

1 Overview and policy assessment

The Reserve Bank has again decided to leave the Official Cash Rate unchanged at 5.75 per cent.

At present, the outlook for inflation remains largely unchanged from that in our *May Monetary Policy Statement*. For the last year, the CPI has been at or above the top of the 0 to 3 per cent target range, in large part because of the impact of the sharp rise in international oil prices, the increase in taxes on cigarettes and tobacco, and the depreciation of the exchange rate over the last year or so. But on present assumptions inflation in the year to September should reduce to 2.4 per cent, and in the year to December to about 2 per cent. Beyond that, after a brief spike in the year to March 2002 as the very low inflation in the March quarter of 2001 falls out of the 12 monthly total, the CPI should track back to somewhere near the middle of our target. The "underlying trend in prices", which the Policy Targets Agreement makes clear should be the proper focus of monetary policy, can not be directly measured, but reasonable estimates suggest that so far it remains well within the target range.

But, in saying that, we are conscious of some risks to that relatively benign assessment. Inflation could turn out to be more persistent than currently seems likely for a number of reasons.

- First, after a year of relatively slow growth, we have assessed that demand and potential supply are roughly in balance at present, implying that there is neither upward nor downward pressure on "the underlying trend in prices". That still seems a good assessment, but there are an increasing number of indicators suggesting that the economy may in fact be operating slightly above full capacity.
- Second, we have assessed that inflation expectations are, and will remain, well anchored within the inflation target. But clearly the longer that headline inflation remains close to the top of or above the target, the greater the risk that inflation expectations will become disturbed, with adverse consequences for wage- and price-setting behaviour. This point takes on particular significance in view of the possibility of further "one-off" price shocks, such as might arise from the present shortage of electricity-generating capacity.
- Third, our judgement about the way in which inflation is likely to evolve assumes that, consistent with past experience, the currently-weak world trading environment will soon result in quite a sharp fall in the world prices of our commodity exports, with resultant disinflationary effect on New Zealand. But we have assumed such a fall each time we have reviewed the inflation outlook in recent

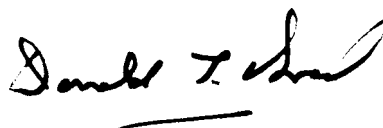
months, and each time we have been surprised by continuing strength in those prices. That strength may continue despite a generally weak world environment, with the result that inflation may turn out somewhat higher than now projected.

- Fourth, we have assumed that the exchange rate will gradually appreciate in the months ahead, producing some downwards pressure on New Zealand prices. But we have assumed some appreciation in the past also, and to date the exchange rate has shown little tendency to rise, despite being under-valued by virtually every measure. If the exchange rate were not to appreciate to the extent projected, inflation would for this reason too probably turn out to be a little higher than projected.

With businesses confident about the outlook for their own activity, rural sector incomes at their highest level in many years, employment intentions at near-record levels, and strong signs of a pick-up in both confidence and activity in residential construction – previously one of the most sluggish parts of the economy – we have no reason to date to regret the relatively cautious manner in which we have reduced the Official Cash Rate in recent months.

Indeed, the current situation would point to an early increase in the Official Cash Rate were it not for the risk that the international environment will turn out to be even weaker than assumed. *Consensus* forecasts still suggest a recovery in world growth next year, but the flow of economic indicators from the United States, Japan, non-Japan Asia and Europe makes a deeper and more prolonged slowdown seem quite likely. Almost every day brings new reports of major corporations laying off thousands of staff and announcing sharp reductions in earnings. At this stage, only Australia among our major trading partners appears to be relatively immune to the international slowdown. If the international environment were to turn out substantially weaker than our projections have allowed, there seems little doubt that the disinflationary pressures on New Zealand coming from overseas would intensify. As a result, inflation could fall into the bottom half of our target range and this would necessitate further easing of monetary policy.

But that is for the future. For the moment, leaving the Official Cash Rate unchanged seems appropriate.



Donald T. Brash
Governor