
1 Policy assessment

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

The New Zealand economy has performed relatively well while headline inflation has increased somewhat since the June *Statement*. At the same time, however, global economic and financial risks have increased.

Domestic economic activity has surprised on the upside and capacity usage appears to have increased. Continued high export commodity prices and, in time, reconstruction in Canterbury are expected to provide impetus to demand over the projection horizon.

However, the outlook for New Zealand's trading partners has deteriorated markedly. There is now a real risk that global economic activity slows sharply.

Global financial market sentiment has also deteriorated. Sovereign debt concerns in Europe and the weakened global outlook have caused international bank funding markets to tighten. If conditions do not improve, New Zealand bank funding costs will increase.

Largely because the New Zealand economy has been doing better than many others, the New Zealand dollar has appreciated since the June *Statement*. The high level of the New Zealand dollar is having a dampening influence on some parts of the tradable sector and on imported inflation.

Annual headline CPI inflation continues to be above the Bank's 1 to 3 percent target band. However, much of the current spike in inflation has been driven by last year's increase in the rate of GST, and will therefore be temporary. Wage and price setters should focus on underlying inflation, which, while rising, is currently estimated to be near 2 percent.

If recent global developments have only a mild impact on the New Zealand economy, it is likely that the OCR will need to increase. For now, given the recent intensification in global economic and financial risks, it is prudent to continue to hold the OCR at 2.5 percent.

Alan Bollard



Governor