

REVIEW OF MONETARY AND ECONOMIC CONDITIONS

In this article, prepared by Terry Creighton, Andrew Bascand and Sarah Devine, monetary and economic indicators between 1 November and 28 February are reviewed.

EXECUTIVE SUMMARY

The movements in monetary indicators which occurred over the review period once again highlighted the importance of interpreting these movements in the light of other relevant information. Although the interest rate yield gap narrowed considerably over the review period until mid-January, this narrowing was not interpreted by the Bank as signalling an easing in the stance of monetary policy. There was no accompanying fall in the exchange rate and real interest rates remained high. Rather, the fall in the interest rate yield gap was viewed as a counterpart to the rise in 5-year bond rates caused by the policy uncertainty arising from political tensions. Even though 5-year bond rates eased after the dismissal/resignation of the Hon. R.O. Douglas and appointment of the Hon. D. Caygill as Finance Minister, these rates nevertheless remained considerably higher during the first half of January than they had been during the previous review period.

In late January, however, declines in interest rates, the yield gap and the exchange rate following statements by the Minister of Finance and the Prime Minister were interpreted as an expected near-term easing in monetary conditions. While many financial market participants inferred from these statements that a monetary policy U-turn was about to occur, the Minister of Finance and Prime Minister subsequently made it clear that they had not intended to signal any policy reversal. To underline the fact that no change in policy was intended, the Bank adopted a relatively firm stance in its Open Market Operations in early February, thereby signalling to the financial markets that the firm monetary policy stance would remain in place.

Further progress in reducing inflation became apparent over the review period, with the increase in the CPI falling to 4.7 per cent in the year to December. This annual inflation rate is the lowest (excluding only two quarters during the wage and price freeze) since the increase of 4 per cent recorded some 19 years ago. Inflation expectations, however, were virtually unchanged between the September and December quarters.

Real economy statistics released over the review period suggested that domestic demand bottomed out in the September quarter and tentatively began to grow again in the December quarter. Consumption and residential investment expenditures now appear to be rising while the indicators with respect to business investment remain mixed. While expectations of future business conditions have been positive since the September quarter, this development has yet to be reflected in investment and employment intentions.

Even though monetary conditions have appeared easier over the past two review periods, the Bank nevertheless considers that monetary conditions remain consistent with the disinflationary stance of monetary policy. With more information now available on the depth of the recession in the June and September quarters, it is now apparent that monetary conditions were somewhat firmer than necessary during April-August 1988. Since August, the continued weakness of domestic demand has minimised the risk that the easier liquidity conditions could pose for further inflation reductions, particularly given the ongoing high level of real interest rates.

The potential for monetary indicators to vary markedly, despite an unchanged monetary policy stance and constant instrument settings, was again amply demonstrated over the review period. This potential has been a dominant theme over the past year as both the recession in the real economy, and the political fall out over social policy, have impacted significantly on monetary indicators. Indeed, these events have reinforced the necessity of taking into account developments in both the real economy and the political arena

when attempting to assess the current state of monetary conditions.

In earlier review articles it has been noted that the state of the real economy is crucial to an assessment of monetary conditions. Notably, that in a recessionary environment, such as the one which has been evident since the September quarter 1987, any particular configuration of monetary indicators is likely to be suggestive of firmer monetary conditions and a more rapid pace of disinflation than would have been the case in a more buoyant economy.

Consequently the Bank has accepted some easing in the monetary indicators as consistent with a continuing firm stance of monetary policy. Another factor which proved to be particularly important in interpreting monetary indicators over the review period was political uncertainty. An increase in political uncertainty tends to reduce the yield gap and depress the exchange rate, even though no change has occurred in the degree of monetary policy pressure.

Movements in monetary indi-

cators over the review period are assessed in this article in the light of the state of the real economy and political developments. Financial indicator movements are examined in the next section of the article, followed by a review of inflation and real economy developments. The article then concludes with an overall assessment of conditions over the review period.

Developments in Monetary Indicators

Monetary indicators remained relatively stable following the political and policy uncertainty over late August and early September which was associated with the Labour Party Conference and the Cabinet reshuffle. Despite the appearance of calm, however, considerable turbulence still lay beneath the political water and this surfaced dramatically over the review period. Political developments over the November 1988 to January 1989 period were the major factor influencing monetary indicators through their impact on expectations of future fiscal and monetary policies, and hence inflation expectations and the future path of the exchange rate and interest rates.

Interest Rates

It was upon long-term interest rates that the political events of the period had the greatest impact. Five-year government stock rates had traded in a relatively narrow range over the seven months to November 1988, showing considerable resistance to falling below the 12.9 per cent level, despite significant falls in both actual inflation and inflation expectations over the period. This resistance was attributable to a number of factors, including negative sentiment surrounding proposed SOE debt funding programmes, doubts about the Government's commitment to the asset sales programme, the impact of superannuation and life insurance reforms, and more general concerns over fiscal and political prospects.

Against this background the news

Figure 1
Interest Rates
government stock and bank bill rates

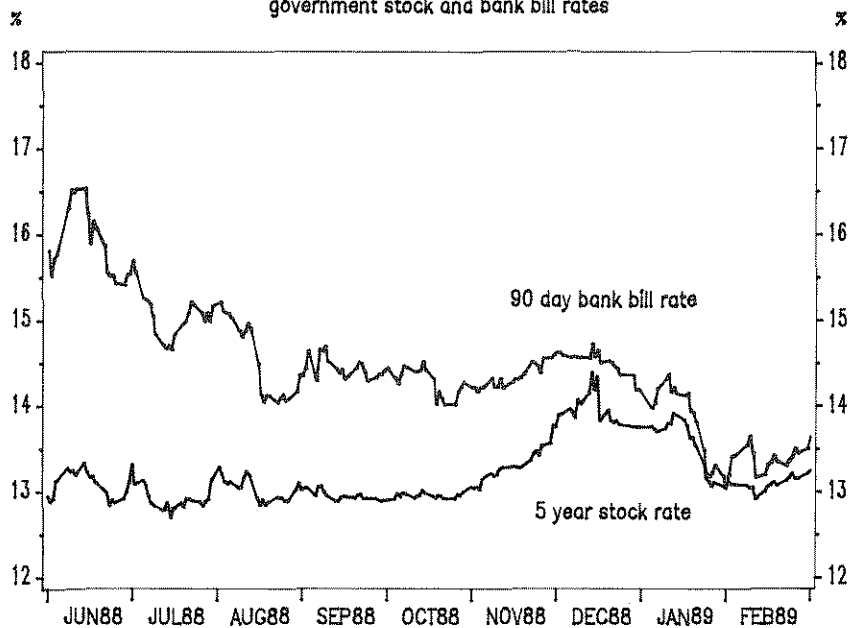
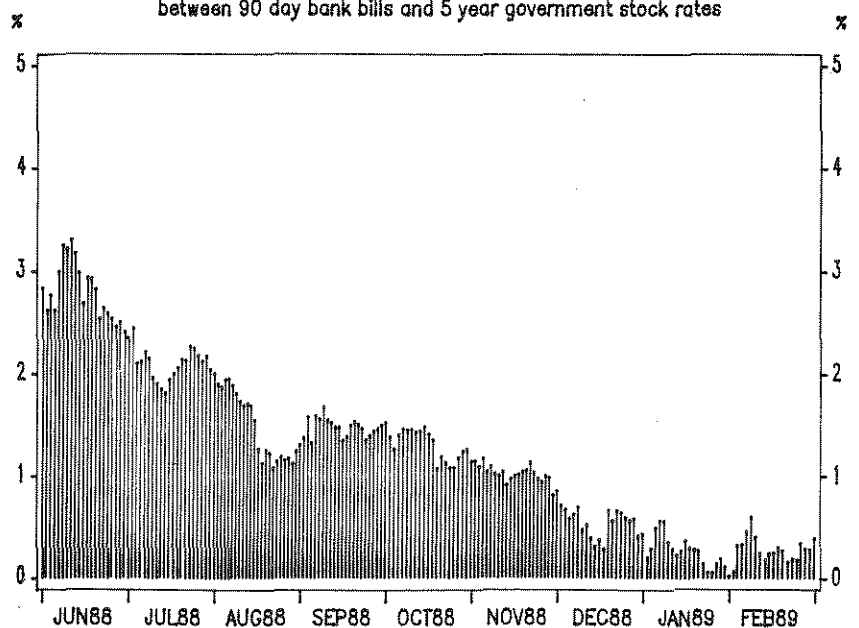


