
1 Policy assessment

The Official Cash Rate (OCR) will remain unchanged at 8.25 percent.

The outlook for economic activity and inflation has become more uncertain since we reviewed the OCR in July. Credit concerns and heightened risk aversion have led to significant turbulence in global financial markets. This development increases the likelihood of a weaker economic outlook for the United States and New Zealand's other key trading partners than in recent forecasts.

The consequences of this financial market turmoil for New Zealand remain unclear at this stage. However, we continue to expect a significant boost to the economy over the next two years from the sharp rise in world prices for dairy products and some other commodities that has occurred over the past year. A sharp decline in the New Zealand dollar since July, if sustained, will act to reinforce the effects of higher world prices on export sector revenues.

Recent inflation outcomes have highlighted widespread inflation pressures but indicators in recent weeks suggest that previous increases in the OCR are starting to dampen domestic spending, which will help to reduce those pressures. In particular, household borrowing growth is beginning to slow and turnover in the housing market continues to fall.

We expect the effects of stronger export revenues on activity and inflation to be broadly offset by a further braking effect from the interest rate increases undertaken earlier this year. However, in the short-term, CPI inflation is likely to rise due to the effects of a lower exchange rate and higher food prices. It is important that this temporary increase in inflation does not affect price or wage setting behaviour in the medium term.

The recent collapse of a number of finance companies and reduced liquidity within the non-bank lending institution sector generally could further act to dampen activity in some areas of the economy, such as property development or consumer financing. However, we currently expect those negative effects to be relatively contained.

At this point, we believe that the current level of the OCR is consistent with future inflation outcomes of 1 to 3 percent on average over the medium term. However, given greater than usual uncertainty at present, we will be watching to see how the upside and downside risks to the outlook are developing.

Alan Bollard



Governor