
1 Policy assessment

The Official Cash Rate (OCR) will remain unchanged at 7.25 percent.

The New Zealand economy continues to show resilience. As reported in earlier statements, we have seen clear signs of easing activity and a rebalancing of demand from the domestic to the external sector since late last year. However, economic activity appears to have been stronger than expected through the first half of 2006, with the expansion of employment particularly surprising. Net exports and Government spending have contributed to the buoyancy in activity, while the easing in household consumption has been more moderate than projected. Similarly, while the housing market has slowed, it continues to exhibit momentum. We expect further dampening effects on demand from high oil prices and higher effective mortgage rates over the period ahead. But, even allowing for these effects, we see more inflation pressure than in earlier reviews.

With overall resource pressures easing more gradually than forecast, annual inflation is not expected to fall below 3 percent until late 2007. Oil price increases and the depreciation of the exchange rate earlier in the year have pushed headline annual inflation to 4 percent in the June quarter. Inflation expectations have continued to drift upwards, influenced by the rising headline inflation numbers. While second-round flow-on effects have so far been limited, this remains a risk given the persistence of demand and labour market pressures. We assume that wages and prices are not unduly influenced by the short-term peak in headline inflation.

Given the continued strength of medium-term inflation pressures, the outlook for monetary policy has become more finely balanced. With inflation now taking longer to move comfortably within the target band of the Policy Targets Agreement (PTA), there is little leeway to withstand further surprises to medium-term inflation pressures. In these circumstances, we are less confident that no further policy tightening will be required in this cycle. In this regard, we will want to be clearer about the economic situation and outlook. However, there is clearly no prospect of an OCR cut for some considerable time.



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