
1 Policy assessment

The Official Cash Rate (OCR) will remain at 7.25 per cent.

Recent economic activity has been weaker than projected in the March *Monetary Policy Statement*. However, the short-term inflation outlook has worsened.

Growth is expected to remain low through 2006, before recovering in 2007. The much awaited economic rebalancing from domestic spending to exports commenced in late 2005, and is expected to continue over the next two years. Export growth will recover as a result of the lower exchange rate and buoyant demand in world markets. At the same time, household spending will be constrained by a continued weakening in the housing market, high petrol prices and a slowdown in employment growth.

While weaker economic activity will reduce medium-term inflation pressures, the short-term inflation outlook has deteriorated. The sharp decline in the exchange rate over March and April will lead to higher prices on imported goods, although weak domestic demand and foreign exchange hedging by importers may dampen this increase. In addition, oil prices have risen by around 20 per cent since the March *Statement*, leading to higher prices for petrol and other transport items. These two effects together are now expected to keep headline CPI inflation above 3 per cent well into 2007.

Given the unavoidable nature of these price shocks, it would be inappropriate for monetary policy to try to counteract their short-term inflation effects. However, it is essential that monetary policy hold the line against any second-round effects that could be felt in wages, prices and inflation expectations. A failure to do so would risk inflation becoming entrenched at a higher level, ultimately delaying a return to stronger growth.

We do not expect to tighten policy in response to the high headline inflation in the short term. But, equally, we cannot afford to ease policy until we have more certainty that future inflation outcomes will be trending down comfortably below 3 per cent. Given this situation, we see no scope for an easing of the OCR this year.



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Governor