

# Inflation in New Zealand's trading partner economies

Satish Ranchhod<sup>1</sup>

Inflation pressures in other economies have important implications for inflation, activity and monetary policy in New Zealand. This article examines inflation trends in New Zealand's trading partner economies over the past decade. Looking at a range of inflation measures, we observe that the low inflation seen in our trading partner economies in the mid-1990s has now given way to a period of higher inflation. Increases in inflation rates have been seen in all regions, with particularly notable increases in Asian economies.

Higher inflation in our trading partner economies has been related to strength in global growth and the closer integration of Asia and emerging markets into the global economy. These developments have contributed to increased demands on productive resources and strong growth in commodity prices. Such increases have been reflected in higher consumer prices and export prices in our trading partner economies. In New Zealand, these developments have contributed to a more challenging environment for monetary policy, with stronger consumer price inflation and increased headwinds for growth.

## 1 Introduction

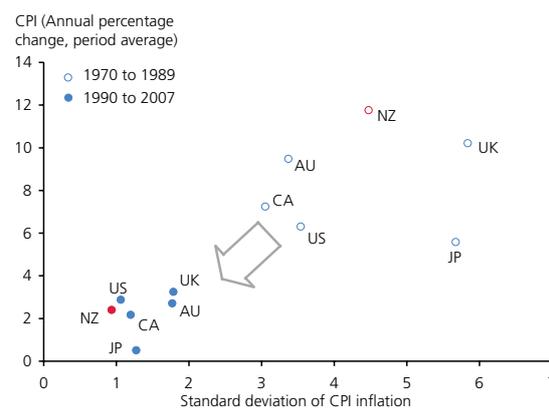
Inflation is ultimately a monetary phenomenon. In recent decades, the successful implantation of monetary policy aimed at price stability has contributed to marked declines in the level and variability of inflation in New Zealand and other developed economies (figure 1). Policy-makers' preferences for low inflation have also contributed to an improvement in inflation outcomes in Asian economies since the early 1990s. But while monetary policy and the preferences of policy-makers will determine an economy's long-run rate of inflation, in the short run inflation can be influenced by a range of factors such as the strength of global activity. Such short-run influences can have important implications for activity and monetary policy, particularly in small open economies such as New Zealand. This article examines inflation in other economies over the past decade, focusing on the increases seen in inflation since 2004. It considers the factors that have contributed to these increases, as well as the implications for prices and activity in New Zealand.

Previous work at the Reserve Bank of New Zealand has also examined such short-run inflation influences. When looking at global inflation, Hunt (2007) found the increased

Figure 1

### Inflation and inflation volatility

(selected trading partners, 1970 to 2007)



Sources: Statistics NZ, DataStream, Cabinet Office (Government of Japan).

Country key: AU Australia, CA Canada, JP Japan, NZ New Zealand, UK United Kingdom, US United States.

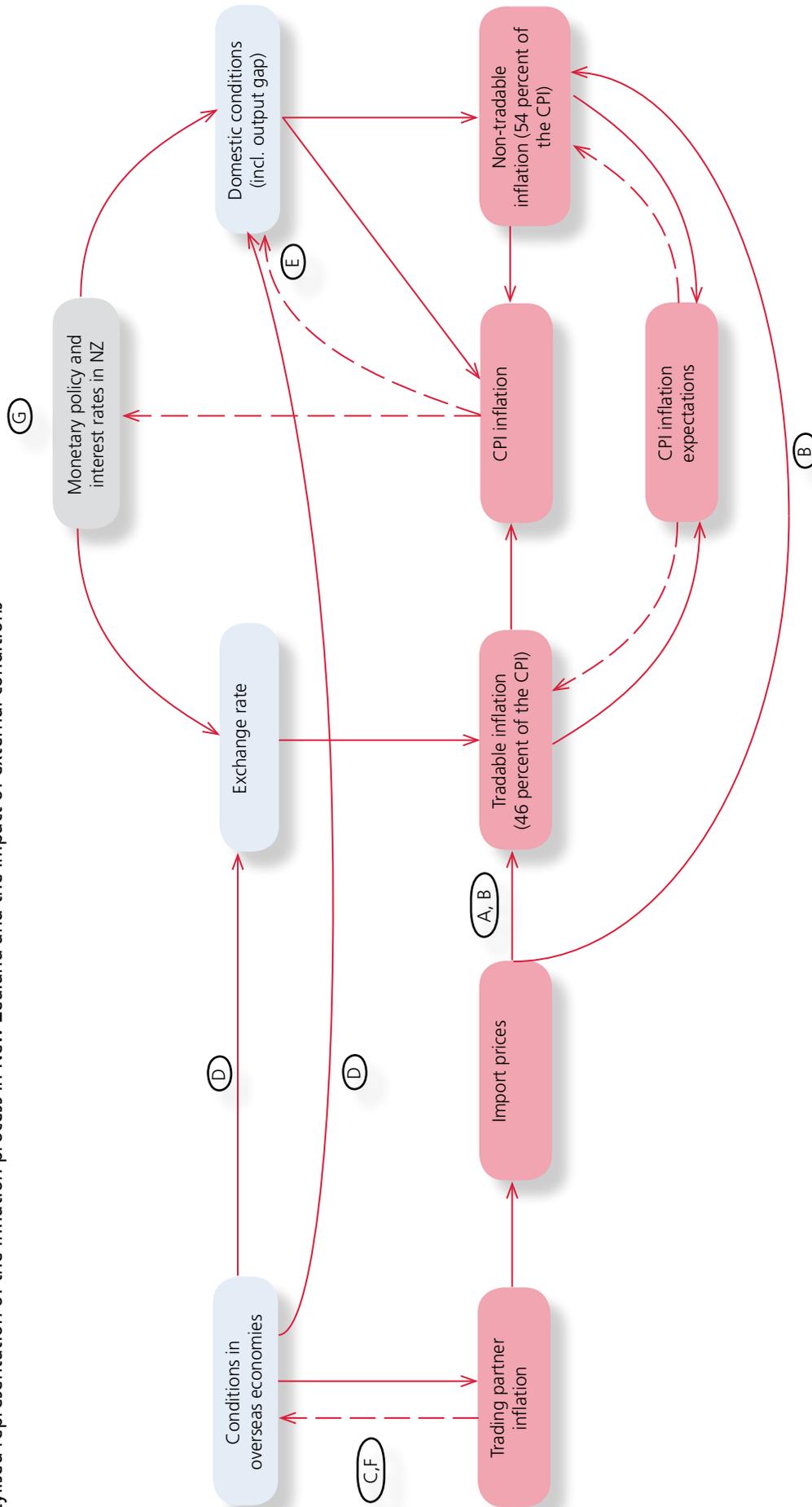
integration of Asia and emerging markets into the global economy had helped to dampen global inflation pressures in the mid-1990s, but that this effect appeared to be dissipating. Hodgetts (2006) looked at changes in New Zealand's inflation process. This work found that increased trade with Asia and emerging markets has been one factor that has helped to dampen inflation pressures in New Zealand since the 1990s.<sup>2</sup>

