
1 Overview and policy assessment

After a considerable period during which the Official Cash Rate has remained stable at 6.5 per cent, the Reserve Bank has decided to reduce it to 6.25 per cent.

This was a finely balanced decision, with clear risks involved both in reducing the rate and in leaving it unchanged. There is on the one hand the risk that the increase in prices caused mainly by increased energy prices and the lower exchange rate will spill over into more widespread inflation, and on the other hand the risk that the world economy, and therefore eventually inflation pressures in the New Zealand economy, will turn out to be materially weaker than allowed for.

The first of these risks is heightened by the fact that significant parts of the economy are operating at close to capacity. To be sure, the construction sector is going through a slow period, and retail sales are subdued. But fuelled by a still-stimulatory exchange rate and relatively buoyant commodity prices, many companies are stretched. Tourism is experiencing very strong growth. Indicators of business and consumer confidence are high. There are many anecdotes of companies finding considerable difficulty in finding staff, particularly in the South Island, and unemployment is at its lowest level for more than 12 years. Previous experience suggests that the tightness of the labour market we are seeing at present could result in inflationary increases in wages and salaries coming through next year. Thus, as discussed in Chapter 4, there are clearly risks that inflation will turn out to be more persistent than we currently project.

Taken on their own, these pressures would argue against any reduction in short-term interest rates, or indeed for some increase in rates of the sort envisaged in our last *Monetary Policy Statement*.

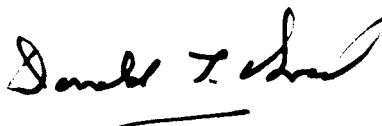
But there are several factors which have changed since that last *Statement*. Because of some one-off factors in the March quarter, it now seems likely that headline inflation will retreat from 4 per cent quite quickly, reducing the risk of a spill-over into wage- and price-setting behaviour. The exchange rate, while still clearly stimulatory, has appreciated somewhat since our last *Statement*, with the Trade-Weighted Index some 4 per cent higher (on 12 March) than we had projected for the first half of this year. Against the Australian dollar, a currency of particular relevance to the manufacturing sector, the New Zealand dollar has appreciated by more than 6 per cent since the last *Statement* was finalised.

Perhaps most important of all, and highlighting the possibility that inflationary pressures will turn out to be weaker than we

now expect, there is increasing uncertainty about how the international economy will evolve over the next year or so. Last November, most commentators projected a continuation of strong growth in the world economy. For the United States, for example, the average of *Consensus* forecasts was growth of 3.4 per cent in 2001; three months later, the average forecast was for growth of only 2.0 per cent. Some commentators are now even more pessimistic, talking about a recession in the United States in the first half of this year, followed by a period of slow growth. Were this to happen, it could have a seriously adverse effect on growth in our other trading partners.

At this stage, we do not know how severe the international slowdown may be, or how long it might last. Most international commentators, even the relatively pessimistic ones, expect the United States economy to recover fairly quickly from the current slowdown. Moreover, there are some special factors, particularly in markets for meat and dairy products, which suggest that New Zealand's export prices might hold up rather better than has been the case in previous periods of slow international growth. If the international slowdown turns out to be relatively brief, or if New Zealand's export prices hold up despite that slowdown, any substantial easing of monetary policy in New Zealand would be quite inappropriate.

But on the basis of emerging data, the risk that the world economy slows by more than assumed in our current projection – with a consequential material reduction in inflation pressures in the New Zealand economy – seems the marginally bigger risk. Today's reduction in the Official Cash Rate may be seen as an insurance premium against that risk. Clearly, if the world economy turns out to be significantly weaker than now seems likely, there may be a need to cut rates further, potentially by a significant margin. We are as keen to avoid inflation falling too far below the mid-part of our target range as we are to avoid its rising too far above it. But for the moment at least, the New Zealand economy is favourably "out of sync" with those of many of our trading partners. It is by no means inevitable that today's reduction in the Official Cash Rate will be quickly followed by further reductions.



Donald T. Brash
Governor