
1 Policy assessment

The Reserve Bank has increased the Official Cash Rate (OCR) by 25 basis points to 6.75 per cent.

In our December and January reviews we emphasised that inflation was expected to remain toward the top of the 1 to 3 per cent target band over the medium term, providing little headroom to absorb additional inflation pressures. We also projected a near-term economic slowdown which was expected to constrain inflation consistent with the Policy Targets Agreement. With the economy remaining very strong and resources becoming increasingly stretched, we assess that a further tightening of policy is now necessary.

The momentum in today's economy is underlined by the continuing vigorous employment growth through December and by ongoing high levels of business and consumer confidence. Investment remains at record levels, our terms of trade remain very favourable and exports are generally holding up well despite the high exchange rate.

Our revised economic projections incorporate a stronger outlook for activity in the near-term with the projected slowing in growth now not occurring until later in 2005. World demand and export prices are projected to moderate through 2005. Net immigration has slowed appreciably. Housing activity continues to ease, but has been held up at least temporarily by last year's mortgage price war. The pipeline effects from last year's policy tightening will continue to raise average effective mortgage rates through this year but the impact will be gradual. The greater momentum in activity in the near term implies stronger underlying inflation pressures than we expected. The additional tightening today is required to contain these pressures.

Since we remain of the view that the economy is close to a turning point, we have to carefully confront the possibility that a further tightening in policy at this stage of the cycle might exacerbate an eventual slowing in activity. However, not responding to the prospect of stronger inflation pressures now would create a risk that inflation expectations and wage and price setting behaviour could change in a way that would make the task of containing inflation more difficult in the future, even if growth slows. Being prudent now reduces the prospect of a tighter monetary policy later on.

Whether there is any further tightening ahead will depend on how the risks play out over the coming period. Certainly, the current outlook offers little scope for an easing of policy in the foreseeable future.



Alan Bollard
Governor