
1 Policy Assessment

The Reserve Bank has increased the Official Cash Rate to 5.75 per cent.

The New Zealand economy has enjoyed strong growth over an extended period. For some time, we have been expecting growth to slow due to a range of factors such as the high exchange rate and declining population growth. But activity has continued to prove stronger than expected, and stretched productive resources have caused inflation pressures to increase across a range of industries.

There remain compelling reasons to expect that momentum in the economy will slow. However, improvements in global demand, rising commodity export prices, and the recent fall in the exchange rate to a less contractionary level point to stronger activity than we projected in March. Moving interest rates higher is thus appropriate to ensure that medium-term inflation remains within the target range. At this stage, further increases in interest rates look likely to be needed over the year ahead, but to a modest degree by historical standards.

Although we expect medium-term inflation to remain consistent with the target range, the recent decline in the exchange rate and higher oil prices mean that we are now projecting annual inflation to rise temporarily above 3 per cent in 2005. This would not be a breach of the Policy Targets Agreement, as the Bank is now required to keep inflation between 1 and 3 per cent "on average over the medium term". Given that inflation is expected to fall in a reasonable time frame, it would not be appropriate to attempt to offset this short-term increase in inflation using monetary policy. However, we will need to remain alert to signs of more enduring effects that could arise if wage or price setting behaviour starts to change. Were that the case, additional monetary policy pressure might be required to keep medium-term inflation pressures in check.

We will continue to update our view of inflation pressures and the policy outlook, as new data come to hand.



Alan Bollard
Governor