

# MONETARY AND ECONOMIC DEVELOPMENTS

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*In this article by Samantha Johnson and Ian Woolford, key monetary and economic developments for the four months to 7 June 1991 are reviewed.*

The last four months has seen substantial progress in New Zealand's attack on inflation. The outlook for inflation has become particularly good. Lower-than-expected inflationary pressures, and a number of one-off factors, could result in annual CPI inflation of close to 2 per cent in December 1991. Flow-on benefits have also been seen in the form of further reductions in wholesale and retail interest rates. Somewhat surprisingly, the exchange rate has remained stable. Analysis of these developments and their implications for policy will be the focus of the Bank's next Monetary Policy Statement, due in August 1991.

A chronology (Appendix 1) charts the key events that have occurred during the review period.

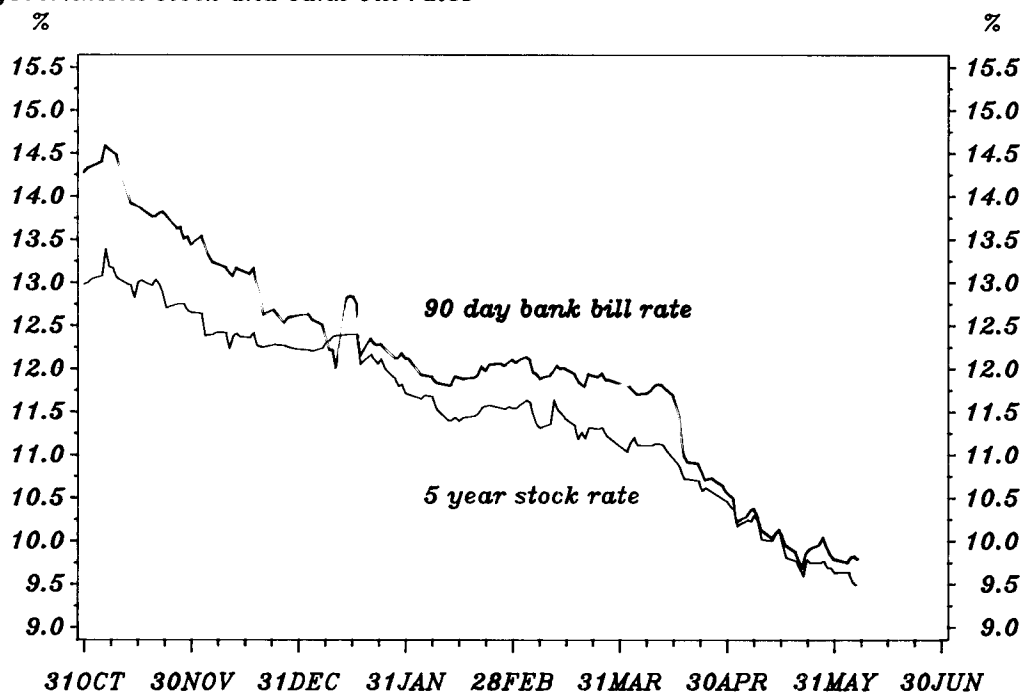
## Monetary Policy Indicators

For a variety of reasons, quantity-based indicators of monetary conditions and of the outlook for inflation have become less useful over recent years. More reliable, though by no means perfect, indicators are found in financial market prices. The Bank now pays particular attention to the exchange rate, the 90-day bank bill and 5-year government stock interest rates, and the (yield) gap between these two interest rates. The real economy, inflation expectations, and the monetary aggregates are also monitored.

