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Editor's note

One of the most frequent questions for the Reserve Bank is how changes in the Official Cash Rate (OCR) affect inflation. There are, in fact, a range of ways through which the OCR influences the inflation rate, some more direct than others. In the first article of this issue, Rishab Sethi and Aaron Drew of the Economics Department provide a detailed account of how monetary policy influences the general price level, sketching out the various steps along the way. The article discusses the channels that the Bank considers to be the most important as well as those that have a more uncertain effect. I am sure the article will become a useful reference for anyone interested in understanding how monetary policy works. A follow-up article planned for later in the year will discuss how the importance of the various channels may have shifted over time.

In the second article, Hannah Kite of the Economic Department reports on a review of the trade-weighted exchange rate index (TWI) that the Reserve Bank has undertaken over the past year. This review considered whether the methodology used to calculate the TWI and the range of currencies included in the calculation remain appropriate.

As a result of this review, the Bank intends to retain the present 5 currency TWI (which includes the US dollar, Japanese Yen, euro, Australian dollar and British Pound) as its official index. The existing calculation methodology (which uses a 50:50 weighting of the GDP of the country or region and its relevant trade share with New Zealand) has also been retained. However, the Bank will begin publishing, as an analytical series, an extended 14 currency TWI, which includes the currencies of a number of Asian economies with which New Zealand's trade has increased markedly in recent years. The article notes that the 14 currency and five currency indices have not been substantially different in history, but this could change in the future given a world of increased exchange rate flexibility, especially in Asia. The new analytical series will be available on the Bank's website and updated daily.

In today's complex banking environment, banks commonly outsource many of their business activities to external providers. In our third article, Tim Ng of the Economics

Department (formerly of the Financial Stability Department) explains the Reserve Bank's policy on the outsourcing of these activities. Tim notes that the outsourcing policy requires that a large bank's board maintain legal and practical control over any outsourced functions such that the bank is able to continue to play its key role of supporting financial activity in the economy, both under normal circumstances and (particularly) under stress.

Our fourth article is by Doug Widdowson of the Financial Stability Department and Kim Hailwood from the Governor's Office. Doug and Kim discuss the importance of financial literacy among households — the ability to make informed judgements and decisions around the use of money and credit. This is an important area and a number of agencies are supporting improvements in New Zealanders' financial literacy in different ways. The article reviews the available evidence about financial literacy and identifies potential areas of concern. It then briefly outlines some of the initiatives underway to improve financial literacy and assesses what else needs to be done.

I hope readers will find these articles interesting and informative.

Bernard Hodgetts

Editor

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