SALT INSIGHT

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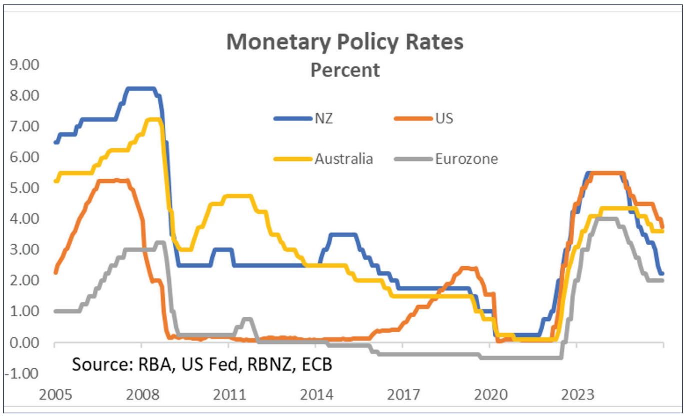
Monetary Policy in New Zealand
Why all the volatility and what can we do about it?

Even a casual observer of global monetary trends must ask themselves the question: why do we in New Zealand seem to have to suffer through the biggest swings in interest rates and economic output in the developed world in the interests of maintaining price stability. In the most recent tightening phase, our Official Cash Rate was joint highest in the developed world, only then to be cut to amongst the lowest. And now, just as the recovery is finding its legs, financial market are expecting the next tightening phase to begin in less than 9-months.

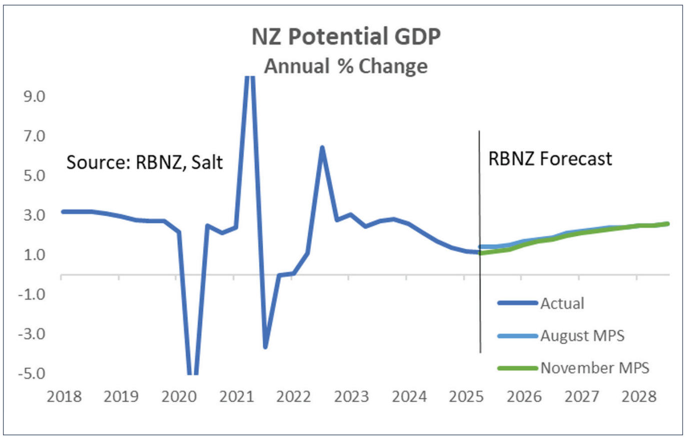


This faster than expected shift in the outlook for interest rates has revived a common question: has monetary policy in New Zealand been too slow to adjust at turning points, only to compensate later with excessive force? The past few years suggest this pattern has been repeated in both directions — delayed tightening followed by aggressive hikes, then delayed easing followed by deep cuts — with predictable consequences for activity, confidence, and inflation volatility.

In our view this is not simply bad luck or forecasting error. It reflects a deeper problem in how policy responds to uncertainty in an economy with low and uncertain potential growth. When spare capacity is limited, the cost of being late is high. And when policy is late, it almost inevitably ends up doing too much.

Low potential growth — the structural constraint

At the heart of New Zealand's volatile economic and interest-rate cycle sits a structural constraint - the economy's speed limit is low and easily breached. Weak productivity growth and volatile migration-led population dynamics have dragged down potential growth over time, leaving the economy prone to inflation pressure even when recoveries still feel fragile, especially in per capita terms. Right now, the RBNZ believes our potential growth rate is a little over 1% per annum, though it is expected to rise as net migration recovers.



In such an environment, monetary policy has little margin for error. Recoveries quickly generate non-tradables inflation, wage pressure, and rents rather than sustained increases in output. Once inflation pressures emerge, the response must be forceful — but that forcefulness is often a consequence of having waited too long.

Slow to move, then forced to overdo it

One of the clearest lessons of the past cycle is that policy has been slow to adjust at key inflection points. Tightening began late relative to the scale of the inflation shock, requiring one of the most aggressive hiking cycles in the developed world. Easing was then delayed despite mounting evidence of a sharp downturn, necessitating a rapid and deep reversal.

This stop-start pattern is not accidental. It reflects a policy approach that places heavy weight on confirmation from backward-looking data in an economy where data are volatile, revised, and often poor proxies for real-time conditions. By the time the signal is clear, policy is already behind the curve — and the only remaining option is to move aggressively.