**Interest rates on 90-day bills and yield on 5-year bonds fell by nearly 2.0 percentage points and over 1.5 percentage points respectively over the review period. Release of the March quarter Consumer Price Index (CPI) in mid-April, and associated Reserve Bank comments, appeared to trigger these falls as, up to just before the inflation release, rates had been relatively stable.**

**Figure 1**

**Interest Rates**  
**government stock and bank bill rates**



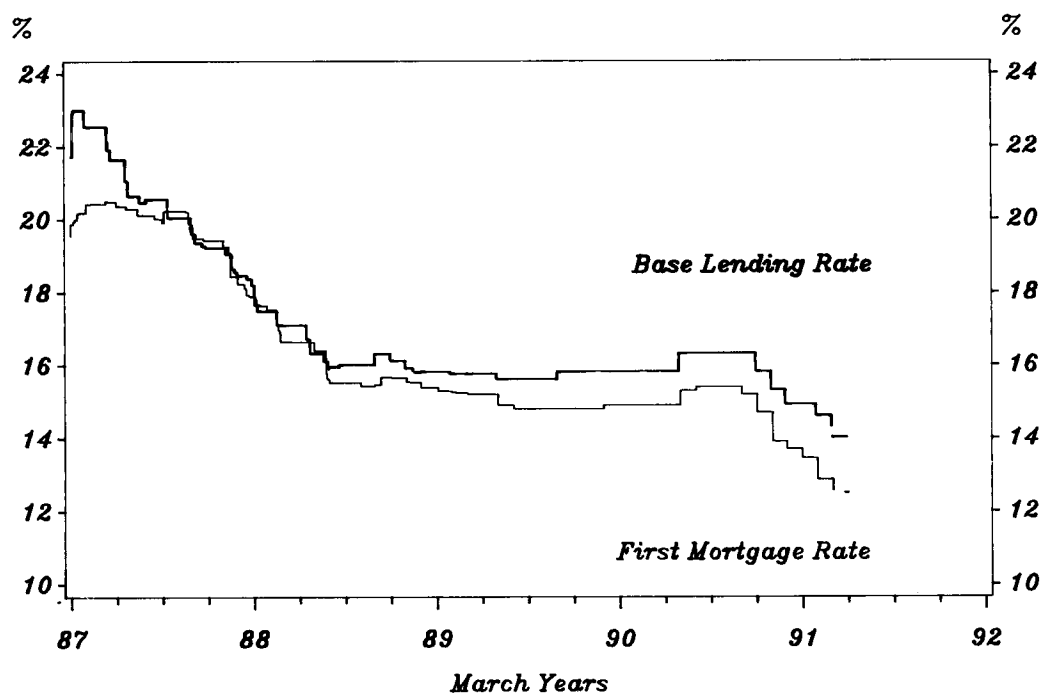
- In the middle of February, 90-day rates had settled at just under 12 per cent. They began to ease in the run-up to the CPI announcement and then fell sharply following the announcement and the Bank's 17 April statement, which indicated that the Bank had been happy with the easing to that point and that the favourable CPI outcome could be expected to ease the pressure on monetary policy. Rates reached their lowest level since 1976. At the end of the period, 90-day bills were trading at just under 10 per cent, around 5 percentage points down on rates prevailing in October 1990.
- Reinforced by lower inflation and better inflation prospects, the steady fall in 5-year bond rates over the six months prior to mid-February continued over the period. Rates fell from around 11.5 per cent in the middle of February to around 9.7 per cent by early June. At current levels these are the lowest 5-year bond rates for over twelve years.
- Overall confidence in the policy approach had been evident even before the CPI release. The announcement on 12 March, of a sharp increase in this year's forecast financial deficit, relative to that forecast in the December "Economic and Social Initiative", had had little effect upon interest rates. Apparently, financial market participants remained of the view that the Government's longer-term fiscal goals would still be achieved.
- Further indications of confidence in the policy mix comes from evidence of relatively strong overseas interest in New Zealand bonds over the last four months. Total estimated overseas holdings of New Zealand government stock increased

from around \$1,485 million in December to around \$1,990 million in March, and rose further in April. As a proportion, overseas holdings have increased from 13.5 per cent to 19.7 per cent of government stock over this time.

