RESEARCH NOTE

MONETARY POLICY WITHOUT MATES: WHY THE RESERVE BANK IS RIGHT TO FOCUS ON PRICE STABILITY

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About the New Zealand Initiative

Our mission is to help build a better, stronger New Zealand. We are taking the initiative to promote a prosperous, free and fair society with a competitive, open and dynamic economy. We develop and contribute bold ideas that will have a profound, positive, long-term impact.

The Reserve Bank was damned if it did and damned if it did not.
But the government made sure it was especially damned.

Abstract

The Reserve Bank of New Zealand has faced sustained criticism for maintaining restrictive monetary policy too long, allegedly driving the economy into an unnecessarily deep recession.

Critics from Prime Minister Luxon to bank economists argue the RBNZ should have cut rates earlier and more aggressively.

This criticism misses the mark. It was the government that correctly instructed the RBNZ to achieve an inflation rate around the middle of the 1-3% p.a. target range. And this is exactly what the RBNZ achieved once it confirmed inflation and expectations were back toward target. Not more, not less. Nor is there any reason to think it over-did it. The Reserve Bank of Australia had a similar problem and brought its inflation rate down by about as much and at much the same speed.

The Bank had to act as it did because it faced building inflation expectations that threatened to become unanchored – a far greater long-term danger than a short-term recession.

Also importantly, the government's fiscal decisions, particularly its tax cuts in 2024, created a policy conflict that made the RBNZ's job materially harder, requiring higher rates for longer. The recession's depth reflects not current monetary policy failure but a combination of prior monetary policy failure and fiscal-monetary policy disjuncture. Greater forward-looking fiscal discipline would make greater monetary policy discipline look more credible and more sustainable.

Executive Summary

- **Economic Shock: New Zealand's economy shrank by 0.9 percent in the June 2025 quarter. That outcome was worse than expected – about three times the Reserve Bank's own forecast and well below the market median.**
- **Political Pressure: The Reserve Bank faced significant political pressure to ease monetary policy, a marked departure from the convention of operational independence.**
- **Policy Misalignment: Budget 2024 delivered tax relief that, due to a timing mismatch with offsetting savings, posed an upside risk to demand, working against the RBNZ's efforts to curb inflation.**
- **International Warnings: The IMF urged fiscal neutrality for any tax relief and highlighted New Zealand's large structural deficit, advising a tighter fiscal stance to support disinflation.**
- **Expectations Risk: The RBNZ's caution was justified by mixed signals on inflation expectations. While some measures were contained, a new business survey in 2025 showed a concerning drift in longer-term expectations, highlighting the risk of easing policy too soon.**

Introduction: A central bank under fire

New Zealand's economy shrank by 0.9 percent in the June 2025 quarter. That outcome was worse than expected – about three times the Reserve Bank's own forecast and well below the market median – and it erased the March quarter's gain.[1]

The result may strengthen the case for a further easing of monetary policy, but it does not justify criticising the Bank's recent decisions. While the current downturn has been exacerbated by challenging global headwinds and trade uncertainties, domestic factors are also important.

Slow domestic productivity growth, a key factor identified by the Treasury, has constrained the economy's potential output.[2] Government deficit spending pushes output spending closer to this constraint. That increases inflationary pressures. In this environment, a simple and convenient narrative has taken hold: the Reserve Bank of New Zealand (RBNZ) is to blame.

The prevailing view, amplified across the political and media landscape, is that the central bank has committed a severe policy error. While acknowledging its own earlier missteps during the pandemic-era stimulus, a point examined in the Bank's 2022 review of its monetary policy formulation,[3] the recent focus of criticism has been that it hiked interest rates too high, held them there for too long and is now moving too slowly to provide relief.

Prime Minister Christopher Luxon declared the Bank should have been more aggressive in cutting rates.[4] His sentiment was echoed by media commentators who declared the Bank had "well and truly stuffed this up".[5]

This research note challenges that simplistic story.

This analysis does not dispute that the RBNZ's high interest rates were the proximate cause of the downturn. However, it argues the Bank had little choice. It was confronted with the insidious threat of inflation expectations breaking free from their anchor, a development that would risk a return to the deficit-spending stagflation of the 1970s and early 1980s. After all, following December 2023 changes, the Monetary Policy Committee's single operational objective is price stability – 1-3 percent, with a focus on the 2 percent midpoint.

