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8

Aggregate Economic Activity and Monetary Policy

Introduction

The AD/AS model can be used to show the factors affecting national income, output, employment and inflation in an economy. This section explores how money, lending (credit) and interest rates affect aggregate economic activity.

The role of money in an economy is like oil in a car engine. It acts as a lubricant. The 2008 credit crunch showed the potential for disaster if the lubricant dries up. The engine (economy) can seize up. At the height of the crisis, banks and other financial institutions were reluctant to lend for fear of bad debts. This quickly affected the real economy causing unemployment to rise and output to fall.

This section examines how money and credit can impact on the real economy. Real economy means employment and the output of goods and services.

What is Money?

Money is possibly the greatest human invention. Without money, trade would be very difficult and the ability of people to specialise in different jobs would be impossible. We rely on money to allow us to trade which allows us to specialise.

Money is a medium of exchange. This means it can be used for buying and selling goods, services and resources. Money is a human invention. No other species has ever used any system of money. The use of money is also an exercise in trust. We accept money for payment because we trust that other people will also accept it. For an item to be used as money it must be widely accepted.

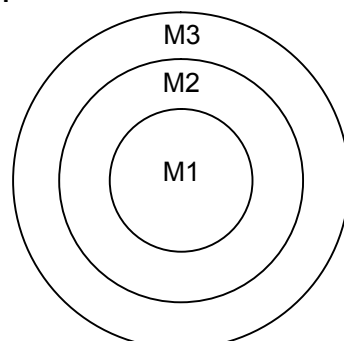
Early items used as money included precious metals such as gold and silver. The names of many modern currencies are derived from names for weights of precious metals. (Dollar = thaler is a weight of silver).

The Categories of Money

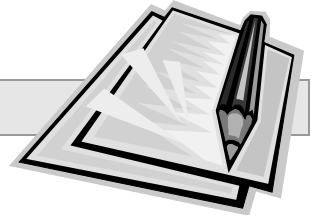
Money can be divided into categories based on liquidity. Liquidity means how easily (acceptably) an item can be used for transactions. The categories of money are:

- **M1** – notes and coins and demand deposits which can be accessed by cheque. M1 is the most liquid form of money. This is called "narrow" money.
- **M2** – M1 plus other on call accounts for example savings accounts operated by EFTPOS.
- **M3** (broad money) – M2 plus other deposits with financial institutions. This includes term deposits with banks and other financial institutions (e.g. finance companies) where it is difficult to access funds immediately.

Items such as gold, silver and even credit cards are not included in official statistics of money.



Classifications of Money

Review Activity

1. Complete the following glossary:

- (a) _____ is any medium of exchange.
- (b) _____ is the key quality of money.
- (c) _____ refers to how easy it is to use an item as a medium of exchange.
- (d) _____ is notes and coins and demand (transaction) deposits.

2. Complete the following passage:

Money is a _____ which means it can be used for transactions. For an item to be used as money it must be widely _____. In a modern society, money is extremely important because it makes trade easier allowing people to _____.

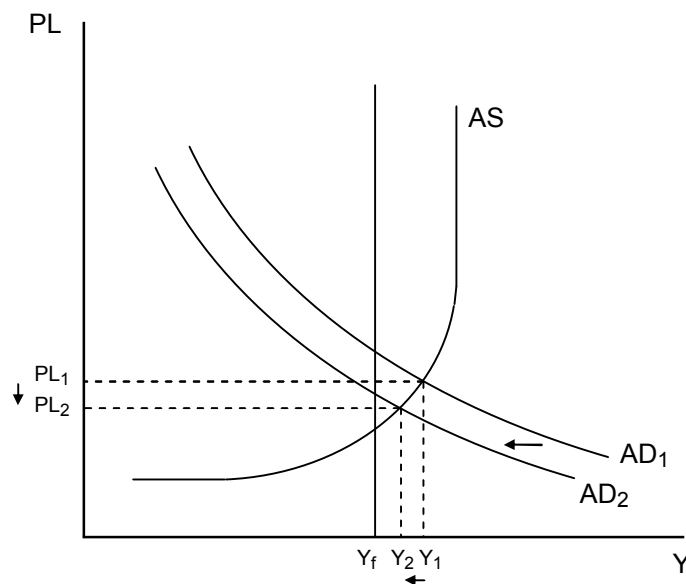
Money can be classified based on its _____ which means how easily it can be used for transactions. Notes, coins and cheque accounts are part of _____ which is the most _____ form of money. An eftpos account would be part of _____ whereas a two year term deposit with the BNZ would be part of _____.

What is Monetary Policy?

Monetary policy is the control of money, credit and interest rates to achieve economic objectives. Monetary policy is a key tool that a government can use to influence aggregate economic activity.

A contractionary monetary policy is aimed at reducing economic activity usually to target inflation. This would mean cutting the money supply and lending in an economy which would cause interest rates to rise. This should reduce aggregate demand in the economy. Firms would be less likely to raise prices leading to lower inflation.

