

Finding signal in the inflation noise

Oil shocks, price setting, and the path back to
2 percent inflation

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** These views are my own and do not necessarily reflect the views of my MPC
colleagues or the Committee as a whole.*

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Reserve Bank
of New Zealand
Te Pūtea Matua

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Introduction

Thanks for coming. A year ago, I spoke here about what tariffs and uncertainty meant for monetary policy. Today, my focus is on fallout from the conflict in the Middle East, and how inflation expectations and price-setting behaviour will influence the path of interest rates as we return inflation back to our 2 percent target mid-point. The world keeps turning, and quickly!

Like all supply shocks, the Middle East conflict has complicated monetary policy.¹ From late February, the conflict disrupted global supply chains and pushed up prices for petrochemicals globally. In our May *Monetary Policy Statement*, we expected inflation in New Zealand to be 4.2% in the June quarter of this year and 4.3% in the current quarter.

As highlighted in our *Monetary Policy Review* last week, near-term inflation pressures eased as shipping through the Strait of Hormuz resumed. We now forecast inflation to be 3.9% in the June quarter and 3.3% in the current quarter. I think developments in the Middle East over the last week suggest upside risks to our September quarter forecast.

Nevertheless, near-term inflation pressures appear to have eased, for the meantime at least, and that is clearly welcome. But the conflict has still delivered another significant inflation shock to the global and New Zealand economies.

As we have been highlighting since the conflict began, the challenge for monetary policy is to ensure that a temporary rise in petrochemical prices does not morph into persistent inflation.² In part, that depends on how firms respond to higher costs when setting prices, which is the focus of my speech today.

Key messages I would like to leave you with are:

- Inflation depends on economic shocks, the economic context into which they land, and how firms and workers respond. Understanding that behavioural response is important in assessing whether cost shocks fade or become embedded in persistent inflation pressure.
- When inflation is high, people pay closer attention to it. Research suggests that New Zealand businesses pass on cost increases more readily now than in the past and are less likely to reduce prices when costs ease. All else equal, this raises the risk that temporary shocks becoming persistent inflation.
- Monetary policy is about separating signal from noise. The signals that matter most can change as the inflation environment changes, so our assessment toolkit must evolve too. When above-target inflation changes expectations and price-setting behaviour, monetary policy may need to respond more firmly to re-anchor inflation expectations.
- Monetary policy cannot shield households and businesses from the direct hit from higher global oil prices. But it can stop a temporary cost shock from becoming embedded in inflation. Understanding price-setting behaviour – and responding decisively when inflation pressures show signs of becoming entrenched – is key to returning inflation to 2 percent over the medium term.

¹ For more detail, see Chapter 2 of the RBNZ's [May 2026 Monetary Policy Statement](#)

² See [Global shockwaves to Kiwi shores: The impact of the Iran conflict on New Zealand](#), by RBNZ Governor, Dr Anna Breman, Auckland, 24 March 2026

The current shock in context

Let's start with some historical context for current events.

The Strait of Hormuz has been a key node in many global supply chains and its closure resulted in large price shocks for many products, including chemicals, fertilisers, sulphur, and aluminium (Figure 1).³ For oil, the closure of the Strait removed around 10 million barrels a day from global markets, triggering one of the largest monthly increases in oil prices ever seen.

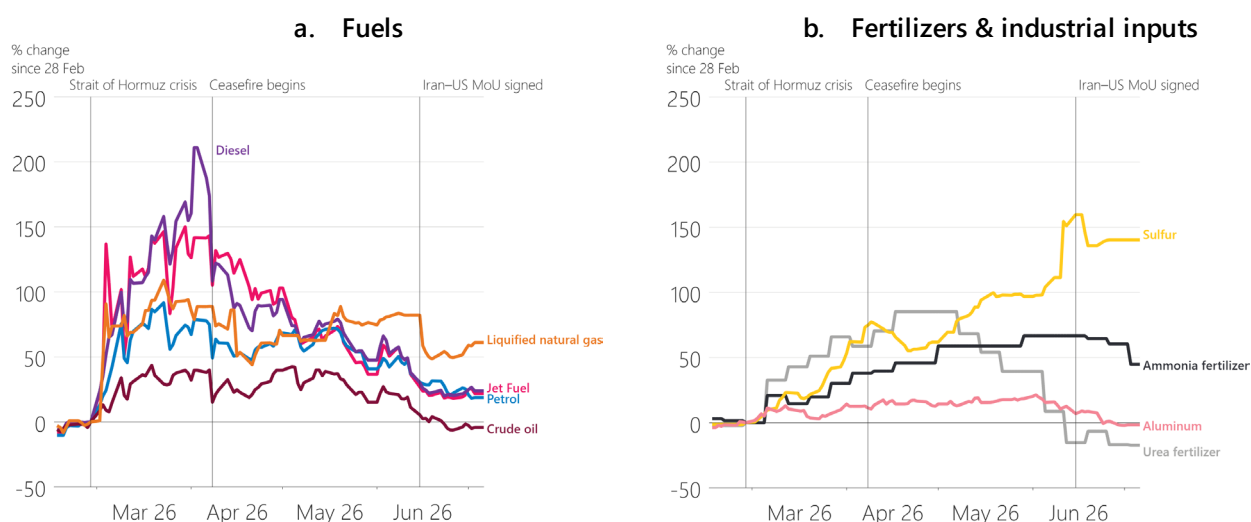
Shipping through the Strait has partially resumed. While some pressures have eased, recent events are a reminder that the situation remains fragile. Even if further disruptions are avoided, the shock's inflationary effects will continue to work their way through global supply chains and the broader economy for some time yet.