<sup>1</sup> Thanks to staff at the Reserve Bank of New Zealand for their comments and assistance with the preparation of this article. Thanks also to Justin Fabo (RBA), Duncan Wooldridge (UBS) and Amy Tang (UBS) for their assistance with the data for this project.

<sup>2</sup> Hodgetts (2006) notes that the adoption of inflation targeting and the anchoring of inflation expectations have been the main reasons for New Zealand's improved inflation performance.

Figure 2

Stylised representation of the inflation process in New Zealand and the impact of external conditions<sup>3</sup>



<sup>3</sup> Figure 2 provides a stylised description of New Zealand's inflation process. It does not purport to capture every possible influence on inflation. For instance it does not distinguish between real and nominal interest rates or exchange rates. Drew and Sethi (2007) provide a more detailed description of the monetary policy transmission mechanism in New Zealand.

---

This article complements the work of Hunt and Hodgetts by looking at a range of inflation measures and accounting for more recent development in New Zealand and abroad. We observe that the benign inflation pressures other economies had been experiencing have now dissipated, with global inflation creeping upwards since 2004. This increase has been associated with strength in global economic activity, particularly in Asia and emerging markets. Strength in activity has contributed to higher commodity prices and rising costs of production in many regions.

Increases in global inflation have contributed to a more challenging environment for monetary policy in New Zealand, adding to domestic inflation pressures while dampening domestic activity. In this environment, the Reserve Bank of New Zealand remains focused on our medium-term inflation goals and ensuring inflation expectations remain anchored.

The article is structured as follows. Section 2 discusses why we are concerned about inflation in other economies. Section 3 examines inflation developments in our trading partner economies, looking at a range of inflation measures. Section 4 examines what has contributed to the changes in inflation over the past decade. Section 5 considers the implications of recent developments for the New Zealand economy. Section 6 concludes.

## 2 Why do we care about inflation in other economies?

Prices changes in other economies affect the New Zealand economy via a number of channels. Among the most important are the impacts on inflation and activity. Inflation in other economies is also an important consideration for monetary policy, both in New Zealand and in other economies. Figure 2, previous page, provides a stylised description of these channels.

### Impacts on domestic inflation

Price increases in other economies directly affect inflation in New Zealand if prices for imported finished goods rise as a

result (this is channel A in figure 2).<sup>4</sup> With 46 percent of New Zealand's consumers' price index (CPI) made up of tradable goods and services (i.e., goods and services that tend to be imported or compete against imports), the effect of such increases on consumer prices can be large.

Additionally, as a large proportion of intermediate goods is imported, inflation pressures in other economies can also affect prices in New Zealand indirectly (channel B). Indirect pass-through occurs when higher prices for productive inputs result in higher prices for final goods and services produced in New Zealand. For instance, higher international prices for oil can result in higher domestic prices for petrol (the direct effect of an oil price increase). They can also result in higher prices for transportation services (e.g., higher taxi fares) and higher prices for goods that rely on transportation services such as freight (e.g., grocery items). Indirect effects can be large (Delbrück, 2005) and may be seen in prices for both tradable and non-tradable goods.<sup>5</sup>

### Impacts on activity

Inflation in our trading partner economies can influence the level of activity in New Zealand. For instance, if inflation increases in other regions, this can constrain household spending in those regions (channel C), potentially reducing their demand for New Zealand's exports (channel D). At the same time, higher imported inflation in New Zealand can constrain consumers' real purchasing power, resulting in reduced demand for both imported and domestically produced goods (channel E).

Inflation pressures in other economies will also affect interest rates and the stance of monetary policy in those regions (channel F). In turn, this can have implications for the strength of demand for New Zealand's exports due to the effects of foreign monetary policy on foreign demand and exchange rates.