More critically, this note contends that the government's own fiscal choices – particularly its decision to implement tax cuts without more than offsetting spending reductions while the RBNZ was still

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1 Stats NZ, "GDP decreases 0.9 percent in the June 2025 quarter," 18 September 2025. https://www.stats.govt.nz/news/gdp-decreases-0-9-percent-in-the-june-2025-quarter/

2 The Treasury, "New Zealand's Productivity Slowdown: Implications for the Treasury's Forecasts and Projections," May 2024. https://www.treasury.govt.nz/sites/default/files/2024-05/tp-productivity-slowdown-implications-treasurys-forecasts-projections.pdf

3 Reserve Bank of New Zealand, "Review of the Formulation and Implementation of Monetary Policy," August 2022. https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/about-us/governance/review-of-the-remit-and-the-charter/2022/rafimp-review.pdf

4 Mandy Te, "PM Luxon: Reserve Bank should have been more aggressive with OCR cuts," interest.co.nz, 25 August 2025. https://www.interest.co.nz/economy/134882/prime-minister-christopher-luxon-says-he-personally-thinks-reserve-bank-should-have

5 Heather du Plessis-Allan, "Perspective with Heather du Plessis-Allan: The pressure's on the RBNZ to fix the economy fast", Newstalk ZB, 16 September 2025. https://www.newstalkzb.co.nz/on-air/heather-du-plessis-allan-drive/opinion/perspective-with-heather-du-plessis-allan-the-pressures-on-the-rbnz-to-fix-the-economy-fast/

fighting inflation – created a policy misalignment. The fiscal policy stance remained stimulatory, begging the question of the political will to sustain a tighter monetary policy. It is a story of two ships passing in the night: monetary policy to raise interest rates to cool an overheated economy while fiscal policy was still pouring fuel on the fire by heavy borrowing. That is bad for overall policy credibility.

We do not here quantify the extent of that effect on the profile of the path for GDP. The point is that it takes two to tango. It is not the RBNZ's fault if fiscal policy is making its government-imposed job harder.

The chorus of critics

The misplaced blame directed at the RBNZ in the last month has been broad and sustained, emanating from political leaders, media personalities and economists, all of whom painted a picture of an institution that was out of touch and incompetent.

Political pressure

In August 2025, Prime Minister Christopher Luxon said the RBNZ should have cut more aggressively and acknowledged sharing his 'reckons and perspective' with the Governor before decisions – a marked departure from long-standing convention intended to protect operational independence.[6]

Finance Minister Nicola Willis was more circumspect but applied pressure indirectly. Following the shocking June 2025 GDP figures, she emphasised that "the Reserve Bank has the largest levers here for ensuring economic recovery".[7] Her consistent highlighting of an upcoming change in the Bank's leadership was widely interpreted as a signal that a policy shift was required.

The critique was made explicit by former Prime Minister Sir John Key, who argued the OCR should be reduced to 2.25% to reignite the housing market.[8]

Media amplification

Influential media commentators translated complex economic debates into a powerful morality tale of institutional failure. Heather du Plessis-Allan of Newstalk ZB was a leading voice, declaring the RBNZ had "well and truly stuffed this up, they have no idea what is going on in this economy".[9]

Her critique centred on the Bank's forecasting errors – predicting a 0.3% contraction when the actual estimate is now 0.9% – as prima facie evidence of incompetence. She had previously argued the Bank

6 "'Personally, I do': Prime Minister agrees Reserve Bank should have cut rates earlier." interest.co.nz. August 24, 2025. https://www.interest.co.nz/economy/134882/prime-minister-christopher-luxon-says-he-personally-thinks-reserve-bank-should-have.

7 "Voters Should Blame Donald Trump for New Zealand's Slow Economic Recovery and 0.9% GDP Slump, Says Willis." Interest.co.nz. Published 18 September 2025, https://www.interest.co.nz/economy/135272/voters-should-blame-donald-trump-new-zealand%E2%80%99s-slow-economic-recovery-and-09-gdp.

