



RESERVE BANK

O F N E W Z E A L A N D

WHAT IS THE OFFICIAL CASH RATE?

The Official Cash Rate (OCR) is the interest rate set by the Reserve Bank to meet the inflation target specified in the Policy Targets Agreement. The agreement signed in September 2002, between the Minister of Finance and the Governor of the Reserve Bank, requires the Reserve Bank to keep inflation, on average over the medium term, at between 1 and 3 percent per annum.

The OCR was introduced in March 1999 and is reviewed eight times a year by the Bank. *Monetary Policy Statements* are issued with the OCR on four of those occasions. Unscheduled adjustments to the OCR may occur at other times in response to unexpected or sudden developments, but to date this has occurred only once, following the 11 September 2001 attacks on the World Trade Centre in New York.

WHAT THE OCR DOES

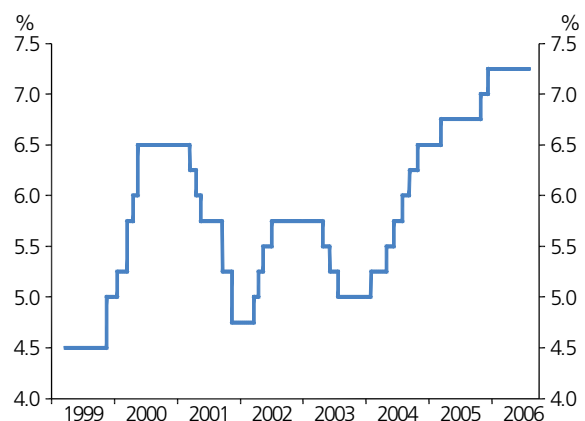
The OCR influences the price of borrowing money in New Zealand and provides the Reserve Bank with a means of influencing the level of economic activity and inflation. An OCR is a fairly conventional tool by international standards. In the past, the Reserve Bank used a variety of tools to influence inflation, including influencing the supply of money and signalling desired monetary conditions to the financial markets. Such mechanisms were more indirect, more difficult to understand, and less conventional.

HOW THE OCR WORKS

Most registered banks hold settlement accounts at the Reserve Bank, which are used to settle obligations with each other at the end of the day. For example, if you write out a cheque or make an EFT-POS payment, the money is paid by your bank to the bank of the recipient. Many hundreds of thousands of such transactions are made every day. The Bank pays interest on settlement account balances, and charges interest on overnight borrowing, at rates related to the OCR. These rates are reviewed from time to time, as is the OCR. The most crucial part of the system is the fact that the Reserve Bank sets no limit on the amount of cash it will borrow or lend at rates related to the OCR.

As a result, market interest rates are generally held around the Reserve Bank's OCR level. The practical result, over time, is that when market interest rates increase, people are inclined to spend less on goods and services. This is because their savings get a higher rate of interest and there is an incentive to save; and conversely, people with mortgages and other loans may experience higher interest payments.

Figure 1
The official cash rate March 1999–December 2006



When people save more or spend less, there is less pressure on prices to rise, and therefore inflation pressures tend to reduce. Although the OCR influences New Zealand's market interest rates, it is not the only factor doing so. Market interest rates – particularly for longer terms – are also affected by the interest rates prevailing offshore since New Zealand financial institutions are net borrowers in overseas financial markets. Movements in overseas rates can lead to changes in interest rates even if the OCR has not changed.