Figure 2
Yield Gap
between 90 day bank bills and 5 year government stock rates



of the Hon. Richard Prebble's dismissal on 4-5 November triggered a rising trend in 5-year stock rates which was sustained through to mid-December as heightening uncertainty over fiscal and political prospects put further pressure on the already thin bond market (see figure 1). By 13 December, 5-year stock rates had climbed to 14.4 per cent, their highest level since February 1988. Short-term interest rates rose only slightly over this period largely in response to short-term liquidity considerations and, consequently, the yield gap narrowed sharply from 1.2 percentage points on 4 November to 0.3 percentage points by 13 December (see figure 2).

The dismissal of the Minister of Finance, the Hon. R.O. Douglas, on 14 December triggered an additional, though short-lived, increase in interest rates. The sharp rise in interest rates which immediately followed the announcement of Roger Douglas' dismissal suggests that the market was reacting to the likelihood that the change in Finance Minister may have heralded a change in policy approach. The reassurances made later that day by the new Minister of Finance, reaffirming the Government's commitment to the objectives of price stability by the early 1990s and the elimination of the fiscal deficit by 1990/91 appeared to restore considerable confidence to the market. Interest rates fell sharply over the following two days and continued to ease further following the announcement of the Reserve Bank's bond repurchase programme on 19 December and the confirmation of the Postbank and Air New Zealand sales on 21 December.

Statements by the Minister of Finance, the Associate Minister of Finance and the Prime Minister over 20-23 January expressing the desirability of lower interest rates and a lower exchange rate accelerated the easing trend which had been emerging with returning confidence, causing a sharp fall in interest rates. Five-year stock rates fell by around 0.5 percentage points to 13.1 per cent

on 26 January, while 90-day bill rates fell 0.6 percentage points to 13.2 per cent over the same period. Consequently the yield curve flattened even further, with the yield gap reaching a low of 0.1 percentage point on 26 January.

The observed interest rate reaction and associated market comment suggested that the Ministerial statements of 20-23 January were taken to signal an easing in the policy stance and a shift away from the goal of price stability towards a primary focus on short-term employment objectives. The Bank acted to correct this misunderstanding by taking a firm stance in its open market operations (OMOs) in early February. This stance put some upward pressure on short-term interest rates, and with increasing concerns about fiscal prospects for 1989/90, 5-year stock rates also moved on a slightly rising trend over most of February.

Movements in bank lending rates over the review period reflected changes in short-term funding costs. Bank lending rates rose marginally in December following sustained increases in wholesale interest rates

since the beginning of the period; the average base lending rate rose by 0.3 percentage points to 16.3 per cent and new first mortgage rates rose by 0.2 percentage points to an average of 15.7 per cent (see figure 3). The subsequent decline in wholesale rates over the second half of the review period has seen average base lending rates ease back to 15.8 per cent but first mortgage rates have yet to decline.

Exchange Rate

The New Zealand dollar, like short-term interest rates, displayed considerable stability over the first six weeks of the review period, despite the growing political and economic uncertainty which dominated the behaviour of the other monetary indicators. The New Zealand dollar had been trading in a range of 60.2-60.5 on the Bank's trade weighted index (TWI) in the week prior to Richard Prebble's dismissal. Following that event the exchange rate dropped briefly below 60 on the TWI (see figure 4). However, the exchange rate remained remarkably stable throughout the following four

Figure 3
Average base lending rates
and first mortgage housing lending rates

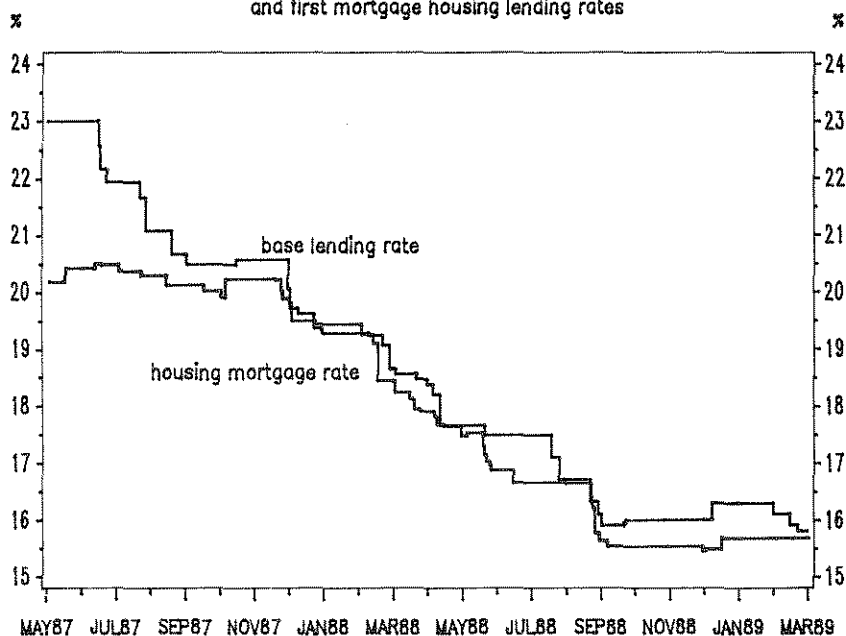


Figure 4
Nominal Exchange Rate
 (daily foreign exchange trade weighted index)
 (June 1979 = 100)



weeks to 13 December, trading in a range of 60.1 – 61.2 on the TWI. This stability appears to have been due to rising interest rates having offset any downward pressure on the exchange rate which arose from growing political uncertainty over the period.