This latest shock added to an already noisy environment. For central banks, understanding inflation expectations and price-setting behaviour is critical to seeing through the noise and ensuring that a temporary price shock does not morph into persistent inflation.

History offers a cautionary tale. In the 1970s and 1980s, a temporary oil shock became embedded in inflation and price-setting behaviour and inflation persisted long after the shock had passed (Figure 2). Restoring price stability required years of tight monetary policy and high unemployment. The lesson is that once inflation expectations drift, the cost of bringing inflation back under control rises sharply.

Of course, today's economy is very different. The 1973 oil supply shock hit when inflation was already high, and inflation expectations were far less anchored. Import protections, widespread wage and price indexation, and limited competition made it more likely that higher oil prices fed into broader inflation.⁴ Most importantly, unlike today, New Zealand did not have an inflation-targeting monetary policy framework to anchor expectations and maintain price stability.

Figure 1: Commodity price changes since 28th February

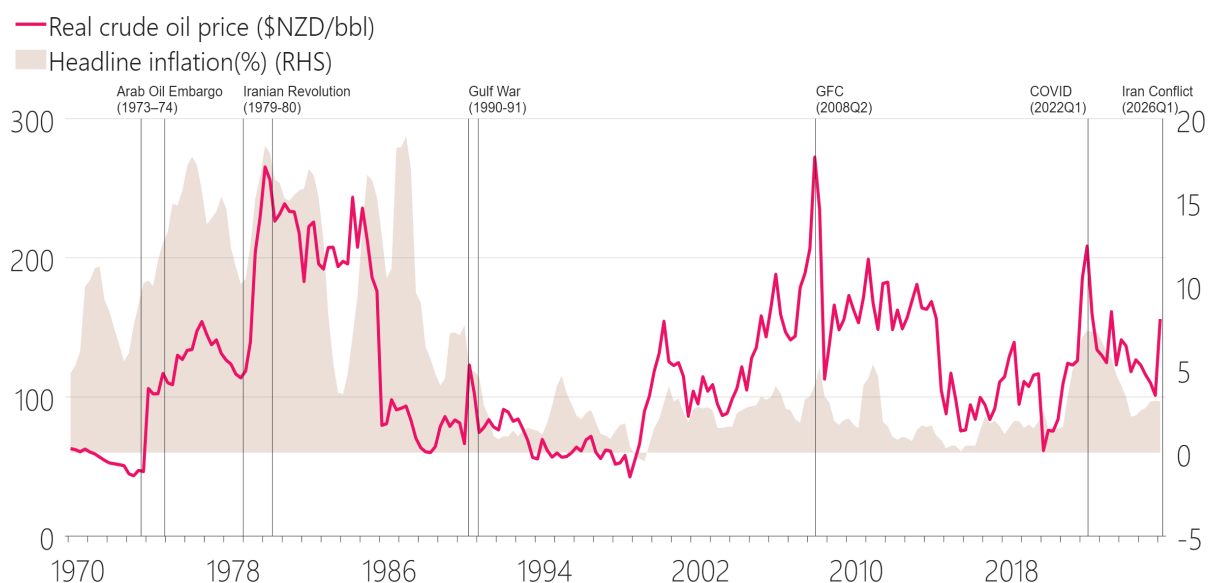


Source: Bloomberg

³ See [Shipping Lanes and Inflation-at-Risk: Hub Shocks and Optimal Monetary Policy](#) by Gai, Prasanna. Guest lecture at the New Zealand Treasury, Wellington, 4 May 2020.

⁴ See [WP-14-2018-Thirty-years-of-inflation-targeting-in-New-Zealand](#) (Buckle, 2018)

Figure 2: Inflation and oil prices since 1970



Source: Federal Reserve Bank of St Louis & RBNZ

Inflation expectations and price-setting in New Zealand

Inflation expectations and price setting behaviour are key channels through which cost shocks – such as an oil price shock – spread through the economy and evolve into broader inflation pressure. Understanding these dynamics is critical for monetary policymakers in responding to an oil price shock.

