
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 August, it was clear that CPI inflation would be approaching the top of our target band by the end of the year, driven by higher international oil prices and cigarette taxes, and by the fall in the exchange rate. It was also clear that the economy had slowed markedly during the first half of this year from the very rapid growth of the second half of 1999.

What was not clear was how the economy would respond to the stimulatory monetary conditions then prevailing. Would depressed business and consumer confidence yield to the buoyant world environment and low exchange rate, leading to a strong resurgence in economic activity and resultant medium-term pressures on the economy's capacity? Or would low levels of confidence become self-fulfilling, leading to slow growth and higher levels of unused capacity? The two scenarios had very different implications for medium-term inflation, and therefore for the direction in which interest rates would need to move.

Three months on, we believe that business confidence is set to strengthen, consistent with economic activity having picked up in recent months and being noticeably stronger in the second half of the year than the first. To be sure, some sectors remain subdued, and this is especially true of the residential construction sector. But in other sectors, most obviously those serving export markets, conditions are very buoyant, with widespread anecdotes of significant staff shortages. Unless economic activity in our major trading partners stalls, we believe that growth in New Zealand will pick up further as we go into 2001, supported by an exchange rate that is even lower than in August.

Three months on from August it is also clear that, in the short-term, annual CPI inflation will peak even higher than we judged likely in August, and indeed will well exceed the top of the target band for the next several quarters. Even so, stripped of the transient elements of the inflation story to do with international oil prices and cigarette taxes, CPI inflation remains well within the target range. In accordance with our longstanding agreement with Government, the Bank will continue to focus on the persistent elements of inflation and ignore the transient elements.

Inevitably, our degree of confidence that the temporary spike in inflation will not become persistent is affected by the

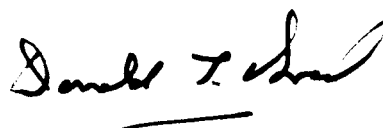
wider situation, including the degree of pressure on the nation's resources. Assuming the exchange rate appreciates modestly from its currently very low level, we believe that the pressure on resources associated with this growth resurgence can be kept in check with a gradual and – by historical standards – rather small firming of interest rates next year. That should, in our judgement, be sufficient to ensure that the current spike in inflation will prove transitory.

But, as always, there are risks. On the downside, there is the possibility that the world economy could slow by more than we presently expect. This could slow the New Zealand economy and reduce inflationary pressures. On this occasion, however, we see the upside inflation risks as rather greater. Not only have we assumed some appreciation of the exchange rate, but more importantly we have not allowed for as strong a response of economic activity to the low exchange rate as has been observed historically. If the exchange rate stimulus proves greater than we have allowed for, the need to increase interest rates will also be greater.

Such a situation would heighten another risk. We have assumed that employers and employees will not adjust their behaviour to reflect the temporary spike in the inflation rate. But if businesses attempt to restore their margins, or employees seek compensation for the increased price of cigarettes, petrol and other imported goods, then inflationary pressures will be more persistent and the need to increase interest rates commensurately greater.

The reality is that the export and import-competing sectors are already operating close to capacity. They will only be able to grow further by attracting people and capital from other sectors of the economy. For this to happen without inflation, it will be important that growth in those other sectors of the economy, those not directly stimulated by the low exchange rate, remains relatively subdued.

In sum, somewhat higher interest rates are likely to be needed, but not quite yet, and the extent of the increase will depend very much on how the world economy evolves, on how the economy responds to the stimulus provided by the low exchange rate, and on the response of employers and employees to the near-term increase in the inflation rate.



Donald T. Brash
Governor