The reallocation of the finance portfolio, on 14 December, saw the exchange rate fall sharply in the following 24 hours with the New Zealand dollar depreciating by around 5-6 per cent against the United States dollar to approximately US60-61 cents and the TWI dropping around 4 per cent to 58.0. The New Zealand dollar then recovered steadily over the following week in response to the reaffirmation of the Government's commitment to its stated policy objectives. By 22 December the New Zealand dollar had reached US63.8 cents and 60.6 on the TWI. The currency then displayed considerable stability over the following four weeks, despite falling domestic interest rates, and strong increases in Australian interest rates.

However, the exchange rate fell

by a sharp 3.8 per cent to 58 on the TWI on 26 January following the Minister of Finance's and the Prime Minister's comments on the desirability of lower interest rates. While the exchange rate rallied slightly over the following week, the TWI fell back to 57.5 by 1 February; in addition to the effect on the exchange rate of the Ministerial comments, there was also further pressure from rising Australian interest rates and a strengthening Australian dollar. The Bank's open market operations stance in early February, which signalled to the market that monetary policy would remain firm, triggered a recovery in the exchange rate. The New Zealand dollar then rose steadily over the month to reach 61 on the Bank's index by 28 February.

Money and Credit Aggregates

Low rates of growth in M3 continued over the December quarter while private sector credit (PSC) growth declined to more satisfactory levels. Average monthly seasonally

adjusted (s.a.) growth rates in both M3 and PSC over the December quarter were slightly below zero, which represented a small decline in M3 growth but a marked drop from the 1.4 per cent (average monthly s.a.) PSC growth rate over the September quarter (see table 1). Despite the low rate of PSC growth over the December quarter, the annual growth rate for PSC in 1988 was, at 9.2 per cent (see figure 5) still high given the weak state of the domestic economy and inflation below 5 per cent. There are, however, several factors which help to explain this apparently high growth rate.

Lending to SOEs, particularly to fund the purchase of their assets from the Government, appears to have been a significant contributor to PSC growth over the December 1988 year. SOE asset purchases are a capital transaction and as such do not have domestic expenditure implications. Thus, to the extent that lending to the SOEs was for this purpose, PSC was inflated relative to final expenditure.

In addition, reintermediation has also boosted PSC over the year. One example was the shifting of a large parcel of loans to the books of an M3 institution from those of its non-M3 parent in September, which increased both PSC and M3 by around 0.4 percentage points.

Finally, the sharp increase in the residual item in the aggregates over the December quarter (an increase largely reflecting recording problems in the returns) indicates that either PSC growth was overstated or M3 growth was understated. This recording problem appears to have been largely, if not entirely, overcome in the January aggregates; PSC fell 0.6 per cent (seasonally adjusted) over January, while M3 rose 2.3 per cent, taking the annual growth rates in PSC and M3 to 7 per cent and 6.9 per cent, respectively.

Allowing for these factors and noting that other countries, such as the United Kingdom, continued to experience high increases in measured credit growth despite low rates of inflation, suggests that PSC

Table 1
Monetary Aggregates: Growth Rates

	M3			PSC		
	Year to year % change	Monthly seas. adj. Change	Quarterly Average Growth Rate (seas. adj.)	Year to year % change	Monthly seas. adj. Change	Quarterly Average Growth Rate (seas. adj.)
1988						
Jan	13.3	0.3		16.6	0.9	
Feb	13.1	1.0		18.0	1.4	
Mar	16.1	1.3	2.6	18.0	3.2	5.5
Apr	13.5	0.3		12.8	-2.4	
May	10.7	0.0		12.8	0.9	
Jun	10.5	1.0	1.3	11.7	0.9	-0.7
Jul	12.3	1.3		13.5	1.8	
Aug	9.9	0.4		12.3	0.9	
Sep	9.4	0.0	1.7	13.2	1.3	4.1
Oct	7.3	-0.6		9.8	-0.7	
Nov	4.8	-1.1		9.8	0.4	
Dec	3.1	-0.9	-2.6	9.2	0.2	-0.1
1989						
Jan	6.9	2.3		7.0	-0.6	

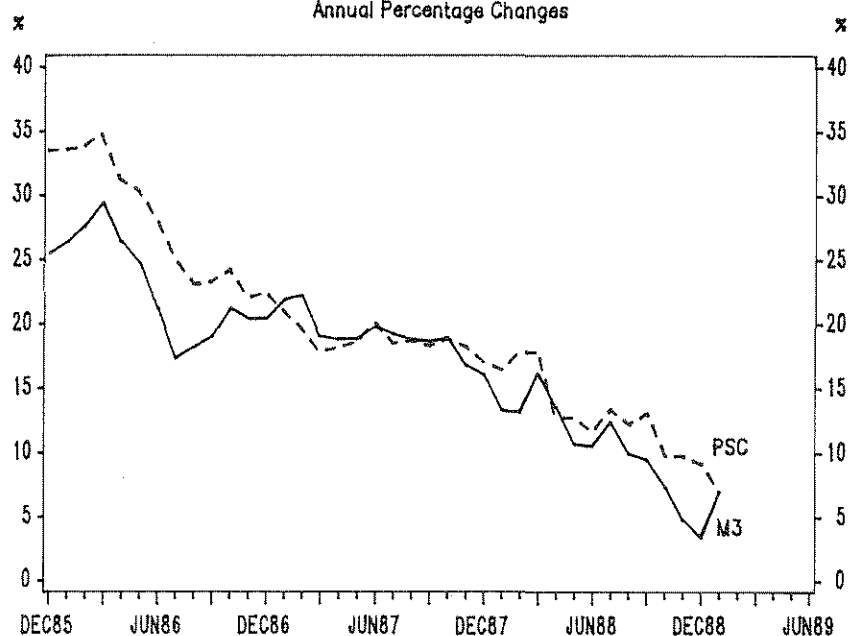
growth over 1988 may not have been excessive.

Inflation and Real Sector Developments

Several indicators released over the review period suggest that the New Zealand economy has passed through the extended trough period which followed in the wake of the October 1987 stockmarket crash and that a gradual recovery in aggregate activity commenced in the December quarter of 1988. Indeed, on an expenditure basis, the level of aggregate activity (i.e. GDP) in the 1988/89 March year is now expected to have risen slightly on the 1987/88 year out-turn, mainly reflecting a strong contribution to growth from the export sector.

While aggregate activity may have lifted on average over the past four quarters, domestic demand remained very weak up until the December quarter 1988. In particular, on the back of a rise in household savings and continued high real interest rates, private consumption and aggregate investment expenditures declined in each of the June

Figure 5
Money and Credit Aggregates
Annual Percentage Changes



and September quarters. More recent indicators of private consumption and residential investment have, however, provided signs of an improvement in activity levels. As a consequence, domestic demand is now estimated to have recovered slightly over the December quarter, although the levels of both consumption and investment expenditures remain below those of the March quarter 1988.

Although it seems likely that aggregate economic activity has emerged from its trough, the labour market situation has continued to deteriorate over the review period. The combined influence of restructuring in both the public and private sectors, rising real product wages over the past three years and the downturn in economic activity over 1987/88, has resulted in a sharp reduction in the level of employment over 1988 with its consequences for registered unemployment numbers being particularly evident over the review period.