Inflation expectations

The Reserve Bank surveys the inflation expectations of households, businesses, and professional forecasters.⁵ Short-term expectations – those for inflation two year ahead – are strongly influenced by current economic conditions, including inflation, and are therefore relatively volatile (Figure 3a). Medium- to long-term inflation expectations – those ranging from two to ten years ahead – are more stable (Figure 3b).

This makes sense. Monetary policy can do little to smooth short-term economic volatility, so near-term inflation will always be relatively noisy. Medium- to longer-term inflation expectations provide a better gauge of whether people are confident inflation will return to the target over time - that is, whether expectations are 'anchored' to our target.

Households and very small businesses typically have higher and more volatile inflation expectations than larger businesses and professional forecasters (Figure 3a).⁶ Rather than closely tracking overall inflation, households tend to base their expectations on salient prices that they encounter most often – such as for fuel, transport, and housing. By contrast, larger firms have stronger incentives and more complete information to track economy-wide inflation.

This does not mean household inflation expectations are uninformative for monetary policy. Reserve Bank research finds that households with more accurate perceptions of current inflation

⁵ The Reserve Bank has surveyed the inflation expectations of large businesses in the Tara-ā-Pūkenga Survey of Expectations (SOE) since 1987. However, the SOE is based on a small sample and does not cover small- or medium-sized businesses. To address this gap, the Reserve Bank launched the Tara-ā-Umanga Business Expectations Survey (BES) in 2025, providing broader coverage and greater flexibility to support monetary policy and economic analysis.

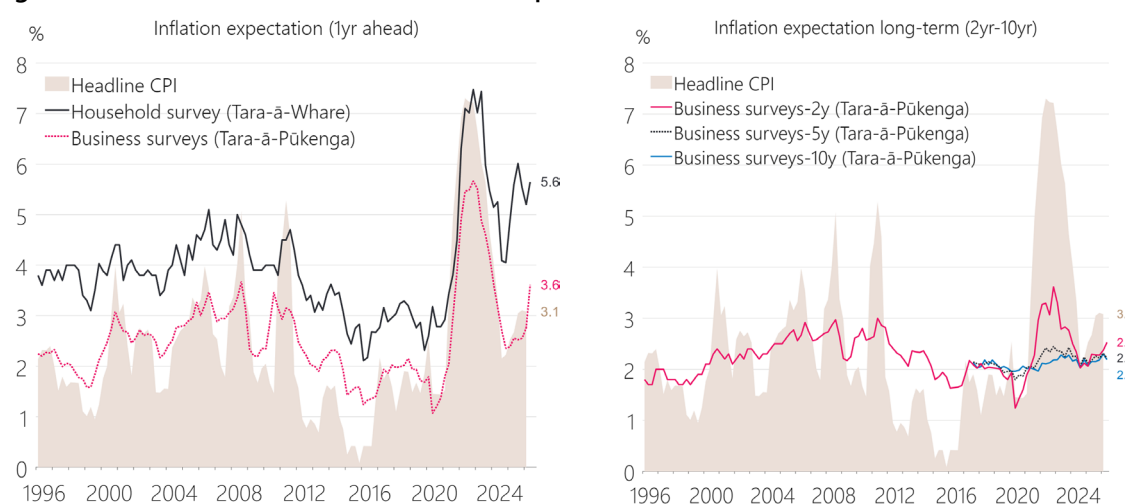
⁶ Bentley (forthcoming), *understanding respondents' long horizon inflation expectations: reviewing New Zealand business survey data*.

tend to form expectations that better predict future inflation.⁷ Focusing on these households reveals a clearer signal of future inflation pressures. Among this group, expectations for inflation two years ahead have increased and become more dispersed since the onset of the Middle East conflict, indicative of increased uncertainty about the inflation outlook (Figure 4).

Our research finds that households and businesses pay more attention to inflation when it is above our 1 to 3 percent target range.⁸ For example, response rates to our inflation expectations surveys increase when inflation is higher. This is consistent with ‘rational inattention’ – people pay closer attention to inflation when it is elevated and less when it is low and stable.