- Exchange rate stability in recent months, together with the perception that real interest rates in New Zealand remained unwarrantedly high, has, and may continue to attract offshore interest in local financial markets.
- Further rounds of reductions in retail lending rates have taken place in response to falling wholesale rates. In the middle of February, base lending rates and mortgage rates averaged 15.3 percent and 14 percent respectively. At the time of writing, base rates and mortgage rates had fallen to just under 14 per cent and 12.5 per cent respectively - the lowest in more than a decade.

**Overseas interest rates have drifted down over the review period. However, on average, these reductions have been considerably smaller than that which has occurred in New Zealand.**

**Figure 2**  
**First Mortgage Housing and Base Lending Interest Rates**

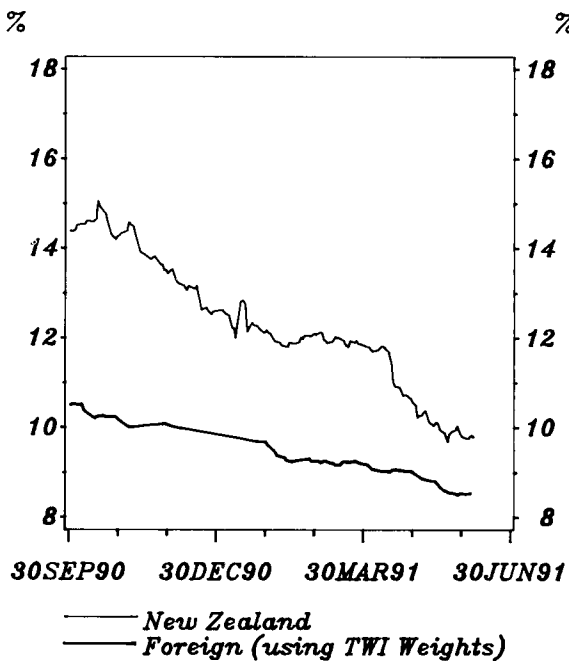


- Nominal interest rate differentials between New Zealand and overseas rates have now narrowed significantly, to below levels prevailing over much of the past year. These differentials are usually important determinants of cross-border capital flows, and thus the exchange rate.
- New Zealand's nominal interest rates are now below those of Australia. More significantly, New Zealand's rates are close to those in Germany and other smaller low inflation European countries. For example, current 90-day rates are 10.1 per cent in Ireland, 9.4 per cent in Denmark, 9.0 per cent in Belgium and 8.9 per cent in Germany. Comparable bond rates are 9.1 per cent in Ireland, 8.9 per cent in Denmark, 9.0 per cent in Belgium and 8.1 per cent in Germany.

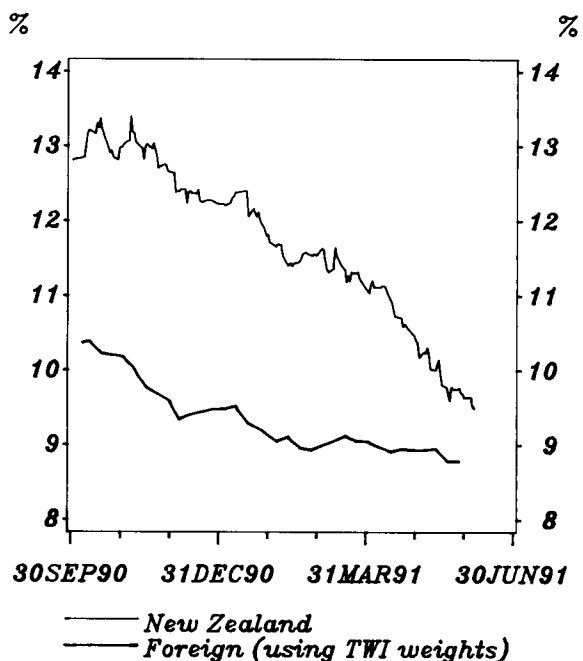
The gap between short-term and long-term interest rates (the 'yield gap') fluctuated around 0.5 percentage points until the middle of April when it halved, reflecting an especially strong reaction from 90-day bill rates to the March quarter CPI result.

