
Volume 71 No. 3, September 2008
Themed issue: Inflation

Contents

Editor's note	3
Articles	
Flexibility and the limits to inflation targeting <i>Alan Bollard and Tim Ng</i>	5
Inflation in New Zealand's trading partner economies <i>Satish Ranchhod</i>	14
The costs of inflation – what have we learned? <i>David Gillmore</i>	26
Events precede ideas: Bob Gordon on macroeconomics and monetary policy <i>Interview conducted by Emmanuel De Veirman and Tim Ng</i>	34
Financial turmoil and global imbalances: the end of Bretton Woods II? <i>Chris Hunt</i>	44
A user's guide to credit ratings <i>Doug Widdowson and Andy Wood</i>	56
For the record	
Discussion papers	63
News releases	65
Publications	71
Articles in recent issues of the Reserve Bank of New Zealand <i>Bulletin</i>	72

This document is also available at www.rbnz.govt.nz

Copyright © 2008 Reserve Bank of New Zealand

ISSN 1174-7943 (print)
ISSN 1177-8644 (online)



Editor's note

This edition of the Reserve Bank *Bulletin* is built around the theme of inflation. This theme is on the minds of many central banks around the world, including the Reserve Bank of New Zealand. We face the difficult challenge of reining in elevated inflation, against a background of high oil and food prices, slowing growth and ongoing global financial instability.

Our first article in this edition, by Governor Alan Bollard and me, discusses how the Reserve Bank's primary function of price stability can best be pursued in circumstances like the present, when forces on the economy push powerfully and persistently in one direction. We note that New Zealand's long-serving inflation-targeting framework has served the country well, and continues to do so. However, we also argue that it can only do so much to promote stability. Above all, there is a need to ensure that, when monetary policy operates flexibly to cope with these powerful forces, the medium-term objective of 1-3 percent inflation continues to anchor inflation expectations, which is what gives us scope to be flexible in the first place.

Our second article, by Satish Ranchhod, discusses how inflation developments overseas over the past decade or so have influenced inflation pressures in New Zealand. Our main trading partners enjoyed low inflation through to the early 2000s, but are now experiencing higher inflation across the board. This period of higher inflation worldwide is due to prolonged strengthening of global activity until very recently, itself partly reflecting ongoing Asian and emerging market growth. Strengthening global demand increased the pressure on productive resources, resulting in higher inflation in the prices of traded goods from all regions, as well as strong increases in the prices of commodities in international markets.

David Gillmore reviews in our third article the research on why inflation is costly, and why price stability is therefore important. Inflation tends to benefit the wealthy at the expense of the poor and those on fixed incomes, and reduces economic growth over the long term. Recent research suggests that inflation above about 3 percent in industrialised countries has materially harmful effects on long-run growth.

Our fourth article is an interview with Professor Robert J. Gordon, the well-known macroeconomist, conducted by Emmanuel De Veirman and me. Professor Gordon has written extensively about inflation dynamics and the measurement of prices (among many other things). In the interview, Professor Gordon offers some interesting insights into how the inflation process works in modern economies, how macroeconomic research on inflation has developed, and some of the challenges currently facing monetary policy.

In this edition, we also present an article by Chris Hunt discussing how the current financial market turmoil has origins in world macroeconomic dynamics. He looks at the role of the very large international flows of funds from many emerging markets running current account surpluses, to advanced economies running current account deficits. These large flows led to an abundant supply of credit worldwide, and a consequent substantial reduction in the price of credit, from about the beginning of this decade – a reduction that has since come to a self-generated and abrupt reversal with the credit market disruptions.

Our final article, by Doug Widdowson and Andy Wood, explains credit ratings and their role in the financial system. Credit ratings are simple risk measures that can assist investors to make investment decisions, but they also have limitations. The article highlights some of the key issues that investors should be aware of when using credit ratings.

Many thanks to those of you who responded to the readers' survey we released with the June *Bulletin*. From your responses, we gained useful insights into what you want to see in the *Bulletin*, and how you want it presented. In the December edition, we will provide a brief report on the survey findings and what we intend to do as a result.

I hope you enjoy the range of articles in this edition.

Tim Ng
Editor

 **RESERVE
BANK**
MUSEUM

The Reserve Bank Museum celebrates and records New Zealand's economic and banking heritage.

Displays range from timelines and interactive exhibits to comprehensive display panels outlining both the Reserve Bank's history and role, and how the New Zealand economic system has developed.

Artefacts include the only working example in New Zealand of the MONIAC hydro-mechanical econometric computer developed by New Zealand economist and inventor Bill Phillips in the late 1940s.

In early 2008, the museum received its 10,000th visitor.

The museum is open 9.30 a.m.–4.00 p.m. weekdays. It is closed weekends, public holidays, and for special events. Please call to confirm opening hours.

Reserve Bank Museum
2 The Terrace
Wellington
New Zealand
ph 04-471-3682
museum@rbnz.govt.nz
<http://www.rbnz.govt.nz/about/museum/2766074.html>



Photography by Stephen A'Court.