1 Policy assessment

The Official Cash Rate (OCR) remains unchanged at 3.0 percent.

Interest rates are now projected to rise to a more limited extent over the next two years than signalled in the September *Statement*.

The pace of economic growth appears to have moderated. Corporate investment intentions are now below average. Household spending also remains weak, with household credit still flat and housing market activity slowing further. House prices may decline a little further in the near term. This continued household and business caution suggests current low interest rates are having a less stimulatory effect than in the past.

On the positive side, activity in New Zealand's trading partners continues to expand. Growth in the Asia-Pacific region remains strong, and growth in the US and UK has turned out a little stronger than was projected. Consistent with this, export commodity prices, which were already very high, continue to increase. While this is encouraging, downside risks to global growth and export prices persist.

Repairs to earthquake damage in Canterbury are expected to add to GDP growth over the projection period. The earthquake appears to have caused about $5 billion of damage to infrastructure, and residential and commercial property.

While the near-term outlook for GDP growth has softened, beyond this, higher export volumes and earthquake repairs are expected to push GDP growth above that projected in the September *Statement*. As growth recovers, current spare capacity will gradually be used up, causing underlying inflation to pick up. More immediately, the recent increase in the rate of GST will cause headline CPI inflation to spike higher temporarily, although there is little evidence of this spike affecting price and wage setting behaviour.

While interest rates are likely to increase modestly over the next two years, for now it seems prudent to keep the OCR low until the recovery becomes more robust and underlying inflationary pressures show more obvious signs of increasing.

The New Zealand dollar has appreciated significantly since the September *Statement*. Sustained strength in the currency is inhibiting the rebalancing of economic activity towards the tradable sector. Accelerated elimination of New Zealand's fiscal deficit could help improve national savings, thereby easing current pressure on interest rates and the New Zealand dollar, and reducing New Zealand's dependence on international borrowing.

Alan Bollard

Governor