- In the early days of the disinflation process the yield gap frequently stood at 6-8 percentage points but has declined as inflation has fallen, to average around 0.5 percentage points for this year.

**Figure 3**  
*NZ and Foreign 90 day Rates*

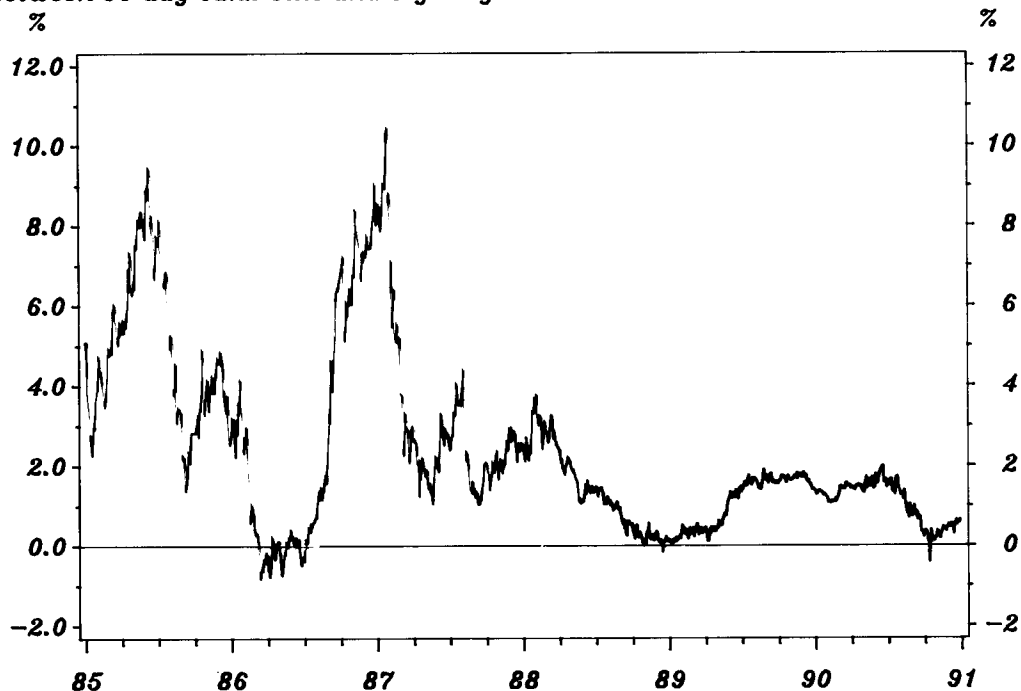


**Figure 4**  
*NZ and Foreign Long Term Interest Rates*



**Figure 5**

**Yield Gap  
between 90 day bank bills and 5 year government stock**



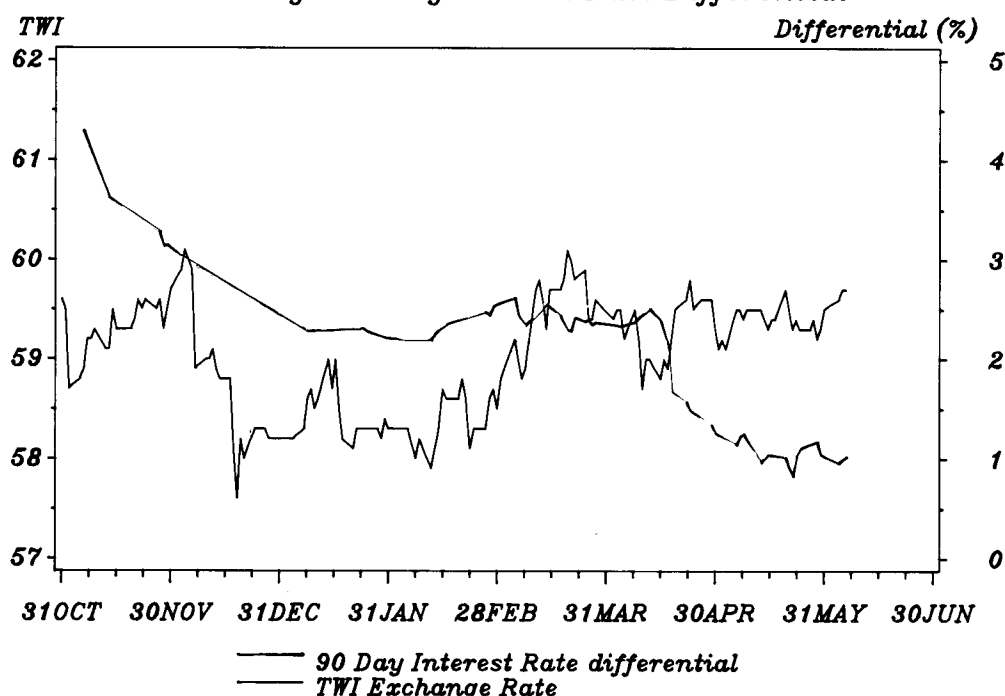
- After the release of the CPI result and the Bank's associated comments, the yield gap settled at between 0.1 and 0.2 percentage points. This was maintained for most of May.
- Provided inflation continues to move towards the Bank's target, the yield gap should ease further and 90-day rates are likely to go below long-term rates, as has been the experience of other disinflating countries.
- When this might happen is uncertain; though caution has dictated the Bank's unwillingness to have a monetary policy easing promote an early move to a positive yield curve. The Bank indicated on 23 April that should the positive expectations for inflation in June be realised and should further meaningful progress be made on the fiscal front in the July Budget, and should the overall inflation outlook remain positive, then it might be appropriate to see a flat or even slightly upward sloping yield curve emerge over the next year.
- On a few days in the middle of May, the yield curve became slightly upward sloping. On being reminded by the Bank of the content of the 23 April speech, financial markets restored a mildly negative yield curve shape.

The New Zealand dollar continued consistently to exhibit strength throughout the period and tended to oscillate around 59.0 on the Bank's trade-weighted index (TWI):

- Of note has been the current lack of a reaction from the TWI to the narrowing of the nominal interest rate differential between New Zealand and overseas rates and other economic developments during the period.
