
1 Policy assessment

The OCR will remain on hold at 6.50 per cent.

As indicated in our October Review, we continue to expect that the current policy position will achieve inflation between 1 and 3 per cent on average over the medium term. This outlook assumes that significant pipeline effects from past interest and exchange rate increases will eventuate and act to further constrain the economy over the period ahead.

Since the last review, overall economic indicators have continued to surprise on the upside. As a result, we have revised upwards our GDP estimates for the second half of 2004 and pushed out our expected timing of the economic slowdown. But the slowdown is still expected in 2005. The easing in house sales, residential building consents and net immigration remain in line with our earlier projections. Reinforcing this outlook is a weakening exports picture, based on softer world growth and the constraining effects of the strong NZ dollar.

Inflation is projected to rise close to 3 per cent before easing back later in 2006. The risks to the inflation outlook are two-sided. On the upside there is clearly a risk that the current momentum in household demand will hold up longer than expected. Rising wage and salary pressures also present an upside inflation risk given the current labour market tightness. On the downside there is the possibility of more exaggerated movements in the US dollar and US interest rates, leading to a stronger New Zealand TWI, weaker exports and less inflation pressure.

The tightening in monetary policy over the past year currently looks sufficient to keep medium term inflation pressures in check. However, with inflation expected to remain toward the top of the 1 to 3 per cent target band over the medium term, there is little headroom to absorb stronger than expected inflation pressures. If such pressures emerge, a further policy tightening cannot be ruled out. Further, the current outlook offers little scope for an easing in policy in the foreseeable future. We will continue to assess inflation pressures carefully as the economic data come to hand.



Alan Bollard
Governor