



ECONOMIC BULLETIN

RBNZ monetary policy scenarios, May 2026.



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The case to hike and the case to wait

- We lay out some plausible arguments the RBNZ might consider to motivate an OCR hike in May or a decision to remain on hold.
- Remaining on hold will be compelling if the MPC wants to see tangible evidence of second round effects on inflation and more evidence on how the real economy is being impacted by the Iran war.
- Raising the OCR in May will be compelling if the MPC prefers to move the OCR back to the neutral zone in a reasonably prompt manner.
- Our *Monetary Policy Statement* preview will provide our judgement on what we expect the MPC to decide.

In this note we consider the arguments that might be made by the RBNZ's MPC members as they deliberate the appropriate course of action at next week's monetary policy review. We set out the case for leaving the OCR unchanged versus the alternative of a 25bp hike (the two most likely outcomes). Later today we will release our formal preview of the meeting, setting out our view on which arguments are most likely to carry the day and what to look out for in the materials and commentary that will accompany the RBNZ's policy decision.

The case for leaving the OCR unchanged.

The strongest case for holding the OCR unchanged is that it remains too soon to conclude that an immediate rate hike is required to achieve the inflation target over the medium term. Indeed, one might be concerned that an increase now might need to be reversed later in 2026 or in 2027. The MPC might conclude this if:

- They are unsure if the OCR is currently stimulatory given the rise in risk aversion associated with the shock and/or that a hike in the OCR at a time of fragile confidence might have an outsized impact on the economy (for example, as the RBNZ's hawkish commentary did in the first half of 2024).
- They believe that the coming weakening in the economy will be so large as to overwhelm any upward pressure on inflation expectations or firm pricing behaviour emanating from the Iran war cost shock, leading to no increase – or indeed lower – inflation over the medium term.
- A further large markdown in global growth forecasts is in the offing, perhaps due to a more protracted Iran war triggering concerns of global recession as per more pessimistic official sector scenarios. In turn, this

might trigger a further tightening in financial conditions if recent strength in global equity and credit markets is reversed.

If this scenario is a material concern, the MPC would likely judge that interest rate expectations and financial conditions are too restrictive for the economic and medium-term inflation outlook, at least given currently available information. In that case, leaving the OCR unchanged would signal that current market pricing is too aggressive and that a greater accumulation of evidence is required before the RBNZ decides to lift the OCR. This would push back on current market pricing.

That's a very dovish scenario and not especially likely right now. More likely, the case for holding the OCR now might simply reflect uncertainty on how quickly policy needs to respond given the significant uncertainties. Waiting allows time to gather further evidence.

The commentary in the Record of Meeting from the April *Monetary Policy Review* suggests that there were a range of scenarios considered by the MPC, with different assumptions about the path of the conflict and its economic impact leading to different conclusions about the timing of policy action. For example, the Record noted:

“If the increase in near-term inflation is largely temporary, the Committee envisages gradually moving the OCR to more neutral levels as activity recovers and near-term inflationary pressures dissipate. However, any signs of significant second-round inflationary effects or increases in medium-term inflation expectations would require decisive and timely increases in the OCR to re-anchor inflation expectations. The Committee is vigilant to these risks.”

and:

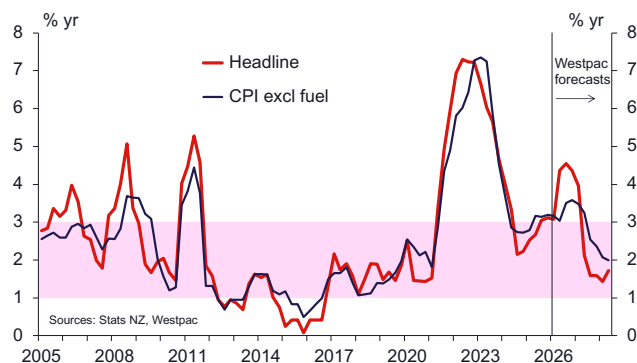
“Some members placed more emphasis on the arguments in favour of an early monetary policy response, noting that further data and analysis would provide greater clarity about medium-term inflation pressures. Other members emphasised downside risks to growth and argued for more opportunity to judge the extent to which weaker growth balances the second-round effects of higher fuel prices.”

Importantly, this discussion shows the debate among the MPC is not about whether the OCR will eventually need to rise *at all* but really just about *when* OCR normalisation should begin (as it was at the beginning of the year, before the Middle East conflict). In this context, the stronger argument for delay rests on when the MPC feels it has enough information to justify a first move towards a more neutral OCR setting. In this case, the MPC would focus on when it has sufficient information on:

- The likely peak level of headline CPI inflation in coming quarters and how this might impact inflation expectations.
- The extent of the likely hit to economic activity and hence the level of excess capacity in the economy, and so the likely evolution of core inflation given the competing influences of a weaker economy but higher inflation expectations.
- The extent to which the pre-existing weakness of the economy will help moderate any second-round effects associated with direct price increases caused by the Iran war (e.g. fuel and fertiliser costs).
- The likely duration of the Iran war and the future path of oil prices.