- One reason may be that over the past six months confidence in the direction of policy has improved. In contrast, the fall in the exchange rate and pressure on interest rates in September/October 1990 may have occurred in response to financial market uncertainty following the Budget and the build up to the October election. Reports point to optimistic sentiment in overseas markets about the direction and sustainability of New Zealand macroeconomic policy.
- To date, the markets appear to have placed surprisingly little weight on possible pressures arising from balance of payments concerns. Consistent with this pattern, significant revisions to the balance of payments numbers in May had no immediate impact on the exchange rate.

Figure 6

Trade Weighted Exchange Rate  
and Domestic-Foreign 90 Day Interest Rate Differential



- Nor do markets appear to have reacted to the Reserve Bank's reiteration that it would not stand in the way of some limited market-led depreciation in response to balance of payments pressures.

**Broad monetary and credit aggregates growth rates have remained fairly consistently rapid.**

- The March 1991 year-on-year growth rates of the broad aggregates were little changed from those in the years to January or February 1991.
- M3 increased by 13.8 per cent over the year. Much of the recent growth in M3 is attributable to a large increase in non-resident New Zealand dollar funding over the last six months, and to changed statistical treatment of Bonus Bonds.
- Domestic Credit increased by 12.3 per cent and Private Sector Credit (PSC) grew by 10.1 per cent, reflecting increased lending to both the household and business sectors. This compares with a growth rate in PSC of 9.7 per cent for the previous year. Growth in lending to households has, however, slowed significantly from the higher rates achieved during 1989/90. Consequently, lending to the commercial sector appears to have made a stronger contribution to growth in PSC than in the March 1990 year. Reduced credit growth to households is consistent with weak demand from that sector, though it is not yet fully clear why it is still so high.

