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# 1 Policy assessment

The Official Cash Rate (OCR) will increase by 25 basis points to 8.00 percent.

Domestic demand has grown strongly since late 2006, particularly in the household sector. Housing market activity has been buoyant, consumer confidence has remained relatively robust and a range of business sector indicators, including employment and investment intentions, have been strong. As we have noted recently, government spending continues to increase, which is contributing to domestic demand.

Following several years of strong growth, firms have indicated that capacity remains stretched and that finding both skilled and unskilled staff has become increasingly difficult. These pressures continue to underpin inflation.

A sustained period of slower growth in domestic activity will be required to alleviate inflation pressures. Lending rates have risen significantly in recent months, partly due to previous increases in the OCR. Given the usual lags, we have not yet seen the effect of these increases on domestic demand and inflation pressures. There are some early indications from recent opinion surveys and other data that growth may be starting to soften, but these are by no means conclusive. Indeed, at present the risks to domestic activity appear to remain on the upside.

A significant development in the past six months has been a marked increase in dairy prices. While there are uncertainties about the future path of these prices, the increases will assist in narrowing New Zealand's trade deficit. The rise in dairy sector incomes will provide a substantial boost to economic activity over the next few years, but will also add to inflation pressures.

Parts of the export sector outside the dairy industry will continue to face challenging conditions due partly to the New Zealand dollar. As we noted in April, the exchange rate is at levels that are both exceptionally high and unjustified on the basis of New Zealand's medium-term fundamentals.

Had we not increased the OCR this year, it is likely that the inflation outlook would now be looking uncomfortably high. This further increase in the OCR is to ensure that inflation outcomes remain consistent with achieving the target of 1 to 3 percent inflation on average over the medium term.

Alan Bollard



Governor