8 "Sir John Key urges 100 basis point interest rate cut to boost NZ economy," NZ Herald, 25 July 2025. https://www.nzherald.co.nz/business/sir-john-key-urges-100-basis-point-interest-rate-cut-to-boost-nz-economy/DTHZTVGQGZDC5ASZGELH3IVUEY/

9 Heather du Plessis-Allan, "Perspective with Heather du Plessis-Allan: The pressure's on the RBNZ to fix the economy fast", Newstalk ZB, 16 September 2025. https://www.newstalkzb.co.nz/on-air/heather-du-plessis-allan-drive/opinion/perspective-with-heather-du-plessis-allan-the-pressures-on-the-rbnz-to-fix-the-economy-fast/

"overdid the squeeze" after having "overdid the money pumped into the economy" during the pandemic, calling the double miscalculation "incompetent".[10]

Her colleague Mike Hosking consistently pressed officials on the timing of rate cuts, famously confronting the Prime Minister with the assertion that cuts "should have been May".[11] He effectively framed the economic pain as a direct result of the Bank's mismanagement and disconnectedness from the reality facing ordinary New Zealanders.

Economic dissent

More technical, but equally sharp, criticism came from economists. Kiwibank's Chief Economist, Jarrod Kerr, consistently argued the RBNZ's tightening cycle was "super aggressive" and "the sharpest hiking cycle ever recorded". He drew an unfavourable comparison with the Reserve Bank of Australia, which took a more gradual approach. "They simply didn't drive their economy into a hole. So I think… I'd rather the RBA approach," Kerr concluded pointedly.[12]

Professor Robert MacCulloch of the University of Auckland went further, dubbing the RBNZ "the architect of our recession".[13] He argued the Bank deliberately "engineered a recession" to clean up its own mess after excessive money printing during the pandemic, causing "untold harm".[14]

While the criticisms have been loud and frequent, they largely overlook the fundamental dilemma confronting the central bank.

The inflation imperative: Why the RBNZ held firm

Missing from this chorus of criticism was any serious engagement with the RBNZ's primary and most dangerous challenge: inflation had gone away on it and other central banks, expectations of continuing high inflation risked becoming entrenched. Its instructions from government were to target annual CPI inflation at the mid-point of a 1-3% range.

The Reserve Bank of Australia (RBA) was in much the same position. And they both got the job done with much the same speed – as the following chart shows:

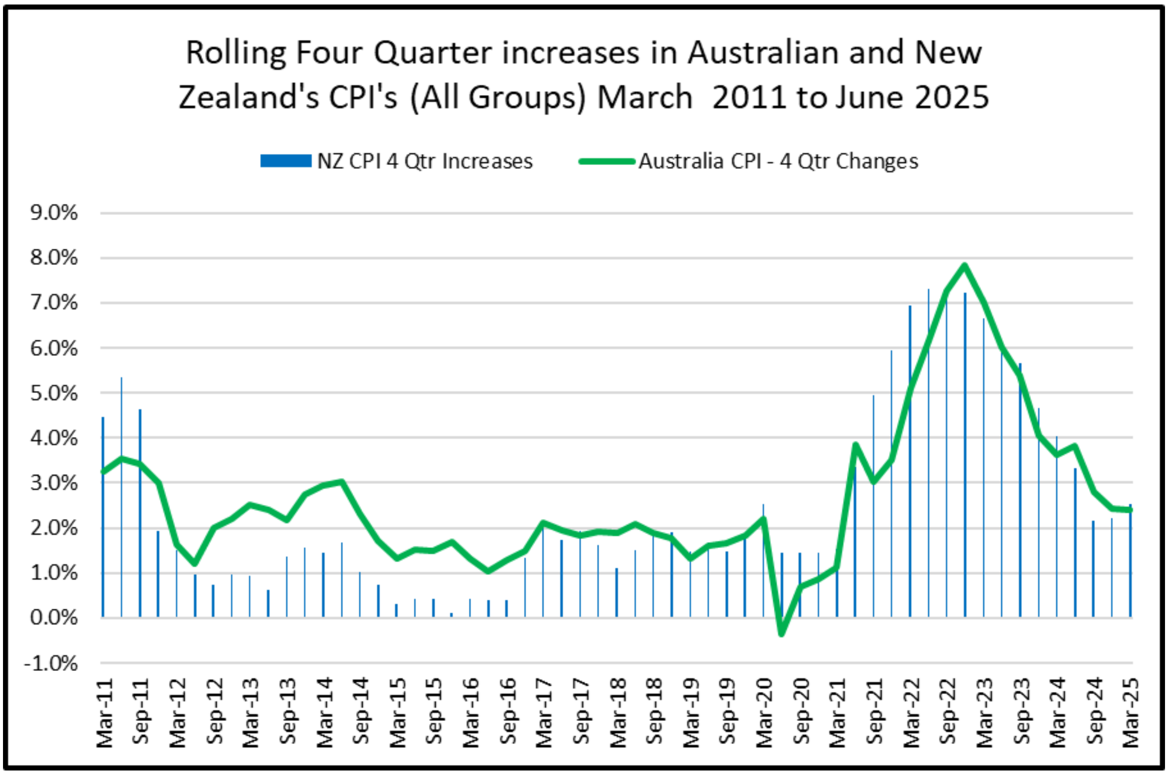
10 Heather du Plessis-Allan, "OCR cuts: The Reserve Bank knows it has stuffed up inflation handling," NZ Herald, 23 October 2024. https://www.nzherald.co.nz/nz/official-cash-rate-cuts-the-reserve-bank-knows-it-has-stuffed-up-inflation-handling-heather-du-plessis-allan/MSJQFEKTUZF5ZH76FQIG7OTH5M/