## Economic Activity

**Recent indicators suggest that overall economic activity has shown at best modest growth over the early months of 1991. As expected, domestic demand has been weak, while the external sector has boosted growth. Recently, some improvement in business and household confidence has been evident.**

- Real expenditure on Gross Domestic Product (GDP) in 1990 appears to have been substantially stronger than previously thought. Real GDP grew by 3.9 per cent over the December quarter, and by 2.3 per cent over the year to December 1990. Rising export volumes, investment, and in the December quarter in particular, private consumption have all contributed to this outcome.
- Recorded growth in 1990 may be something of a statistical oddity. In keeping with much anecdotal evidence, more recent indicators point to a weak state of **domestic demand**, especially among consumers. Retail sales have fallen sharply in recent months, and in the year to March were 1.2 per cent lower than in the previous year. Over the same period, indicators of building investment have also fallen, with the value and number of permits issued, of both dwellings and other buildings, declining.

- Meanwhile, **export volumes** are estimated to have risen by 4 per cent in the year to March 1991 while import volumes appear to have levelled-off. Export growth has been widely spread across product categories.
- After reaching historical lows early in the year, recent **confidence surveys** have begun to show an upturn in business and consumer confidence. The National Bank's May Business Outlook has shown a significant improvement in business confidence and expectations of activity, with particular optimism about manufacturing exports. Of particular interest is a recovery of investment intentions, pointing to a perception that a recovery in activity would be sustainable. A recent household survey also shows a sharp improvement.
- Increases in confidence are consistent with falling interest rates for both households and businesses, and rising commodity prices. The price of New Zealand's commodity exports, as measured by the ANZ commodity price index, rose for the second successive month in April, after a sustained period of price falls.
- Recent revisions to the **balance of payments** current account data, arising primarily from improvements in the quality and comprehensiveness of the statistics, may also help restore some confidence. The current account deficit for the year to March 1990 was revised from \$4.2 billion to \$2.2 billion. In the year to December 1990 the deficit is estimated to be \$1.9 billion, compared with a \$2.1 billion deficit in the year to December 1989. Preliminary analysis suggests that approximately \$1 billion out of the \$2 billion improvement will be ongoing in nature.
- **Unemployment** has continued to rise, with the official Household Labour Force Survey (HLFS) unemployment rate reaching 10.5 per cent in the month of March, and on a seasonally adjusted basis, 9.5 per cent for the March quarter.

## Inflation and Inflation Expectations

**Falling inflation and the continued pursuit of price stability have been reflected in lower surveyed inflation expectations.**

