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# 1 Overview and policy assessment

The Reserve Bank has again decided to leave the Official Cash Rate unchanged at 6.5 per cent.

When the Bank finalised its last *Monetary Policy Statement*, early in May, most indicators pointed to a continuation of reasonably robust growth throughout this year. To be sure, there was some evidence that growth in retail spending was slowing from the rapid growth of 1999, and the housing market was clearly sluggish. But businesses' confidence in prospects for their own activity was high, levels of capacity utilization were high, consumer confidence was high, tourist arrivals were running at a rate some 18 per cent above the same month in 1999, the growth in our major trading partners was strong, and monetary conditions were providing a supportive environment. There were also widespread anecdotes, especially from some of the provincial areas, of difficulty in finding workers.

Back then, we estimated that growth in the March quarter had slowed in comparison to the very rapid growth of the two preceding quarters, but projected growth to pick up to about 1 per cent per quarter through the balance of the year. On this basis, we saw a gradual increase in interest rates as being appropriate to keep inflation under control over the next few years.

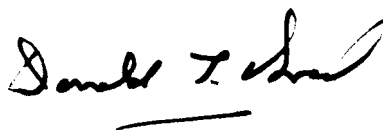
Since that *Statement* was finalised, a lot of things have changed. It seems very likely that, because of an unexpectedly rapid further increase in international oil prices, a substantial increase in excise tax on cigarettes, and a significantly lower exchange rate than assumed in our May projection, CPI inflation will increase quite markedly over the next few months, and may well come close to the top of our 0 to 3 per cent target band by the end of this year. On the other hand, while growth in the March quarter turned out to be a little stronger than we had assumed, it now seems clear that growth slowed very sharply in the June quarter, and may well have been negative. Business confidence has fallen sharply, as indeed has consumer confidence. Changes in labour legislation and other policy announcements have collectively created considerable uncertainty, and appear to have led to some deferment of new investment and employment. Even the September quarter now seems likely to record only modest growth.

As a result, pressure on the economy's capacity seems likely to be less over the next few quarters than previously expected, and as a consequence the medium-term pressures on inflation less than expected also, notwithstanding the imminent short-term blip in inflation.

There is considerable uncertainty about where the economy goes from here. One school of thought suggests that, given continuing growth in our major trading partners, moderate interest rates, and an exchange rate which is close to historical lows, economic activity and business confidence will bounce back strongly before long. Given the near-term increase in the CPI, the risk that employees will seek wage compensation for that increase in the CPI, and the considerable squeeze on margins being experienced in many parts of the economy, this view of the world sees the prospect of significant inflationary pressures next year, and a need for the Bank to keep increasing interest rates.

Another school of thought suggests that business confidence may take a considerable time to recover fully, and any significant slowdown in major markets such as Australia and the United States could exacerbate an already difficult situation. This view of the world suggests that there is no risk of inflation accelerating next year, and so no need to increase interest rates further – and indeed potentially a need to reduce interest rates, to prevent inflation falling towards the bottom of the target range.

Clearly, the data on economic activity in a small economy such as ours tend to be “noisy”, and the Bank needs to steer through that noise as best it can. Given the uncertainty about the outlook, leaving the Official Cash Rate unchanged seems the prudent thing to do right now.



Donald T Brash  
Governor