Chapter 1 – Monetary policy

Monetary policy means the actions taken by the **Reserve Bank of New Zealand (RBNZ)** to maintain price stability and support maximum sustainable employment. The group at the RBNZ that makes decisions about Monetary Policy is the **Monetary Policy Committee** (**MPC**). The Minister of Finance issues this committee a **Remit**. This is the document that defines what is meant by price stability and maximum sustainable employment.

The **Reserve Bank Act 1989** makes the RBNZ responsible for formulating and implementing monetary policy. The RBNZ is also responsible for issuing notes and coins, supervising other banks and financial institutions, and supervising insurance companies. It can also intervene in the foreign exchange market if it considers that the exchange rate is too high.

Why does the RBNZ, rather than the Minister of Finance, decide on monetary policy?

In New Zealand, governments are elected every three years. If short-term changes are made to monetary policy and interest rates for political reasons, this would negatively affect long-term financial stability. It is better that monetary policy should be implemented independently of the government, as long as there is a high degree of transparency and accountability, so the elected government can see that the RBNZ is acting in the country's best interests.

Price stability

Price stability is currently defined as keeping inflation between 1% and 3%, on average, over the medium term, with a focus on keeping future average inflation near the 2% midpoint.

The rate of inflation is measured by the **Consumers Price Index** (**CPI**). This calculates the average price change of all the goods bought by an average household. It is a weighted index, so if there are price changes for goods that households spend more on, these will have a greater influence on the average price change than would changes in the price of goods that households spend less on.

Why maintain price stability?

For firms, the negative impacts of **inflation** include:

- uncertainty concerning planning and budgeting
- difficulties in replacing capital
- speculative rather than productive investment
- exports that are less competitive.

For households, the negative impacts of inflation include:

- discouraging savings
- encouraging borrowing and consumption
- loss of purchasing power
- greater inequality of income and of wealth distribution
- fiscal drag
- planning difficulties
- inflationary expectations.

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Interest rates also influence economic activity via the exchange rate. When New Zealand interest rates are relatively higher than interest rates overseas, investors overseas increase demand for New Zealand dollars on the foreign exchange market so they can invest in New Zealand. The exchange rate appreciates.

A *higher exchange rate* reduces demand for New Zealand exports and makes imports relatively cheaper. This causes aggregate demand to fall further as exports fall and imports rise. Imported raw materials and oil are also cheaper, increasing aggregate supply and further reducing inflationary pressure.

Thus, an increase in the OCR causes:

- interest rates to rise
- exchange rate to rise
- exports to fall, imports to rise and aggregate demand to fall
- aggregate supply to rise
- less inflationary pressure.

OCR↑ ➡ r↑ ➡ er↑ ➡ X↓ & M↑ ➡ AD↓ & AS↑ ➡ PL↓

The process of changes in the OCR flowing through the economy is called the **transmission mechanism**, which can be defined as 'the series of changes that occur after an OCR announcement by the RBNZ'. (Interest rates change, affecting consumption and investment, affecting aggregate demand, and so on.)

There is a **time lag** – a delay in time between the announcement of a change to the OCR and the effect of the change in the economy. It can take up to two years before the full effect of a change in the OCR on the economy is felt.

Inflationary expectations

If firms expect their costs to increase, they increase prices to cover their increased costs. If households expect prices to rise, they will ask for higher wages to cover the higher prices. They will also spend faster to beat the price rises. These expectations then actually cause prices to rise.

Jawboning

The Reserve Bank at times reaffirms its commitment to keeping prices stable and warns households and firms that the consequences of increasing inflationary pressure through their actions will lead to an increase in the OCR and higher interest rates.

Contractionary and expansionary policies

An **expansionary monetary policy** involves reducing interest rates or increasing the money supply to increase demand, increase production, and create jobs.

A **contractionary monetary policy** involves increasing interest rates or reducing the money supply to reduce demand and reduce inflation.

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Questions: Monetary policy

Answers p. 59

1. Explain the meaning of the following concepts and terms.

   a. Monetary policy: ______

   b. Price stability: ______

   c. Monetary Policy Committee: ______

   d. Jawboning: ______

   e. Large-scale asset purchases: ______

   f. Maximum sustainable employment: ______

2. a. Identify the institution at 2 The Terrace, Wellington, shown in the following photograph.

   ______

   b. Who is the current Governor of this institution? ______

   c. What is the main role of this institution? ______

   d. Identify *two* other roles of this institution.