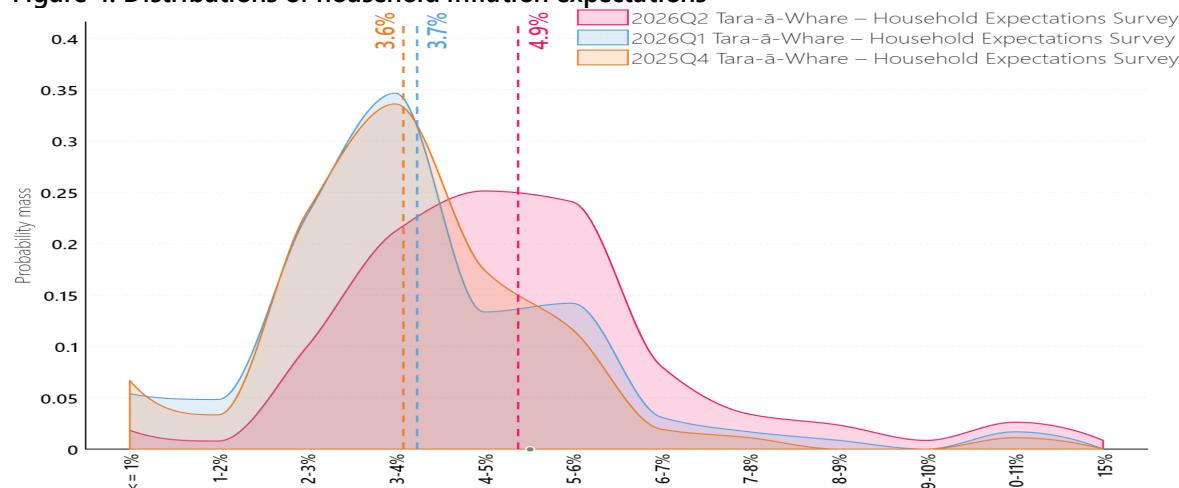
With inflation having been above our target range for 14 of the 25 quarters since 2020, I’m pretty sure people are paying close attention to it now. If people place greater weight on elevated inflation in their decisions, the risk of a temporary cost shock becoming more persistent increases.

Figure 3: Household and business inflation expectations



Source: RBNZ

Figure 4: Distributions of household inflation expectations



Note: The distribution of 2-year ahead inflation expectations among households with accurate perceptions of current inflation (within 2 percentage points). Mean expectations rose from 3.6% in 2025q4 to 3.7% in early 2026q1 and 4.9% in 2026q1. The distribution also widened, with the standard deviation rising from 1.6 to 2.1 over the period.

Source: RBNZ

⁷Coleman (forthcoming), *Extracting Better Information from the Household Expectations Survey*.

⁸ (See [Chadwick, Cherry & Galimberti, 2026](#))

Price setting by firms

Inflation expectations are a key determinant of firms' pricing decisions. If businesses expect cost pressures to persist or other businesses to increase their prices, they are more likely to raise their own prices, helping spread inflation through the economy. Of course, expectations are only part of the story – firms also respond to actual costs and broader economic conditions.

Today, New Zealand firms adjust prices more frequently but by smaller amounts than they did in the past (Figure 5). For example, during the post-pandemic inflation surge, firms adjusted prices about every 5 months on average – roughly as often as during the high-inflation era of the 1970s and 1980s. But because inflation was much lower post-COVID, the average size of these price changes was much smaller than in the earlier high-inflation decades.

Essentially, advances in digital technology have made it cheaper and easier for firms to review and change prices, allowing them to respond more quickly to shifts in inflation expectations, actual costs, and broader economic conditions. Larger firms tend to reprice more frequently, meaning that their pricing decisions can provide an early signal on inflation pressures in the economy (Figure 6).

New Zealand businesses have also become more likely to increase prices when costs increase, and less likely to cut them when costs fall (Figure 7).⁹ That is, price-setting has become more asymmetric, with firms quicker to pass through rising costs than to reverse price increases as inflation recedes. This pattern is most evident among firms in the services sector, which is an increasingly large share of the New Zealand economy.

Cost pressures are the main reason firms change their prices, with more than 90 percent of firms citing labour and other input costs as key (Figure 8).¹⁰ Firms tend to respond more quickly to changes in input costs than wage costs.

Also, pricing decisions are shaped less by the number of competitors they face and more by the prices those competitors charge and the willingness of customers to shop around and switch suppliers. In New Zealand, where competitive pressures are weak in some markets, firms may be relatively less constrained in lifting prices.¹¹ We are undertaking further research to better understand how competition influences pricing behaviour and inflation.

