RESERVE BANK

OF NEW ZEALAND

What Is Inflation?

Inflation is the term used to describe a rise of average prices through the economy. It means that money is losing its value.

The underlying cause is usually that too much money is available to purchase too few goods and services, or that demand in the economy is outpacing supply. In general, this situation occurs when an economy is so buoyant that there are widespread shortages of labour and materials. People can charge higher prices for the same goods or services.

Inflation can also be caused by a rise in the prices of imported commodities, such as oil. However, this sort of inflation is usually transient, and less crucial than the structural inflation caused by an over-supply of money.

The effects of inflation

Inflation can be very damaging for a number of reasons. First, people may be left worse off if prices rise faster than their incomes. Second, inflation can reduce the value of an investment if the returns prove insufficient to compensate them for inflation. Third, since bouts of inflation often go hand in hand with an overheated economy, they can accentuate boom-bust cycles in the economy.

Sustained inflation also has longer-term effects. If money is losing its value, businesses and investors are less likely to make long-term contracts. This discourages long-term investment in the nation's productive capacity.

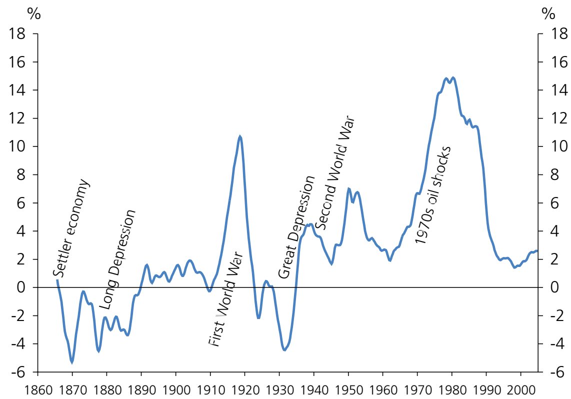
The flip-side of inflation is deflation. This occurs when average prices are falling, and can also result in various economic effects. For example, people will put off spending if they expect prices to fall. Sustained deflation can cause a rapid economic slow-down.

The Reserve Bank is as concerned about deflation as it is about inflation. In New Zealand, however, it has historically been more usual for prices to rise. As Figure 1 shows, there have been only brief periods of deflation in the past 150-odd years, and these have been associated with economic depressions. The graph also shows that, once the economy had become established, New Zealand did not have sustained high inflation until the 1970s and 1980s.

Figure 1

New Zealand inflation 1862–2004

(5-year centred moving average)

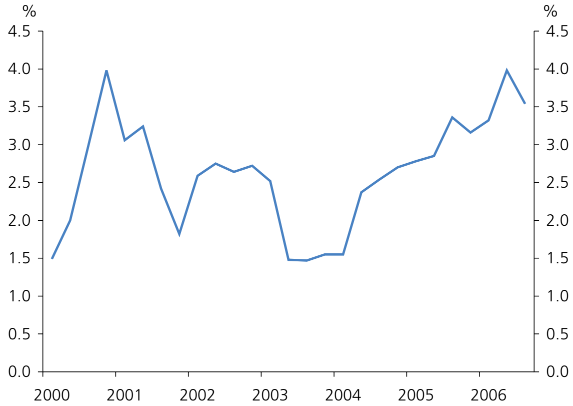


Inflation targeting

In the late 1980s the government gave the Reserve Bank responsibility for keeping inflation low and more stable than it had been. Statutory authority was provided in the Reserve Bank of New Zealand Act 1989, and the specifics were set out in a written agreement between the Governor of the Reserve Bank and the Minister of Finance. This 'Policy Targets Agreement' initially called for a reduction of inflation to 0–2 percent increase in the Consumers Price Index (CPI) by 1992. It has been revised several times since, and the current agreement, signed in September 2002, calls for inflation to be kept within 1 to 3 percent a year, on average over the medium term. This means that, as the graph shows, inflation can exceed the 1–3 percent target range in the short term. However, in the medium term it remains within that band, on average, and this means that the very high inflation rates of the 1960s and 1970s – which at times exceeded 18 percent per annum – do not occur.

Figure 2

New Zealand inflation 2000–2006



The effect of this arrangement is clear from Graph 2, in which inflation has remained within a narrow band. The Bank controls inflation through an economic tool known as the Official Cash Rate, covered in a separate sheet.

Measuring inflation

There are various ways of measuring inflation. The one used in the Policy Targets Agreement is the CPI published by Statistics New Zealand. This records the change in the price of a weighted 'basket' of goods and services purchased by an 'average' New Zealand household. Statistics New Zealand weights and indexes the various items in the basket and forms the 'all-groups' index. The percentage change of this index is typically referred to as 'CPI inflation', and is usually expressed over both a quarterly and annual period.

The contents of the basket are defined by Statistics New Zealand, which periodically reviews and re-weights them, using data obtained from their annual Household Economic Survey. This is necessary because the basket of goods and services purchased by the average household will change over time.

The Reserve Bank Inflation Calculator

The Reserve Bank has published an interactive inflation calculator on its website, at:

http://www.rbnz.govt.nz/statistics/0135595.html

This calculator allows users to input a sum of money and compare its value, in terms of the CPI and other measures for pre-CPI years, between any two quarters from 1862, to the latest quarter for which CPI figures are available.

Reserve Bank of New Zealand

2 The Terrace, Wellington, New Zealand

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www.rbnz.govt.nz