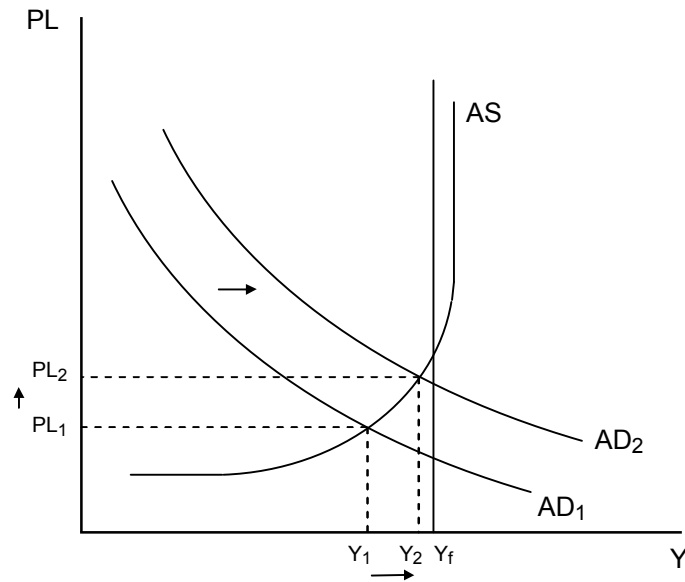
The Effect of Contractionary Monetary Policy on the AD/AS Model



An expansionary monetary policy aims to increase economic activity. This would involve increasing the money supply and lending and lowering interest rates. It aims to increase aggregate demand. This type of policy may be used during a recession to reduce unemployment and increase national output.

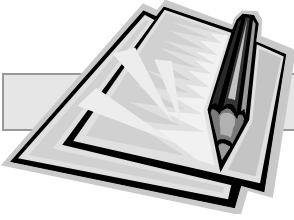
During the 2008 credit crisis most countries introduced aggressive expansionary monetary policies to try to avoid a deep recession.

The Effect of Expansionary Monetary Policy on an Economy With a Recessionary Gap



Note:

The impact of an expansionary monetary policy on inflation depends on the equilibrium of the economy. If the economy has high levels of unemployment then the increase in AD will have no or low effect on inflation. This is because resources are readily available.

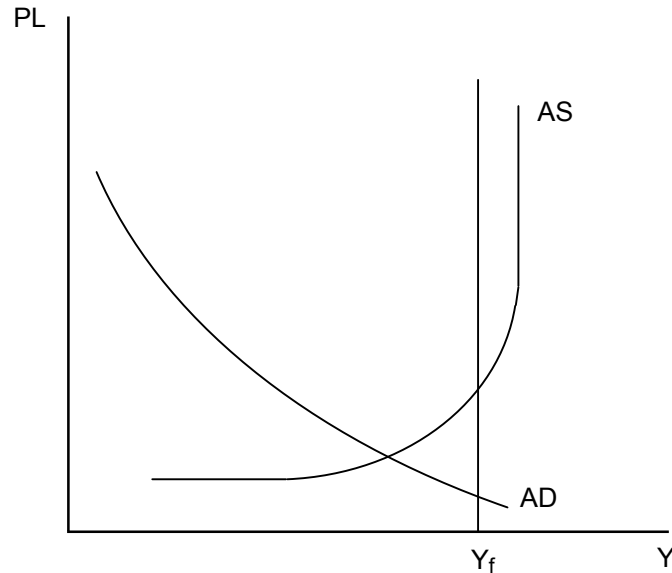


Review Exercise

1. Complete the following glossary:
 - (a) Aggregate economic activity refers to national output and _____ and _____ and _____.
 - (b) Monetary policy is the control of _____ and _____ and _____ to influence economic activity.
 - (c) A contractionary monetary policy aims to _____ aggregate demand and economic activity usually to control _____.
 - (d) An expansionary monetary policy aims to _____ aggregate demand and economic activity usually to increase _____ and _____.
 - (e) A contractionary monetary policy would involve _____ interest rates and _____ the money supply and credit. This should _____ aggregate demand.
 - (f) An expansionary monetary policy would involve _____ interest rates and _____ the money supply and credit to _____ aggregate demand.

2. The AD/AS model below shows the equilibrium for an economy.

AD/AS Model



- (a) Label the equilibrium and situation for this economy.
- (b) Circle the likely policy objective for the government in this situation:

Reduce Unemployment

Control Inflation

- (c) Circle the type of monetary policy most appropriate in such a situation:

Contractionary

Expansionary

- (d) What should be done to:

- (i) Money supply?

(ii) Credit (lending)?

(iii) Interest rates?

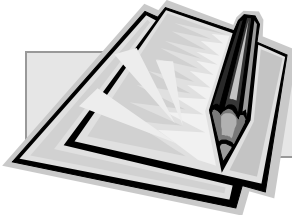
(e) How would these changes affect:

(i) Consumption spending?