Inflation

Further progress towards lowering consumer price inflation was made with the December quarter CPI out-turn of 1.2 per cent. The December 1988 quarter outcome, resulting in an annual rate of increase of 4.7 per cent, is the lowest annual increase in the Consumers Price Index (CPI) (excluding only two quarters during the wage and price freeze), since the increase of 4 per cent recorded some 19 years ago (see figure 6). The most significant contributions to the December quarter out-turn included rises in telephone rentals; fresh fruit and vegetables; one third of the impact of the Budget night rise in tobacco excise taxes; increased new car prices; and continued rises in housing rentals, partly associated with public sector rental reviews (Housing Corporation and Railways Corporation). House prices also recorded a slight increase, but mortgage and car credit interest rates fell, as did used car, petrol and toll call prices.

Around one-quarter of the price

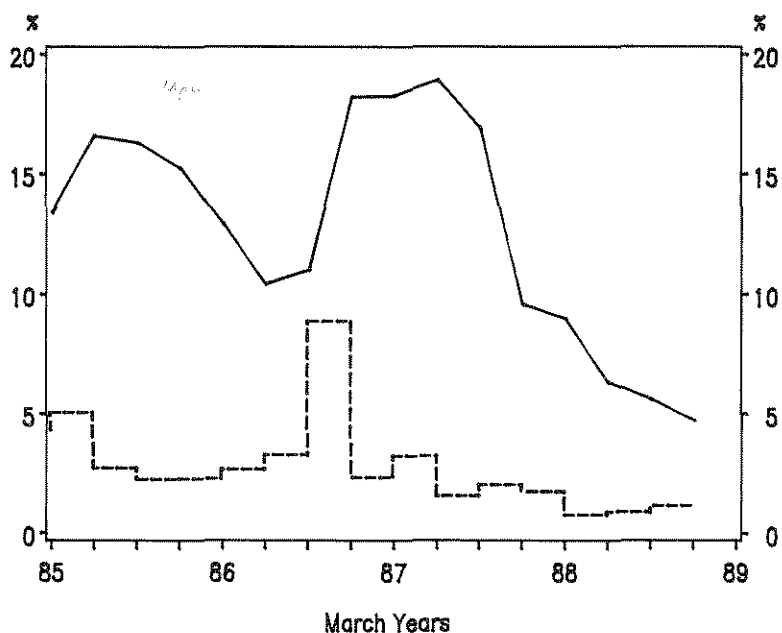
rises expected to result from the August depreciation are estimated to have been reflected in the December quarter CPI outcome. The flow through to consumer prices of rising commodity prices, reported in the September quarter Producers Price Index out-turn, also provided upward pressure on the December quarter CPI.

A further fall in the annual rate of inflation is expected in the year to March 1989, when the inflation rate is forecast to decline to around 4-4.5 per cent. This forecast is based on an estimated March quarter 1989 out-turn in the vicinity of 1-1.5 per cent. The relatively high forecast March out-turn reflects an allowance for the second step rise in tobacco taxes and for higher import prices feeding through from the August exchange rate decline. The further influence of these factors in the June quarter is expected to result in the annual inflation rate holding up at 4-5 per cent until September 1989.

Inflation is then expected to decline to around 3.5 per cent in the

Figure 6

Consumers Price Index
Annual and Quarterly Percentage Change



March 1990 year as the influence of the above mentioned one-off factors passes, tariff reductions continue to occur and growth in unit labour costs declines (as a result of the moderate 1988/89 wage round and further productivity improvements); this forecast assumes a stable nominal exchange rate at around 60 on the TWI and no increase in GST or other government taxes or levies.

Despite continued progress in reducing actual inflation and forecasts of sub-4 per cent inflation for the year ahead, business expectations of inflation remain at around 5 per cent; in the latest RBNZ Survey of Expectations (see page 48 of this *Bulletin*) inflation expectations for the year to December 1989 were 4.8 per cent, essentially the same as in the previous RBNZ Survey. The persistence of inflation expectations at rates above actual outcomes for the period concerned has continued to support real interest rates and hence to depress real activity (see page 52 of the Survey of Expectations article in this *Bulletin*).

Real Sector Developments

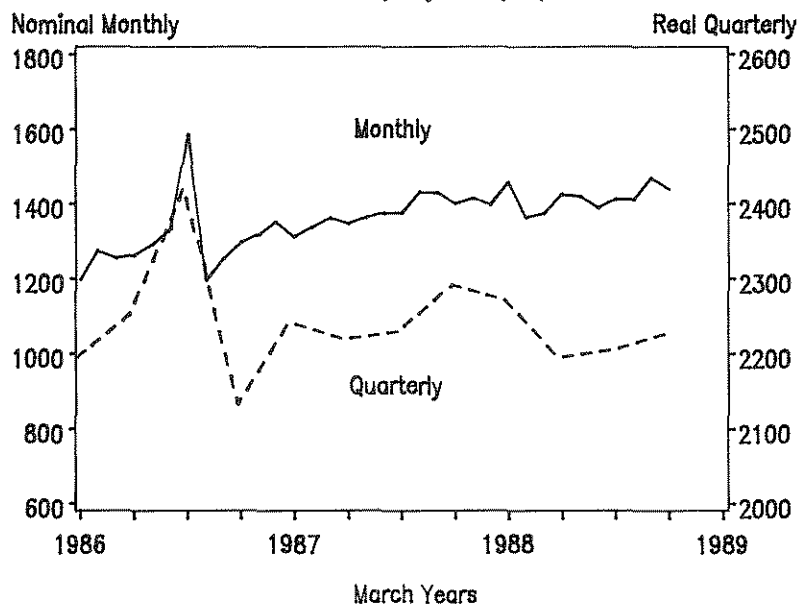
In the midst of a further reduction in inflation and an additional deterioration in registered unemployment, clear signs have emerged which portray an upturn in the aggregate level of economic activity. With respect to *private consumption*, real retail sales (seasonally adjusted and excluding motor vehicles) bottomed out in the September quarter and rose by around 1 per cent in the December quarter 1988 (see figure 7).

Further evidence of a rise in consumption expenditures over the December quarter was provided by car registration statistics, which recorded average monthly increases of over 15 per cent. Although part of this rapid growth in car registrations reflected the bringing forward of purchases to beat exchange rate depreciation related price rises and a continued rise in purchases of overseas sourced second hand cars, there has nevertheless been a recovery in underlying demand for new vehicles.

The modest rise in consumption over the last half of 1988 can be associated with a number of influences. In particular, real disposable incomes have improved over this period due to a rise in farm incomes, declines in mortgage servicing costs and the one-off wealth effects of redundancy payments. In addition, the 1 October tax cuts provided a stimulus to the spending power of some households.

