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# 1 Policy assessment

The Official Cash Rate (OCR) will remain on hold at 6.75 per cent.

Since our June *Monetary Policy Statement*, economic indicators have broadly confirmed the slowdown in activity that commenced in the second half of 2004. The slowdown has been concentrated in sectors such as manufacturing and tourism that have been exposed to the high exchange rate. The non-traded sectors of the economy on the other hand, such as household and business services and construction, have maintained their high growth of recent years. The housing market in particular has remained strong, underpinning consumption growth. Reflecting the slow pullback in domestic demand, capacity and labour shortages are expected to persist well into 2006.

New developments in oil prices have made the future more uncertain. Oil prices have surged in recent months and are now 20 per cent higher than projected in June, some 60 per cent up from the end of 2004. As a consequence, headline CPI inflation is now forecast to approach 4 per cent over the next few quarters before returning below 3 per cent by early 2007. Monetary policy will not attempt to offset the unavoidable first-round price effects of the oil price spike. However, it will be used to resist any flow-through to ongoing price and wage inflation. Further out, the higher oil prices are expected to have a dampening effect on both world and domestic economic activity, thus taking some pressure off monetary policy in the medium-term.

Fiscal policy is also adding to uncertainty. The shape and economic impact of new post-election policies is not clear at this point. However, it does appear likely that fiscal policy will become more expansionary in the period ahead.

Right now, it is too early to make a call on the relative strength of the emerging cross-currents and how these will translate into medium-term inflation pressures. It will be several months before the persistence and global impact of the oil shock become more apparent. A similar period could be needed for the fiscal outlook to be clarified. We are concerned, however, that the risk of higher medium-term inflation has increased. Consequently, further monetary policy tightening may still prove necessary to ensure inflation is kept within the 1 per cent to 3 per cent target band on average over the medium-term. Certainly there remains no prospect of a cut in the OCR in the foreseeable future.



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Governor