(ii) Investment spending?

(iii) Aggregate demand?

(f) Draw and label the change on the AD/AS model on the previous page.



Reading (or Listening) Comprehension Activity

The following passage outlines a key battle in Economic thinking about the role of government in determining aggregate economic activity.

Read the passage and complete the true/false comprehension quiz.

Keynesian v Monetarist Economics

By the late 1970s Keynesian economic policies that had been used since WW2 in many countries were proving ineffective. Countries were experiencing rising inflation and unemployment and low or no economic growth. The traditional Keynesian recipe for controlling unemployment by increasing government spending was not working. It was creating more inflation and public debt.

From the 1980s a school of economic thinking called monetarism emerged to replace Keynesian policy in many countries including New Zealand.

Monetarists led by Milton Freidman were strong believers in the neoclassical view that markets should be allowed to operate freely to achieve efficiency. The outcome would be beneficial at both micro and macro level. Remember neoclassical economists believed that the economy will always tend to full employment output.

The monetarists believe that the key role of government should be to control the money supply and credit to ensure low or no inflation.

The Quantity Theory Of Money (Fisher Formula)

Monetarism is based on a formula called the quantity theory of money developed by Irving Fisher in the 1920s.

$$MV = PQ$$

where:

- M** is the quantity of money in an economy (M_1).
- V** is the velocity of circulation, i.e. how fast money changes hands.
- P** is the general price level.
- Q** is quantity of goods and services produced, i.e. real GDP.

(PQ is the same as nominal GDP).

Monetarists believe that the velocity of circulation is fairly constant and the economy tends to full employment. This means if money supply increases by 10% this will eventually cause price level to rise by 10% (inflation).

Friedman's Golden Rule

Friedman's golden rule was that the growth in the money supply should only keep pace with the growth in output. This would ensure there was enough lubricant for transactions to occur but not too much to cause inflation.

Over the past 20 years New Zealand has followed the monetarist prescription with the introduction of the Reserve Bank Act in 1989. This has meant controlling interest rates, money supply and credit to control inflation. This has been the main target of aggregate economic policy in New Zealand.

Comprehension Quiz

State whether the following statements are true or false.

- | | | |
|--|----------------------------------|-----------------------------------|
| 1. Keynesian policy aimed to reduce unemployment during a recession through increased government spending. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 2. By the late 1970s many economies were experiencing rising inflation and falling unemployment. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 3. Monetarists believe controlling unemployment should be the key target of economic policy. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 4. Monetarist believe markets are the most efficient means of allocating resources. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 5. $MV = PQ$ is the quantity theory of money. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 6. V represents the value of money. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 7. Q is real GDP. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 8. PQ is the same as nominal GDP. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 9. Friedman believed governments should control M to control inflation. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 10. Friedman's rule was that M should only increase at the same rate as Q . | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 11. If the money supply increases faster than national output this will usually cause inflation. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |
| 12. New Zealand currently follows Keynesian policies aimed at full employment. | true
<input type="checkbox"/> | false
<input type="checkbox"/> |

Monetary Policy and the Reserve Bank in New Zealand

The Reserve (Central) Bank has the responsibility for implementing monetary policy in New Zealand. Under the 1989 Reserve Bank Act the Reserve Bank was given independence from political interference to operate monetary policy to control inflation.

Under the Act the Reserve Bank has a Policy Target Agreement (PTA) with the government to control inflation. At present this agreement states that the Reserve Bank must keep inflation between 1 to 3%.

Other roles of the Reserve bank are shown in the diagram below:



To see how the Reserve Bank operates monetary policy it is necessary to have an understanding of how money and credit are created.

The Biggest Confidence Trick of all Time - The Creation of Money

The best way to understand the magic of money is to follow a new country starting its money system from the beginning.

The country of Navarnia is a wine growing island in the Hauraki Gulf that has just gained independence from Zealandia. The government of Navarnia decides to set up its own money system.

It establishes a Central (Reserve) Bank to operate the money system. Private banks must register with the Central Bank to operate in Navarnia.

The Reserve Bank arranges for the new currency to be printed. It then lends the new money to the government in exchange for an IOU (Treasury Bill).

