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# 1 Overview and policy assessment

We have decided to reduce the Official Cash Rate again, by 25 basis points to 5.75 per cent.

It is easy to see why virtually all commentators have been expecting another easing of monetary policy. The economies of many of our major trading partners, and particularly Australia, the United States, Japan, and non-Japan Asia, have grown quite slowly in recent months, and a more prolonged slowdown than that expected a few months ago is possible. Central banks in Australia and the United States have eased policy substantially over the last four months in response.

At home, business and consumer confidence have fallen, and investment spending has slowed. There is no sign of any widespread increase in asset prices (with the exception of the prices of some rural land), and growth in money and credit remains relatively weak. The drought which has affected significant parts of the country may reduce next season's agricultural production, tempering growth in income and spending in the rural economy.

But the inflation outlook is less clear than these factors alone would suggest. The problem is not that we expect June quarter inflation to be much higher than that in the March quarter. Both the slight fall in the CPI in the March quarter and the appreciably higher figure we expect in the June quarter are the result of one-off or temporary factors to which monetary policy should not respond.

Rather, what makes the outlook for inflation less clear than that suggested by a simple reading of today's headlines about the world economy – or the currently more subdued state of business confidence – is a number of other factors.

To begin with, although it is easy to imagine scenarios where the world economy slows a lot further, it is not yet by any means clear that growth in our main trading partners will continue to be weak next year, the time most relevant to what we do with monetary policy today. *Consensus* forecasts continue to suggest that the world economy will pick up again next year, while in recent weeks world financial markets also seem to be responding to that prospect.

Secondly, while any prolonged period of slow growth would almost inevitably lead to excess capacity in the global economy, and produce disinflationary pressures in New Zealand requiring a further monetary policy response, it is not at all clear that a relatively mild slowdown in the world economy will produce significant downwards pressure on inflation in New Zealand. So far, the world prices of many of New Zealand's commodity exports have held up surprisingly well, despite

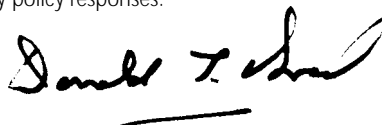
the slowdown in the growth of our trading partners. In other words, one of the major channels through which a weaker world economy typically affects New Zealand does not yet appear to be operating as previous experience would suggest.

Thirdly, and again atypically, we go into this period of relatively slow growth in our trading partners with the New Zealand dollar at historically very low levels. This low exchange rate is providing useful insulation against the slowing world economy. Although to date the low exchange rate does not appear to have produced as much growth in net exports as we would have expected, it still seems likely that the low exchange rate will eventually produce reasonably strong stimulus to the export and import-competing sectors of the economy – in a way fully consistent with the many anecdotes we are hearing of growth in industries such as pastoral agriculture and tourism. Indeed, if historical relationships were to reassert themselves, a continuation of the low exchange rate would almost inevitably require higher interest rates to keep the pressure on resources from generating future inflation.

Fourthly, although the increase in wages and salaries has, to date, been broadly consistent with a continuation of low inflation, unemployment is currently near 13-year lows, with many reports of employers finding difficulty finding staff. Similarly, some measures of capacity utilisation suggest little scope to increase output substantially without an increase in inflation.

Finally, while much has been made of the decline in the business sector's confidence about the outlook for the economy in general, it is important not to lose sight of the fact that most businesses continue to be relatively optimistic about their own future.

This *Statement*, and indeed previous ones, have highlighted the tension between contradictory influences on the future path of inflation in New Zealand. In such an environment, it is prudent to adjust policy cautiously as we observe the evolving balance of those influences. At this stage, we see inflation settling back near the middle of our target range with something close to the current interest rate settings. But it is not difficult to identify outcomes that are rather less benign – in either direction – and that would require more vigorous monetary policy responses.



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