11 "'Personally, I do': Prime Minister agrees Reserve Bank should have cut rates earlier." interest.co.nz. August 24, 2025. https://www.interest.co.nz/economy/134882/prime-minister-christopher-luxon-says-he-personally-thinks-reserve-bank-should-have.

12 "Why did New Zealand interest rates go higher than Australia's." RNZ, August 20, 2025. https://www.rnz.co.nz/news/business/570577/why-did-new-zealand-interest-rates-go-higher-than-australia-s.

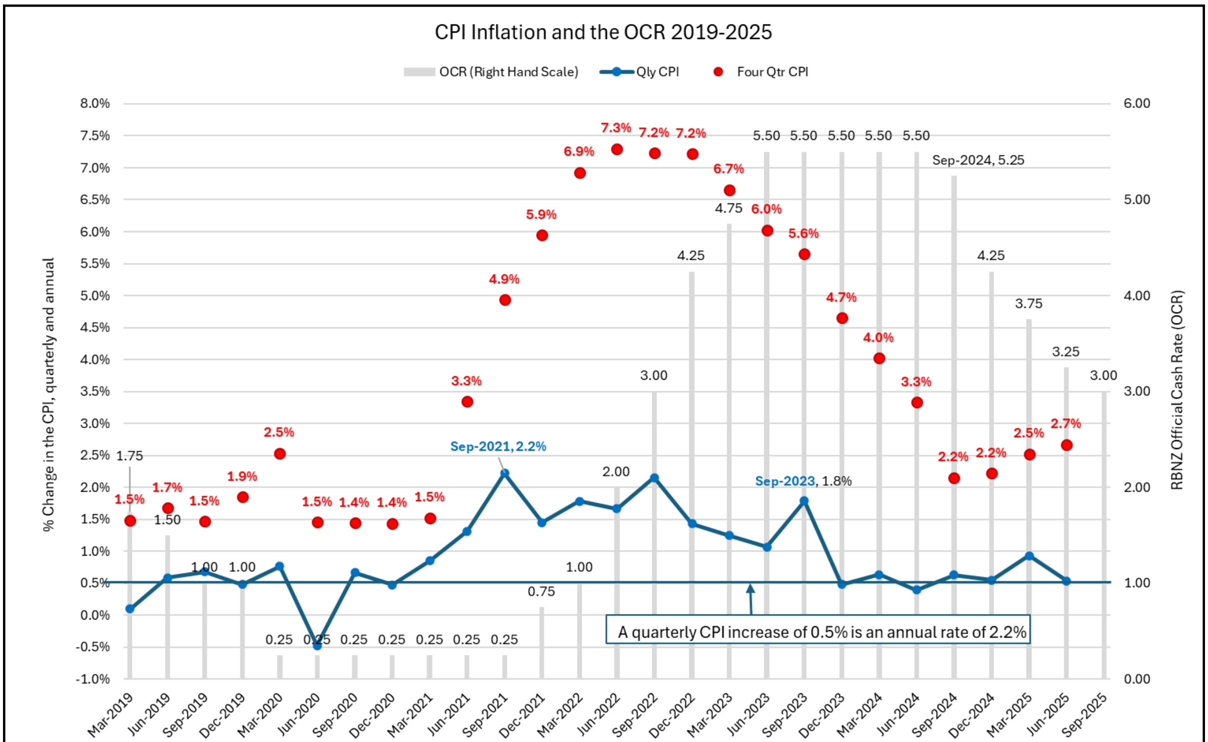
13 MacCulloch, Robert. "Let the Good Party Times Roll at the Reserve Bank of NZ - the architect of our Recession - no austerity there." Bassett, Brash & Hide, March 23, 2024. https://www.bassettbrashandhide.com/post/robert-macculloch-let-the-good-party-times-roll-at-the-reserve-bank-of-nz-the-architect-of-our-re.