   (1) ______

   (2) ______

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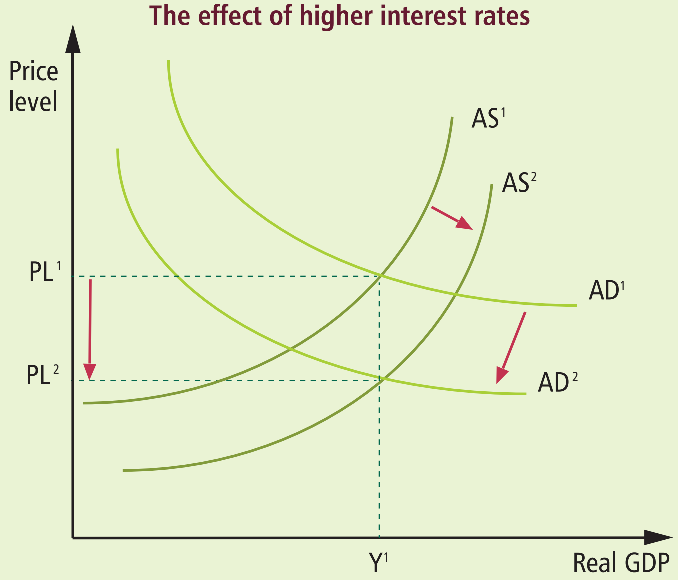
AS/AD model

Any increase in the Official Cash Rate causing interest rates to rise will have an impact on both aggregate demand and aggregate supply.

The effect of higher interest rates



Aggregate demand

Aggregate demand will decrease as the following take place.

- Consumption (C) falls as the costs of borrowing increase for households and the incentive to save also increases.
- Investment (I) falls as the costs of borrowing for firms increase, making some projects less profitable.
- The higher exchange rate causes net exports (X – M) to fall.

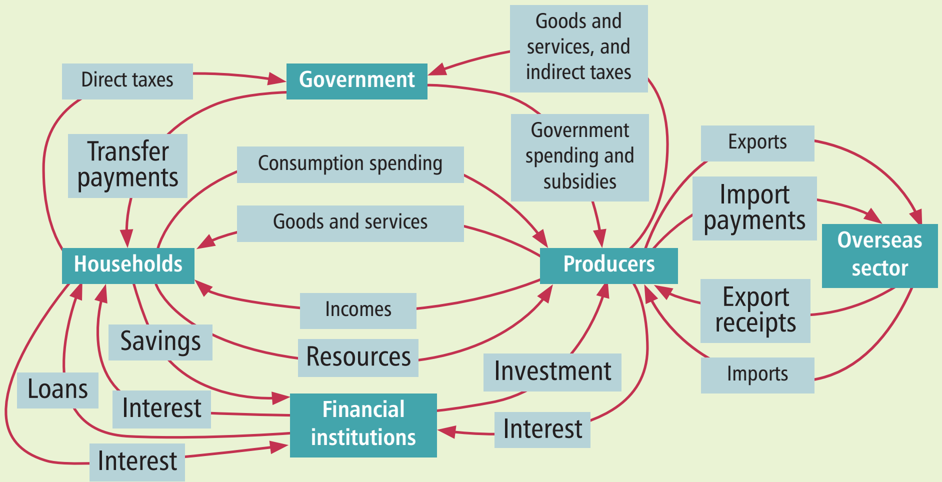
Aggregate supply

Aggregate supply is likely to increase as the higher exchange rate lowers the cost of oil and other imported raw materials, reducing firms' costs of production.

The combined effect is a fall in the price level from PL^1 to PL^2.

Circular flow model

An increase in the Official Cash Rate causes interest rates to rise.



