Fin-Ed Centre

FINANCIAL EDUCATION AND RESEARCH CENTRE

Understanding your financial world

The link between Fiscal and Monetary Policy

The links between fiscal and monetary policies are both direct and indirect.

- The direct link is in the way the government's deficit is funded – whether by borrowing (or the sale of **government securities**, such as government bonds) or by creating new money.

Box 17.3 Government securities

Government bonds

These are a medium-term (generally 3–10 years) instrument paying a fixed coupon or interest rate. They are aimed at the wholesale market of mainly large institutional investors.

Government bonds are sold through regular, usually monthly, competitive tenders, whereby the price, or the effective yield, is determined by market bids.

Treasury Bills

These are a short-term (usually with maturity of up to around 12 months) wholesale debt instrument, primarily used to meet the government's seasonal financing needs during the year. Bills are zero-coupon instruments – they pay no interest but rather are initially sold at a discount to their par value, implying an effective yield for the holder of the bills. Bills are sold through regular weekly tenders.

Retail bonds

These are aimed at small savers. The sole retail instrument on issue is Kiwi Bonds. This is a fixed-interest instrument which is transferable; that is, it may be sold by the holder to another party. If redeemed prior to maturity there is an interest penalty. Kiwi Bonds are issued with six-month, one-, two- and four-year maturities. The interest rate is set by the government on the basis of a formula, whereby the rates on each issue are linked to the current market yields on wholesale government bonds of comparable maturities.

Source: Statistics New Zealand

(Sloman and de Boer, 2009, p344)

- The indirect link is the use of monetary policy to reduce the inflationary effect of an expansionary fiscal policy.

Non-monetised deficit (also known as fully-funded deficit)

One way for governments to finance an expansionary fiscal policy is to borrow money from the public or private sector in both New Zealand and from overseas. It does this by selling

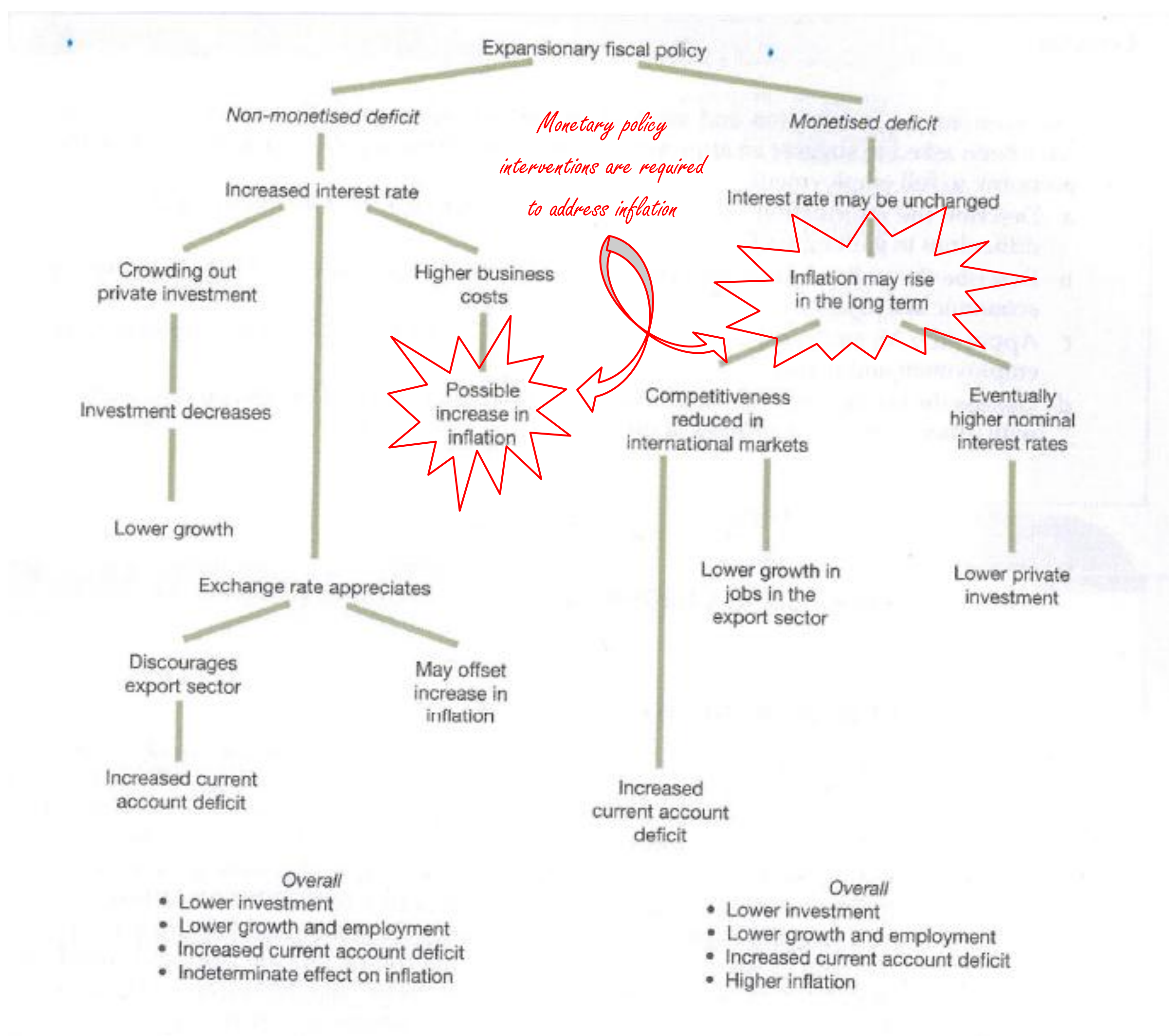
Adapted from Sloman, J. and de Boer, P. (2009). *Economics*. Pearson: Auckland, New Zealand and The Financial Times. (2013). *Financial Times Lexicon: Monetisation*. Retrieved 2013, August 19 from http://lexicon.ft.com/Term?term=monetisation

government securities (see above). Although there are sales of government securities to members of the public, the bulk of sales are to financial institutions i.e. local and overseas banks. The key difference between a non-monetised deficit and a monetised deficit is that total amount of money (known as the money supply) does not increase when the deficit is non-monetised.

Monetised deficit

A monetised deficit is when a government borrows and repays the borrowing with newly printed currency or borrows from the Reserve Bank, which is similar to printing money. The effect of this is to increase the money supply. Inflation is an unfortunate consequence of monetisation because now the supply of money exceeds its demand. An attempt to purchase goods and assets with this excess money supply will drive up prices and generate inflation. Indeed, monetisation to finance a deficit is referred to as inflationary financing of the deficit. Because of the impact on inflation, this method of deficit financing is not favoured.

The link between fiscal policy and monetary policy



Adapted from Sloman, J. and de Boer, P. (2009). *Economics*. Pearson: Auckland, New Zealand and The Financial Times. (2013). *Financial Times Lexicon: Monetisation*. Retrieved 2013, August 19 from http://lexicon.ft.com/Term?term=monetisation