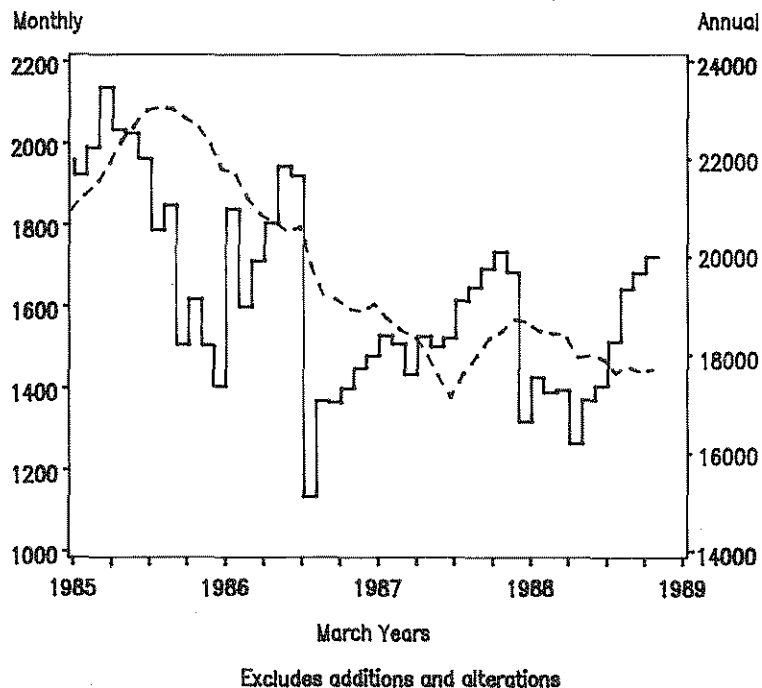
At the same time, however, a recovery in the household savings rate has taken place relative to 1987. This recovery probably reflects job security concerns, the rise in real post-tax interest rates and the need to rebuild savings in the wake of the 1987 sharemarket crash. As a result of this rise in the household savings ratio, private consumption is expected to decline (albeit slightly) in 1988/89 despite a modest increase in real household disposable incomes. The consumption profile is expected to be considerably stronger in 1989/90 reflecting a continued rise in household disposable incomes and a

Figure 7
Retail Trade (1)
Seasonally adjusted (\$m)



(1) : Retail sales excluding the automotive sector

Figure 8
Private Building Permits -- Dwellings



Excludes additions and alterations

slowing down in the rate at which savings are being rebuilt.

Signs of a recovery are also evident in the house-building sector. After declining between April and August 1988, permits issued for new private dwellings have since recorded monthly rises (see figure 8). In December and January new private dwelling permits rose by around 3 per cent and, when combined with rises close to 9 and 10 per cent in October and November, should foreshadow a rise in actual *residential investment* activity through the first half of 1989. Factors contributing to the expected recovery in house construction include falling construction costs relative to the cost of purchasing existing houses, rising incomes, a reduction in the *nominal* costs of mortgage servicing, and the Housing Corporation building program – which is expected to contribute significantly to dwelling construction activity for the year as a whole. A moderating influence, however, will be the ongoing high level of *real* mortgage interest rates.

Over the review period, there were few signs of recovery in actual *private business investment*. On the one hand, commercial building activity has continued to decline and by the September quarter 1988 the value of non-residential building work put in place was 7 per cent below that of the previous September quarter. Similarly, transport equipment investment expenditures were 11 per cent lower over the same period. However, plant and machinery investment expenditures have expanded over the past year and in the September quarter 1988 were 5.1 per cent above those of the September quarter 1987. In aggregate, private business expenditures declined by 2 per cent in seasonally adjusted terms over the September quarter.

Forward *indicators of business investment* have been mixed. Over the three months to December 1988, the value of non-residential permits issued was about 7 per cent lower than in the three months to Nov-

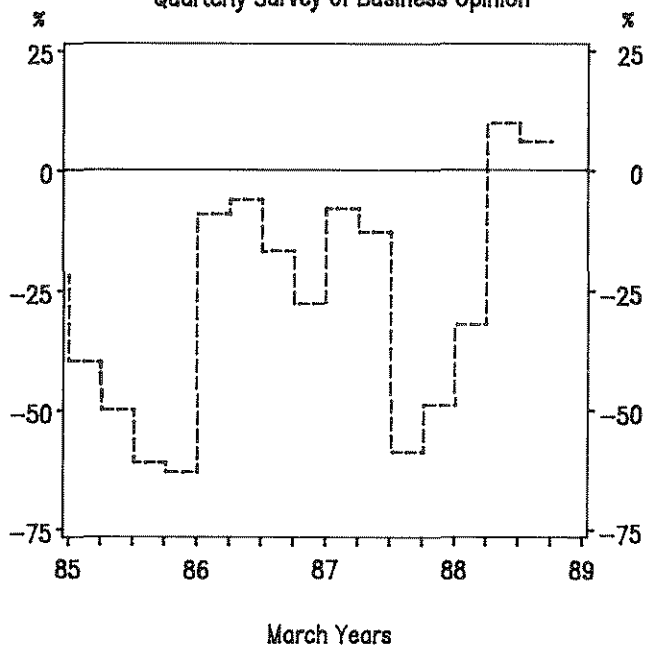
ember 1988. Indicators of plant and machinery, and transport equipment investment, on the other hand, have improved. After being depressed for some time as a result of excess capacity, forward import orders for transport equipment were 28 per cent higher in the December quarter 1988 than one year earlier. Indicators of future investment in plant and machinery rose in the December quarter 1988 and were around 5 per cent higher than they were in the previous December quarter.

The overall level of business confidence recorded a significant upturn in September and October. The NZIER September 1988 Quarterly Survey of Business Opinion (QSBO) showed a net 10 per cent of respondents nation-wide expecting an improvement in the general business situation over the next six months compared with a net 32 per cent of total respondents expecting general business conditions to deteriorate in the June quarter survey (see Figure 9). The National Bank reported a similar trend improvement, with their Index of Business confidence

yielding a positive result in September for the first time in 1988. These upturns were widely attributed to the earlier exchange rate depreciation, and subsequent period of exchange rate stability, the buoyant state of export commodity prices and the anticipated positive impact of the October 1988 tax cuts.

While political tensions over November and December weakened business confidence from previous levels, several recent opinion surveys indicate that business confidence has nevertheless remained positive. The December NZIER QSBO indicated that general business sentiment remained slightly optimistic. Economy-wide, a net 4 per cent of respondents expected conditions to improve over the next six months. Furthermore, the National Bank's Business Confidence Index also reported only a moderate easing in optimism in December, with 30 per cent of respondents expecting conditions to improve over the next twelve months, following an out-turn of 39 per cent in November.

Figure 9
Business Confidence
Quarterly Survey of Business Opinion



Survey evidence points towards optimism about future manufacturing export sales and some recovery in consumer spending. In addition manufacturers and builders have initiated a restocking phase which should contribute towards aggregate economic growth over 1989/90. However, investment intentions generally remain depressed in the face of slack capacity in many sectors. Moreover, despite an expectation of a pick-up in sales (both export and domestic), the effective firming in real post-tax interest rates in the wake of political tensions over the review period may be acting as an obstacle to new investment. Therefore a continued rise in actual demand together with a permanent reduction in interest rates, in line with the current low inflation environment, are probably both necessary prerequisites for a significant lift in investment intentions.