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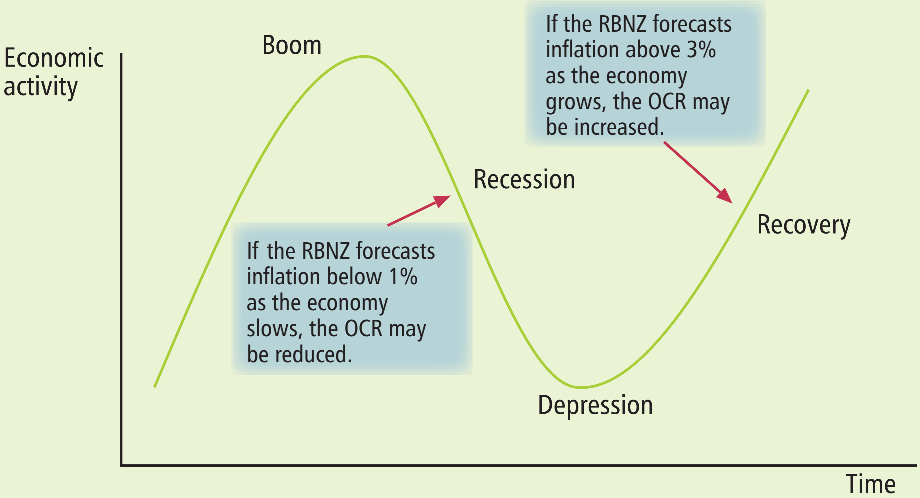
The effects of higher interest rates are:

- an increase in household savings
- fewer loans to households
- fewer loans to businesses for investment
- lower export receipts for firms from the overseas sector
- higher import payments from firms to the overseas sector.

Flow-on effects

Higher interest payments reduce consumption spending by households, and less indirect tax is paid to the government. Less investment by firms and less export income for firms, with higher spending on imports mean less demand for resources from households. This in turn leads to less employment and lower incomes for households, which reduces consumption spending, so less direct tax is paid to the government, and there are less savings.

Business cycle model



In the *recovery phase* inflationary pressure starts to increase. If the Reserve Bank expects the general level of prices to rise in the medium term beyond the 1–3% target band, it will increase the OCR. This will reduce consumption, investment and net exports, and slow economic growth.

In the *recessionary phase* a rapid decline in economic growth could cause deflation with the problems that would follow as households reduced spending. Businesses would reduce investment because of the lower consumption and lower demand for goods and services. If the Reserve Bank expects the general level of prices to rise in the medium term below the 1–3% target band, or even to fall, it will decrease the OCR. This has the effect of stimulating consumption, investment and net exports, and increasing economic growth.

Questions: Monetary policy and economic models

Answers p. 60

1. Describe why the demand for New Zealand dollars in the foreign exchange market increases when the OCR is increased.

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Chapter 3 – Other policies to maintain price stability

Other policies by which the government can maintain price stability include those to reduce aggregate demand and/or increase aggregate supply.

Reducing aggregate demand

Reducing aggregate demand can be achieved by:

- increasing income taxes
- encouraging saving by households
- reducing government expenditure
- increasing the core-funding ratio (so banks have to borrow more from within New Zealand rather than borrowing from overseas to fund their loans)
- allowing a high exchange rate to reduce export receipts and increase import payments
- placing controls on the availability of credit or requiring higher deposits on mortgages and time payments.

Requiring higher deposits for mortgages reduces aggregate demand.

Increasing aggregate supply

Increasing aggregate supply can be achieved by:

- improving productivity
- allowing a high exchange rate to reduce the cost of imported raw materials
- setting controls on how fast wages can increase or imposing a wage freeze
- legislating for labour market changes that give employers more control over setting wage rates
- increased spending on research and development to improve technology.

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The **OECD** (Organisation for Economic Co-operation and Development) helps its 35 member countries develop sustainable economic growth and employment, improve living standards and expand world trade. The OECD provides advice on the best ways to promote economic development, tourism, agriculture and the environment.

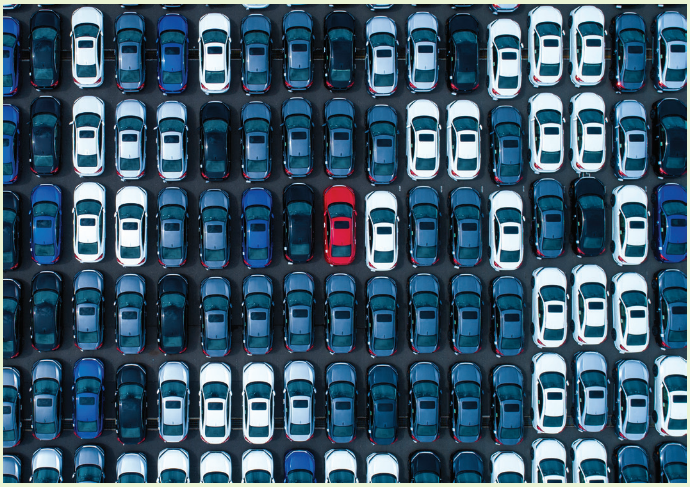
Free trade and protectionism

Free trade occurs when there are no restrictions on the flow of goods and services between countries. **Protectionism** is taking place when the government of a country uses some method to restrict imports into its country, in order to reduce competition and protect its domestic firms.