---

<sup>4</sup> The precise nature of pass-through from overseas inflation pressures to prices in New Zealand would also be affected by a range of factors including exchange rate movements, import substitution and the strength of domestic activity.

<sup>5</sup> Non-tradable goods and services are those that are produced domestically and that do not face strong competition from imports.

## Impacts on the stance of monetary policy

The impact of inflation in other regions on New Zealand cannot be separated from the stance of monetary policy in New Zealand. The Reserve Bank of New Zealand's focus on headline inflation means that we must balance developments in the prices of tradable goods against inflation pressures stemming from the non-traded sector. If inflation in imported goods/the traded sector increases or decreases, this can affect the level of domestic activity and non-tradables inflation that is consistent with our overall inflation aims, at least over short periods (Bean, 2006).<sup>6</sup> The response of monetary policy to such conditions (channel G) will ultimately determine the level of inflation in New Zealand and can also influence the level of domestic activity.<sup>7</sup> Consequently, it is not necessarily the case that New Zealand will experience higher (or lower) inflation simply because inflation in our trading partner economies increases (or decreases).

## 3 What has happened to prices in other economies?

In this article, we examine a range of measures to develop a broad understanding of how inflation in our trading partner economies has evolved. The measures we look at are:

- CPIs – these measure the cost of the basket of goods purchased by the 'average' household in an economy.
- Producer price indices (PPIs) – these measure the prices for goods produced by firms and can be informative

when assessing cost pressures in an economy that affect domestic prices and export prices.

- Export prices in other economies – such prices are relevant when examining how inflation pressures in other regions pass through to inflation and activity in New Zealand.

Across all of the measures examined, there has been an acceleration in inflation in our trading partner economies since 2004.<sup>8</sup> This acceleration has been largest in our main trading partner economies in Asia, excluding Japan (AxJ), but inflation in developed economies has also accelerated.<sup>9,10</sup> Table 1 provides a summary of inflation rates by region and time period.

**Table 1**  
Trading partner inflation measures<sup>11</sup>

	1997 to 2003	2004 to 2007	Change
<b>Consumer prices</b>			
All regions	1.6	2.4	+0.8
Developed econs.	1.6	2.2	+0.7
AxJ	1.1	2.9	+1.8
<b>PPIs</b>			
All regions	0.5	3.8	+3.2
Developed econs.	0.6	3.6	+2.9
AxJ	0.5	4.4	+3.9
<b>Export prices</b>			
Developed econs.	-0.5	2.5	+3.0
<b>AxJ economies</b>			
Hong Kong	-2.1	1.4	+3.5
Singapore	-2.4	0.2	+2.6
Korea	-5.4	3.1	+8.5
Taiwan	-0.5	1.3	+1.9

Sources: RBNZ estimates, DataStream, national sources.

<sup>6</sup> For instance, Bean (2006) notes that favourable changes in import prices can allow an economy to operate at a higher level than would otherwise be consistent with price stability aims. However, Bean goes on to note that this is unlikely to be sustainable for prolonged periods.

<sup>7</sup> While monetary policy can influence the level of growth in the short term, in the longer term an economy's maximum sustainable rate of growth is determined by a range of factors. These include decisions by households and firms (particularly those related to investment), technological developments and the regulatory environment. However, appropriate monetary policy can ensure a more favorable environment for longer-term growth via the pursuit of price stability (Bollard and Ng, 2008).

<sup>8</sup> The presence of structural breaks around 2004 in the inflation series examined was confirmed using Chow's break point test.

<sup>9</sup> New Zealand's major trading partners in AxJ are China, Hong Kong, Malaysia, Singapore, Korea and Taiwan. When examining inflation in AxJ, we focus on these economies.

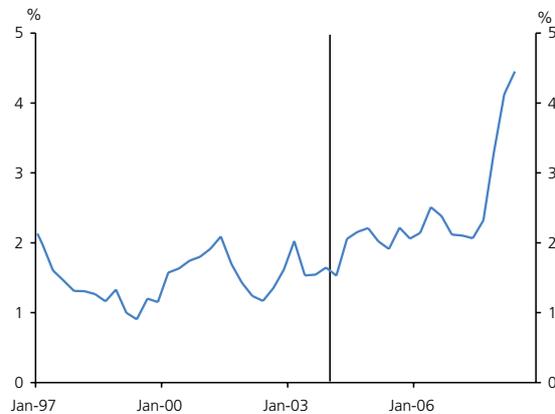
<sup>10</sup> The developed economies examined are the US, UK, Eurozone, Canada, Japan and Australia.

<sup>11</sup> When examining consumer price inflation in Australia, we have used data from the Reserve Bank of Australia that removes the impact of GST being introduced in 2000.

### Trends in consumer prices

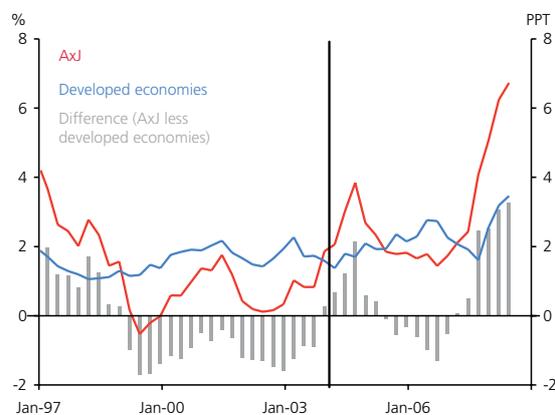
Since 2004, consumer price inflation in our trading partner economies has gradually trended upwards (figure 3). In recent years, these increases have been exacerbated by large increases in prices for food and fuel. Consumer prices have also been pushed up by the indirect effects of higher prices for commodities (though, as discussed later, these are not the only factors that have contributed to higher prices).