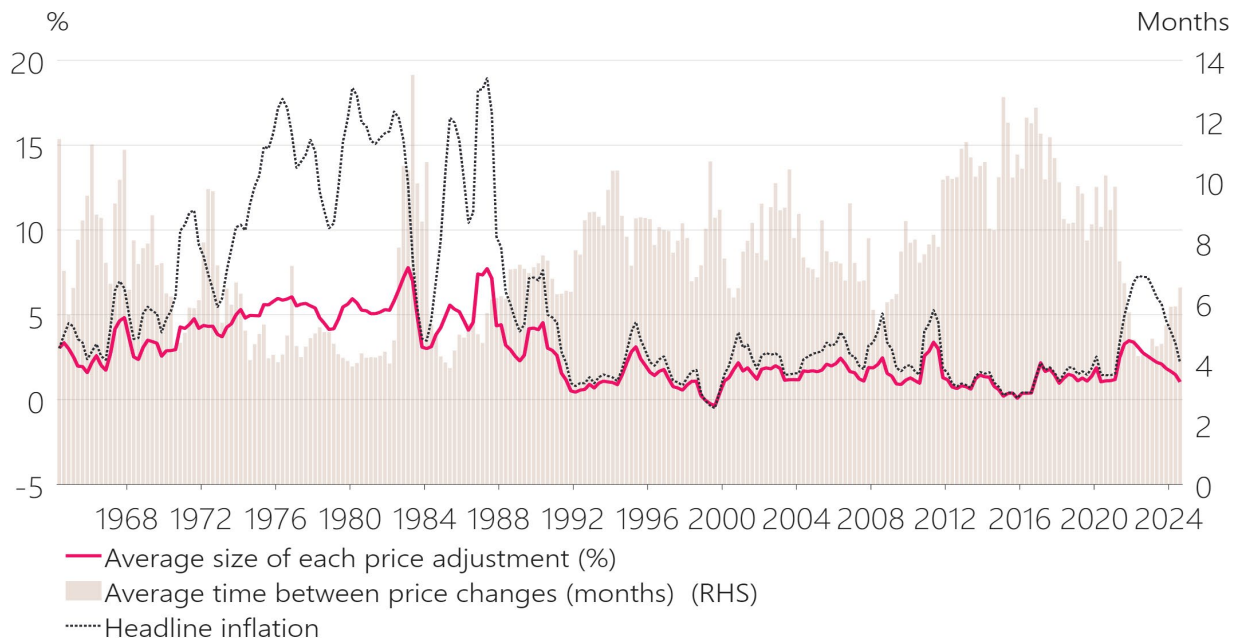
Taken together, these findings suggest that cost shocks may now pass through and become embedded in inflation more quickly than in the past. They also highlight how quickly firms can adapt and change their behaviour when cost pressures persist. This reinforces the importance of keeping inflation expectations anchored and closely monitoring price-setting behaviour to assess the likely persistence of inflation and the appropriate stance of monetary policy.

⁹ [Buckle, Ryan and Song \(2026\)](#)

¹⁰ [Chen, Ludvich & Stannard \(2026\)](#)

¹¹ Commerce Commission market studies have found weak competition across several key sectors — including [grocery retail](#), [building materials](#), [banking](#), and [electricity](#). International evidence suggests that more concentrated markets are associated with greater inflation persistence and stronger cost pass-through — see [Bräuning, Fillat & Joaquim \(2022\)](#).

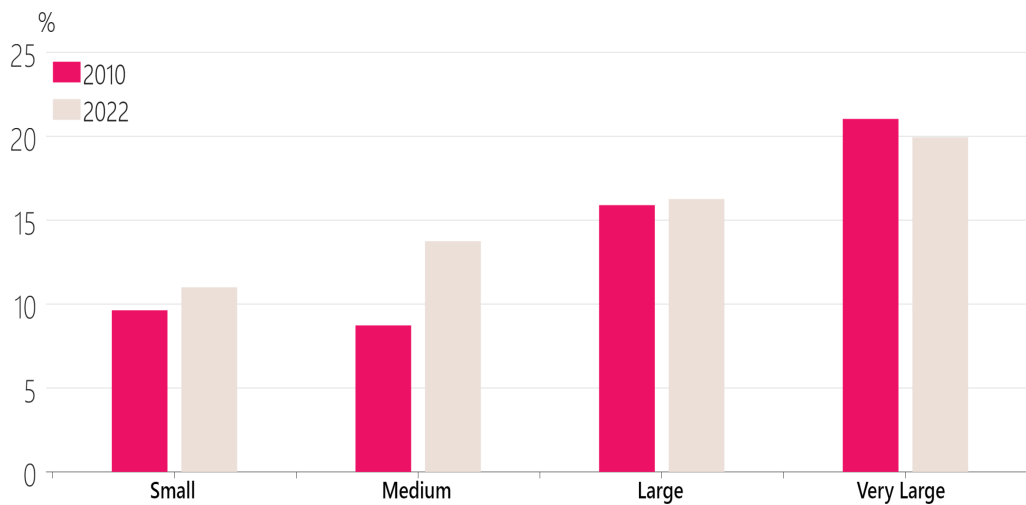
Figure 5: Duration and size of price changes by New Zealand businesses



Note: The figure shows how firms' pricing behaviour evolved from 1968 to 2024. The average size of each price change has generally declined since the 1980s.