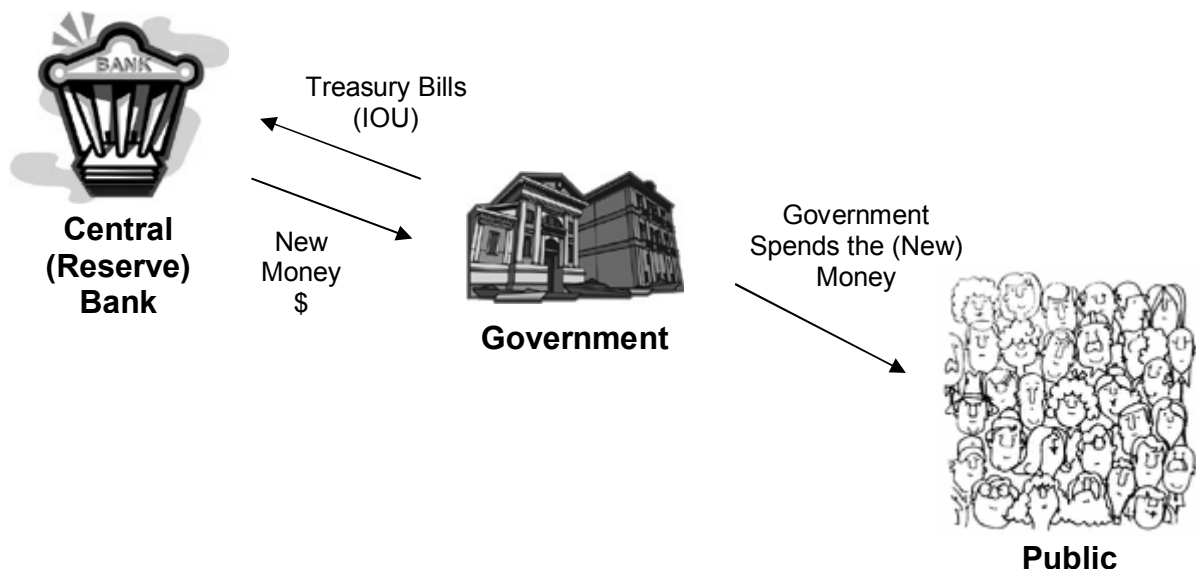
Navarnia now has its own money.

The government starts spending the new money on teachers, police, roads, hospitals and benefits.

The new money is now in circulation.

A Primary expansion of the money supply is when a government borrows from the Central Bank and spends the new money.

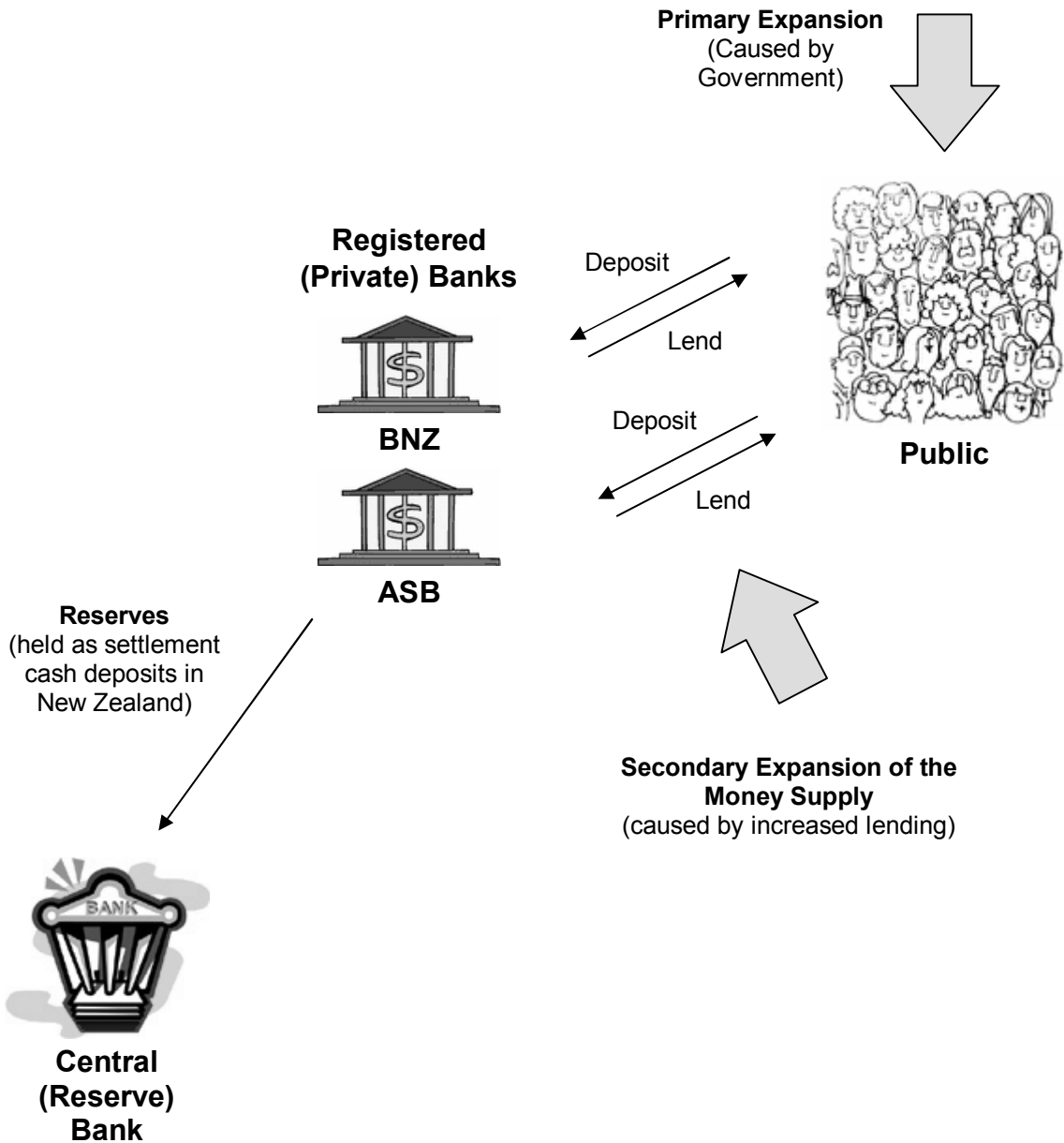
A Primary Expansion of the Money Supply (How New Money is Created)