**Figure 3**  
**Consumer price inflation**  
*(weighted average of trading partners, annual percentage change)*



Sources: RBNZ estimates, DataStream, RBA.

**Figure 4**  
**Consumer price inflation by region**  
*(weighted average of trading partners, annual percentage change)*



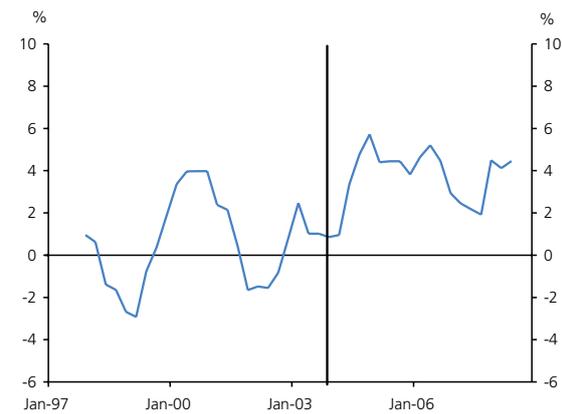
Sources: RBNZ estimates, DataStream, RBA.

Increases in consumer price inflation have been particularly large in AxJ economies. This has occurred at the same time as New Zealand's trade with AxJ has increased significantly (AxJ's share of New Zealand's imports has risen from 13 percent in 1997 to 29 percent at the end of 2007). Inflation rates have also risen in other economies, but such increases have been more modest.

### Trends in producer prices

In addition to increases in consumer prices, our trading partner economies have experienced pronounced increases in PPI inflation since 2004 (figure 5). This growth in producer prices has been similar across developed economies and AxJ (figure 6). In part, this reflects that many of our trading partner economies have faced similar increases in imported input costs in recent years, particularly for commodities (inflation in producer prices will also be determined by domestic conditions).<sup>12</sup> Such increases in production costs are likely to have contributed to the increases in other inflation measures seen in all of the regions examined.

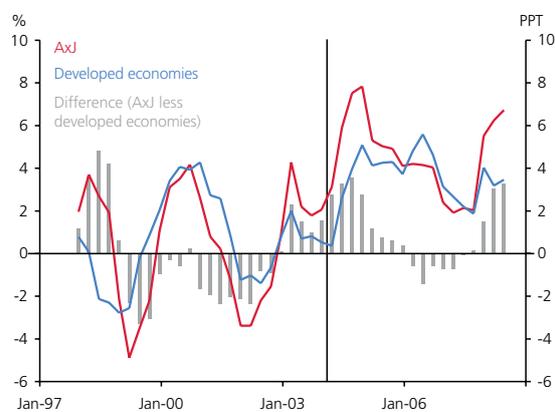
**Figure 5**  
**Producer price inflation**  
*(weighted average of trading partners, annual percentage change)*



Sources: RBNZ estimates, DataStream.

<sup>12</sup> Besley (2007) makes a similar finding when looking at consumer prices. He notes that higher prices for commodities (including energy and food) have been a significant contributor to the similarities in inflation trends in economies such as the UK, Eurozone, US and China in recent years.

**Figure 6**  
**Producer price inflation by region**  
*(weighted average of trading partners, annual percentage change)*



Sources: RBNZ estimates, DataStream.

### Trends in export prices<sup>13</sup>

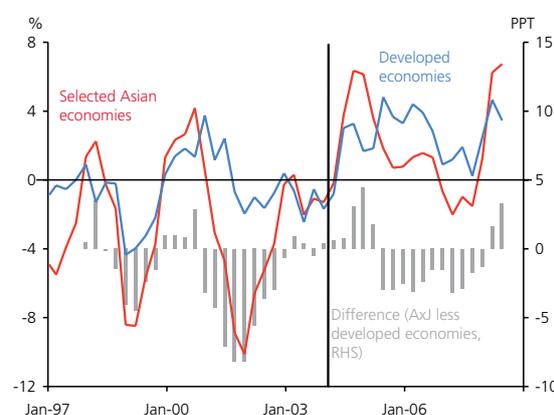
Recent years have also seen an acceleration in export price inflation in both developed economies and in AxJ. As with consumer prices, increases in export price inflation have been largest in AxJ economies, which have shifted away from 'exporting deflation' as they tended to do in the mid-1990s and early 2000s (figure 7). Nevertheless, from table 1 we see that export price inflation in AxJ economies still tends to be low compared to that in developed economies. Further, developed economies, from where the majority of New Zealand's imports are sourced, have also shifted away from exporting deflation since 2004 (figure 8).

While the average rate of export price inflation has increased in AxJ, there is some uncertainty about what has happened to export prices from China, our second-largest market for imports. Data from the Chinese National Bureau of Statistics indicate that export price inflation in China has accelerated sharply in recent years, but these data are only available from 2005. Indirect indicators of Chinese export prices based on import prices in other economies tell a mixed story. On balance, it seems likely that the rate of Chinese export price inflation has increased in recent years, particularly given strong increases in costs of production. However, even

<sup>13</sup> Hunt (2007) notes that the shift in China's exports to high-quality and higher value-added products may mean that export prices tend to overstate quality adjusted price movements in China. This may also be a concern when examining inflation in other parts of Asia.

if the rate of Chinese export price inflation has increased, it may still be modest.