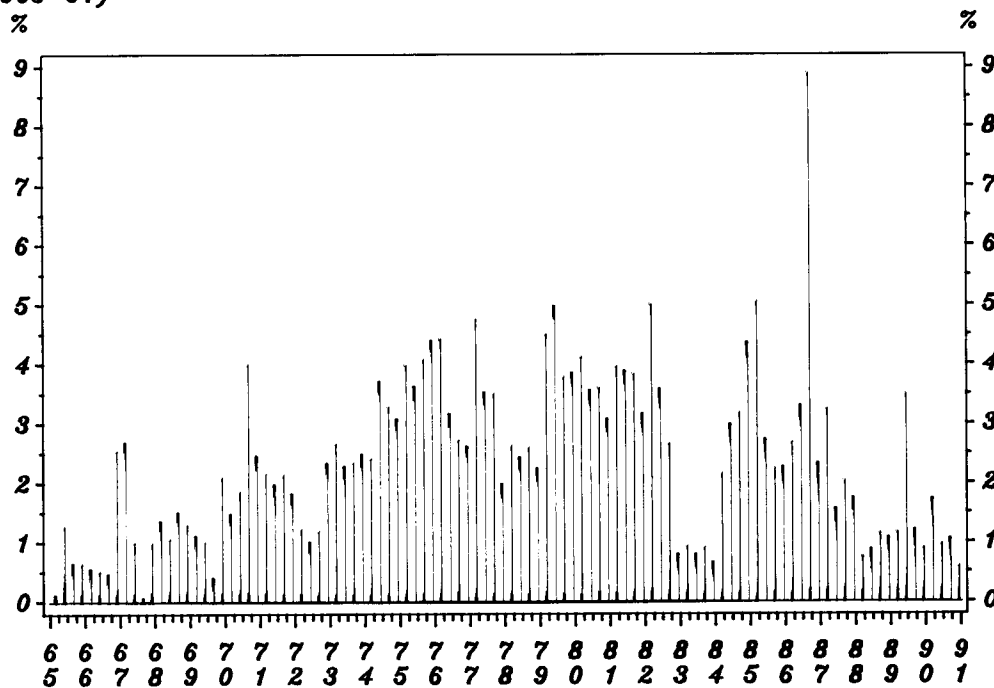
- Surveyed expectations of inflation fell steadily over the period and are at the lowest levels recorded for many years. The NZIER Quarterly Survey of Business Opinion for March reports that more respondents now expect a further easing in inflationary pressures. Only a small majority of respondents now expect to face higher costs over the coming quarter.

- Looking a year ahead, the Reserve Bank's Survey of Expectations in May recorded that inflation is expected to be 3.0 per cent for the year to March 1992, down from a year ahead expectation of 4.2 per cent in the previous survey. The National Bank's May Business Outlook reports year-ahead expectations of 4.8 per cent, down from 7.2 per cent in October 1990. The two surveys cover different sets of respondents

**Inflation has fallen in recent months. Further declines, due to weak activity, associated low wage growth, a continuing fall in petrol prices, and further falls in mortgage interest rates, are expected in coming quarters.**

- The Consumer Price Index rose by only 0.6 per cent in the March quarter 1991 - a result lower than most market expectations and the lowest since December 1969. The inflation rate fell to 4.5 per cent for the year to March 1991, compared with the 4.9 per cent increase in the year to December 1990.
- Further sharp falls appear to be in prospect. In the face of high unemployment wage inflation has largely evaporated, while world inflation has slowed. A number of one-off gains are also expected from falls in mortgage rates, and lower food and petrol prices.

**Figure 7**  
**Quarterly CPI Inflation**  
**(1965-91)**



- Inflation in the year to December 1991 may now be around 2 per cent, significantly lower than the 3.8 per cent forecast in the February 1991 Monetary Policy Statement. Underlying inflation (i.e. abstracting from temporary and other special factors) will be higher, at between 2.5 and 3 per cent.