14 MacCulloch, Robert. "Professor Robert MacCulloch: NZ's Economy is being smashed since the RBNZ has bizarrely admitted it is in breach of its own Remit." Breaking Views NZ, November 1, 2024. https://breakingviewsnz.blogspot.com/2024/11/professor-robert-macculloch-nzs-economy.html.



There is no evidence here of the RBNZ overshooting on the government's inflation target instructions, or of it being much different from Australia in getting inflation down.

Nor does the chart below provide grounds for comfort that inflationary pressures are fully scotched in New Zealand. The following chart shows New Zealand's CPI tracking back up towards the top of the 1-3% range, hopefully largely for one-off reasons.



Source: Capital Economics Limited, using RBNZ's end of quarter values for the OCR and SNZ's All Groups CPI

As this chart also shows, the Bank's actions in progressively raising the OCR from its 0.25% level starting from the end of 2021 reflected textbook central banking in the face of a sharp rise in the quarterly rate of inflation after March 2021.

The expectations game

Modern central banking is fundamentally about managing expectations. If households and businesses believe inflation will stay around the 2% target, their behaviour tends to make it a self-fulfilling prophecy. Businesses set prices accordingly and workers moderate wage demands. The economic system remains stable.

However, if expectations become "unanchored" – if people start believing high inflation and ongoing fiscal deficits will persist – it can trigger a destructive wage-price spiral. As Adrian Orr put it, 'Mutiny is not a sign of success' – a reminder that losing public confidence in the path back to target would have been far costlier than a shorter-term downturn.[15] This challenge is particularly acute in New Zealand, where research has shown firms' inflation expectations are historically poorly anchored compared to other developed economies, making them more susceptible to shocks.[16]

This was the spectre haunting the RBNZ throughout 2023 and 2024. Critics focused on falling headline inflation, but this missed the divergence between imported and domestic price pressures. Annual tradables inflation — influenced by global factors — fell sharply through 2023-24 (to about 0.3 % in the June quarter 2024), while annual non-tradables inflation — driven by domestic costs such as rents, insurance and council rates — remained elevated (around 5.4 % in the June quarter 2024), easing only slowly.[17]

In its August 2024 Statement, RBNZ revised its expectations: non-tradables inflation had been marginally higher than the May forecast, prompting concern that domestic inflationary pressures were easing more slowly than earlier projections had assumed.

The expectations picture was mixed across horizons. In August 2024 the RBNZ business Survey of Expectations showed declines at all horizons, including 2-year at 2.03% and 5- and 10-year near 2%.

However, in 2025, the Bank's expanded business survey module reported longer-term expectations rising – to 3.06% at five years and 3.94% at ten years in May – while data from the separate Survey of Expectations showed the 2-year measure rose to 2.28% by Q3 2025. These shifts underscored the risk that longer-term expectations could drift if policy eased too quickly.[18] By Q2 2025, the RBNZ's sectoral factor model of core inflation was ~2.8% y/y, slightly down from Q1, which suggests that while inflation pressures are easing, underlying price pressures remain notably sticky.[19]

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15 Orr, Adrian. "Navigating Monetary Policy Through the Unknown." Speech, Peterson Institute, Washington DC, October 24, 2024. Quoted in "Orr hints at more 'incremental' reduction in Official Cash Rate." Interest.co.nz, October 23, 2024. https://www.interest.co.nz/economy/130400/reserve-bank-governor-adrian-orr-says-having-inflation-back-1-3-target-range.