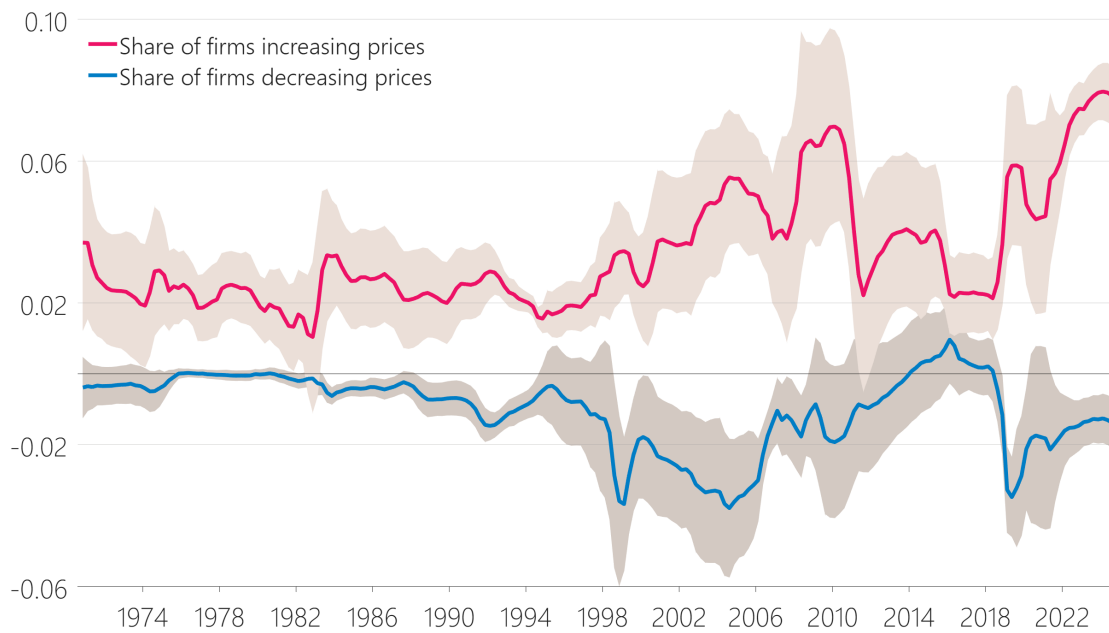
Source: RBNZ- [Buckle, Ryan and Song \(2026\)](#)

Figure 6: Share of firms changing prices monthly or more often



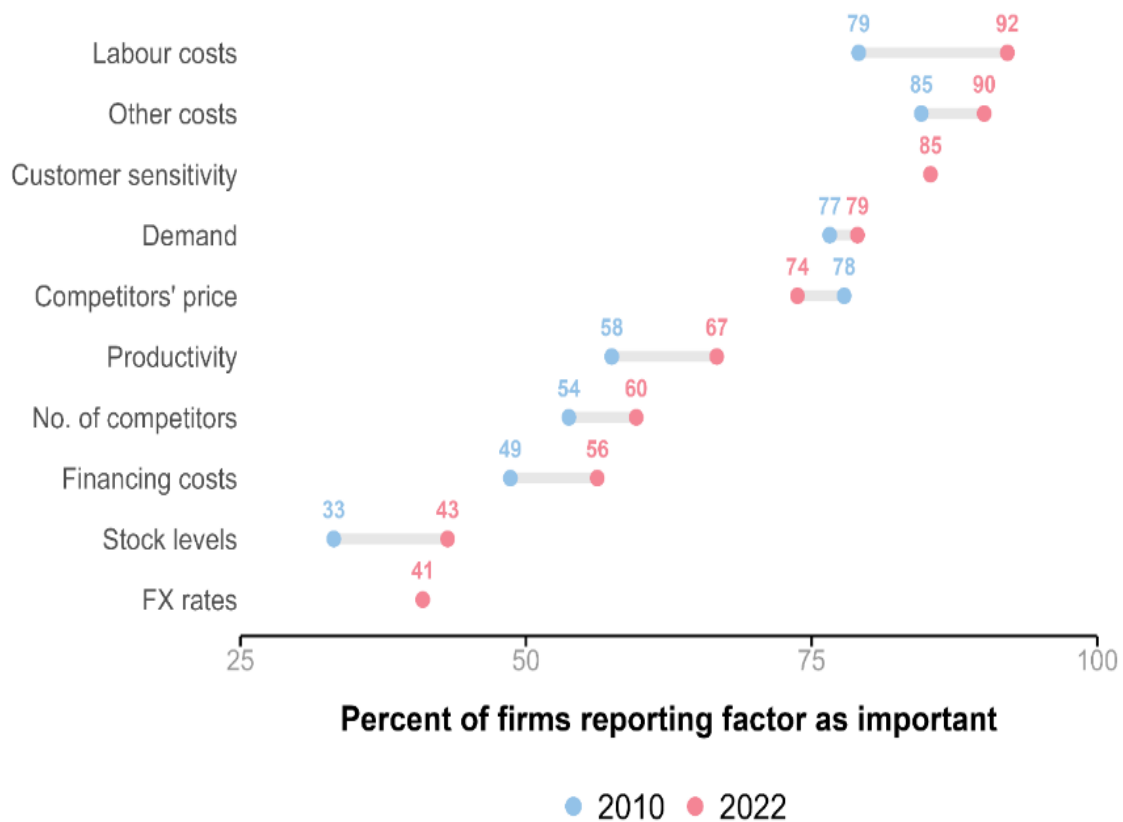
Note: This figure shows the estimated percentage of firms in each size category that changed prices at least monthly (i.e., daily, weekly, or monthly), by year. Source: [Chen, Ludvich & Stannard \(2026\)](#)

