
1 Overview and policy assessment

The Reserve Bank has decided to increase the Official Cash Rate to 5.75 per cent.

The economy has now been growing since mid-1998 at a rate of around 3 to 4 per cent per annum. Barring surprises, we expect growth will continue at a broadly similar pace over the next two or three years. This outlook is supported by strong growth in our trading partners, a recovery from the droughts of the last two summers, and the very stimulatory monetary conditions which have prevailed over most of the last two years.

For all of that period, there has been surplus capacity in the New Zealand economy, which has contributed to the generally low inflation seen recently. But we estimate that that surplus capacity has now been largely exhausted. This assessment is reinforced by a range of indicators, some of which are near levels last seen just preceding the increase in inflation in the mid-nineties. This is particularly true of indicators of capacity utilisation. Inflation expectations and pricing intentions have also turned up. Overall, the balance of risks now points quite clearly in the direction of rising inflation pressures over the next one to two years.

For this reason, we are confident that the increases in the Official Cash Rate in November and January were well justified, and that continuing to remove monetary stimulus with today's increase is appropriate.

Looking further ahead, however, there is ample scope for alternative views on the prospects. Our central projection, on which we base the forward track for monetary conditions, contains a fairly subdued pattern of growth in household expenditure, consistent with increased debt levels beginning to weigh on household sector behaviour. But the evidence to support this relatively slow growth in household expenditure remains fragmentary. The exchange rate is also at historic lows and may be providing stronger stimulus to the export and import-competing sectors than we have allowed for in these projections. In short, we can readily envisage a need for monetary conditions to tighten further, and perhaps more quickly, than is projected in this *Statement*.

But there are also arguments to be made on the other side. To the extent that recent growth has resulted from favourable weather patterns, it is likely to be fairly transitory, and can

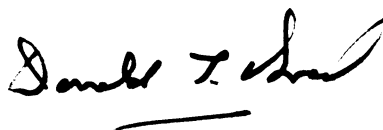
therefore be safely ignored for monetary policy purposes. Perhaps we will find that the economy can grow more quickly than we now expect without inflation, as central banks in some other developed countries have found in the last few years. To date, we have seen little evidence that actual inflation has begun to turn up. Indeed, CPI inflation turned out to be somewhat lower than we had expected in the September 1999 quarter, and much lower than we had expected in the December 1999 quarter. These factors at least raise the possibility that, beyond the next few months, monetary conditions will not need to tighten as much as now projected.

That is for the future. As for now, it is our assessment that, even after today's adjustment to the OCR, overall monetary conditions continue to be supportive of economic activity, not restrictive.

Contrary to our expectations in the November *Monetary Policy Statement*, the New Zealand dollar has not appreciated since the start of the year; indeed, it has depreciated further. There are a number of reasons for that, some of which (for example, still relatively weak commodity prices) imply that the exchange rate stimulus is being offset by other factors, and some of which (for example, rising interest rates abroad) don't imply this.

At this stage, the Bank has chosen to respond to this exchange rate weakness cautiously. But the longer the exchange rate remains persistently weaker than assumed, the greater the likelihood, all else equal, that the stimulus to the export and import-competing sectors will prove sufficiently strong to warrant more marked increases in interest rates than those currently projected.

Overall, faced with these uncertainties about how events will unfold, but in a situation where excess capacity appears to be largely used up, the prudent course of action is to ease up on the accelerator fairly quickly, while pondering the need for pressure on the brakes further down the track.



Donald T Brash
Governor