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# 1 Policy Assessment

The Reserve Bank has increased the Official Cash Rate from 6.00 per cent to 6.25 per cent. Further tightening of monetary policy is likely to be required.

The New Zealand economy is performing very strongly. On balance, the recent economic data has delivered positive surprises. Economic growth is near its peak, but resources will remain stretched for some time, and inflation pressures remain strong.

In terms of the economic outlook, there are risks to consider. The consensus view in our projections is that global economic activity is expanding at a reasonable pace. However, high world oil prices and softer growth in the US could slow global economic growth. Further, if the TWI continues to rise, or if commodity prices fall sharply, our growth prospects would be weaker.

Domestically, the economy is heavily influenced by housing activity, which we expect to continue to slow over coming months. However, if that weakening is delayed, then household spending would continue to expand at a rapid rate, fuelling inflation pressures. This could be compounded by continuing strength in the labour market.

So far, inflation has been kept in check by the rising New Zealand dollar, which has pushed import prices lower. We expect domestic inflation to remain strong due to tight production capacity. Assuming the exchange rate is near a peak, import prices are unlikely to continue falling. As a result, even though economic growth is likely to be slowing next year, inflation is projected to increase.

The Reserve Bank is required to keep inflation between 1 and 3 per cent "on average over the medium term". Also, section 4(b) of the Policy Targets Agreement requires us to minimise unnecessary instability, hence monetary policy must always be a balancing act. We are using this flexibility to the full. However, looking ahead we do not have much inflation headroom, which is why we are continuing our incremental tightening of monetary policy.



Alan Bollard  
Governor