Figure 7: Time-varying relationship between inflation and price changes by firms



Note: This figure shows how firms' pricing behaviour has changed over the past 60 years. It tracks how strongly inflation influences a firm's decision to raise or lower prices, using a rolling window that moves through history. Source: RBNZ- [Buckle, Ryan and Song \(2026\)](#)

Figure 8: Perceived importance of the drivers of price changes



Source: [Chen, Ludvich & Stannard \(2026\)](#)

Price setting and inflation forecasting

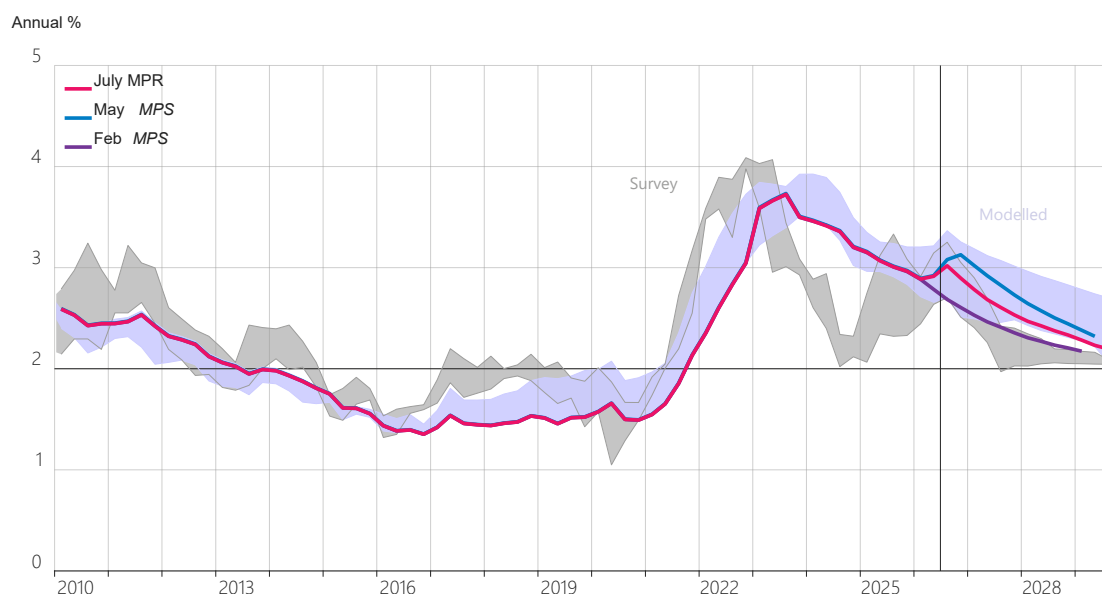
Price setting in aggregate

In our forecasting model, we use an aggregate indicator of price-setting behaviour that summarises the complex web of pricing decisions made by firms across the economy. Our research suggests there is no single best gauge of pricing behaviour. Instead, the challenge is to identify which indicators give the clearest signal of inflation persistence as economic conditions evolve.

When inflation is low and stable, model-based measures that capture the lingering influence of past inflation can be particularly helpful in forecasting persistent inflation pressures. When inflation is high and volatile, measures of current inflation and cost pressures become more important. This is consistent with our findings that firms place greater weight on recent inflation when making pricing decisions during periods of high inflation.¹²

Our aggregate measure of price setting rose sharply in 2021 and 2022 as the post-pandemic inflation surge prompted firms to review their prices more often and pass through cost increases more quickly (Figure 9). It has since declined as tighter monetary policy reduced inflation pressures in the economy. While it has ticked up this year following the Middle East conflict, we expect it to resume its downward trend to levels consistent with headline inflation at 2 percent over time.

Figure 9. Price-setting behaviour



Note: Measures are standardised to account for differences in historical averages and volatility. Values are deviations from each measure's historical average in standard deviation units. Survey measures include 1-year ahead household inflation expectations and 1- and 2-year-ahead business inflation expectations. Model-based measures are from NZSIM, a more inflation-sensitive NZSIM variant, and a 3-year backward-looking average of headline inflation. Projections are based on historical relationships with headline inflation and conditional on our current inflation forecast.

Source: RBNZ, July 2026 MPR

¹² Kendall & Sing (2025) and Lee (2026) both find that measures grounded in past inflation outperform alternatives in explaining and forecasting non-tradables inflation during periods of economic stability. Bayamagnai (2023) and Brennan & Turnip (forthcoming), *Seeing inflation expectation differently: Behavioural insights from the NZ Philips curve*, similarly point to households and firms placing more weight on recent inflation outcomes during periods of high inflation.

