Fin-Ed Centre

FINANCIAL EDUCATION AND RESEARCH CENTRE

# Understanding your financial world

**Monetary Policy**

Monetary policy refers to the use of **financial instruments** to influence the economy through factors like interest rates and exchange rates. Changes in these factors affect peoples' decisions about spending, saving and investing.

**Monetary policy and the Reserve Bank of New Zealand**

The RBNZ uses **monetary policy** to manage **inflation**.

Under the Reserve Bank Act 1989 the sole aim of the Reserve Bank and monetary policy has been to achieve price stability. Because the Reserve Bank has only one aim for monetary policy, and because it is independent of the government, the risk of price stability being sacrificed for political motives is removed.

**Inflation targeting**

For the Reserve Bank, price stability means maintaining the inflation rate in New Zealand at between 1% and 3% per annum. This range is known as the inflation target and the target is set out in the **Policy Targets Agreement** (PTA) between the Minister of Finance and the Governor of the Reserve Bank.

The target is set by the government to establish an environment for positive and sustainable economic growth by removing uncertainty and risk associated with inflation. The Governor of the Reserve Bank is accountable for ensuring inflation targets are met and the Governor can be dismissed for failing to meet the targets. Progress in achieving monetary policy is announced in six-monthly **monetary policy statements**.

**The Official Cash Rate**

The **Official Cash Rate** (known as the **OCR**) is the tool that the Reserve Bank uses for monetary policy. This tool gives the Reserve Bank considerable influence over short-term interest rates and the creation of credit in the New Zealand economy.

The OCR is the interest rate for registered banks when they borrow from and lend to the Reserve Bank (in the Reserve Bank's role of banker to the registered banks). This borrowing and lending happens because banks do not always balance the incomings and outgoings

Adapted from Sloman, J. and de Boer, P. (2009). *Economics*. Auckland, New Zealand: Pearson and Williamson, M. (2008). *Year 12 Economics Study Guide*, 3rd ed. Auckland, New Zealand: ESA Publications (NZ)

when they **settle** payments and receipts from their customers' bankings. If there is a shortfall the banks must borrow from each other or the Reserve Bank so that their customers' payments are honoured.

The OCR then becomes a benchmark for other interest rates, such as mortgage loan interest rates, and has a knock-on effect in peoples' and businesses' decisions to save, spend, invest and borrow, and onto inflation. It is not the absolute rate that is set by the Reserve Bank that is important, it is the direction. That is why there is a strong focus on whether the OCR is increased, decreased or stays the same whenever the Reserve Bank makes its OCR announcements. These announcements take place every six weeks. A rise (known as 'tightening') or fall (loosening or easing) in the OCR can be expected to increase or decrease all other interest rates.

**Changing the OCR**

The Reserve Bank takes into account a range of indicators in the economy when setting the OCR. These indicators include:

- Domestic trade – especially retail, wholesale and manufacturing sales
- Investment – building permits and inventories
- Incomes and prices – labour cost, average hourly earnings, the consumer price index (CPI) and Producers Price Index (PPI)
- Labour market and balance of payments – registered unemployed, official unemployed, filled jobs, terms of trade, imports and exports of goods and the current account balance
- Gross domestic product
- Marketscope survey – of inflation expectations.

**Effects of Changing the OCR**

If the Reserve Bank thinks that high interest rates are unduly depressing business confidence and investment it may reduce the OCR, and as rates fall there is more borrowing and an increase in consumer spending (because it is cheaper to borrow or there is less incentive to save). A fall in interest rates may also mean investing in New Zealand is less attractive for foreigners and their demand for New Zealand dollars will fall, leading to a depreciation of the New Zealand dollar. The depreciation of the New Zealand dollar however means that imports will be more expensive and this will contribute to inflation.

The opposite effects occur when there is a tightening of monetary policy.

For a more detailed explanation of the effect of changing the OCR, see the Powerpoint presentation: *The Effect of the OCR*.

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