
1 Overview and policy assessment

The Reserve Bank has decided to increase the Official Cash Rate to 6.5 percent.

Information which has become available since the Bank's March *Monetary Policy Statement* indicates that there was very strong growth over the second half of 1999. As a result, the level of GDP in the December quarter was 5.8 percent higher than it had been a year earlier. Even allowing for a significant post-Y2K slowing in growth in the March quarter, we estimate that over the last two years the economy has grown to the point where demand is now exerting pressure on the economy's supply capacity and beginning to create inflationary pressures. This conclusion, which may well be surprising to many, is supported by a range of indicators, including high levels of capacity utilisation, increasingly widespread anecdotes about the difficulty which employers are having in finding staff, and the high levels of confidence which businesses have about the prospect for their own sales and profitability.

We project that growth will continue to be moderately strong over the next year or so, before slowing somewhat to around the sustainable growth rate further out. This projection of continued growth is based on our expectation that growth in our main trading partners will continue to be strong and on the lagged effect of the stimulatory monetary conditions which have prevailed over the last two years. The slowdown in growth to a more sustainable rate further out reflects the gradual tightening of monetary policy which has taken place in recent months, and which is conditionally projected to continue.

Measures of inflation have been somewhat volatile of late, with some numbers rising and others remaining relatively low. Despite this volatility, it seems clear that general inflation pressures are beginning to build, reinforcing our sense that demand is beginning to put pressure on capacity. It seems likely that measured inflation would increase in the next year or two were monetary conditions not to be gradually tightened further.

At present, we see overall monetary conditions as somewhat stimulatory. While current interest rates are providing little or no stimulus to the economy, the exchange rate still seems to be providing support to the export and import-competing sectors. Under the circumstances, and with

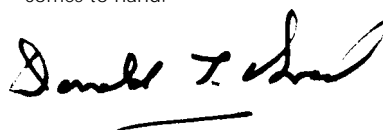
inflation beginning to pick up, it seems appropriate that monetary stimulus continue to be removed over the near term.

It should be noted, however, that we currently see rather less need for interest rates to increase over the next year or two than was the case in the mid-nineties. Indeed, at this stage we project 90-day interest rates to peak at a level well below their mid-nineties peak. This view is based on an expectation that household sector spending will increase more moderately in this cycle, the result in turn of a much higher level of household sector debt and an expectation that weaker net migration will mean that the housing market will remain subdued.

We are projecting a gradual increase in the exchange rate. This exchange rate appreciation is a result of improved global trading conditions for New Zealand, a projected rise in domestic interest rates, and an expected reduction in the balance of payments deficit. One factor suggesting a more modest appreciation in the exchange rate during this cyclical upswing than in the last is the outlook for domestic and foreign interest rates. With interest rates rising globally, in particular in the United States, it appears unlikely at this stage that New Zealand rates will rise substantially above rates overseas, in contrast to what happened in the mid-nineties.

But it is important to realise that the only thing which is absolutely certain at this stage is where the Official Cash Rate is being set in the present. Our projections are, as always, highly conditional. Were the United States and/or Australian economies to slow more sharply than now seems likely, for example, it is very possible that monetary policy would not need to tighten as much as now projected in New Zealand. Conversely, if the Japanese economy picked up more strongly, or household expenditure in New Zealand showed signs of rising strongly, then policy might well need to tighten by more than projected.

With a new *Monetary Policy Statement* issued approximately each three months, and an additional review between each *Monetary Policy Statement*, there is ample opportunity to adjust the Official Cash Rate as appropriate as new information comes to hand.



Donald T Brash
Governor