The result is not precision, but amplitude with large swings in interest rates and activity that amplify the cycle rather than smooth it.

The problem with data dependency — when the data just isn't right

The modern emphasis on data dependency is intended to enhance flexibility and credibility. In practice, in New Zealand's case, it has too often encouraged reactive policymaking.

Quarterly GDP is volatile and heavily revised. Migration data swing sharply. Productivity is measured with long lags. Housing and population growth blur the line between demand and supply. In this environment, waiting for clean confirmation before acting is not prudence — it is inertia.

The asymmetry is crucial. Weak data are taken as evidence of spare capacity, justifying delayed tightening or aggressive easing. Subsequent rebounds, often driven by population growth rather than productivity, are then interpreted as overheating, forcing abrupt reversals. Policy ends up chasing noisy data prints rather than managing risk around a low and binding speed limit.

In a small, supply-constrained economy, excessive data dependency does not reduce mistakes - it concentrates them.

Earlier, smaller moves — and why the RBNZ hasn't delivered them

There is a credible alternative: earlier, smaller policy adjustments that respond to changes in direction rather than waiting for certainty about levels. This is not about fine-tuning; it's about risk management.

Incremental moves made earlier can materially influence financial conditions in New Zealand's fast-transmission system without triggering sharp contractions or overheating. Crucially, they reduce the likelihood that policy later must "catch up" through oversized moves.

Yet this approach has been under-used. The preference seems to have been to wait for data validation, then move decisively. The outcome has been more cumulative movement in interest rates, deeper downturns, and faster re-emergence of inflation risk.

Why this matters for productivity — not just the cycle

The costs extend beyond short-term volatility. Large and unpredictable swings in interest rates and activity raise uncertainty around demand, financing costs, and returns on capital. That discourages the long-horizon business investment required to lift productivity.

Firms respond rationally by delaying investment, favouring short-term projects, and concentrating activity in housing and local services rather than tradables, scale, and innovation. This reinforces weak productivity, which in turn lowers potential growth — setting up the next volatile cycle.

In that sense, monetary volatility is not just a response to low productivity; it is increasingly part of the problem.

Who needs to do what?

Achieving a better outcome requires action on multiple fronts.

First, the Reserve Bank of New Zealand.

The RBNZ has scope to materially improve outcomes by changing how it manages uncertainty. That would involve placing less weight on point forecasts and individual data prints, and more weight on uncertainty, scenario analysis, and risk management in an economy with a low and binding speed limit. Moving earlier and in smaller increments at turning points would reduce the risk of policy falling behind the curve and then having to overcompensate later. A more active and symmetric use of macro-prudential tools, particularly given the dominance of housing in the transmission mechanism, would also help reduce the burden placed on the OCR alone. None of these changes would eliminate volatility, but together they would materially reduce the tendency for monetary policy to be slow to adjust and then forced to overdo it.

Second, the Minister for Economic Growth.

Monetary policy cannot compensate for a persistently weak supply side. Without a sustained lift in productivity, every cyclical recovery will continue to run into capacity constraints sooner than expected, dragging inflation and interest-rate expectations back into play. That places an unfair and ultimately destabilising burden on monetary policy. The task for economic policy is therefore not to engineer faster demand growth, but to expand the economy's productive capacity through higher-quality investment, skills, infrastructure, competition, and tradables growth. Lifting productivity raises potential growth and, in doing so, gives monetary policy more room to operate with smaller and less disruptive adjustments over the cycle.

Third, Statistics New Zealand.

Better policy decisions require better real-time information. In a small, volatile economy, heavy reliance on data dependency is only defensible if the underlying data are timely, reliable, and fit for purpose. Large revisions to GDP, delayed productivity measures, and uncertainty around population and labour-supply dynamics materially complicate monetary policy calibration. Improving the timeliness and quality (less revisions) of core economic statistics would not eliminate uncertainty, but it would reduce the risk that policymakers are reacting to noise rather than signal. In that sense, strengthening the statistical base is a critical input into macroeconomic stability.

The bottom line

New Zealand's volatile interest-rate cycle is not simply the product of shocks or bad luck. It reflects an economy with low potential growth, weak data, and a monetary policy framework that has been too slow to move at turning points and too aggressive once forced to act.

Inflation targeting is meant to smooth the cycle, not amplify it. Achieving that outcome will require not just structural reform, but a shift away from policy by data print toward earlier, more cautious, and more robust decision-making, supported by better data and a serious commitment to lifting productivity.