
1 Overview and policy assessment

The Reserve Bank has decided to increase the Official Cash Rate from 4.75 per cent to 5 per cent.

In the last few months of 2001, we reduced the Official Cash Rate by 100 basis points despite a domestic economy which was weathering the international downturn well. We did this partly because we expected the negative confidence effects of the events of 11 September to damage both the global and New Zealand economies, and partly because it had become clearer that, even before the events of 11 September, the world economy was weaker than previously expected. Both led us to expect downwards pressure on inflation. Indeed, in November we reduced interest rates by a little more than our projections suggested might be necessary, on the grounds that the risks in the international economy seemed clearly biased to the downside.

But we also noted in November that it was "conceivable that the combination of a stronger underlying performance of the New Zealand economy and a global slowdown that blows over rather more quickly than now expected will require a reversal of recent interest rate cuts in the not-too-distant future."

In the event, the performance of the New Zealand economy has indeed been stronger than we expected, and the risks to the global economy also look less threatening. Economic activity in the United States has picked up more quickly than most observers expected late last year, and the Australian economy looks robust.

Not that the global economy as a whole looks particularly strong. On the contrary, it seems likely that on average our trading partners will grow only moderately this year, and significant risks remain. The Japanese economy continues to have major difficulties, the US recovery could stumble over the high level of debt already accumulated, and global equity markets remain vulnerable to further weakness. But on balance these risks appear less than they did four months ago.

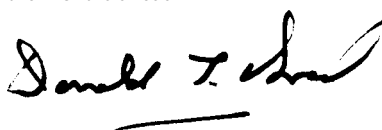
Locally, the domestic economy has been surprisingly buoyant. After a brief pause in October, retail spending has been strong. Visitor arrivals have also recovered quickly. Turnover in the housing market has been high, and residential investment has surged. Employment growth has been strong, and unemployment is close to its lowest level in 13 years. Although we are still expecting relatively slow growth in investment spending this year – a delayed response to the sharp downturn in business confidence which followed 11 September – it now

seems likely that investment too will be stronger than we expected in November. Imports have recently been very strong, confirming that domestic demand is relatively robust.

The reasons for the economy's holding up well are fairly clear. Both consumer and business confidence have bounced back to pre-11 September levels. Interest rates have been at low levels for several months. While the exchange rate has strengthened a little recently, it has been well below most estimates of its long-term equilibrium value for about two years. And in recent months there has been a sharp turnaround in net migration, from a net outflow of some 10,000 per annum to a net inflow of between 35,000 and 40,000, at an annual rate, now. Even though the composition of current net immigration is rather different from that in the mid-nineties, we still judge that in the short-term this net inflow of people will increase demand by rather more than it increases supply, thus adding to inflationary pressure.

Looking forward, it seems clear that, if things evolve as now seems likely, there will be a need for higher interest rates if inflationary pressures are to be contained. The economy is already operating at close to full capacity, and indications are that pressures will grow further in the absence of some increase in interest rates. Headline inflation has been at or above the top of our inflation target for much of the last 18 months, and for a number of reasons that seems likely to continue to be true for most of this year. Some of the causes of this relatively high inflation relate to matters to which monetary policy should not react (such as the increased tax on petrol, and the weather-related increase in the price of fruit and vegetables). But the risk is that this prolonged period of inflation near the top of the inflation target may lead people to adjust their inflation expectations upwards, making the task of controlling future inflation more difficult.

Even after today's decision, monetary conditions remain stimulatory. Today's increase in the Official Cash Rate simply represents some withdrawal of monetary stimulus, much of which was put in place as insurance against risks which have now receded. At the moment it seems likely that there will need to be some further reduction in monetary stimulus over the months ahead.



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