

The primary objective of monetary policy is to maintain price stability. Price stability means “keeping inflation at low levels” and is defined in an agreement between the Governor of the Reserve Bank and the Minister of Finance called the Policy Targets Agreements (PTA).

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The current account is made up of the balance on goods, balance on services, balance of income and balance of current transfers. A balanced current account can be achieved by negotiating free trade agreements with countries, such as the UK, in order to increase our exports and balance our current account balance.

The government goal with employment is to keep the unemployment rate low (an unemployment rate of somewhere between 4 and 6 percent). There will always be unemployment due to Frictional and Structural unemployment as they are inevitable in a growing, changing economy. The government goal is therefore to have little cyclical unemployment as it is potentially the most damaging of the forms of unemployment.

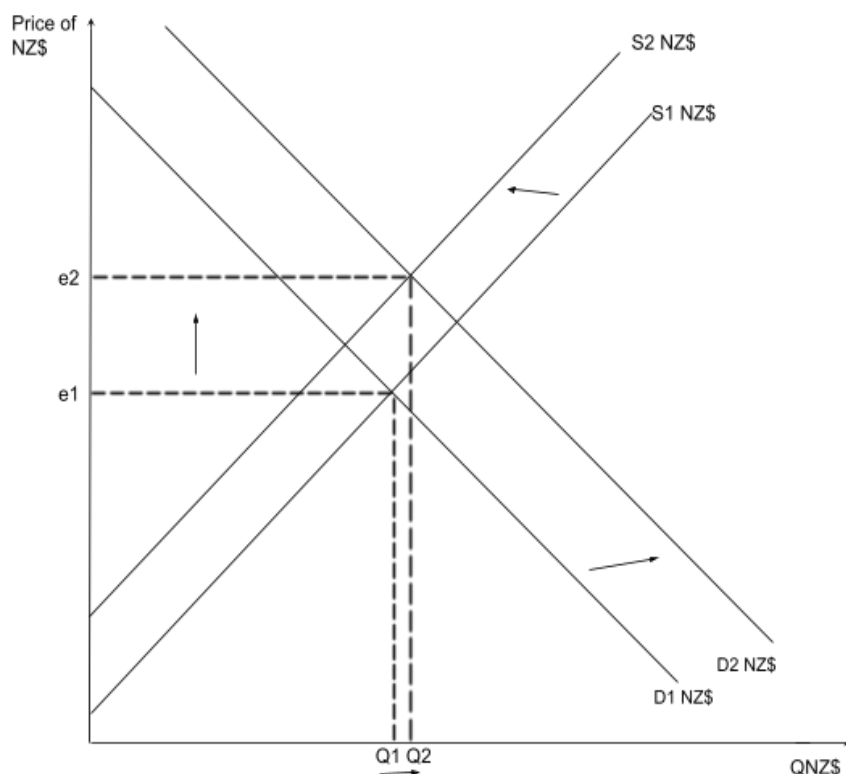
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The government goal is to keep inflation between 1 and 3 percent over the medium-term, with a focus on keeping future inflation near the 2 percent midpoint. Price stability is all to do with inflation.

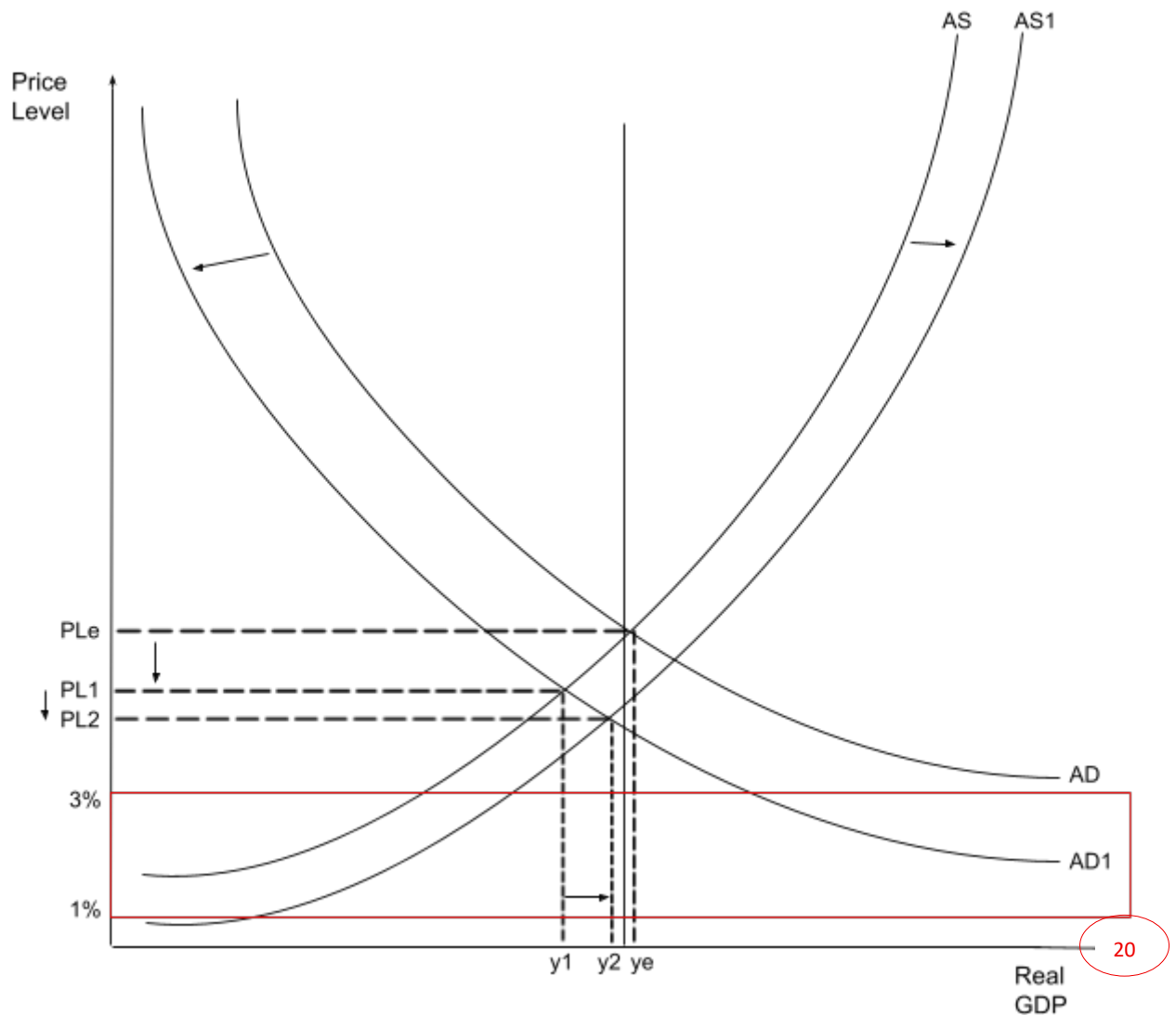
The student also explained why inflation is problematic for households and producers ....