16 Kumar, Saten, Hassan Afrouzi, Olivier Coibion, and Yuriy Gorodnichenko. "Inflation Targeting Does Not Anchor Inflation Expectations: Evidence from Firms in New Zealand." NBER Working Paper No. 21814, December 2015. https://www.nber.org/papers/w21814.

17 Reserve Bank of New Zealand. Monetary Policy Statement, August 2024, pp 16-17. Wellington: RBNZ, 2024. https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/publications/monetary-policy-statements/2024/aug-140824jvb/mps_report_aug2024.pdf

18 Reserve Bank of New Zealand. "Tara-ā-Umanga Business Expectations Survey." August 2025 https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/statistics/series/m/m15/2025/business-expectations-survey-august-2025.pdf

19 Reserve Bank of New Zealand. "Sectoral Factor Model of Core Inflation." https://www.rbnz.govt.nz/statistics/sectoral-factor-model-core-inflation.

A note on expectations surveys

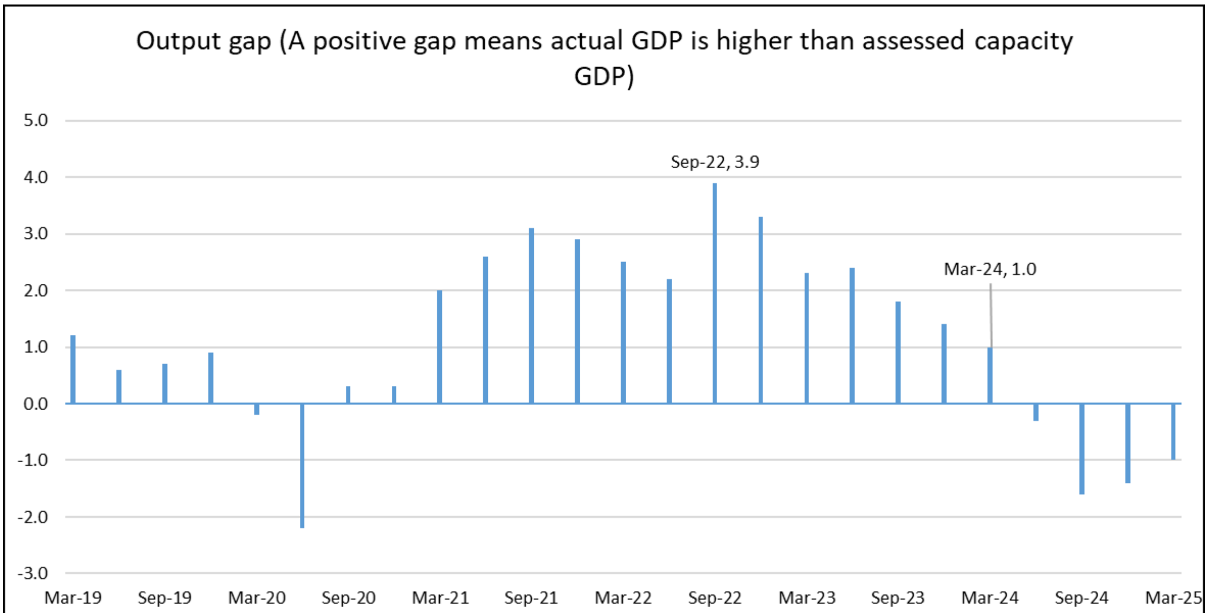
The RBNZ uses several tools to measure inflation expectations. The main quarterly Survey of Expectations (M14) polls business leaders and professional forecasters on their outlook for key indicators. The horizon that matters most for monetary policy is typically the two-year-ahead measure, as it reflects beliefs about where inflation will be after the effects of interest rate changes have transmitted through the economy. In 2025, the Bank introduced a new, more comprehensive business survey module to better capture longer-term expectations (five and ten years ahead), providing a richer picture of how well expectations are anchored.

The fiscal misalignment

The RBNZ was not operating in a vacuum. While it was applying the monetary brakes, the government was keeping its foot on the fiscal accelerator, creating a policy conflict that made a deep recession almost inevitable.

Both monetary and fiscal policy were too expansionary for too long after the Covid-19 lockdowns. Actual output was above normal operating levels. Fiscal policy stayed expansionary and monetary policy had a tougher job to do as a result.