Methods of protectionism

Methods of protecting domestic firms include the following.

- **Tariffs**: A tax on imports making imported goods more expensive so it is easier for domestic firms to compete with the imports
- **Quota**: A limit on the quantity of a good that can be imported
- **Import licensing**: A restriction on which firms are permitted to import certain goods
- **Anti-dumping measure**: A ban if another country is trying to get rid of a surplus by selling the goods below cost
- **Health regulations**: Requiring imports to be treated or processed in some way
- **Local-content laws**: Imports have to be partly processed in the importing country
- **Biosecurity regulations**: Requiring treatment such as fumigation and inspections
- **Subsidies to domestic producers**: Making the domestic goods cheaper than imports
- **Red tape or regulations**: Requirements for permits or inspections.



'Dumping' of cars means selling the exported cars for below cost.

Arguments for free trade

Reasons the New Zealand government is currently committed to free trade include the following.

- New Zealand producers gain access to a wide range of overseas markets.
- New Zealand exporters face fewer barriers from other countries.
- New Zealand consumers pay less for imported goods.
- There is a wider range of products available for New Zealand consumers.
- Resources are used efficiently.
- Consumers are not subsidising the jobs of those in protected industries.
- There is little incentive for protected industries to become efficient and reduce their costs of production if there is no competition.

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Chapter 6 – Government policies to increase growth

Measuring living standards

Traditionally, living standards were measured by wealth and material comfort, the possessions people were able to accumulate. Nowadays, the definition includes other factors such as health, education, a clean environment and freedom.

A clean environment – part of a good standard of living

The types of capital that contribute to the flow of goods and services and improve the standard of living include the following.

- **Financial and physical capital**: The factories, machines, roads, houses, computer software and forms of wealth that affect production and consumption.
- **Human capital**: The knowledge, skills, and health of the population, in addition to personal attributes that contribute to a person's happiness.
- **Social capital**: Institutions such as the law, and political processes that allow people to feel a part of society and to work together to get the best use from the resources available to them.
- **Natural capital**: The earth's natural resources, which support life, including a stable climate, quality water, and getting rid of waste products without a negative impact on the environment.

Economic growth is defined as an increase in the production of goods and services in New Zealand from one year to the next.

Sustainable economic growth will allow future generations to enjoy a standard of living at least as good as people enjoy now. So any increases in production should not deplete resources or harm environments in a way that will affect the living standards of New Zealanders in the future.

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The law and economic growth

The two laws you need to be familiar with because of their impact on economic growth are the **Resource Management Act** and the **Public Finance Amendment Act**.

Resource Management Act

The Resource Management Act 1991 (RMA) is the main law detailing how the New Zealand natural environment should be managed.

The aim of the RMA is to promote the sustainable management of natural and physical resources so:

- they are available for future generations
- they are not adversely affected by activities
- soil, water, air and ecosystems can continue to support life.

The RMA lets district and regional councils set rules for activities, such as what you can use a piece of land for; how much noise you can make; what hours you can operate; and if you can use chemicals on the site. Similarly, there are rules for how much parking you must provide for staff and customers; how much water you can take from a river or stream; how much waste you can discharge into the air or a river; and what advertising signs you can put up.

Public Finance Amendment Act

The Public Finance Amendment Act 2004 included an earlier law, the Fiscal Responsibility Act 1994, which sets out the principles of responsible fiscal management the government must follow. The government can depart from them temporarily but must publicly explain why it needs to do so.

The principles of this law are to:

- reduce public debt to prudent levels
- plan for a budget surplus on average so deficits are balanced by surpluses and debt is *kept* at prudent levels
- increase the assets owned by the government so the government's net worth improves over time (the net worth is the difference between all the assets the government owns and what it owes)
- keep future tax rates stable and predictable.

Questions: Government policies to increase growth

Answers p. 62

1. Write definitions for each of the following terms in the 'First definition' column on the following table. When you have done all you can, use the 'Second definition' column to complete the ones you did not know, or to correct the definitions that were incorrect or incomplete.