On the first point, at the April *Review* the RBNZ indicated that headline inflation would rise above 4% in the June quarter, largely reflecting higher energy prices from the Iran war. It is still unclear whether the June quarter will mark the peak, given there is no visibility on when the Strait of Hormuz will reopen. Westpac, for example, sees an inflation peak in the September quarter, although with low confidence given the uncertainty over the path for energy prices. The MPC may therefore see 4% as a lower bound for peak headline inflation and remain open to a higher outcome. The June quarter CPI release in late July, after the July policy review, will provide a firmer guide (as will the path of prices through the quarter as seen in the monthly Selected Price Indexes).

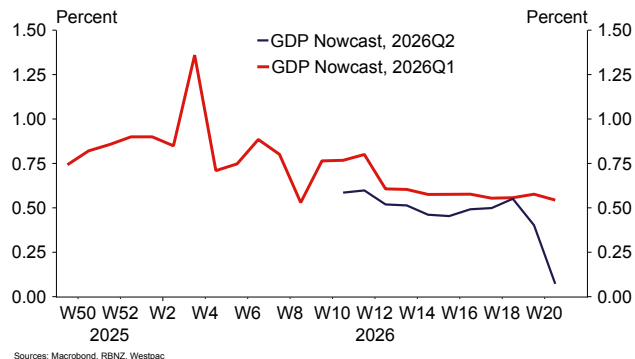
Headline and core inflation



On the second point, the RBNZ has virtually no new information on how core inflation pressures are currently evolving. Governor Breman indicated in her press release that core inflation did not rise in the March quarter and remained within the target range, but there is little information since then. Meaningful new evidence is unlikely to be available before the June quarter CPI, especially as few services pricing gauges affected by the Iran war are captured in the monthly selected price index releases. The absence of clear evidence of stronger core inflation is a strong argument for waiting. There is similarly little evidence yet on second-round inflation pressures as it is still too early for clear signs to emerge.

Some evidence may appear in the May selected price indices in late May, but the June quarter CPI is more likely to be the key source of information. That supports holding the OCR in May and July while waiting for firmer evidence.

RBNZ GDP Nowcast



Looking at how core inflation might evolve further ahead, more information is available on how the war is likely to impact excess capacity in the economy. December quarter GDP growth modestly undershot the RBNZ’s forecasts (by 0.4%). However, the RBNZ’s “Nowcast” of cumulative GDP growth over the first half of this year points to growth of 0.6%, which is a substantial 1.0% lower than forecast in the February MPS. The RBNZ’s updated forecasts will therefore almost certainly project greater excess capacity in the economy over at least the next year, providing an offset to the higher inflation starting point. This would support a wait-and-see approach.

Uncertainty around the duration of the Iran war may also favour delaying OCR normalisation. An early end to the conflict would likely mean a shorter spike in headline inflation and less risk to inflation expectations and pricing behaviour. If the MPC thinks hostilities could end soon, this might suggest that the RBNZ reverts back to something like its February *Monetary Policy Statement* stance, i.e. while a rate hike is possible before year end, it is not a given. In that scenario, the MPC may view the recent tightening in financial conditions as premature and potentially reversible, while still helping to contain any emerging core inflation pressure.

The case for a 25bp increase in the OCR.

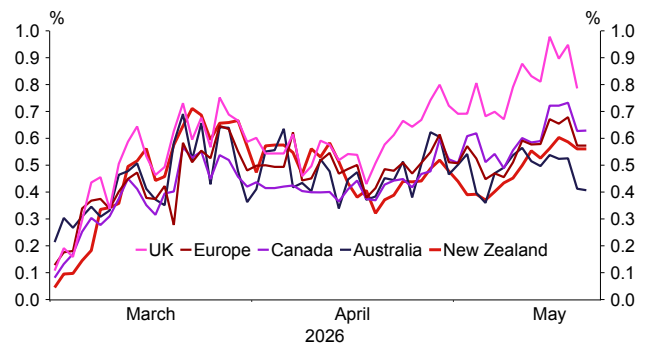
A rate increase would be on the table if the MPC accepts that OCR hikes in 2026 are now unavoidable, as current market pricing, analyst expectations and market sentiment almost uniformly suggest. If the MPC believes OCR increases are coming in the next six months, the bar for starting now may be fairly low.

The April MPR Summary Record of Meeting revealed that there was a group of MPC members in favour of taking a proactive approach to returning the OCR towards more neutral levels. In both the November 2025 and February 2026 MPS forecasts, end-2026 inflation was expected to

be close to the middle of the target range (2.2% and 2.3% respectively), whereas the RBNZ may now expect inflation to be above 4% at the end of 2026 (Westpac’s current forecast is 4.4%). This is a materially different outlook and points to greater inflation risk.