The following chart shows the RBNZ's measure of this evolving pressure on capacity constraints. It was not until the June quarter 2024 that a level of normality had returned. And by that time the RBNZ was reducing the OCR.



Source: RBNZ Database for its August 2025 MPS, Figure 6.5.

The tax cut timing disaster

Budget 2024 delivered tax relief of about $3.7 billion per year – $14.7 billion over four years – primarily via threshold adjustments and tax credits.[20] While the government argued the package was broadly fiscally neutral, this overlooked a critical timing mismatch.

Treasury framed the package as fully funded, but the RBNZ warned that the "timing difference between immediate tax relief and phased savings posed an upside risk to the forecast of aggregate demand".[21] This fiscal expansion adds to aggregate demand, putting upward pressure on domestic inflation and forcing monetary policy to compensate.

In plain English: the government's tax cuts meant monetary policy has to be tighter than otherwise.

The IMF warning

This was not just a domestic concern. The IMF urged that any 2024 tax relief be fiscally neutral to avoid boosting inflation and noted New Zealand's cyclically-adjusted primary deficit at 2.8% of GDP – among the largest in advanced economies.[22] The government defended the package as 'fiscally neutral' relative to its own plans for higher spending. In practice, this meant it delivered tax cuts and trimmed spending elsewhere to avoid a still larger deficit — but the result was still a structural primary deficit of 2.8% of GDP, among the largest in advanced economies. In macroeconomic terms, the package was far from neutral, and ill-suited to conditions of high inflation and tight monetary policy.

The mixed policy signals of lower inflation with tax cuts amidst fiscal could be expected to make the RBNZ's job harder. Does the government support a disinflationary monetary policy or not? To criticise the RBNZ for doing its job, further begs the question of what the government really wants.

Conclusion: a reassessment of culpability

The misplaced blame directed at the Reserve Bank of New Zealand misses the real lesson of the 2024-2025 recession. Monetary policy needs mates. The more credible and disciplined is fiscal policy looking forward the more a disinflationary monetary policy will be seen to be politically sustainable. That would make any central bank's task easier.

The RBNZ did its job once it was clear that inflation had broken out and had to be brought down. It did not abandon the Government's inflation target. Instead, it maintained its restrictive policy stance despite the counterproductive fiscal stimulus. That was the right thing to do.

The government's fiscal choices – particularly the timing of its tax cuts and its continuation of prolonged deficit spending – were working against the counter-inflation objective. That was not the RBNZ's fault. The criticism of the Bank appears, in this light, to be a regrettable exercise in blame-shifting.

Of course, a tighter fiscal policy in conjunction with the unchanged inflation objective for monetary policy might not have avoided recession. Pain from running too easy monetary and fiscal policies for too long is unavoidable.

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[20] New Zealand Government. "Budget 2024 – Budget at a Glance." Wellington: The Treasury, May 2024. https://budget.govt.nz/budget/pdfs/at-a-glance/b24-at-a-glance.pdf.

[21] Reserve Bank of New Zealand. Monetary Policy Statement, May 2024. Wellington: RBNZ, 2024. https://www.rbnz.govt.nz/monetary-policy/monetary-policy-statement/mps-may-2024.

[22] International Monetary Fund. "New Zealand: 2024 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for New Zealand." IMF Country Report No. 24/122. Washington, DC: IMF, May 2024. https://www.elibrary.imf.org/downloadpdf/view/journals/002/2024/122/002.2024.issue-122-en.pdf.

The immediate lesson is that a more coherent and longer-term policy focus is needed. New Zealand governments face a long-haul fiscal task if public debt ratios are to be returned to prudent pre-Covid levels.

To better sustain economic activity along that path business and investor confidence needs to be generated about the quality and determination of forward-looking fiscal and regulatory policies. They need to credibly counter the inherited legacy of imprudence, divisiveness and the undermining of the rule of law and parliamentary sovereignty.

Leadership and a credible and cohesive forward-looking plan really matter. The blame game is an unconstructive distraction.

To be clear, the RBNZ made mistakes which caused the post-Covid inflation outbreak. But once it had realised these mistakes, it did what its mandate required under challenging circumstances.

The ball is in the government’s court to build business, investor and householder confidence that it has a credible framework for correcting the fiscal imbalances and restoring spending confidence.