The people of Navarnia eventually deposit the new money with the registered (private) banks. The banks hold some of the deposits back with the Central Bank as reserves. This is to cover withdrawals (which hopefully won't all happen at the same time). They lend the rest out.

A secondary expansion of the money supply is caused by an increase in bank lending (credit creation process)

A Secondary Expansion of the Money Supply



So now there is more money in the economy. People still have their deposited money but there is also new loans (credit).

These loans will be spent and eventually deposited with the banks again. This allows them to lend out more money.

If you think this is a confidence trick, it is. The trick only works if people with deposits in the banks believe they can get their money back whenever they want. This is impossible if they all want their money at the same time.

A banker's worst nightmare is when people lose confidence in the banking system and demand their money back at the same time. The credit crunch in 2008 nearly caused this to happen in many countries.

A secondary expansion of the money supply is the result of a primary expansion. The new deposits allow the banks to increase their lending (credit). The increase in credit due to bank lending is called the credit creation process.

Primary Expansion of Money Supply

When the government borrows from the central bank and spends it. New money is created.

Secondary Expansion (Credit Creation Process)

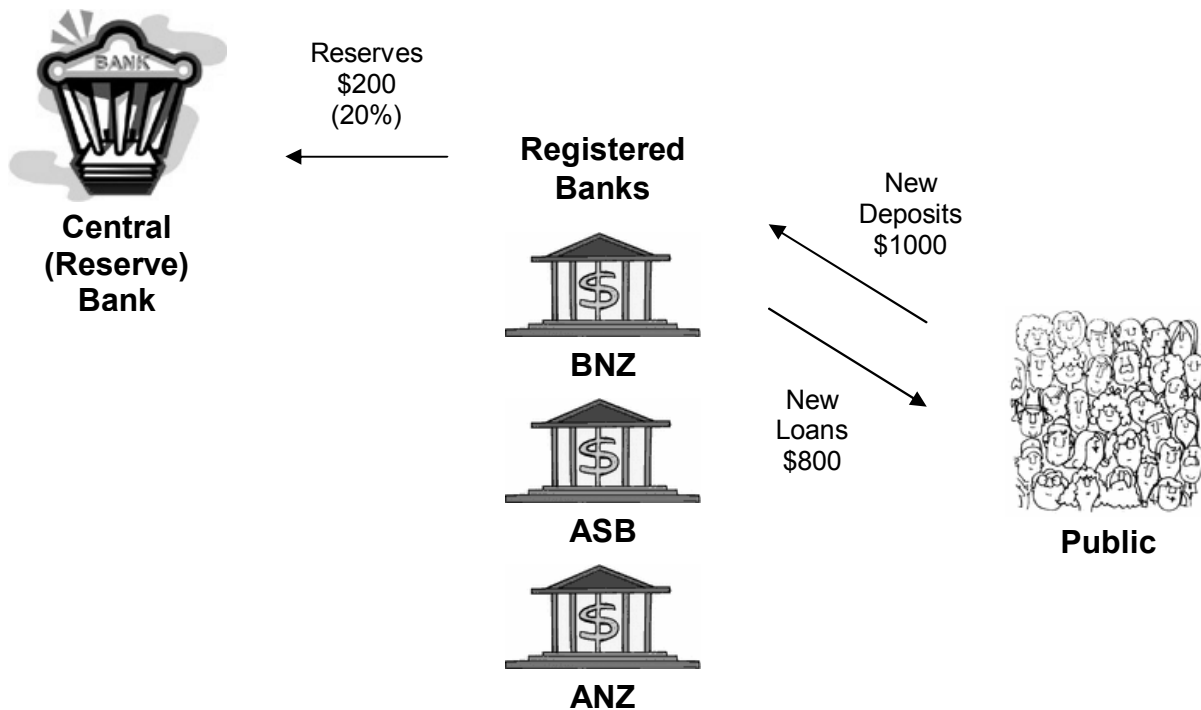
When a primary expansion of money allows banks and other financial institutions to increase their lending.

Calculating Changes in Money Supply and Credit – The Credit Multiplier

A primary expansion allows a secondary expansion of the money supply because it lets banks increase their lending.