The student also provided a general explanation of how the Reserve Bank uses the OCR (official cash rate) and other tools (e.g. quantitative easing, forward guidance) in the monetary policy toolbox to stimulate or contract the economy by ....

#### i. Foreign Exchange Market model:



ii. AD/AS model



The direct impact of the current contractionary monetary policy (due to the high inflation) on price stability is that if the Reserve Bank wishes to discourage spending and lower inflation, they'll raise the OCR. This is when the contractionary monetary policy occurs. When the Reserve Bank raises the OCR, this can be used to help the economy lower inflation.

An **increase in the OCR means market interest rates increase**. It will be more expensive for banks to borrow from the Reserve Bank, therefore higher interest rates are passed on to producers and households. This leads to a **decrease in consumer spending (C)** because saving is encouraged due to higher returns and borrowing is discouraged as it becomes more costly.

A **decrease in investment spending (I)** occurs. The cost of borrowing for businesses will also increase. This leads to an **decrease in Aggregate Demand (AD = Consumer Spending + Investment Spending + Net Exports)**

(Exports - Imports). On the AS/AD Model, this causes the AD curve to shift to the left because there is a lack of demand which causes the price of goods and services to decrease which helps with price stability. There would be a decrease in real GDP, though the increase in aggregate supply offsets it. Aggregate supply increases as a higher exchange rate lowers the cost of production as it is cheaper to import raw materials. The AS curve then shifts to the right from AS to AS1. Real GDP shifts from  $y_1$  to  $y_2$ .

With an increase in interest rates is an increase in the value of the New Zealand Dollar (NZD). With an appreciation, exporters are worse off because they are less price competitive for overseas buyers to purchase our products as they need to exchange more of their currency for every NZ\$. This results in the demand for our exports, such as meat and dairy products, falling and export receipts decreasing. Importers are better off with the NZD appreciating as it is more price competitive for New Zealanders to buy products from overseas as one NZ\$ buys more foreign currency. The demand for imported products increases so import payments increase as they are cheaper (more price competitive).

Demand for the NZ\$'s comes from the people who have overseas currency wanting to buy NZ currency. When our interest rates increase relative to other countries the demand for our dollar increases by foreign investors. In order to invest in NZ banks those foreign investors will need NZ\$. They will then convert their currency into NZ\$'s. There's then an increase in demand for NZ currency from D1NZ\$ to D2NZ\$ and the exchange rate appreciates. At the same time, NZ investors also take advantage of the higher interest rates and keep more of their money in NZ (invest less in overseas banks), decreasing the supply of NZD from S1NZ\$ to S2NZ\$.

#### i. Flow-on effect on the current account:

With an increase in interest rates is an increase in the value of the New Zealand Dollar. Known as an appreciation as the demand for NZD increases, shown on the Foreign Exchange Market Model as a shift from D1NZ\$ to D2NZ\$. Though overseas currencies convert to less NZD so for producers exports decrease and imports increase. Export receipts decrease causing profitability for exporters to fall as overseas payments convert to less NZD. They may need to reduce production and use less resources such as labour. Imports become cheaper, therefore producers with imported inputs as well as consumers purchase of imports will increase. The balance of goods worsens (X-M) and AD decreases as X falls and M increases. An appreciation of the NZD for consumers means imported goods (including overseas travel) are relatively cheaper as NZD buys relatively more in foreign currency terms; increased purchasing power of the NZD.

