

MONETARY POLICY SOME QUESTIONS AND ANSWERS

This article provides answers to a number of questions commonly raised about the framework of monetary policy. The answers are intended not to be comprehensive but rather to give a basic level of understanding of monetary policy: both the rationale behind it and the way it currently operates.

General

What is monetary policy?

Monetary policy is one of the main instruments of macroeconomic policy, and is an essential component of any economic package designed to achieve the broad objectives of economic policy. These objectives are generally expressed in terms of improving living standards while at the same time maintaining price stability. Monetary policy generally aims to influence the growth of the monetary aggregates (i.e. the financial assets of the private sector) which in turn affect the level of aggregate demand in the economy. (A more detailed description of the relationship between monetary policy and the ultimate objectives of macroeconomic policy and a description of the instruments of monetary policy are given later in this article — see, also, June 1985 *Bulletin*, page 293.)

Which economic objective is monetary policy best suited to achieving?

Moderate growth in the monetary aggregates is considered to be a necessary prerequisite for a lower, more stable rate of inflation.

The achievement of monetary control is therefore the *intermediate* objective of monetary policy. Economic theory suggests, and the experience of many overseas countries demonstrates, that monetary policy can be successful in achieving a low and stable rate of inflation in the medium-term (i.e. after a lag of 2 — 5 years). Mainly, because of the length of these lags, it is not considered useful to attempt to influence short-term movements in economic activity with monetary policy. This point has been amply demonstrated both in New Zealand and overseas in the past, where attempts at 'fine-tuning' monetary policy to counteract fluctuations in output, employment and the balance of payments have often worsened rather than improved economic stability. Past experience therefore suggests that monetary policy is most suited to providing a stable financial environment that is conducive to low inflation and sustained real economic growth.

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What is the money supply?

There is no single definition of the money supply. In most countries, a range of monetary aggregates are compiled, incorporating the public's holdings of cash, plus deposits with various financial institutions. In New Zealand, a broad measure of the money supply, called M3, is the most widely used definition. In addition to currency in circulation, M3 comprises the deposit liabilities of most of the major financial institutions.

What is the relationship between money supply growth and inflation?

Rapid money supply growth in excess of the economy's ability to produce goods and services will generally lead to excess demand pressures in goods and labour markets as nominal incomes rise faster than real output growth in the economy. This in turn will tend to put upward pressure on wages and prices and downward pressure on the exchange rate. A close relationship between monetary growth and inflation is only likely to emerge over a period of several years. In the short-term, other influences such as inflationary expectations, the level of spare capacity in the economy, and overseas price movements, will also affect the path of domestic inflation.

How does monetary policy interact with other elements of Government economic policy?

To be successful in controlling inflation at minimum cost (i.e. in terms of unemployment and reduced real economic activity) it is essential that monetary policy be properly co-ordinated with the other instruments of economic policy.

A firm fiscal policy stance is required, since the size of the fiscal deficit is an important factor in determining the amount which the Government has to borrow to maintain control over the money supply. The larger the fiscal deficit, the greater will be the Government's claim on private sector savings, which in turn will tend to push up interest rates and crowd out private sector investment spending.

Flexibility in other areas of the economy is also important if monetary policy is to be effective in

achieving its objectives. If some sectors of the economy are protected from market forces through artificial barriers, such as import licences or other trade restrictions, then the overall adjustment to a low inflation environment may be delayed and the costs to other more exposed sectors may be increased.

Similarly, inflexibility or market rigidities in the labour market may also tend to result in the effects of a firm monetary policy being reflected more in a loss of output and employment opportunities than would otherwise be the case, at least in the short run until wages and salaries adjust.

Indicators and Targets of Monetary Policy

Does the Government have a target for growth in the money supply?

The Government does not have a target for growth in any particular monetary aggregate. For such a target to be meaningful, the Government would have to be confident that there was a stable relationship between growth in the aggregate or aggregates chosen and movements in prices or nominal incomes over time. The identification of such a stable relationship has been hampered over recent years by the effects of deregulation and financial innovation in the financial system. Therefore, the use of various monetary aggregates as indicators of monetary conditions needs to be continually reassessed in the light of developments in other indicators, such as interest rates and the exchange rate.

Do interest rates and the exchange rate provide suitable alternative targets for monetary policy?

Though movements in both interest rates and the exchange rate are used as indicators of monetary conditions, neither provides a suitable alternative target for policy. Nominal interest rates can only be meaningfully used as an indicator of monetary conditions when assessed in relation to people's expectations about future rates of inflation. These expectations are notoriously difficult to measure. In addition, the theoretical and empirical linkages between interest rates and inflation are less well established than the linkages between monetary growth and inflation.