The strength of *export growth*, in both volumes and prices, has contributed substantially to the upturn in activity since last year, even though to some extent export demand has been met by reductions in stocks (particularly in the wool and dairy sectors). There has also been weak import demand, which has combined with high export growth to produce a record trade surplus of \$3,175 million in the year to December 1988; the trade surplus in the year to December 1987 was much lower, at \$925 million. Due almost entirely to rises in the merchandise trade balance, the current account deficit has narrowed substantially to a provisional¹ \$389 million in the year to December 1988, compared with \$2,932 million for the year to December 1987 (see Figure 10). At 0.6 per cent of Gross Domestic Product (GDP), the 1988 deficit is the lowest since 1973/74.

Export volumes are expected to continue to expand in 1989/90 as a result of a more competitive real exchange rate and ongoing strong

¹ Since this review article was written the current account deficit has been revised, substantially, to \$1158 million.

world economic growth. Manufacturing exports, particularly to Australia and Japan, should expand gradually, while continued forestry, non-pastoral primary product and tourism growth is expected. On average, export prices are forecast to stabilise at current levels. Import volumes are, however, also expected to rise in response to the recovery in domestic expenditure; indeed the recent rise in surveyed import orders in November and December 1988 foreshadow a recovery in import demand associated with the rise in retail activity and re-stocking. These developments in exports and imports are expected to result in a current account deficit of \$500-\$700 million over the March 1990 year, constituting about 1 per cent of GDP.

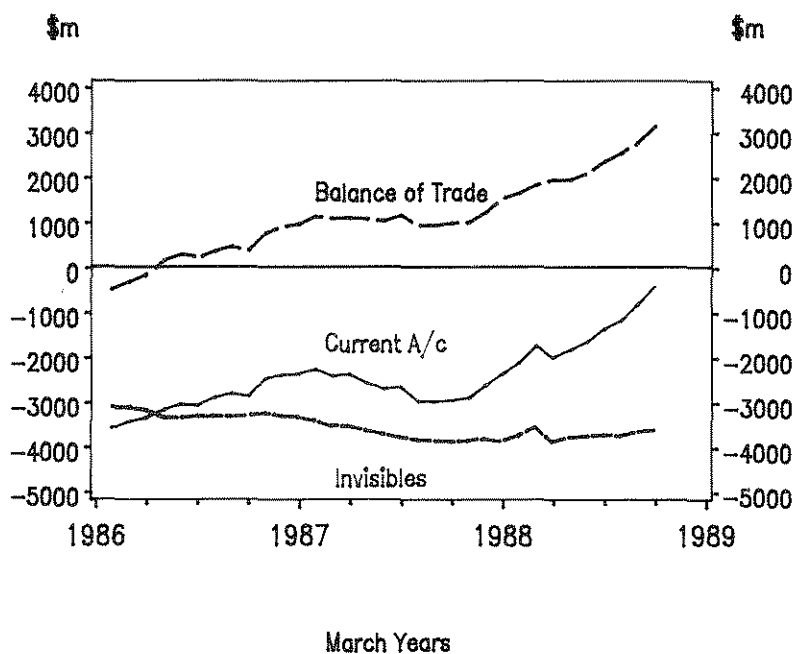
Although clear signs of economic recovery emerged during the review period, registered *unemployment* continued to rise. The number of people registered as unemployed rose by almost 20,000 in the December quarter to 144,900 (seasonally adjusted). However, the Household Labour Force Survey (HLFS)

reported virtually no change in the unemployment rate for the December quarter, with the unemployment rate remaining at 6 per cent. Similarly, the broader jobseekers measure of unemployment was, at 7.7 per cent in the December quarter 1988, little changed from the September quarter level.

The number of persons registered as unemployed has since continued to rise, reaching 150,300 on a seasonally adjusted basis in January. Unemployment is expected to continue to deteriorate through until mid-1989 and it is not anticipated that there will be any significant reduction until early 1990. On an official HLFS basis, the unemployment rate is expected to peak at around 7-7.5 per cent before easing slightly by March 1990.

In part, the lagged response of unemployment to activity changes reflects the likely return of non-participants to the labour force, and a possible reduction in net migration outflows, which would substantially offset the forecast recovery in employment growth. However, employment growth itself is also ex-

Figure 10
Balance of Payments



pected to be retarded in the initial recovery phase, as businesses utilise existing spare capacity and take advantage of recent improvements in labour productivity. Furthermore, the costly nature of redundancy agreements may discourage firms from taking on new staff before the upturn in business activity is viewed as being sustainable.

Overall, signs of improvement in economic indicators over the review period suggest the economy is slowly emerging from the recession and associated trough period which extended through to the September quarter 1988. Higher unemployment has resulted from restructuring and the decline in activity but, at the same time, considerable progress has been made in lowering inflation, inflationary expectations, and the current account deficit. While growth in export earnings should continue to stimulate economic activity, it is apparent that a further upturn in confidence will be required before we see significant upturns in either investment or employment.

Assessment

The movements in monetary indicators which occurred over the review period highlight the importance of interpreting these movements in the light of other relevant information.

The narrowing of the interest rate yield gap which occurred over the six weeks to mid-December was not accompanied by either a significant depreciation of the exchange rate or a fall in short-term interest rates. Rather than indicating an easing in the monetary stance, this narrowing of the yield gap reflected the building into 5-year stock rates of an increasing uncertainty premium as the conflict between the Finance Minister (Hon. R.O. Douglas) and the Prime Minister intensified.

However, when interest rates, the yield gap and the exchange rate all fell sharply in late January, the Bank perceived an easing in monetary conditions. The cause of these movements, namely the statements made

by the Minister of Finance (Hon. David Caygill) and the Prime Minister over 20-23 January about the need for interest rates and the exchange rate to fall, undoubtedly suggested to financial market participants that a monetary policy U-turn was about to occur. The Minister of Finance and the Prime Minister had not intended, however, to signal a policy reversal. The Government remained committed to a disinflationary monetary policy aimed at achieving price stability by the early 1990s. To correct the false impression which had developed in financial markets about the stance of monetary policy, the Reserve Bank adopted a firmer stance in open market operations (OMOs) in early February. As a result, short-term interest rates, the yield gap and the exchange rate all moved up in early February.

Over the review period as a whole, there appears to have been some easing in monetary conditions with long-term interest rates (nominal and real) and the exchange rate back around their levels at the start of the review period but with a significantly narrower yield gap and lower short-term real interest rates. Despite this easing in monetary conditions, which has continued over the past two review periods, the Bank nevertheless considers that monetary conditions remain consistent with the disinflationary stance of monetary policy. Real interest rates remain high and are still restraining nominal demand. In addition, it has become apparent in the latter half of the year that the depth of the recession in domestic demand over the six months to September 1988 was greater than expected, with the result that monetary conditions during April-August 1988 were somewhat firmer than necessary. Moreover, progress made in reducing inflation in 1988 has reduced the amount of disinflationary pressure which monetary policy must now exert to achieve price stability by the early 1990s. Having drawn this conclusion, however, the Bank is ever mindful of the risk of an

unwarranted relaxation in monetary conditions which could reignite inflationary pressures and hence necessitate a renewed tightening of monetary policy.

