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Research
Economy Watch

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RBNZ Takes Fright

- **Cash rate raised by 25 basis points to 2.75%**
- **But RBNZ spooked by growth concerns**
- **So signals October rate pause**
- **We follow suit**
- **However, there is still much more to come**

The RBNZ raised the cash rate 25 basis points to 2.75%. Anything else would have been flabbergasting.

In our preview, we highlighted that the key message financial markets were looking for from the Bank was whether there would be one or two more rate increases before the end of the year, October/December or both. If you take the Reserve Bank's published interest rate track literally the answer to that question is only one, at the December meeting. There is certainly no suggestion of two rate hikes by year's end as had been our central scenario.

Also notable is that the RBNZ has maintained its forecast "terminal" rate at 3.28% not only implying there will only be two more rate hikes in total but that a cash rate below the forecast horizon neutral will be sufficient to keep inflation under control.

We are surprised by the RBNZ's approach, but it would appear concerns about lower growth and higher unemployment have dominated the decision-making process. In terms of actual forecasts, the growth numbers are modestly weaker and the unemployment rate a tad higher than at the May Monetary Policy Statement, but the Bank delivered a very clear message about where it thought the risks might lie. In the record of meeting the Bank says "All members agreed that downside risks to activity were significant and the recovery could remain uneven. They also noted growth in activity may not flow through into additional employment as expected, particularly if businesses are relatively more focussed on efficiency and technology investment in the short term."

Be that as it may, concerns about growth did not encourage the RBNZ to lower its inflation forecasts which are broadly unchanged on what was published back in May. There are a few tweaks in recognition of oil price gyrations but the expectation that inflation will be well and truly under control by the second half of next year is maintained.

We maintain our view that if there is reason to raise rates again by the end of the year, and the current cash rate is below neutral, then there is little sense in pausing in October and resuming in December yet that is exactly what the RBNZ's interest rate track implies. Moreover, given the RBNZ's revised economic forecasts it is difficult to imagine there being a data surprise that could justify the RBNZ changing its mind.

Most important in this regard is the fact that the Q2 CPI, to be released October 22 could well come in lower than the 0.8% the Bank is now forecasting. And there is a very good chance Q2 GDP, set for release September 17, prints with a negative sign whereas the RBNZ is forecasting zero.

There is no update on the Household Labour Force Survey before the next meeting but we think anecdotal evidence and monthly partials will suggest the unemployment rate might end up higher than the RBNZ currently forecasts.

The one thing that could rattle the RBNZ's cage is the currency response to today's MPS. Unsurprisingly, given the RBNZ's generally dovish rhetoric, market interest rates have fallen and the NZD has taken a hit. As we write the currency has fallen roughly 50 basis points on a TWI basis to 66.1. Given likely moves by central banks elsewhere there is a decent chance the currency falls further putting upward pressure in imported inflation. We will watch this space carefully.

Yet despite the relatively dovish nature of today's commentary the Governor made it clear that another rate increase is likely but the timing uncertain. She also stressed again that monetary policy remains stimulatory. Moreover, despite the focus on weak activity pushing inflation lower, four of the six members of the Monetary Policy Committee are on record as saying that they "saw upside risks to inflation relative to the central projection". Importantly, the Governor was one of those four accompanied by Karen Silk, Prasanna Gai and Hayley Gourley.

Upside inflation risks are where our concerns lie. We too are very worried about the risks to growth, but we are less convinced that this will keep inflation in check. We remain bothered that:

- Inflation expectations are too high
- The inflationary impact of the Middle East still has some way to play out
- Monetary conditions remain stimulatory
- Other supply shocks such as technology\memory are evolving
- The NZD faces considerable downside pressure
- New Zealand's potential growth rate is under downward pressure generally
- And, specifically, skill mismatches in the labour market are likely to create upward pressure on wages.

Putting all this together leaves us very confused as to what we should do with our interest rate track:

- Should we lower our forecast track to acknowledge the RBNZ's apparent reluctance to hike rates;
- Do we remove one of the two hikes we expected prior to the end of the year because the RBNZ's track does not include such a move or do we stick to our guns that rate increases are still needed to get the cash rate back to neutral;
- Or should we conclude that the general data flow will cause the RBNZ to become more concerned about inflation as time passes.

Taking everything into consideration we are, reluctantly, are dropping our expectation that the Reserve Bank will raise the cash rate again in October. We are strongly of the view that they should, but when the Reserve Bank hands you an interest rate track that says they are not keen to do so you have to find reason why they might change their mind. We can't find that reason in the next six weeks between meetings. Moreover, given the Reserve Bank's messaging we think the market will quickly price out October (it already is) and this will provide further justification for the Bank to pause. If the Bank had wanted to send a message that October was very live it could have. Instead, it went out of its way not to.

