1 Policy assessment

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

Recent data have confirmed our earlier view that economic growth is slowing. Business activity and confidence have been softening for some time. On the other hand, household spending has only recently started to wane. A key driver of strong household spending has been the buoyant housing market which, while showing signs of cooling, still remains very active. Over the next two years, we expect overall growth to remain subdued while a major rebalancing takes place, with a recovery in net exports as domestic demand weakens. A decline in the New Zealand dollar exchange rate is expected to play a role in this rebalancing.

Despite the slower growth, inflation and cost pressures remain persistent. Labour market and resource pressures have built up over many years of high growth and will take some time to dissipate. Labour costs in particular are growing strongly, at a time when firms are finding it difficult to lift sales and productivity. Realistic wage and price setting behaviour will be an important factor determining the severity of the downturn as inflation pressures are brought under control. The other key inflation risk over the next two years remains the housing market. We need to see this market continue to slow, so that consumption moderates and helps to reduce inflation pressures.

As long as these inflation risks remain under control, we do not expect to raise interest rates again in this cycle. However, given the time that it will take to bring inflation back towards the mid-point of the target band, we do not expect to be in a position to ease policy this year. Any earlier easing would require a more rapid reduction in domestic inflation pressures than the substantial slowing already assumed in our projections.

Alan Bollard

Alan Bollard
Governor