OPEN MARKET OPERATIONS
Period: 1 November – 30 November

Date	Transaction	Maturity	Volume Offered \$m	Volume Bid \$m	Total Amount Sold \$m	Total Amount Purchased or Advanced \$m	Range of Bids Received %	Range of Successful Bids %	Average of Successful Bids %
1 November	Sellback	11/11/88	30	117		20	12.36-13.78	13.78	13.78
		17/11/88	—	199		20	13.01-13.81	13.80-13.81	13.80
2 November	Govt. Stock	15/03/89	10	41		10	14.00-14.08	14.06-14.08	14.07
3 November	Sellback	14/11/88	30	140		30	12.78-13.55	13.40-13.55	13.43
		16/11/88	75	180		67	12.78-13.87	13.40-13.87	13.63
		21/11/88	60	283		60	13.35-14.02	13.62-14.02	13.86
4 November	Govt. Stock	15/03/89	—	45		18	14.00-14.06	14.05-14.06	14.05
		21/11/88	55	320		55	13.32-13.90	13.65-13.90	13.76
		15/03/89	—	16		10	14.04-14.05	14.05	14.05
8 November	Sellback	11/11/88	30	110		30	10.75-12.10	11.53-12.10	11.72
		14/11/88	30	120		30	11.02-12.65	12.55-12.65	12.60
9 November	Sellback	10/11/88	10	10		10	9.92	9.92	9.92
10 November	Treasury Bills	25/01/89	20	102	20		14.24-14.40	14.24-14.25	14.25
11 November	Sellback	14/11/88	100	115		90	9.65-10.40	9.76-10.40	10.03
		15/11/88	60	125		15	10.06-11.13	10.71-11.13	10.87
		21/11/88	100	230		100	12.47-12.85	12.85-13.60	13.06
		15/11/88	85	100		50	9.65-11.27	11.01-11.27	11.14
15 November	Treasury Bills	17/11/88	20	120	20		12.94-14.27	12.94	12.94
		21/11/88	20	110	20		13.03-14.27	13.03	13.03
		19/01/89	50	95	30		14.13-14.43	14.13-14.29	14.21
		25/01/89	70	95	25		14.11-14.42	14.11-14.32	14.20
		07/02/89	50	117	50		14.20-14.38	14.20-14.30	14.28
16 November	Sellback	17/11/88	15	105		15	13.97-14.80	14.80	14.80
17 November	Treasury Bills	18/01/89	—	50	10		14.34-14.48	14.34	14.34
		25/01/89	—	122	45		14.33-14.48	14.33-14.36	14.35
		21/11/88	25	185		25	15.15-15.75	15.65-15.75	15.69
21 November	Treasury Bills	22/02/89	—	55	35		14.48-14.57	14.48-14.51	14.50
22 November	Treasury Bills	18/01/89	—	78	20		14.49-14.68	14.49-14.51	14.50
		22/01/89	—	57	10		14.50-14.68	14.50	14.50
		01/03/89	50	117	50		14.46-14.68	14.46-14.49	14.48
		29/11/88	160	375		135	13.91-14.45	14.30-14.45	14.35
23 November	Sellback	01/12/88	100	360		25	13.97-14.40	14.35-14.40	14.38
		28/11/88	40	130		20	12.40-13.08	12.85-13.08	12.97
		01/12/88	90	335		90	12.88-13.90	13.66-13.90	13.73
25 November	Sellback	29/11/88	25	140		25	13.37-15.01	15.01	15.01
28 November	Sellback	02/12/88	20	130		20	14.51-15.51	15.45-15.51	15.49
29 November	Treasury Bills	05/01/89	30	10	5		14.65-14.70	14.65	14.65
		22/02/89	30	12	12		14.59-14.61	14.59-14.61	14.59
30 November	Sellback	05/12/88	20	120		20	13.85-14.75	14.75	14.75
1 December	Sellback	05/12/88	40	215		40	13.85-14.58	14.58	14.58
2 December	Sellback	05/12/88	20	100		20	12.83-13.50	13.50	13.50
5 December	Treasury Bills	21/12/88	—	175	30		14.25-14.62	14.25-14.32	14.29
		28/12/88	30	90	30		14.26-14.62	14.26-14.34	14.30
		14/12/88	40	155	20		13.62-14.16	13.62	13.62
6 December	Treasury Bills	21/12/88	50	197	45		14.09-14.28	14.09-14.12	14.10
		18/01/89	50	108	50		14.34-14.51	14.34-14.37	14.35
		14/12/88	50	225	50		13.78-14.36	13.78-13.94	13.88
		18/01/89	50	102	30		14.35-14.56	14.35-14.45	14.42
8 December	Sellback	25/01/89	50	60	5		14.45-14.62	14.45	14.45
		15/12/88	—	200		60	13.15-13.95	13.65-13.95	13.81
9 December	Sellback	19/12/88	35	120		35	13.65-14.30	14.15-14.30	14.23
12 December	Treasury Bills	22/12/88	55	167	40		13.74-14.25	13.74-13.78	13.76
		11/01/89	30	40	15		14.16-14.20	14.16	14.16
		25/01/89	—	92	13		14.56-15.05	14.56	14.56
13 December	Treasury Bills	01/02/89	35	97	32		14.61-15.05	14.61-14.75	14.72
		08/02/89	—	92	40		14.74-15.05	14.74-14.75	14.74
		15/12/88	70	60		40	12.50-12.66	12.65-12.66	12.66
		16/12/88	50	25		25	12.86	12.86	12.86
14 December	Sellback	19/12/88	150	215		130	13.02-13.40	13.10-13.40	13.28
		29/12/88	70	238		70	13.20-13.85	13.59-13.85	13.73
		16/12/88	20	80	20		13.02-14.13	13.02	13.02
15 December	Treasury Bills	21/12/88	30	40	30		13.95-14.23	13.95-14.02	13.98

