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# 1 Overview and policy assessment

The Reserve Bank has decided to increase the Official Cash Rate to 5.0 per cent. This means that, while monetary policy will remain stimulatory in the near term, it will be less so than previously. Using a motoring analogy which I have used before, the Reserve Bank's foot is easing back on the accelerator, but not applying the brakes, at least at this stage.

We foreshadowed a change of this sort in August, and financial markets have for some time factored it into interest rates. But the change may nevertheless surprise some of the general public, particularly in the light of the small fall in GDP in the June quarter. Certainly this fall in GDP was unexpected, and we had to look very carefully at the available data to assess its implications.

On balance, we judge that the small fall in June quarter GDP was an aberration, and we expect the economy to have bounced back strongly during the September quarter. Indeed, at this stage we think it likely that growth in the September quarter reached 1.3 per cent. We base that on a very wide range of indicators, including data on retail spending, credit growth, housing consents, exports, tourist arrivals, business and consumer confidence, capacity utilisation, hours worked, stock slaughtered, milk production, job advertisements, and increasingly widespread anecdotes of skill shortages. As this growth continues – and indications are that the economy is now growing at an annualised rate of around 4 per cent – the small amount of excess capacity in the economy, and associated downwards pressure on inflation, should disappear next year.

And this is not a surprise. The June quarter aside, the economy has been growing at a reasonably brisk pace since the middle of 1998. The world economy appears considerably stronger than it did even three months ago. And monetary conditions, which have been stimulatory since the middle of 1998, have become more stimulatory since the August *Monetary Policy Statement*.

More stimulatory since August? Interest rates have in fact increased somewhat since August, for both short and long terms. But, with the TWI averaging around 54 in recent weeks, the exchange rate has been not only some 6 per cent below the level assumed for the second half of 1999 in our August *Statement*, it has almost been back to the low point it reached in the early nineties. This has been providing strong

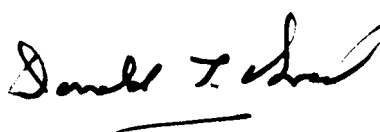
support to the export and importing-competing sectors of the economy. Indeed, on any reasonable definition monetary conditions have been easier recently than at any time in the last decade.

So on balance we are persuaded that monetary policy should be less stimulatory as we go into 2000. Despite that, we see growth continuing at close to 4 per cent per annum over the next two years. By making monetary policy somewhat less stimulatory now, we make our best contribution to ensuring that growth is steady and prolonged.

What of the future? With continuing strength in the international economy and robust growth domestically, we expect monetary conditions to move gradually to more neutral settings over the next year or so. That process is under way for a number of our important trading partners also.

But we are in a different environment to that of the eighties or even early nineties. In particular, with inflation expectations rather better anchored at low levels than was the case previously, we do not currently expect to see interest rates go back to the levels reached in the mid-nineties; still less to the levels reached in the mid-eighties. Moreover, even the gradual reduction in monetary stimulus now projected is of course conditional on how the economy actually evolves: any major slowdown in the world economy, for example, would change the picture substantially.

As a footnote, it should be noted that the increase in the Official Cash Rate announced today is unrelated to the projected rise in consumer price inflation to some 2.6 per cent early next year. That increase in inflation is the result of a series of one-off factors, such as the recent sharp increase in international oil prices, none of which reflects demand pressures within the New Zealand economy. For this reason, as well as the fact that this blip in inflation will have passed by the time monetary policy decisions taken today have any impact, it would be quite inappropriate to adjust policy in response to this development.



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