Our inflation forecast

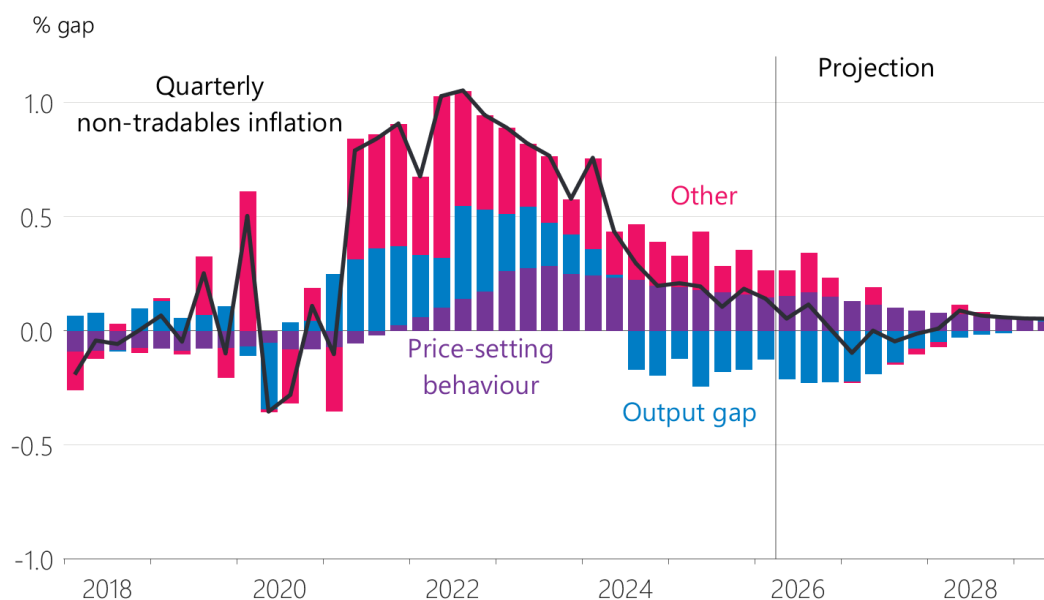
Despite the near-term increase in headline inflation caused by the Middle East conflict, we expect inflation to fall back to the mid-point of our 1 to 3-percent inflation target over the next year. Key to this expectation is excess productive capacity in the economy, which is making it more difficult for firms to pass on cost increases and more likely that near-term inflation pressures dissipate. Spare capacity is also expected to weigh on firms' pricing decisions, making price-setting behaviour more consistent with low and stable inflation over time. Less stimulatory monetary policy will also mean less medium-term inflation pressure.

This is a very different economic environment to 2022 when Russia's invasion of Ukraine led to a surge in global energy prices. Back then, there was excess demand in the economy, which made it easier for businesses to pass higher costs on to consumers, adding to inflation pressure and making a temporary shock more persistent (Figure 10).

A key risk for monetary policy currently, is that after a prolonged period of inflation above 2 percent, businesses and households expect higher inflation to persist. This would embed near-term cost pressures into medium-term inflation, requiring a tighter monetary policy response to return inflation sustainably to target. If expectations stay anchored, however, the economy will absorb this shock at lower cost.

Finally, it is important to acknowledge that inflation pressures are not just about price-setting behaviour and capacity pressures in the economy (as shown by 'other' in Figure 10). For example, significant and sustained increases in administered prices – which are prices influenced by government – are currently contributing to elevated inflation. Over the year to 2026Q1, administered price increases contributed about 0.7 percentage points to annual headline CPI inflation of 3.1 percent.

Figure 10: Drivers of non-tradables inflation



Note: This figure shows what has been pushing non-tradables inflation up or down each quarter. Non-tradables inflation is expressed as deviation from target.

Conclusion

Understanding how firms respond to cost shocks is fundamental to keeping inflation low and stable. Especially now, as higher global oil and petrochemical prices have increased costs for households and businesses. Even though oil prices have eased, the effects of the shock will continue to reverberate through the economy for some time yet.

Monetary policy cannot soften the direct hit to real incomes from higher global petrochemical prices – we are collectively worse off with a deterioration in our terms of trade and national purchasing power. But it can prevent first-round price effects from becoming second-round inflation pressure.

In short, when firms can pass on higher costs more easily, inflation becomes more persistent. And the more persistent inflation becomes, the harder monetary policy must work to bring it back to target. In contrast, when the inflation target is credible and inflation expectations are well anchored, the Monetary Policy Committee (MPC) will need to respond less to temporary shocks, meaning less volatility in output and employment will be necessary to return inflation to target.

Encouragingly, medium-term inflation expectations remain well anchored. Spare capacity in the economy should help limit pass-through. But after a prolonged period of above-target inflation, anchored inflation expectations cannot be taken for granted.

Last week, MPC noted that with inflation still above target and economic activity expected to strengthen, some further reduction in monetary stimulus is likely to be required. How price setting behaviour evolves from here is a key uncertainty around that expectation. If inflation pressures stemming from the Middle East conflict prove to be more persistent than expected, we will respond. Because when expectations become embedded in price-setting behaviour, bringing inflation back to target becomes much more difficult and costly.