The amount of new lending will be affected by the fraction of deposits that the banks hold back as reserves. The higher the fraction of reserves, the smaller the overall expansion of the money supply.

Diagram Showing Impact of Reserves on Lending



Settlement Cash Deposits

In New Zealand the reserves held by registered banks with the Reserve Bank are called settlement cash deposits. These deposits play a key role in the operation of monetary policy in New Zealand.

The banks must keep a positive balance in these settlement cash deposits to meet withdrawals. The Reserve Bank can influence the level of settlement cash deposits by using monetary policy. This allows it to control the amount of lending in the economy.

Credit Multiplier

The credit multiplier is used to calculate the overall growth in the money supply due to a primary expansion.

$$\text{Credit Multiplier } k = 1/r$$

where:

r is the fraction of deposits held as reserves.

Example

A government borrows \$50 million from the Reserve Bank and spends it. (Primary expansion \$50 million).

The new money is eventually deposited with the banks. This allows them to increase their lending. They hold back 20% of deposits as reserves.

$$\text{Credit multiplier} = 1/0.2 = 5.$$

Therefore the \$50 million primary expansion will cause the money supply to increase by \$250 million (50×5).

New money is \$50 million.

New lending (advances or credit) is \$200 million.



Review Exercise

1. Complete the following glossary:
 - (a) _____ is the control of money supply, credit and interest rates to influence aggregate economic activity.
 - (b) _____ is the agency responsible for operating monetary policy in New Zealand.
 - (c) _____ is any item used as a medium of exchange.
 - (d) _____ is the agreement between the government and the Reserve Bank to keep inflation between 1-3%.
 - (e) _____ is the portion of bank deposits that are kept with the Reserve Bank as settlement cash.
 - (f) _____ occurs when a government borrows from the Central Bank and spends the money.
 - (g) _____ refers to a secondary expansion of the money supply due to increased bank lending.

2. Classify the following items as **M1**, **M2**, **M3** or **not money**:

- (a) An ASB 2 year term deposit. _____
- (b) A savings account operated by Eftpos. _____
- (c) A cheque account. _____
- (d) Notes and coins. _____
- (e) A credit card. _____
- (f) Gold bullion. _____
- (g) A 3 year deposit with a finance company. _____

3. Complete the following passage:

The Reserve Bank in New Zealand is responsible for operating _____ policy. It has a contract with the government called the _____ under which it must keep inflation between _____. The Reserve Bank operates independently from political control under the _____ Act of 1989.

The Reserve Bank also issues _____. It is also responsible for _____ the financial sector to ensure that banks are operating in a prudent (safe) manner.

4. Complete the following passage explaining how money and credit are created:

A primary expansion of the money supply occurs when the government borrows from the _____ and spends it.

This creates new _____ at the registered banks in an economy. The banks keep some of the deposits as _____ and _____ the rest out.

The increased lending by the banks is called the _____ process or _____ expansion. The size of the overall increase in the money supply is determined by the proportion of deposits that are held as _____. The formula used to calculate the overall increase in money supply is called the _____.

5. Banks hold 25% of deposits as reserves. The government borrows \$40 million from the Reserve bank and spends it:

(a) What is the value of the credit multiplier?

(b) Calculate the overall increase in the money supply.

(c) Calculate the increase in lending (advances)

Monetary Policy in New Zealand

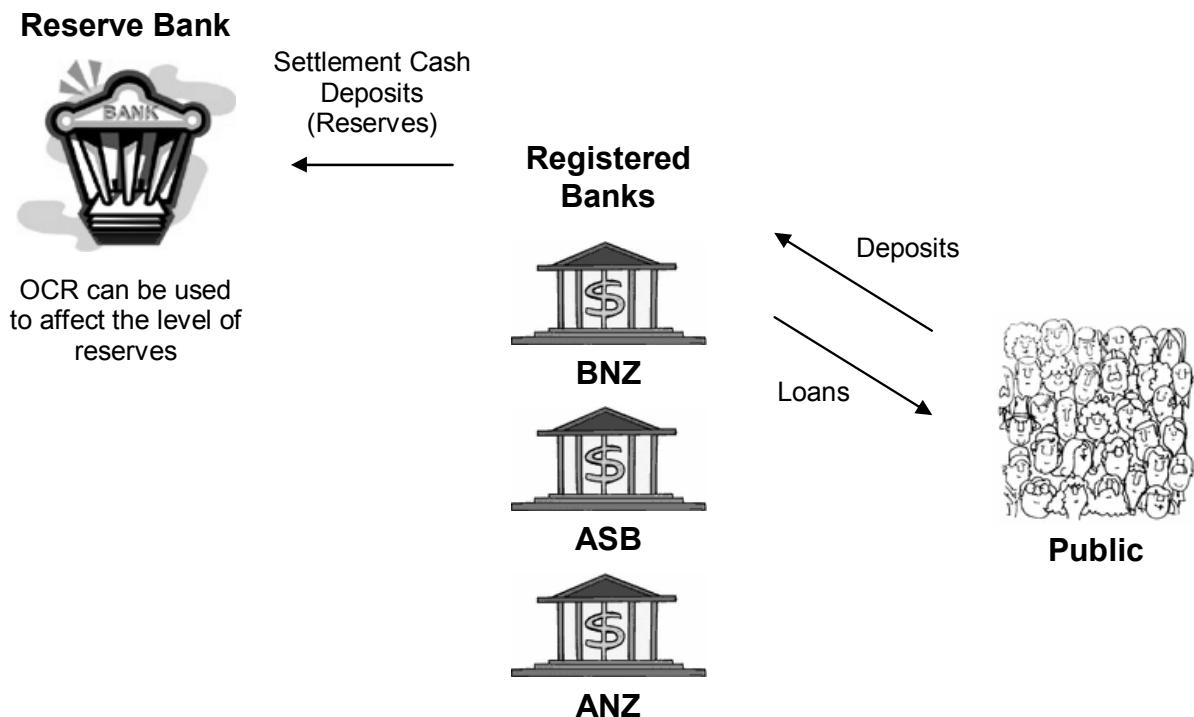
The Reserve Bank of New Zealand is responsible for keeping inflation between 1 to 3% under its policy target agreement with the government. It does this by using monetary policy to control the level of money, credit and interest rates in the economy.