We remain of the view that inflation will fall back to around 2.0% quite quickly, but it won't stay there in the manner that the Bank currently forecasts. Once they realise that the cash rate is still likely to head higher than the 3.25% peak that they have assumed. With October now out of our track we have lowered our own peak to 3.75% but the clear message here is that the Reserve Bank still has plenty of work to do.

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Full text of today's RBNZ OCR Review:

Media release

The Monetary Policy Committee today reached consensus to increase the OCR to 25 basis points to 2.75 percent.

Inflation increased to 4.1 percent in the June quarter because of higher fuel prices arising from the conflict in the Middle East. Core inflation, expected wage growth, and inflation expectations remain consistent with inflation returning to the 1 to 3 percent target band by mid-2027 and the 2 percent target midpoint later next year.

After lacklustre growth in the June quarter, New Zealand's economic recovery has most likely resumed but remains uneven. Resilient demand from New Zealand's trading partners and strong export prices are supporting income growth and investment in export-exposed sectors and regional New Zealand. In contrast, weak income growth, job insecurity, and flat house prices continue to weigh on household spending and residential investment, particularly in Auckland and Wellington.

The recovery is expected to strengthen and broaden. The Committee expects New Zealand's export sector to remain resilient and household spending to gradually increase. Conditions in the labour market should improve as the recovery gathers pace. Purchasing power will increase as inflation returns to the 2 percent target mid-point.

The global economy is facing significant risks that could affect commodity prices and demand for exports. New Zealand's economic recovery could be stronger or weaker than expected and price pressures could generate more persistent inflation. The Committee remains vigilant and will respond as necessary to ensure inflation returns sustainably to the 2 percent target mid-point over the medium term.

The Committee judges that gradually removing monetary stimulus is appropriate to return inflation to the 2 percent target mid-point while supporting growth and employment. This decision reduces the risk that the OCR needs to increase by more later. Future policy decisions will depend on the Committee's judgement of the balance of risks to medium-term inflation.

Summary record of meeting – September 2026

Annual consumers price index inflation is above the Monetary Policy Committee's 1 to 3 percent target range. Inflation increased to 4.1 percent in the June 2026 quarter, largely driven by higher fuel and related prices due to the Middle East conflict. The Committee is setting monetary policy to return inflation to 2 percent by late 2027. Economic activity is expected to strengthen and broaden.

Inflation is forecast to fall to 2 percent by late 2027

The Committee expects inflation to remain elevated this year before returning to the target band by mid-2027 and reaching the 2 percent mid-point later next year. Excluding vehicle fuels, annual CPI inflation decreased to 2.9 percent in the June quarter. Most measures of core inflation are within the 1 to 3 percent target band.

As the effects of higher fuel prices drop out of the annual CPI calculation, spare capacity and the gradual removal of monetary stimulus are expected to support inflation returning to the 2 percent target mid-point.

Forward-looking indicators of inflation and spare capacity are consistent with achieving the medium-term target. Longer-term inflation expectations remain near 2 percent, while most measures of one- and two-year-ahead inflation expectations have fallen since May. Expected wage growth is consistent with returning inflation to 2 percent.

Trading partner inflation has increased and export prices remain resilient

High and volatile energy and petrochemical-derived product prices have increased inflation in many of New Zealand's trading partners, increasing import prices. Global supply chains, refining capacity, and trade flows remain disrupted.

Despite recent geopolitical events, economic growth in New Zealand's trading partners has remained resilient and the outlook has improved. Continued demand and supply-side constraints in global food markets have resulted in elevated prices for New Zealand's commodity exports. This is partly offsetting higher import prices, and New Zealand's terms of trade are projected to resume their long-run upward trend.

New Zealand's economic recovery is resuming and expected to broaden

The Committee assessed that growth was lacklustre in the second quarter of 2026. The economic recovery is expected to have resumed in the third quarter, while remaining uneven across sectors and regions.

The Committee noted that economic conditions remain favourable for households and businesses exposed to the export sector, contributing to a recovery in business investment. Resilient trading-partner demand and strong export prices are supporting activity in the South Island and some North Island regions.

The Committee assessed that positive spillovers from the export sector into the broader economy have been limited. Households and businesses more exposed to the domestic economy continue to face challenging conditions.

Employment growth has not been sufficient to fully absorb new entrants into the labour market and unemployment is elevated, particularly in Auckland and Wellington and for youth and the long-term unemployed. Some households are moving to regions with stronger labour markets as part of this economic adjustment.

In some regions, job insecurity and falling real house prices may be contributing to precautionary behaviour. Household saving rates have increased and consumption growth remains weak. Strong growth in dwelling consents has not yet translated into residential construction nationwide.

Household consumption growth is expected to gradually strengthen. The labour market is expected to slowly improve, with employment growing and unemployment falling as the economy recovers. A pick up in real income growth and a modest recovery in house prices supported by past and current monetary stimulus is expected to strengthen household balance sheets, consumer confidence and spending. Improvements in the terms of trade from next year will also support national income growth over the forecast period.