**Figure 7**  
**Export price inflation by region**  
*(annual percentage change)*



Sources: RBNZ estimates, DataStream, Bank of Korea.

Note: The Asian economies examined in figure 7 are Hong Kong, Singapore, Korea and Taiwan. Data for other economies in AxJ was not available.<sup>14</sup>

## 4 What has contributed to the trends seen in inflation?

As noted earlier, inflation is ultimately a monetary phenomenon. But in the short run, it can be affected by a range of factors. To examine the near-term factors that have contributed to the increases in inflation in our trading partner economies, it is useful to look first at the factors that contributed to lower inflation before 2004. This is because some of the same factors that previously contributed to lower inflation have evolved and are now contributing to higher inflation.

<sup>14</sup> In 1997, Korea shifted to a floating exchange rate. This saw a large decline in the Korean won and a large increase in won-denominated export prices. Because of this structural break, won-denominated export prices are not suitable for this examination. Instead, we have used foreign currency-denominated export prices, which the Bank of Korea describes as being "impervious to exchange rate fluctuations" (Bank of Korea, 2008). Movements in foreign currency-denominated export prices and won-denominated export prices are similar except around the time the won was floated.

## The mid-1990s and early 2000s

In addition to policies targeting price stability, two key contributors to subdued rates of inflation seen in the mid-1990s were 1) impacts of globalisation and 2) the state of global economic activity.<sup>15</sup>

1. The IMF (2006) has described globalisation as “the acceleration in the pace of growth of international trade in goods, services, and financial assets relative to the rate of growth in domestic trade.” During the 1990s and early 2000s, this process dampened inflation pressures via a number of channels. Among the most significant was the increased integration of Asia and emerging markets into the global economy. Reduced trade barriers allowed many economies access to lower-cost imported goods from emerging markets. At the same time, inflation pressures were also dampened by the effective increase in the global labour force, as well as increased competitive pressures in many markets associated with increased trade openness.<sup>16</sup> Pain *et al.* (2006) estimate that the effect of these developments may have reduced inflation in OECD economies by around 0.2 percentage points. In emerging markets, the IMF (2006) found that increased trade openness increased the probability of ‘low’ inflation.<sup>17</sup>
2. Inflation pressures are closely linked to the strength of activity in an economy relative to its level of productive

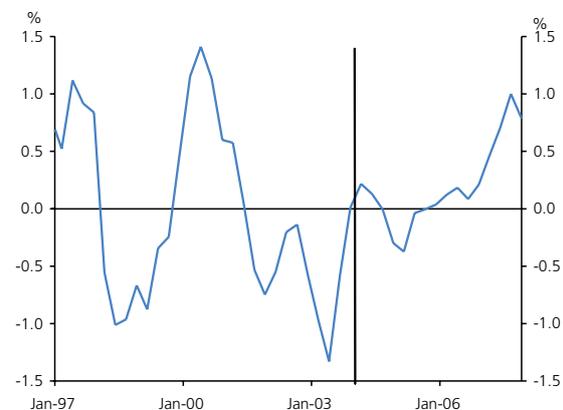
<sup>15</sup> While globalisation may have dampened global inflation pressures, its impact on inflation rates may not be large in all economies. For instance, Feyzioglu and Willard (2006) find the prices in China have only a small and temporary impact on prices in the US and Japan. Further, Mishkin (2007) reviews several of the channels through which globalisation may affect inflation and notes its impact may not be large.

<sup>16</sup> The increased integration of emerging markets into the global economy has effectively doubled the global labour supply (Bean, 2006). This has been reinforced by increasing urbanisation of populations in emerging markets. Such changes can affect inflation pressures in developed economies via increased competitive pressure in labour markets and via activities such as off-shoring (Hunt, 2007). The IMF (2006) notes that a moderation in unit labour cost inflation was seen over the 1990s.

<sup>17</sup> IMF (2006) defined low inflation in emerging markets as an inflation rate of less than 10 percent per annum. After accounting for factors such as monetary policy credibility and exchange rate regimes, the IMF found that increased trade openness increased the probability that an economy would experience low inflation by around 10 percent.

resources. This measure of capacity utilisation is frequently referred to as the output gap. When economies are growing slowly relative to their potential or trend rates of growth, resource utilisation tends to be low (i.e., the output gap tends to be negative). At such times, demands on resources ease, indicating a corresponding reduction in inflation pressures. Between 1997 and 2004, there were two periods where there was a material easing in activity in our trading partner economies and when the world output gap turned negative (figure 8). The first was related to the Asian financial crisis in 1997–1998. The second in 2001–2002 was associated with the bursting of the dot com bubble and related sharp fall in equity markets. During this latter period, global growth and confidence was also affected by 2001’s terrorist attacks in the US, the emergence of SARS and disruptions to investment cycles related to Y2K concerns (RBNZ, 2007). These slowdowns were particularly pronounced in Axi economies (figure 9) and have been linked to demand-related easing in import and commodity prices (HSBC, 2008). During these periods, declines in import prices had sizeable effects on consumer price inflation.<sup>18</sup>

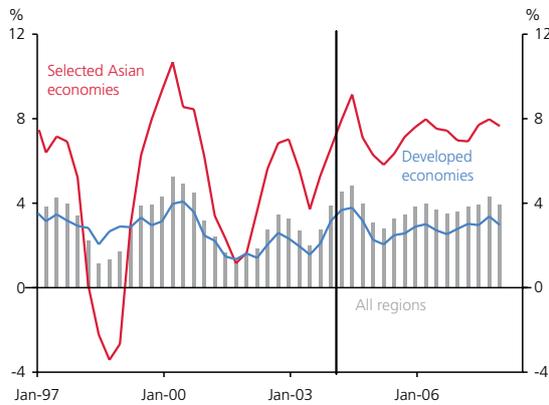
Figure 8  
World output gap  
(weighted average of New Zealand’s main trading partners)



Source: RBNZ estimates.