The Official Cash Rate (OCR)

The main tool of the Reserve Bank is the OCR. This is the interest rate on the settlement cash deposits that the registered banks hold as reserves with the Reserve Bank.

If the Reserve bank is concerned about inflation it will increase the OCR causing the banks to hold more reserves therefore decreasing their lending.

Diagram of NZ Banking System



The Operation of Monetary Policy

Reserve Bank must keep inflation between 1-3 %
(Policy Target Agreement)



If the Reserve Bank is concerned about inflation it increases the OCR.
This is a **contractionary** monetary policy



The registered banks hold more reserves as settlement cash deposits
with the Reserve Bank



Less lending available



Interest rates (mortgages, personal loans etc) rise



Consumption spending falls (increase saving and less borrowing)



Investment spending falls because it is more expensive to borrow



The exchange rate appreciates because people want to buy NZ dollars
to get the higher interest rates. The higher exchange rate causes net
exports (X-M) to fall

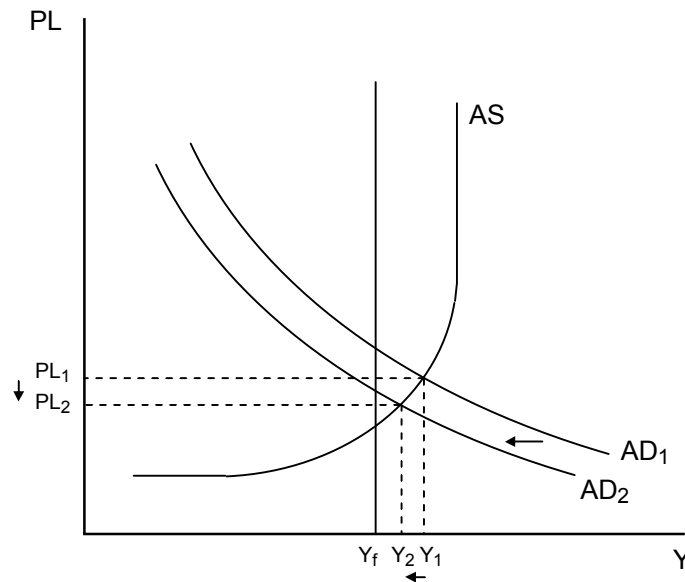


Aggregate demand falls (C, I, X-M fall)



Firms are unlikely to increase their prices so inflation falls

The Effects of a (Contractionary) Monetary Policy on the AD/AS Model



Contractionary Monetary Policy → AD falls → Less Inflation

Other Tools That Can be Used by the Reserve Bank for Monetary Policy

- Open market operations are when the Reserve Bank buys and sells Reserve Bank Bills (IOUs) to the financial sector. If it sells these bills it is soaking up money from the economy. The banks and other institutions buy these bills because of the yield (return) on them. Selling Reserve Bank Bills reduces the money supply and causes interest rates to rise. This would indicate a contractionary monetary policy.
- Jawboning is when the Reserve Bank Governor tries to talk the financial markets into raising or lowering interest rates or their lending. In recent years the Governor has tried to use jawboning to talk down the value of the New Zealand dollar in the foreign exchange markets. So far he has had little success.
- Buying and selling New Zealand dollars in the foreign exchange market. The exchange rate has a major effect on aggregate demand through its impact on net exports. In recent years the Reserve Bank has been concerned about the high value of our exchange rate harming our exporters. A higher exchange rate for the New Zealand dollar makes our exports less competitive overseas. It has taken the unusual step of selling New Zealand dollars in the Forex market to try to drive down the value of our dollar. It has had little success so far.

