
1 Policy assessment

The Official Cash Rate (OCR) will increase by 25 basis points to 7.25 per cent.

As emphasised in our September *MPS*, and again at the October OCR Review, we remain concerned about the tightness of resources and the persistence of inflation pressures. Exporters and other businesses exposed to the very high exchange rate are under considerable pressure and general business sector confidence is falling in the face of declining profit margins. However, overall demand continues to outstrip available capacity. The main driver of the strong demand is household spending, linked to a still-buoyant housing market. Increasing government spending and continued strong business investment are also boosting total demand. The resulting excess demand, reflected in a growing current account deficit, is continuing to fuel inflation.

Excluding one-off oil price effects, inflation has been trending upwards. Furthermore, while headline inflation is expected to return below the upper end of our target band by mid-2006, it is projected to remain high throughout the projection period. In addition, there is a risk that inflation could track higher. Mortgage credit growth and house prices have held up longer than anticipated; we are forecasting these to slow markedly in 2006, but continued strength remains a risk. The current high rates of increase in labour and other business costs present a further risk, particularly if inflation expectations become locked in at current high levels.

The main downside risk to our projections is the prospect of a faster-than-expected correction in domestic demand, leading to a harder landing for the economy and a more rapid easing of inflation pressures. A further downside risk arises if the current exchange rate strength persists, putting greater downward pressure on activity and medium-term inflation.

This outlook, combined with the lack of inflation headroom, has led us to increase the OCR today. Whether further tightening is needed will depend on the extent to which housing and demand pressures show signs of moderating over the months ahead. However, we do not yet see any prospect of a policy easing in the foreseeable future.



Alan Bollard
Governor