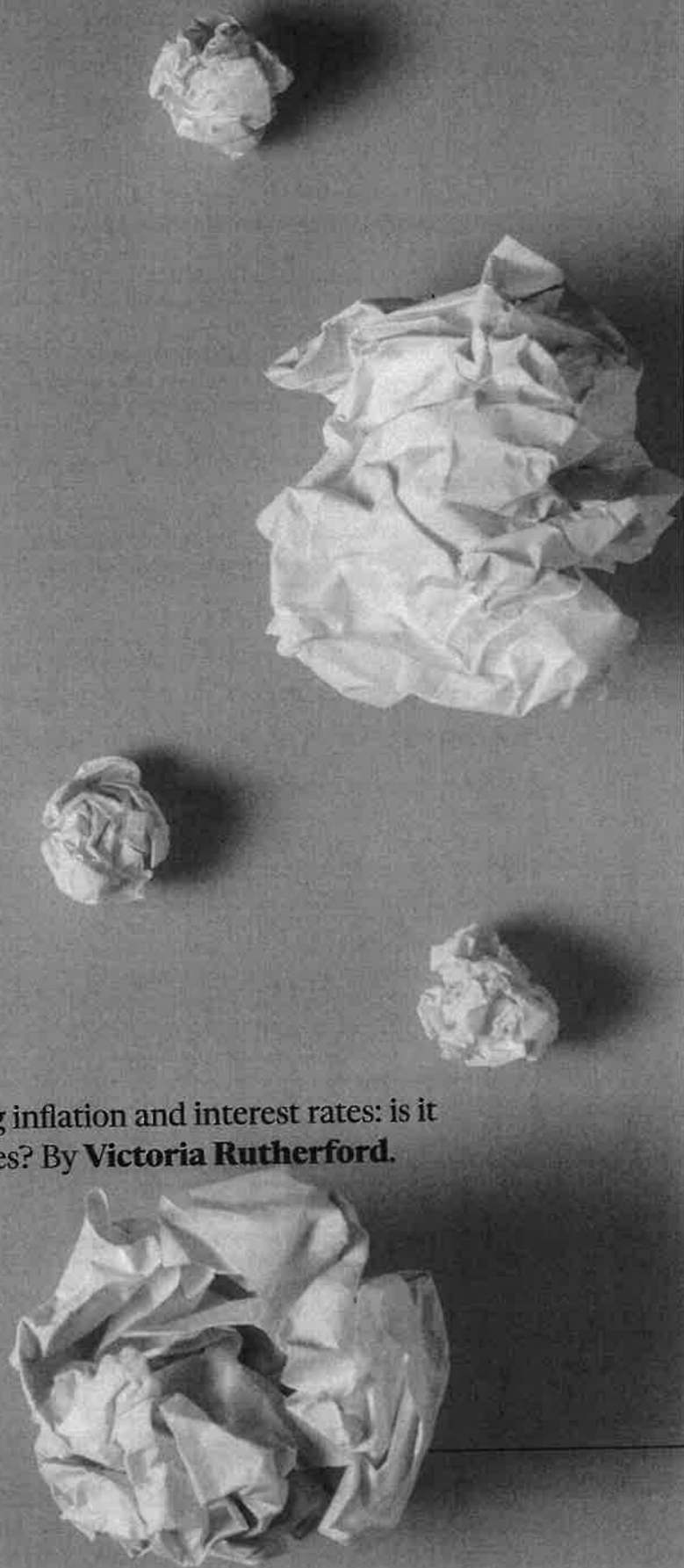


Rethink methodology. the

The methodology for calculating inflation and interest rates: is it time for a rethink in volatile times? By **Victoria Rutherford**.



The impact of rising inflation and the interest rate hikes designed to kill it have raised questions about whether the methodology used by the Reserve Bank of New Zealand (RBNZ) to measure inflation and set interest rates is outdated.

Timaru-based New Zealand Agri Brokers (NZAB) director Andrew Laming says his business uses mechanisms which could be improved, such as adopting inflation measurements monthly rather than quarterly. This would help avoid the lag time and address where the current approach may lead on to unintended impacts in future.

"The lagged nature of our system is quite startling. We probably haven't cared about it before because we've never seen such quick or dramatic shifts in inflation. It simply wasn't that volatile."

To understand why this is an issue, we need to look at how inflation is calculated, Laming says.

Inflation occurs when demand for goods and services in the economy outpaces supply. High inflation dents our trust in money – if we believe it won't be worth a similar amount in the future it starts to lose its "trust".

Inflation is calculated by Stats NZ, examining a "basket" of goods and services and their change in price over time, presented as a Consumer Price Index (CPI). At 7.2%, it's well above the 1-3% mandated by the RBNZ.

Laming identifies three key areas where improvements could be made.

1 CPI is measured over a 90-day period and looks backwards

The CPI for the Dec 2022 quarter was 7.2%. In October last year households were paying an average of only 4.07% on their home lending as they still had fixed rates in place.

"Household savings were still semi-high and [Reserve Bank governor] Adrian Orr hadn't delivered his November monetary statement reprimanding public spending and talking of significant further increases in rates. In other words, people hadn't changed much at this point."

In countries such as the USA, CPI is measured monthly and Laming believes adopting this system would be a good start.

2 CPI records a change in price, not volume

The calculation methodology measures the changes in price of goods or services, but it doesn't measure the change in volume of how many or how much they're purchased for. They are weighted, but that weighting only changes every few years.

"If food prices (which make up about 19% of the index)

go up for the year by 10% but we all collectively spend 10% less because we can't afford as much (meaning purchasing volume goes down), this registers as a 10% increase in inflation (for that category) even though we may have spent a similar amount to the previous year.

"Economics eventually solves this – that is, if we all start buying less of something that costs more, that 'in theory', with all else held equal, might lead to a build-up of stock of that item, which would then mean prices would go down to bring supply and demand back into equilibrium. But that takes time to work through – again, 'a lag'."

3 Fixed rates – average interest rates on home loans are still low (but rising fast)

About 50% of all fixed rate loans will come off this year. In November 2022, the average rate (a mix of historical fixed rates) was only 4.07% and an estimated 4.5% by the end of Jan – while the current short-term re-fix rate is much higher at 6.5%. In short, the impact on spending in the economy is set to intensify.

Given the high use of fixed rates by New Zealand homeowners, albeit short in length (1-3 years), Laming says you could effectively put up the Official Cash Rate (OCR) to 10% and it wouldn't make much difference to how much a homeowner is paying in interest right now.

"This comment is an extreme example, as it would scare the population into spending less due to fear of the future – but the point is that it takes time for the increase in OCR to work its way into actual spending habits. You must be patient to see its effects as it flows through the fixed curve."

The impact is happening quicker in farming and in business where loans are typically floating, commercial-type products and they see rises as the 30- or 90-day bill goes up.

Laming says the lagged nature of this system is startling.

There are OCR decisions being made using a period of time that has well passed, using methodology that doesn't fully capture people's reducing spending habits. That doesn't even have an impact on the wallet until sometime in the future.

It's important to remember a lag can work both ways too, Laming says. "When we need to kick-start our economy again due to low GDP, an OCR drop will take time to filter back through the economy. We run the risk of locking in the pain for longer with these dramatic shifts in OCR."

"History is not always a good guide for future results, and all of this could be completely wrong if we're not out of this inflation spiral yet," he says. "But whatever the actual answer is, our current lagged methodology for setting rates based on historical data requires a rethink." ②



This story has been edited for length and clarity – for the full article go to www.nzab.co.nz