
1 Policy assessment

The Official Cash Rate (OCR) will increase by 25 basis points to 7.50 percent.

Recent indicators show clear evidence of a pick-up in economic activity in late 2006 and early 2007. Strengthening domestic demand is being supported by a resurgence in the housing market and an expansionary fiscal policy. The acceleration in housing reflects firming net immigration, a recovery in confidence, a continuing rapid expansion of mortgage credit at very low margins, and strong growth in household incomes. The recent lift in export commodity prices – particularly dairy – may also be a factor. All this is adding to resource pressures and increasing the risk of a re-emerging inflation problem in the medium term.

The short-term inflation outlook continues to ease. CPI inflation is projected to be around the middle of the target band through 2007, benefiting from lower oil prices and the high exchange rate. Domestic price inflation is also expected to moderate somewhat in 2007, assisted by the effect of lower headline inflation on inflation expectations. Despite this, domestic inflation is projected to remain at high levels over the medium term and is subject to considerable upside risk.

Our concern is that the recent pick-up in housing and domestic demand may gain momentum, giving rise to a stronger cyclical upturn at a time when resources are already very stretched. This could reverse the rebalancing of the economy that has been underway since late 2005 and present substantial risks to the medium-term inflation outlook. It would also increase the prospect of a more costly correction in the country's external deficit.

We are continuing to assess alternative measures that might support the OCR, working with the relevant government agencies. These include a tightening of tax rules applying to housing investment and changes to bank capital requirements to help moderate the amplifying effect of credit on the housing cycle. However, we will continue to rely on the OCR as the primary instrument of monetary policy.

The current policy tightening is aimed at reducing the risk of an unsustainable rebound in activity. Depending on the persistence of the current upturn, further tightening may be required. A return to a moderating trend in housing and domestic demand will be essential if we are to see a reduction in medium-term inflation pressures.

Alan Bollard



Governor