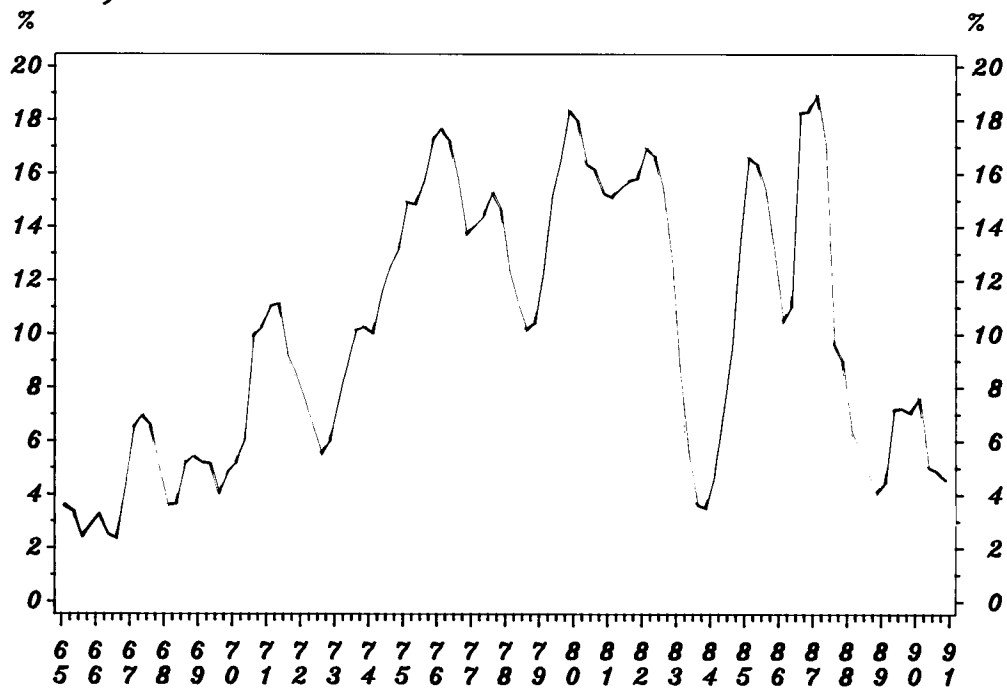
## Overview

Although measured inflation could fall from 4.9 per cent last year to around 2 per cent this year, as noted some of this decrease will be as a result of one-off factors such as falls in oil prices and home mortgage rates - which do not, in themselves, represent a fall in medium-term and long-term inflationary pressures. The rate of 'underlying' inflation provides the Bank with a more accurate picture of whether or not the medium-term inflation prognosis is consistent with the December 1993 date set for achieving price stability.

Thus, when formulating monetary policy, the Bank's prime focus is on underlying inflation. Such a focus prevents an inappropriate easing or tightening of policy in response to one off price movements such as an oil shock. Temporary elements of downward pressure on inflation will become less relevant during 1991, with the result that measured inflation would rise in the absence of anything else changing. While it is likely that underlying inflation will continue to moderate at sufficient pace to prevent measured inflation from actually recording an increase, the temporary nature of some elements now affecting inflation suggests the need for caution in any easing of policy. Nonetheless, it is worth noting that even underlying inflation is now projected to end 1991 in the bottom half of the 2.5-4.5 per cent indicative range established in the February 1991 Monetary Policy Statement. This would increase the likelihood of achieving price stability by 1993 without the need for additional monetary policy pressure.

**Figure 8**

**Year on Year CPI Inflation**  
**(1965-91)**



# APPENDIX 1

## Main Developments

Some events during the period have impacted upon or had implications for monetary policy and inflation. These events included:

- 21 February: The Reserve Bank released its third Monetary Policy Statement.
- 28 February: The President of the United States, Mr George Bush, ordered the suspension of United States - led allied combat operations in the Gulf, signalling the end of the war against Iraq.
- 12 March: The Government announced an increase in the year to June 1991 financial deficit from \$691 million - as projected in the December "Economic and Social Initiative" - to \$1.4 billion.
- 17 April: \*
- \* The March quarter CPI figure was released.
  - \* The Reserve Bank said that the March quarter CPI result, combined with good prospects of further falls in the annual inflation rate, should help to ease the pressure on monetary policy.
- 23 April: The Governor of the Reserve Bank gave a speech in which he outlined the conditions under which a flat or positive yield curve could emerge over the coming year. These conditions include: the realisation of the positive expectations for inflation in June, and further progress toward reducing the fiscal deficit in the July budget.
- 15 May: In response to the emergence of a slightly upward-sloping yield curve, the Reserve Bank contacted financial market participants to remind them that the conditions - as stated on 23 April - for a flat or positive yield gap were not yet evident.

21 May: The Department of Statistics announced a large favourable revision from around \$4.2 billion to \$2.2 billion in the year to March 1990 Balance of Payments current account deficit.

30 May: The Bank of New Zealand announced a \$71.03 million loss for the year to March 1991.