<sup>18</sup> IMF (2006) found that during the slowdowns noted above, declines in import prices took more than 1 percent off inflation in some advanced economies.

**Figure 9**  
**Trading partner GDP**  
*(annual percentage change)*



Sources: RBNZ estimates, DataStream.

**Post-2004**

Since 2004, we have observed stronger inflation in our trading partner economies across all of the measures examined. A key contributor to this has been the strength of global activity. From figure 9, we see that between 2004 and 2007 our trading partners experienced relatively firm growth. Notably, AxJ experienced more consistent growth than it did between 1997 and 2003. Sentance (2007) highlights three key factors that contributed to this strength in global activity.

- First is monetary policy, which adopted a more stimulatory stance in many economies in the early part of this decade in response to weakness in demand. For instance, in the US the Federal Funds Target Rate was reduced from 6.5 percent in 2000 to just 1 percent in 2003.

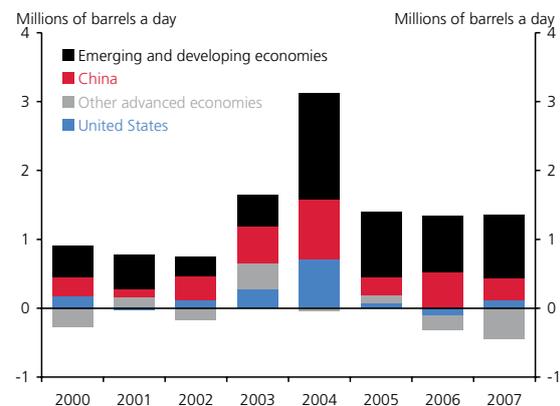
Policy-makers in Asia also adopted a more supportive stance around this time as they attempted to insulate their economies from the volatility the region had experienced during the financial crisis of 2001. To accomplish this, exchange rates and interest rates were kept artificially low, contributing to increases in exports and foreign exchange earnings. These policies also helped to stimulate domestic demand.

- Second is the liberalisation of financial markets, which has allowed for greater ease in directing funds from those countries with surplus savings into investment in other regions.

- Third is the structural changes in trade patterns related to globalisation and the closer integration of Asia into the global economy.

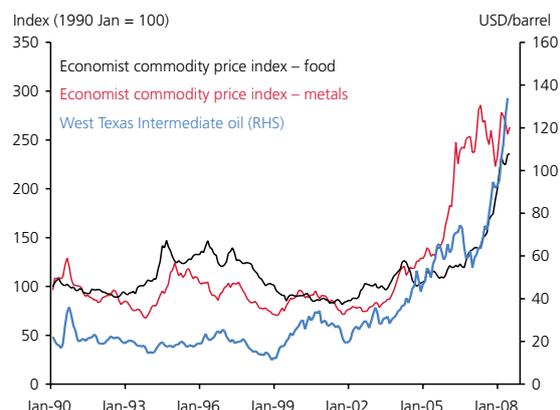
Of these factors, the third is notable because, as outlined above, globalisation contributed to lower inflation prior to 2004. However, in recent years the inflation-dampening effects of globalisation have started to dissipate. One reason for this is that the robust growth seen in AxJ and emerging markets has resulted in structural increases in demand for resources, particularly fuel (figure 10). As a result, there have been strong increases in the prices for many commodities in recent years (figure 11). Demand from economies in these regions for both hard and soft commodities appears likely to continue growing for some time, as growth in these economies is more energy and commodity intensive than in developed economies (Lipsky, 2008).

**Figure 10**  
**Growth in global oil consumption**



Source: IMF.

**Figure 11**  
**Commodity prices**



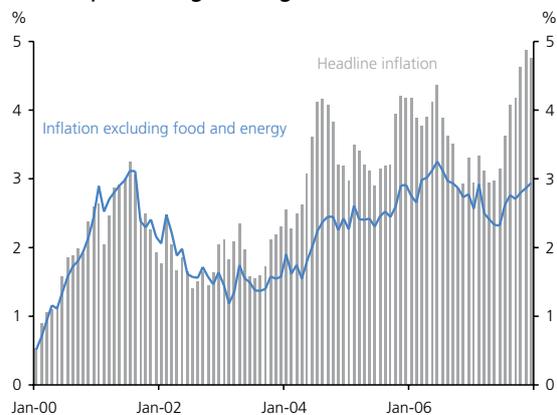
Source: DataStream.

Commodity price increases contribute to higher global inflation via direct increases in consumer prices (e.g., higher prices for vehicle fuels). They also add to inflation pressures via the indirect channels discussed earlier. This is of concern for New Zealand, as the impact of higher commodity prices will be felt in all regions that import commodities, not just in those that have experienced increases in demand. This includes developed economies that are sources for the majority of our imports.