Why Target Inflation?

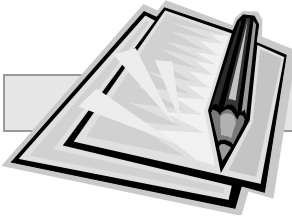
High rates of inflation are generally regarded as harmful because they distort price signals. People put money in speculative assets such as property or gold to try to keep its value. This discourages investment in productive assets such as factories and machinery.

High rates of inflation cause people to lose trust in a currency. This has occurred in Zimbabwe in recent years. Governments can print money in the short term to pay their bills but people quickly realise what is happening. They start refusing to use the currency as a medium of exchange. This can cause trade and output to fall.

Economists disagree on what level of inflation is tolerable. Most believe somewhere under 5% is desirable. If people build higher rates of inflation into their expectations they will start demanding higher wages leading to a wage price spiral as occurred during the 1970s.

Why Not Aim for Zero Inflation?

New Zealand has an inflation target of 1-3%. The reason we don't aim for 0% is that being too strict on inflation could lead to deflation which is more harmful. Also the main tool for measuring inflation is the Consumer Price Index. It is not perfectly accurate in measuring changes in the general price level so being too staunch would be pointless. It is important to have a degree of flexibility.



Chapter Review Exercise

1. Complete the following glossary:
 - (a) _____ is the control of the money supply, credit and interest rates to influence economic activity.
 - (b) _____ is when a central bank cuts interest rates and increases the money supply and credit to increase aggregate demand.
 - (c) _____ is when a central bank increases interest rates and reduces the money supply and credit to reduce aggregate demand.
 - (d) _____ is the interest rate set by the Reserve Bank in operating monetary policy in New Zealand.
 - (e) _____ is the term for reserves held by the registered banks with the Reserve bank.
 - (f) _____ is the type of monetary policy aimed at controlling inflation.
 - (g) _____ is the type of monetary policy aimed at reducing unemployment and increasing national output.

2. Put the following steps in order to show how the Reserve Bank uses monetary policy to control inflation in New Zealand.

	Number from 1 to 8 in order of sequence
Banks will hold more settlement cash deposits (reserves).	
The funds available for lending will decrease.	
The Reserve bank must keep inflation between 1 to 3%.	
C, I and X-M will fall.	
Interest rates will increase.	
If the Reserve bank is concerned about inflation it will increase the OCR.	
AD will fall.	
Firms will be less likely to increase their prices.	

3. Complete the passage to explain how the Reserve Bank uses monetary policy to decrease the effects of a recession.

A recession is defined as two consecutive quarters (6 months) of _____ . Other features of a recession are _____ unemployment and _____ aggregate demand.

During a recession the Reserve bank would usually _____ the OCR. This represents an _____ monetary policy. This would encourage registered banks to hold _____ settlement cash deposits. This would cause lending to _____ and interest rates in the economy to _____ .

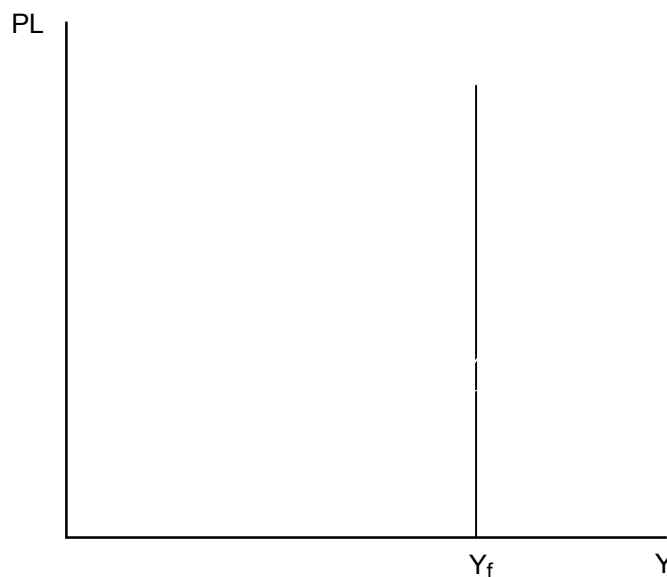
Lower interest rates should cause consumption spending to _____ because _____ .
 Investment spending should _____ because _____ .
 _____ .

Lower interest rates should cause the exchange rate for the NZ dollar to _____ . This should cause net exports to _____ .

An expansionary monetary policy is aimed at _____ aggregate demand. This should _____ unemployment and _____ national output during a recession

4. On the axis below draw an AD curve showing an economy with a large recessionary gap.

AD/AS Model



5. Show on your axis above the effect of an expansionary monetary policy.
6. What has happened to:
- (a) National output? _____
- (b) Unemployment? _____
- (c) Inflation? _____
7. Explain why an expansionary monetary policy may not cause inflation during a recession.