While core inflation measures remain inside the 1-3% target range, they sit mostly in the top half of the range (for example, the 10% trimmed mean is 2.3% and the RBNZ’s sectoral factor model estimate of core inflation is 2.6%). This gave the MPC little room to manoeuvre even before the Iran war cost shock. A large output gap provides some basis to expect inflation to move lower given time. But the MPC will be mindful that inflation has been persistently high since 2022 and outside the 1-3% target range for much of that time. The MPC may feel it has only finite space to take further risks with a protracted period of above-target inflation.

Change in market pricing for the 3-month rate in two years’ time, selected countries



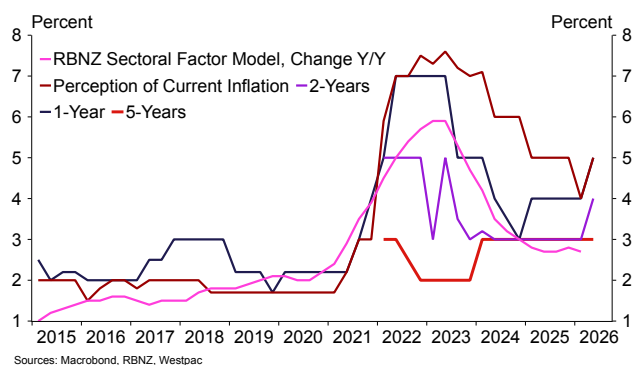
The MPC will take some account of other central banks’ reaction functions to the Iran war shock. Market pricing suggests policy rates will rise over the next 18 months in most jurisdictions, while central bank commentary ranges from actual tightening (Norway, Australia) to near-term tightening (the ECB), tightening biases (Canada, Japan), and more neutral stances (the UK and the US). New Zealand stands out because the policy rate is around 75bp below neutral on the RBNZ’s assessment, whereas in most other jurisdictions the policy rate is closer to neutral.

Data on inflation expectations and firm pricing behaviour suggest a risk of persistent inflation. Business surveys confirm a large and broad cost shock to businesses that is putting a lot of pressure on margins. Firms report that weak demand limits space to raise prices, but nonetheless pricing intentions indicators are historically high. Consumer inflation expectations are high and have been quick to reflect the Iran war shock. This shows consumers understand that price increases are likely and may even see increases as inevitable and justified. It’s likely consumers will be more accepting of price increases in the current environment.

Professional forecasters and business experts also expect increased inflation as far as 2 years ahead. This is interesting as this group likely understand that oil prices will most likely fall back in the next 6-12 months. However, despite this, they see inflation remaining close to 2.5% versus for example Westpac's own forecast of inflation below 2% two years ahead (driven by a large, assumed fall in energy prices). Together this is indicative of an expectation of persistent inflation among the business community which may have implications for pricing behaviour.

Most critically, the broadest surveys of households and businesses conducted by the RBNZ suggest there are significant risks of elevated inflation over the 5-10 year horizon. These surveys suggested relatively high levels of 5-10 year expectations coming into the Iran war shock. While it may be premature to conclude the RBNZ has lost credibility, it's fair to say that respondents' experience of high inflation since 2021 may be cementing a concern that the RBNZ is not as "laser focused" on inflation as it could be.

Median household inflation expectations – RBNZ survey



Real interest rates appear very low given the increase in inflation and inflation expectations that's occurred. While uncertainty is so high, we are unlikely to see those rates translate into expanding investment and consumption. But the situation could change quite quickly if uncertainty resolves (for example, if global demand remains resilient or if an unexpectedly fast resolution of hostilities occurs). Current low real rates are providing some cushion to the economy now and could quickly spur activity later even as the legacy of high inflation remains. Is it clear that such low real interest rates are appropriate?

Another issue is the exchange rate which remains weak. It is around 2% lower than assumed by the RBNZ in February and around 3% lower over the last year. This has likely added to tradable inflation in the last year and is providing a well-needed fillip to the export sector. Should the terms of trade shock associated with the Iran war intensify then the exchange rate would likely further adjust, creating further inflation headwinds. The MPC will be cautious to not keep NZ interest rates too low so as to invite excessive FX depreciation.

These arguments suggest that the RBNZ has work to do to ensure persistent inflation behaviours don't become entrenched via the Iran war shock. It could be premature to conclude that restrictive conditions are required now given the large output gap and high levels of uncertainty. But positioning policy closer to a neutral level could help balance upside inflation risks and better position the MPC if restrictive conditions become necessary.

Beginning the normalisation process in May allows for a gradual and cautious tightening path that would be no faster than current market pricing. It allows for OCR increases every second meeting at *Monetary Policy Statements* when the most information is available along with fresh medium-term forecasts. It also gives the MPC the option to not raise the OCR at the pre-election October meeting while ensuring the OCR reaches the bottom of the RBNZ's effective neutral range of 3% by end 2026. This approach manages inflation risks while providing options to scale the pace of tightening up or down as more information becomes available.

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