In addition to the effects of higher commodities prices, strength in global activity has added to inflation via increased demands on productive resources. The firm growth in the global economy in recent years has seen the world output gap rising to elevated levels (figure 8) with a corresponding increase in inflation pressures. This has been seen most clearly in AxJ, where inflation has risen to elevated levels even excluding the direct effects of higher food and fuel prices (figure 12). Consumer price inflation excluding food and fuel prices has also risen in developed economies, but these increases have been more modest (figure 13).

Overall, the strength of global activity and the closer integration of Asia and emerging markets into the global economy appear to have been major contributors to recent increases in global demand and cost pressures. The resulting

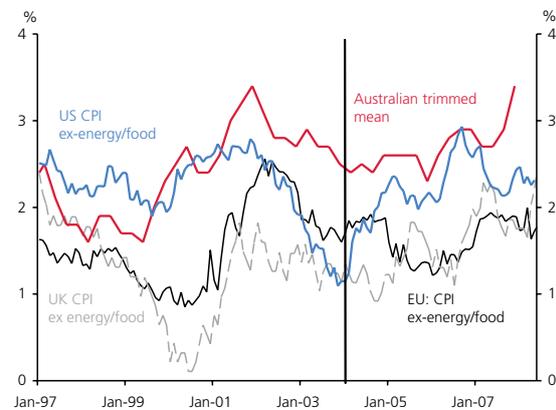
**Figure 12**  
**Consumer price inflation in AxJ<sup>19</sup>**  
*(headline and ex-food and energy inflation, annual percentage change)*



Source: UBS.

<sup>19</sup> The definition of AxJ used by UBS varies slightly from that used in the rest of this paper. The UBS measure also includes Thailand, Indonesia, the Philippines and India.

**Figure 13**  
**Core inflation measures**  
*(annual percentage change)*



Source: DataStream.

increases in costs of production have been important contributors to increases in consumer prices and export prices in all our trading partner economies, not just those in AxJ.

## 5 What does this mean for New Zealand?

### Impacts on inflation

Over the past decade, the impact of the global economy on inflation in New Zealand has changed.

Hodgetts (2006) finds strong reason to suggest globalisation and increased trade openness dampened inflation in New Zealand in the mid-1990s, as it did in many other economies. Since 1997, New Zealand retail prices for goods such as household appliances and clothing have fallen or have experienced relatively subdued rates of inflation. This has largely been a result of falls in the foreign currency prices for imported manufactured goods over this period (prices for these same items had been rising prior to 1997 – see figure 14).<sup>20</sup> Over this same period, there has also been a large increase in New Zealand's imports from low-cost economies such as China.

<sup>20</sup> Hodgetts (2006) notes that some of the softness in prices for imported goods is the result of competitive pressures in New Zealand.

Figure 14

Foreign prices for imported manufactured goods



Sources: Statistics New Zealand, RBNZ estimates.

However, since 2004, inflation developments in other economies have contributed to a less favourable inflation environment in New Zealand. Inflation in export prices from our trading partner economies, while still relatively low, has risen from the deflationary levels seen before 2004 (table 1). Additionally, commodity price increases have contributed to stronger domestic inflation pressures. Of these two developments, the latter may be of greater concern at this stage.

- Strong increases in the prices for imported commodities have directly contributed to higher prices in New Zealand. For instance, domestic prices for petrol in the CPI rose by 50 percent between March 2004 and December 2007.<sup>21</sup>
- Commodity prices increases have not been limited to imports. Growth in global demand has seen prices for some of New Zealand’s main agricultural exports also rising strongly in recent years, with particularly large increases in prices for dairy. These increases have passed through to higher domestic prices for food products such as milk and cheese.
- Commodity prices increases have also added to inflation in New Zealand via indirect channels and ‘third county effects’ (i.e., increases in the prices of the goods New Zealand imports due to rising costs of production in

other economies). Such increases have been most clearly evident in higher costs for transportation services (such as international air travel) and food costs (for instance, higher imported grain costs have contributed to higher poultry prices).

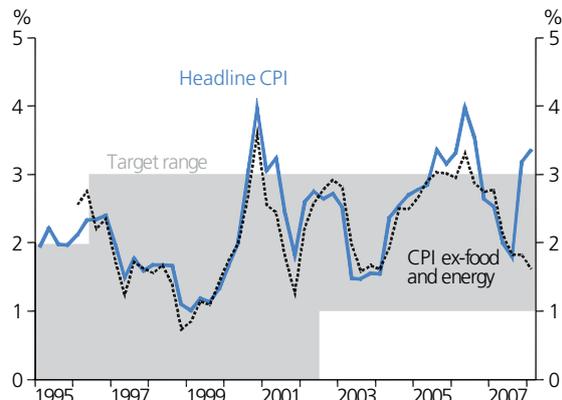
Challenges for monetary policy

Increases in inflation in our trading partner economies and the increases in commodity prices in recent years have created a more challenging environment for monetary policy in New Zealand. These developments have dampened consumers’ spending power.<sup>22</sup> At the same time, they have contributed to headline inflation rising to levels above our target band (figure 15).

Figure 15

Headline inflation and ex-food and energy inflation

(annual percentage changes)



Sources: Statistics New Zealand, RBNZ estimates.

The situation is complicated by uncertainty regarding the persistence of changes in imported inflation pressures and commodity prices. Monetary policy-makers cannot know *ex ante* how persistent changes in imported inflation will be. We may look through the initial increases in imported inflation, if it is believed they are due to temporary phenomena (e.g., increases in commodity prices associated

<sup>21</sup> While the majority of the change in motor fuel costs is attributable to changes in the costs of imported fuels, some of the increases in prices seen in recent years will be attributable to changes in exchange rates and taxes.