On balance, the Committee assesses that spare capacity remains in the economy, particularly in the labour market. Looking forward, strength in the external sector and the effects of accommodative monetary policy will continue to support and broaden the recovery, absorbing spare capacity over the medium term.

Financial conditions have tightened in recent months

Domestic financial conditions have tightened. Higher wholesale interest rates have led to a comparable increase in bank mortgage and business lending rates and a small appreciation in the exchange rate, partly reflecting expectations of future OCR increases.

The Committee noted a more limited pass through of higher wholesale interest rates to term deposit rates, which is lowering the cost of new funding for banks. A greater pass through to deposit rates would be more consistent with the desired stance and transmission of monetary policy.

Members agreed that domestic financial stability continues to pose no material trade-off to its inflation objective.

Risks to global and domestic economic growth

The Committee discussed risks to the global outlook. There are significant risks to financial stability from the serviceability of public and private debt and ongoing fiscal deficits. Geopolitical instability also continues to present considerable risks. Uncertainties remain about the sustainability of various asset valuations, including for AI-related investments.

El Niño weather conditions do not necessarily imply that New Zealand will experience a drought. However, adverse global and local weather events can impact supply, posing upside risk to commodity and food prices. Although risks to the global economy remain heightened, the Committee expects global economic conditions to remain favourable for New Zealand's export-facing businesses over the medium term.

Members discussed risks to New Zealand's economic recovery. Consumption growth could be subdued if employment and house price growth remain weak, or if precautionary behaviour persists. If this were to occur, the recovery could be weaker and current unevenness could continue. Alternatively, consumption growth could be stronger and absorb spare capacity faster than currently anticipated.

Members highlighted that the real economy is showing signs of adjusting to a range of structural changes, but transitions can be slow and contribute to divergences across sectors and regions. It was noted that monetary policy cannot influence the ultimate path of these real adjustments.

The Committee remains vigilant to inflation risks

The outlook for medium-term inflationary pressures depends on price-setting behaviour and the speed with which spare capacity in the economy is absorbed. Recent elevated inflation is expected to continue to impact price setting, keeping inflation more persistent than otherwise.

Hayley Gourley, Karen Silk, Prasanna Gai and Anna Breman saw upside risks to inflation relative to the central projection. These members observed that more persistence in energy and petrochemical prices could raise near-term inflation risks, impact price-setting behaviour, and lead to more sticky inflation over the medium term. Price-setting can be a front-loaded process, meaning businesses could raise domestic prices more than import costs warrant. They also noted that high administered price inflation could continue. These factors increase the risk that monetary policy needs to lean against broader inflation pressures.

Paul Conway and Carl Hansen saw risks to inflation as balanced. These members shared concerns that high inflation could become embedded through price-setting behaviour. But weighed against this, they saw activity risks as skewed to the downside and noted that these could weigh on inflation. They highlighted the potential effects of weak house prices and precautionary behaviour, weakening growth in household spending.

All members agreed that downside risks to activity were significant and that the recovery could remain uneven. They also noted growth in activity may not flow through into additional employment as expected, particularly if businesses are relatively more focused on efficiency and technology investment in the short run.

Gradually removing monetary stimulus remains appropriate

The Committee discussed the monetary conditions required to return inflation sustainably to the 2 percent target mid-point.

When considering the policy response at this meeting, there was a clear consensus across the Committee. All members agreed that gradually removing monetary stimulus is consistent with achieving the medium-term inflation target, conditional on the outlook.

Members reflected on the potential trade-offs associated with a faster or slower monetary policy response. The Committee judged that its response balances containing inflationary pressures against the risk of holding the OCR and then having to raise it faster and to a higher level later.

All members agreed that the central projection for the OCR is appropriate. Conditional on the central economic outlook, members judged that the OCR may need to increase further. The Committee assessed that its monetary policy stance would guard against the effects of the oil price shock leading to persistently elevated price-setting behaviour, while supporting growth and employment.

However, the future OCR path is not pre-determined. The Committee's response to data is not mechanical, as it depends on its assessment of various factors that impact inflation. Currently, indicators of medium-term inflation are consistent with inflation returning to target.

The Committee decided by consensus to increase the OCR by 25 basis points to 2.75 percent

The Committee judged that increasing the OCR to 2.75 percent is appropriate to sustainably return inflation to the 2 percent target mid-point while avoiding unnecessary instability in output, employment, interest rates and the exchange rate.

Future policy will depend on the Committee's judgement of the balance of risks to medium-term inflation. This approach allows the Committee to observe and assess the effects of reduced monetary stimulus.

On Wednesday 2 September, the Committee decided by consensus to increase the OCR by 25 basis points to 2.75 percent.

Attendees:
MPC members: Anna Breman (chairperson), Carl Hansen, Hayley Gourley, Karen Silk, Paul Conway, Prasanna Gai
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