
1 Policy assessment

The Reserve Bank has decided to increase the Official Cash Rate from 5.25 per cent to 5.5 per cent.

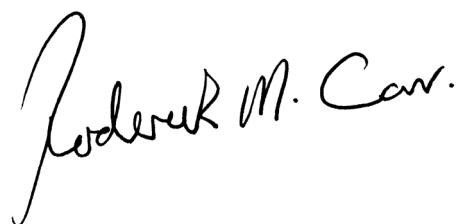
Demand conditions no longer warrant the degree of interest rate stimulus that seemed necessary late last year. The economy's ability to meet increasing demand without pressure on costs, margins and therefore prices appears limited. Core inflation is still at the upper end of the 0 to 3 per cent target band, leaving little headroom for price pressures to accelerate from here on.

Pressures on resources look likely to be maintained in the foreseeable future. New Zealand's population is expanding rapidly with the sharp turnaround in net migration. Migration is contributing more to strong household spending, residential construction and housing market activity than it is to the availability of labour. And a recovery in global demand – although fragile in some respects – is now underway with *Consensus Forecasts* rather more optimistic than earlier in the year.

The influences on inflation are not all operating in the same direction. The exchange rate has been rising and international prices for some key exports, such as dairy products, have fallen sharply. These factors, if sustained, will reduce domestic activity to some degree and help to dampen inflation pressures in due course.

On-balance, in the absence of some further withdrawal of monetary stimulus, these factors together would place additional pressure on the economy's already-stretched resources, producing a rise in inflation pressures. Accordingly, today's decision is a further step in the process of reducing the interest rate stimulus that we put in place last year, when the outlook for the economy looked decidedly weaker.

At this point, it appears likely that further increases in interest rates will be required over the year ahead, possibly to a greater extent than we projected in March. However, as discussed further in this *Statement*, the outlook is always subject to uncertainty. We will continue to monitor the range of influences on the inflation outlook and make the necessary policy adjustments.



Rod Carr
Acting Governor