<sup>22</sup> While higher prices for imported commodities have reduced households’ real purchasing power, strong prices for New Zealand’s commodity exports combined with movements in the exchange rate have provided some offset.

---

with poor weather conditions). However, if price increases are actually due to sustained increases in demand (as they appear to have been in recent years), there is likely to be less room to accommodate such increases. In large part this is because, with commodity prices continuing to increase over a protracted period, there is increased risk that inflation expectations will creep upwards. This uncertainty regarding the persistence of imported inflation pressures will also have implications for the level of domestic activity/non-tradables inflation that is consistent with our overall inflation aims.

As discussed in Bollard and Ng (2008), another article in this *Bulletin*, monetary policy considerations in this environment are finely balanced. The tightening of policy to offset lingering inflation pressures may risk exacerbating the slowdown in domestic activity resulting from strong inflation pressures and reduced real incomes. However, if policy is too loose, there is a risk that inflation expectations will become unanchored.

Ultimately, the Reserve Bank's Policy Targets Agreement requires us to ensure price stability. Of paramount importance in achieving these aims is ensuring inflation expectations remain anchored, as they play a pivotal role in determining the level of inflation at medium-term horizons. Monetary policy is unlikely to respond to the near-term impacts of recent increases in international inflation pressures. However, policy will need to remain sufficiently firm to ensure that inflation expectations remain consistent with our medium-term target for inflation (Bollard and Ng, 2008).

## 6 Conclusion

Over the past decade, New Zealand and our trading partner economies have enjoyed relatively low and stable rates of inflation. This is first and foremost a result of policies focusing on the achievement of price stability and reducing inflation expectations. Between 1997 and 2003, we also experienced inflation tailwinds in the form of increased trade with low-cost economies and low levels of resource pressures in the global economy. These developments helped to dampen inflation pressures in New Zealand.

But while inflation remains relatively low, increased strength in global activity (particularly the sustained strength in Axi) has contributed to an increase in global inflation pressures and commodity prices since 2004. In New Zealand, these developments have contributed to increased imported inflation pressures. The persistence of these increases has created a more challenging environment for monetary policy in New Zealand. In addressing these challenges, the Reserve Bank has had to carefully balance its medium-term price stability goals against its desire to avoid unnecessary instability in activity. In determining the appropriate stance of monetary policy in this environment, we continue to focus on ensuring medium-term price stability and that inflation expectations remain anchored.

There remains a large degree of uncertainty regarding the persistence of the imported inflation trends seen in recent years. Indeed, following several years where commodity prices have persistently surprised on the upside, prices for some commodities have softened very recently. As a result, we may now see some easing in the imported inflation pressure seen since 2004. However, with structural increases in demand for many commodities in Asia and emerging markets (as well as tight supply conditions for some commodities), the outlook for monetary policy may remain challenging for some time.

## References

- Bank of Korea (2008), 'Export Import price index, June 2008', [www.bok.or.kr](http://www.bok.or.kr)
- Bean, C (2006) 'Globalisation and inflation', *Bank of England Quarterly Bulletin*, 46 (4), pp 468-75.
- Besley, T (2008) 'Inflation and the global economy', *Bank of England Quarterly Bulletin*, 48 (2), pp 207-213.
- Bollard, A and T Ng (2008) 'Flexibility and Limits to Inflation Targeting', Reserve Bank of New Zealand *Bulletin*, 71 (3), this edition.
- Delbrück, F (2005) 'Oil prices and the New Zealand economy', Reserve Bank of New Zealand *Bulletin*, 68 (4), pp 5-15.

- 
- Drew, A and R Sethi (2007) 'The transmission mechanism of New Zealand monetary policy' Reserve Bank of New Zealand *Bulletin*, Volume 70 No. 2, June 2007 pp 5–19
- Feyzioglu, T and L. Willard (2006) 'Does inflation in China affect the United States and Japan', IMF Working Paper, WP/06/36.
- HSBC (2008) 'Don't look now!' HSBC Global Economics Q3 2008.
- Hodgetts, B (2006), 'Changes in the inflation process in New Zealand', Reserve Bank of New Zealand *Bulletin*, 69 (1), pp 18-30.
- Hunt, C (2007) 'Emerging Asia and global inflation', Reserve Bank of New Zealand *Bulletin*, 70 (1), pp 34-44.
- IMF (2006) 'How has globalization affected inflation?' Chapter III, IMF *World Economic Outlook*, April 2006.
- Lipsky, J (2008) 'Commodity prices and global inflation' speech at the Council on Foreign Relations, New York City, <http://www.imf.org/external/np/speeches/2008/050808.htm>
- Mishkin, F (2007) 'Globalization, macroeconomic performance, and monetary policy', speech at the Domestic Prices in an Integrated World Economy Conference, Board of Governors of the Federal Reserve System, Washington, D.C., September 27, 2007
- Pain, N, I Koske and M Sollie (2006), 'Globalisation and Inflation in the OECD Economies', OECD Economics Department Working Papers, No. 524, OECD Publishing.
- Reserve Bank of New Zealand (2007), 'A review of economic developments and monetary policy since 2000', submission to Finance and Expenditure Select Committee Inquiry into the Future Monetary Policy Framework' pp 36-65.
- Sentance, A (2007) 'The global economy and UK inflation' Bank of England *Quarterly Bulletin*, 47 (4), pp 574-581.