Term	First definition	Second definition
Fiscal policy		
Expansionary		
Contractionary		
Taxation		
Direct tax		

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Indirect tax		
Disposable income		
Purchasing power		
Budget surplus		
Budget deficit		
Operating balance		
Broad-base tax system		
Sustainable management		
Public debt		
Prudent		
Assets		
Net worth		

2. The list gives types of capital. Classify the types of capital on the table following the list.

climate	farm animals	laws	skills
computer software	forests	machines	water
elections	health of population	personal attributes	wealth
factories	knowledge	roads	

Financial and physical	**Human**	**Social**	**Natural**

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ANSWERS

Achievement Standard 91227 (Economics 2.6)

Monetary policy (page 5)

1. a. Actions taken by the RBNZ to maintain price stability and support maximum sustainable employment
   b. Keeping inflation at low levels
   c. The group at the RBNZ that makes decisions about Monetary Policy
   d. Warnings by the RBNZ Governor to households and firms if their behaviour is creating inflationary pressure
   e. The RBNZ purchasing government loans from retail banks by creating new electronic money
   f. Having as many people employed as possible. There is no specific numerical target for this; instead, MSE is estimated using a range of indicators like the number of new jobs created, the participation rate, workforce productivity, etc.
2. a. The Reserve Bank of New Zealand
   b. Adrian Orr (subject to change)
   c. To implement monetary policy
   d. To issue notes and coins; to ensure the banking system is sound; to manage foreign currency reserves (any two)
3. a. Grant Robertson (subject to change)
   b. The Remit
   c. This is the document that defines what is meant by price stability and maximum sustainable employment.
   d. See www.rbnz.govt.nz for the current rate.
   e. See www.rbnz.govt.nz for the current rate.
4. In 'expansionary' segment: decrease OCR / decrease interest rates / increase money supply
   In common segment: decisions about interest rates and the money supply
   In 'contractionary' segment: increase OCR / increase interest rates / decrease money supply
5. a. The Governor of the RBNZ
   b. 15 September 2011
   c. The rate of inflation was above 3%, but some of this had been caused by the increase in GST from 12.5% to 15% in 2010.
   d. The OCR announcement indicates where medium-term inflationary pressure is likely to come from and potential RBNZ actions in response to that pressure.
   e. Jawboning
   f. It is likely to reduce both wage demands from households and wage-rise offers by firms, so household incomes and nominal wages will not rise much more than the underlying rate of inflation, reducing future inflationary pressure.
6. Monetary policy means the actions taken by the Reserve Bank of New Zealand (RBNZ) to maintain price stability and support maximum sustainable employment. The **Reserve Bank Act 1989** makes the RBNZ responsible for formulating and implementing monetary policy. The group at the RBNZ that makes decisions about Monetary Policy is the **Monetary Policy Committee (MPC)**. The Minister of Finance issues this committee a **Remit**. This is the document that defines what is meant by 'price stability' and 'maximum sustainable employment'. The Official Cash Rate (OCR) is the main tool used by the RBNZ to achieve price stability and maximum sustainable employment.
7. a. OCR rises ➡ interest rates rise ➡ consumption and investment fall ➡ aggregate demand falls ➡ less inflationary pressure
   b. OCR ⬆ ➡ r ⬆ ➡ C ⬇ & I ⬇ ➡ AD ⬇ ➡ PL ⬇
8. a. OCR rises ➡ interest rates rise ➡ exchange rate rises ➡ exports fall, imports rise ➡ aggregate demand falls ➡ aggregate supply rises ➡ less inflationary pressure
   b. OCR ⬆ ➡ r ⬆ ➡ er ⬆ ➡ X ⬇ & M ⬆ ➡ AD ⬇ & AS ⬆ ➡ PL ⬇
9. *Your explanation should contain the idea that the RBNZ is responsible for maintaining both price stability and maximum sustainable employment when setting the OCR.*
10.

Event	Would inflation ⬆ or ⬇	Would RBNZ ⬆ or ⬇ the OCR?	Explanation
Rising house prices	⬆	⬆	May lead to higher borrowing and consumption spending, increasing AD and creating inflationary pressure
A fall in the exchange rate	⬆	⬆	Increases export receipts and reduces import payments so 'net exports' increases, increasing AD and creating inflationary pressure
A long drought	⬇	⬇	Lower production in farming sector reduces profits, incomes, consumption, investment and export receipts, so AD falls, reducing inflationary pressure
Continued high commodity prices	⬆	⬆	Increases export receipts, increasing AD and creating inflationary pressure

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INDEX

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