Similarly, any attempt to target the exchange rate would require the authorities to continually make the difficult judgment as to what exchange rate level is appropriate on the basis of underlying market conditions. Past experience both in New Zealand and overseas suggests that governments are rarely able to make such judgments successfully on an ongoing basis. History also provides many examples of the costs which can arise for both the taxpayer and the economy as a whole from maintaining an exchange rate which is out of line with the market determined rate.

What criteria does the Government use to judge whether the stance of monetary policy is appropriate?

Because no single monetary aggregate currently provides a sufficiently reliable measure of monetary conditions, it is necessary for the Government to examine a range of monetary indicators, including movements in the various monetary and credit

aggregates, interest rates and the exchange rate. No specific criteria to assess the degree of firmness of policy have been established for any individual indicator, for the reasons mentioned above. Rather the Government forms an on-balance judgment based on a review of all the indicators.

In the absence of a target for one or more of the indicators of monetary conditions, what operating guidelines does the Government use to communicate the stance of monetary policy?

The stance of monetary policy is presently expressed in terms of the Government's intentions regarding growth in the monetary base. The Government sets a target for growth in the monetary base which it considers to be consistent with the medium-term objectives of achieving control over growth in the money supply and, ultimately, inflation. The appropriateness of this target is kept under review in light of developments in the various monetary indicators noted above.

What is 'primary' liquidity and why is it important?

The term 'primary liquidity' (PL) refers to the monetary base concept which is used in New Zealand as an operating target for monetary policy. PL consists of those assets which are readily available to private sector financial institutions to settle their debts with each other, and, more importantly, with the Government. All transactions between the Government and the private sector must be settled in Reserve Bank 'cash' and so financial institutions need to hold a 'buffer stock' of cash or near-cash assets to cover expected and unexpected payments by their customers to the Government. Control of PL growth is an important requirement for monetary control in the medium-term.

Instruments of Monetary Policy

How does the Government control growth in PL?

The main instrument used to control PL is the sale of medium-term Government stock by competitive tender. The Government also sells debt in the retail market at rates which are linked to the market yields determined in the wholesale stock tenders.

The sale of both wholesale and retail stocks reduces PL by substituting relatively illiquid government debt for cash and other liquid reserves of the financial sector.

What is the relationship between primary liquidity and the money supply?

Control over growth in PL will enable the Government to control growth in the money supply over time by constraining the extent to which financial institutions are able to expand their balance sheets (i.e. increase their lending and deposits). If the supply of PL assets is constrained to below the level which financial institutions require to support their lending and deposit-taking activities, then institutions will either be forced to restrict their lending or to compete more actively for deposits. This will tend to put upward pressure on interest rates which in turn will tend to reduce the demand for credit. Ultimately, this will slow the rate of

growth in the money supply. However, this process may take some time to work through and the linkages between growth in PL and the money supply are unlikely to be particularly tight in the short run.

What does the Government mean when it says that it intends to 'fully fund' net public sector injections over the current fiscal year?

'Fully funding' means that the Government intends to fully offset all liquidity injections arising from the fiscal deficit, Reserve Bank transactions with the private sector and maturing public debt by selling medium-term government debt through the stock tenders (after allowing for retail debt transactions). In other words, the Government intends to allow no growth in PL over the year as a whole. However, PL may still be permitted to vary on a weekly or monthly basis to accommodate the seasonal liquidity fluctuations caused by timing differences between government revenues and expenditures.

Does an increase in the borrowing programme imply a tightening of monetary policy?

Not necessarily. The size of the borrowing programme should be considered in relation to expected net public sector injections. An increase in the borrowing programme may simply reflect higher than previously anticipated fiscal injections, in which case the underlying stance of monetary policy (implicit in the target for PL growth) would remain unchanged.

Other than the borrowing programme, are there other instruments of monetary policy which are used by the Government?

The Government has two other monetary policy instruments in addition to the public debt programme. These are Reserve Bank discount policy, which affects the terms on which financial institutions can obtain cash in exchange for short-dated securities, and the interest rate paid on the cash held by financial institutions at the Reserve Bank. By changing these parameters, the Government can influence the demand for PL relative to the supply (which is determined by the public debt programme). In general, however, these instruments are not varied in an active manner, and monetary policy is conducted primarily through altering the supply of liquidity through the public debt programme.

Does the removal of direct controls, such as reserve ratios and credit guidelines, make it more difficult to achieve monetary control?

Direct controls are not required for monetary policy to be effective, provided that interest rates are allowed to vary. Controls such as ratios and credit guidelines may appear to force a more immediate adjustment on financial institutions but any increase in monetary control which may be obtained in the short run is likely to be at the expense of greater short-term interest rate volatility. Close short run control of growth in particular monetary aggregates is not necessary for monetary policy to be successful in achieving its objective of control over inflation in the medium-term. Indeed, monetary policy is at best a fairly blunt instrument in the short-term.