Date	Transaction	Maturity	Volume Offered \$m	Volume Bid \$m	Total Amount Sold \$m	Total Amount Purchased or Advanced \$m	Range of Bids Received %	Range of Successful Bids %	Average of Successful Bids %
16 December	Treasury Bills	11/01/89	40	30	10		14.34-14.46	14.34	14.34
		25/01/89	50	35	10		14.39-14.48	14.39	14.39
		28/12/88	50	90	50		13.75-13.89	13.75-13.80	13.78
		08/02/89	50	50	20		14.28-14.55	14.28-14.32	14.30
		15/02/89	50	105	15		14.32-14.55	14.32-14.38	14.78
19 December	Treasury Bills	22/12/88	—	110	30		13.18-13.75	13.18	13.18
20 December	Treasury Bills	28/12/88	—	20	20		13.33	13.33	13.33
21 December	Treasury Bills	22/12/88	60	220	58		12.68-12.95	12.68	12.68
22 December	Treasury Bills	22/03/89	20	59	2		14.35-14.49	14.35-14.38	14.36
		25/01/89	—	55	25		14.14-14.20	14.14-14.16	14.14
23 December	Sellback	16/01/89	30	85		30	13.60-14.11	13.75-14.11	13.95
28 December	Sellback	04/01/89	40	90		40	12.50-13.15	12.85-13.15	12.99
29 December	Treasury Bills	16/01/89	—	145		45	13.00-13.89	13.68-13.89	13.75
		08/02/89	—	90	10		13.93-14.16	13.93	13.93
		15/02/89	—	90	10		13.97-14.16	13.97	13.97
		29/03/89	20	116	20		14.00-14.19	14.00	14.00
30 December	Treasury Bills	28/02/89	—	93	45		13.95-14.19	13.95-14.03	13.98
4 January	Treasury Bills	28/02/89	70	95	70		13.73-14.00	13.73	13.73
5 January	Sellback	09/01/89	—	100		35	12.80-13.80	13.80	13.80
		16/01/89	—	115		20	13.05-13.88	13.88	13.88
6 January	Treasury Bills	15/02/89	65	80	20		13.99-14.15	13.99	13.99
		28/02/89	65	95	45		14.07-14.24	14.07-14.12	14.10
9 January	Sellback	10/01/89	50	195		50	14.00-14.50	14.43-14.50	14.48
10 January	Sellback	13/01/89	45	165		5	13.50-14.43	14.43	14.43
		16/01/89	45	141		40	14.00-14.53	14.53	14.53
11 January	Sellback	16/01/89	70	273		70	13.23-13.94	13.89-13.94	13.92
		28/02/89	10	50	10		14.08-14.19	14.08	14.08
12 January	Treasury Bills	23/01/89	55	140	15		13.30-13.99	13.30-13.40	13.37
		15/02/89	55	55	10		13.84-13.99	13.84	13.84
		28/02/89	55	105	30		13.93-14.03	13.93-13.99	13.97
16 January	Treasury Bills	25/01/89	35	105	35		13.25-13.99	13.25	13.25
17 January	Treasury Bills	25/01/89	—	65	20		13.33-13.85	13.33-13.60	13.53
		28/02/89	—	85	5		13.92-14.00	13.92	13.92
18 January	Treasury Bills	25/01/89	30	55	10		13.50-13.90	13.50	13.50
		28/02/89	30	95	20		13.76-13.95	13.76	13.76
19 January	Sellback	24/01/89	20	105		20	13.50-14.01	14.01	14.01
20 January	Treasury Bills	28/02/89	—	290	60		13.80-13.90	13.80-13.82	13.87
		22/03/89	—	180	20		13.80-13.92	13.80	13.80
23 January	Sellback	24/01/89	60	160		60	12.50-13.25	13.09-13.25	13.09
		30/01/89	70	95		10	12.75-13.09	13.09	13.09
25 January	Sellback	30/01/89	—	190		75	12.25-13.10	13.10	13.10
		31/01/89	75	165		75	12.18-13.10	13.10	13.10
26 January	Treasury Bills	28/02/89	10	42	10		13.18-13.30	13.18	13.18
27 January	Sellback	30/01/89	10	30		10	13.25-14.10	14.10	14.10
30 January	Treasury Bills	03/02/89	30	30	30		13.45-13.50	13.45-13.50	13.46
		22/02/89	100	85	20		13.23-13.30	13.23-13.25	13.24
		28/02/89	—	265	70		13.21-13.37	13.21-13.26	13.24
		08/03/89	100	225	30		13.21-13.45	13.21-13.25	13.23
31 January	Treasury Bills	03/02/89	20	25	5		12.65-13.07	12.65	12.65
		22/02/89	—	55	10		12.93-13.07	12.93-12.94	12.93
		28/02/89	—	95	40		12.89-13.07	12.89-12.99	12.94
		08/03/89	50	55	35		13.01-13.07	13.01-13.04	13.02
1 February	Sellback	02/02/89	15	45		15	13.00-13.01	13.01	13.01
		15/09/89	—	66		6	13.13-13.24	13.24	13.24
2 February	Sellback	09/02/89	20	110		20	13.45-14.40	14.40	14.40
		13/02/89	—	165		45	13.00-14.30	13.78-14.30	14.14
3 February	Treasury Bills	28/02/89	35	75	35		13.50-13.95	13.50-13.60	13.54
7 February	RB Bill	08/02/89	10	50	10		13.90-15.00	13.90	13.90
8 February	RB Bill	10/02/89	7	14	7		13.85-14.22	13.85	13.85
		14/02/89	5	10	5		14.05-14.58	14.05	14.05
		17/02/89	2	2	2		14.05	14.05	14.05
8 February	Treasury Bills	28/02/89	—	145	41		13.90-14.95	13.90-14.02	13.96

Date	Transaction	Maturity	Volume Offered \$m	Volume Bid \$m	Total Amount Sold \$m	Total Amount Purchased or Advanced \$m	Range of Bids Received %	Range of Successful Bids %	Average of Successful Bids %
9 February	Treasury Bills	13/02/89	50	125	50		14.59-14.96	14.59	14.59
		15/02/89	50	55	50		14.59-14.75	14.59	14.59
		16/02/89	50	75	15		14.59-15.00	14.59	14.59
10 February	Treasury Bills	15/02/89	-	205	50		12.58-13.29	12.58	12.58
		16/02/89	-	75	50		12.72-13.29	12.72	12.72
		17/02/89	-	95	125		12.62-13.34	12.62-12.68	12.65
		28/02/89	40	95	40		13.05-13.29	13.05-13.08	13.07
13 February	Treasury Bills	23/02/89	-	150	50		12.57-13.15	12.57	12.57
15 February	Treasury Bills	16/02/89	80	360	80		13.46-13.89	13.46	13.46
		22/02/89	100	210	100		13.45-13.87	13.45-13.50	13.47
		23/02/89	100	221	85		13.45-14.15	13.45-13.50	13.47
16 February	Sellback	27/02/89	30	110		30	13.50-13.82	13.82	13.82
17 February	Treasury Bills	24/02/89	35	70	35		14.34-14.50	14.34	14.34
20 February	Sellback	21/02/89	15	45		15	12.95-13.30	13.30	13.30
21 February	Treasury Bills	08/03/89	50	130	30		13.42-13.99	13.42	13.42
		22/03/89	-	75	20		13.43-13.70	13.43-13.46	13.44
		28/03/89	30	75	30		13.43-13.56	13.43-13.46	13.45
22 February	Treasury Bills	17/03/89	-	135	15		13.47-13.55	13.47	13.47
		22/03/89	-	175	35		13.44-13.53	13.44-13.46	13.45
23 February	Treasury Bills	02/03/89	10	40	10		13.85-14.30	13.85	13.85
24 February	Sellback	27/02/89	20	75		20	14.00-14.66	14.11-14.66	14.50
27 February	Treasury Bills	20/03/89	-	75	45		13.64-14.10	13.64-13.69	13.67
		22/03/89	-	20	10		13.69-13.93	13.69	13.69
		28/03/89	-	85	15		13.63-13.80	13.63-13.70	13.67
		31/03/89	-	220	45		13.63-13.87	13.63-13.72	13.68
28 February	Treasury Bills	22/03/89	100	20	10		13.88-13.99	13.88	13.88
		31/03/89	100	220	10		13.90-14.09	13.90	13.90