
1 Overview and policy assessment

The Reserve Bank has decided to reduce the Official Cash Rate from 5.25 per cent to 4.75 per cent.

Clearly, a good deal has changed since our last assessment of the inflation outlook in August. At that time, we noted a number of factors which might have kept inflation at or above the top of our inflation target. In particular, we noted the possibility that there might have been more pressure on the economy's productive capacity than we had estimated. We suggested that there could well have been a case for an early increase in the Official Cash Rate were it not for the possibility that the world economy might turn out weaker than assumed at that time.

The international environment has indeed turned out to be much weaker than seemed likely in August. Even before the tragic events of 11 September, it is now clear that the world economy was slowing quite rapidly in July and August. The events of 11 September have exacerbated that slowdown by dealing a blow to business and consumer confidence around the world. The outlook for almost all of our major trading partners is now looking markedly weaker than it did three months ago. In response, most major central banks have eased monetary policy quite significantly. We too moved quickly to cut the Official Cash Rate, from 5.75 per cent to 5.25 per cent, on 19 September.

The slowdown in the international economy is already affecting the New Zealand economy and will continue to do so. For many months, we have been expecting the world prices of the commodities which New Zealand exports to decline and, with some notable exceptions, this has not happened. But export prices are now falling across a wide front, while nervousness about air travel is having an adverse impact on the growth of tourism. Business confidence has declined markedly, and we are expecting investment spending to slow. There can be little doubt that the New Zealand economy has already slowed quite sharply from the robust pace of the first half of the year, and is likely to continue growing rather slowly in the immediate future. This will exert downwards pressure on inflation in New Zealand.

At 4.75 per cent, our short-term interest rates are somewhat higher than those in many other developed countries. In large part that reflects the fact that New Zealand enters this period of slow international growth in a relatively strong position. Certainly, growth in the first half of the year was stronger than we had estimated in August, with the result that there was more pressure on the economy's productive capacity, and

therefore on inflation, than we had assumed.

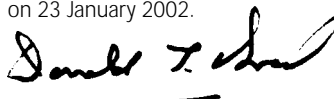
Moreover, since August many businesses have continued to prosper. The residential property market continues to trade well ahead of last year, helped by relatively low interest rates and a turn-around in migration flows. Export prices, though now declining, remain moderately strong for the most part, while the low New Zealand dollar provides additional support for export industries. Unemployment remains at its lowest level in 13 years. While inflation should be down to around 2 per cent in the year to December this year – a marked reduction from the 4 per cent for calendar 2000 – it looks likely to return to around 2½ per cent in the year to March 2002 as the artificially low inflation number in the March 2001 quarter drops out of the 12-monthly total.

In normal circumstances, this still relatively buoyant domestic economy might suggest the need for somewhat higher interest rates, not lower interest rates.

But these are clearly not normal circumstances. The international environment seems more threatening than at any time in more than a decade and, if things turn out even worse than we expect, we may well be faced with the need to reduce interest rates still further. At this stage, it is our assessment that monetary policy has now been set to accommodate quite a bit of additional weakening in the global environment. That reflects our judgement about the risks that lie ahead of us.

The uncertainty in the present situation is very considerable however. It is 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 rates cuts in the not-too-distant future. We will be monitoring all of the information as it becomes available, and will be constantly vigilant to the implications of that information for the outlook for inflation. The projection contained in Chapter 3 of this *Statement*, which shows interest rates slightly higher than those consistent with today's decision, is a good illustration of how easy it is to envisage quite different outcomes from those implicit in today's decision.

The Bank is next scheduled to review the Official Cash Rate on 23 January 2002.



Donald T. Brash
Governor