For employees in exporting firms they may face lay-offs, redundancies, reduced hours of work, falling income. For those in domestic firms who are facing increased competition from imports may face layoffs.

#### ii. Flow on impacts on unemployment

An increase in unemployment is a negative side effect of a contractionary monetary policy. Firms recruit fewer people as a result of the economic downturn and decreased production levels. The demand for labour depends on the demand for the goods and services the labour produces, it is therefore called a

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derived demand. As a result, the unemployment rate in the economy rises as there is a decrease in the demand for labour from domestic producers and exporters. There will then be a recessionary gap as seen on the AD/AS model.

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The student provided a general explanation of fiscal policy (contractionary and expansionary) by referring to the government's budget ....

At present, the New Zealand government is operating a contractionary fiscal policy. They are increasing tax rates, one example is the Labour Government quietly introduced an extension to the GST net to include funds management fees, Airbnb rooms and Uber fares. Combined, the change is expected to drag in an extra \$272m a year in tax revenues from 2026. They have also forecasted to cut spending in the health sector. From 2020/2021 to 2021/2022 spending allocations for health jumped from 21,047.8 million to 27,569.9 due to covid-19. Now since covid-19 related spending has decreased, a big factor being significantly less PCR tests, the health budget for 2022/2023 has dropped down to 22,811.4 million.

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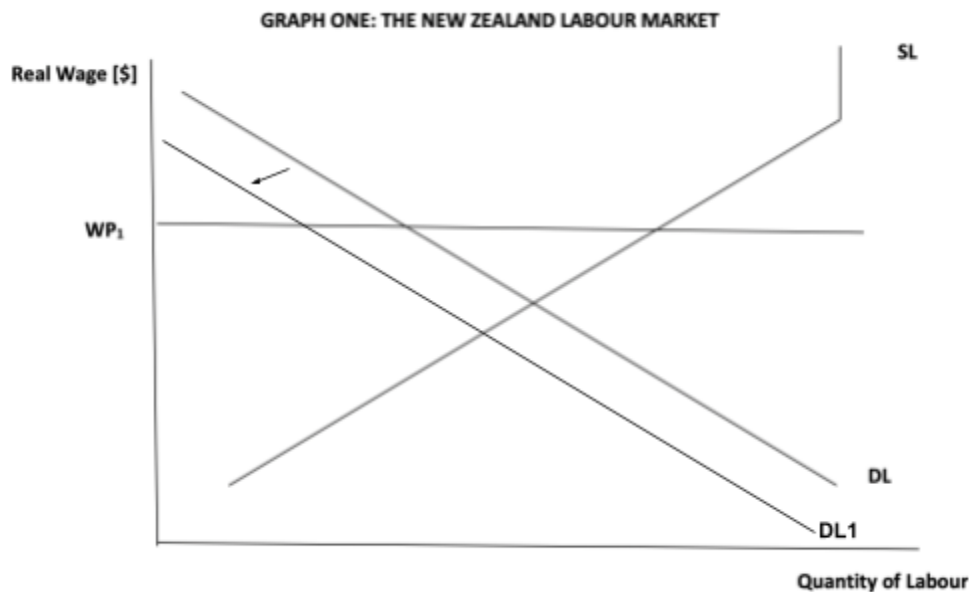
The direct impact of a contractionary Fiscal Policy on price stability is consumption spending decreases as households have less disposable income. Investment spending decreases as businesses invest in less capital goods and government spending also decreases as they are sending less of their revenue back into the economy. So C, I and G all decrease, shifting aggregate demand to the left from AD to AD1. Price level then decreases from PL1 to PL2, lowering inflation closer to the governments desired goal of between 1 and 3 percent.

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The flow on effects of a contractionary fiscal policy is a decrease in government spending. There's a decrease in import payments compared to export receipts as the economy contracts. The reduced government spending in the health sector after covid could also result in less imports of vaccines and testing kits. This means an increase in AD because of more net exports (exports greater than imports) and the current account deficit will decrease leading to a more balanced current account.

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## ii. Flow on impacts on unemployment



The flow on effects of a contractionary fiscal policy is a decrease in government spending. The government's demand for goods and services decreases and firms decrease their production levels. On the AD/AS model Real GDP decreases from  $y_1$  to  $y_2$ . There's an increased recessionary gap as the demand for labour from domestic producers and importers falls. With significantly less PCR testing, less labour is needed to provide the testing service (having to keep open testing stations, process the tests, send out results etc). Demand Labour shifts to the left from DL to DL1. So a contractionary fiscal policy would cause an increase in unemployment.

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The student included an explanation of a third policy (free trade agreement) to minimise negative flow-on effects of the previous two policies on trade and employment, which is not required for Achieved. However, while this policy has positive effects on trade and employment, this policy would jeopardise the original objective of price stability as it will lead to higher inflation.