Furthermore, direct controls do not provide a

substitute for flexible interest rates and the payment of market interest rates on government debt. The use of direct controls in a controlled interest rate environment will eventually result in financial flows being diverted into uncontrolled areas, thereby undermining the overall effectiveness of monetary policy.

Interest Rates

Does the Government determine interest rate levels in the current policy environment?

No. In a flexible interest rate environment, interest rate levels are determined by the overall demand for credit from both public and private sectors, relative to the supply of savings. The Government is just one of many borrowers in the economy, albeit a large one, and must therefore compete for finance along with everyone else. Interest rates on government borrowing are determined by competitive tender (either directly, or indirectly in the case of retail stock) and will therefore reflect the real returns available on alternative investments, both in New Zealand and overseas, as well as people's inflationary expectations.

Why are market-determined interest rates essential for monetary control?

Interest rates provide the main transmission channel through which changes in the supply of and demand for money influence savings, consumption and investment decisions throughout the economy. It is therefore essential for monetary control that interest rates be allowed to vary. Any attempt to control interest rates below their market level is likely to undermine the effectiveness of monetary policy over time by encouraging the channelling of funds into uncontrolled areas.

Why doesn't the Government encourage interest rates down by refusing to pay high rates on its own borrowing?

Refusal to pay market-determined interest rates on its own borrowing would mean that the Government would be unable to sell sufficient quantities of government debt to fund the net public sector injection. This in turn would lead to more rapid growth in the monetary base than may be consistent with monetary control, and ultimately control over inflation, in the medium-term. Some fall in interest rates may well result initially if the Government stopped paying market rates on its debt. However, any such fall would be unlikely to be sustainable beyond the short-term, since more rapid monetary growth would only fuel inflationary expectations and therefore lead to higher nominal interest rates over time.

Are high interest rates inflationary?

Interest rates represent a cost to borrowers and therefore a rise in nominal interest rates may well add to inflation in the short-term as producers attempt to recoup the increased cost of debt servicing by charging higher prices for their products. On the other hand, interest rates also represent a return to savers and, more generally, are an important determinant of the level of expenditure in the economy. High interest rates are one

of the main transmission channels through which a firm monetary policy exerts a constraint on domestic spending and ultimately on inflation.

How can the authorities get interest rates down?

Low nominal interest rates are ultimately only sustainable in a low inflation rate environment. Therefore, control over inflation is a prerequisite for achieving a permanent reduction in interest rates in the medium-term. Interest rates may only follow inflation down with a lag, because it takes time for both savers and borrowers to adjust their thinking to a low inflation rate environment. This will be particularly the case where a long period of high inflation has been experienced in the past. In addition, other factors, such as the size of the fiscal deficit, the level of economic activity, and overseas interest rates will influence the level of domestic interest rates.

Liquidity Management Policy

What is the aim of liquidity management policy?

Liquidity management policy is concerned with the management of short-term liquidity flows. Financial flows between the Reserve Bank (as the Government's banker) and the private sector occur on a daily basis, resulting in fluctuations in the level of cash and PL. The main role of liquidity management policy is to ensure that there is sufficient liquidity to enable transactions between the Government and the private sector to take place in an orderly manner, while remaining consistent with the overall stance of monetary policy.

How does it relate to monetary policy?

Liquidity management policy operates within the short-term (i.e. on a day-to-day and week-to-week basis), mainly on the composition of PL (i.e. the distribution of PL between cash and Treasury bills of

different maturities). Monetary policy operates on the medium-term path of PL itself. Though liquidity management policy may appear to be more active in terms of involving daily and weekly operations, its role is essentially supportive to the operation of monetary policy, as carried out through the stock tender programme.

What are Treasury bills and how are they different to government stock?

Treasury bills and government stock are both forms of government borrowing, and the distinction between the two mainly relates to the term involved and to their policy implications. Treasury bills are a short-term funding instrument used primarily to smooth short-term fluctuations in the cash component of PL and to fund the seasonal component of the net public sector injection. Thus, bills are generally sold with maturities of less than one year, whereas government stock is generally sold for maturities of more than one year. Bill tenders are also held more frequently, usually on a weekly basis, compared with a monthly timetable for the stock tenders. Bill tender amounts are also likely to be more variable, reflecting the uneven pattern of government revenue and expenditure over the course of the year.

What are Open Market Operations and why are they used in addition to Treasury bill tenders?

The term 'open market operations' refers to transactions between the Reserve Bank and the private sector which are designed to withdraw or inject liquidity. These may be in government securities (government stock or Treasury bills) or private paper (such as transferable certificates of deposit or commercial bills) and may involve outright purchases and sales or buy-backs. Open market operations may be carried out on a daily basis, and their objective is largely to smooth unexpected liquidity fluctuations which were not taken account of in setting the weekly Treasury bill tenders.