Reserve Bank Annual Report

The following are extracts from the Reserve Bank Annual Report for the year ended 31st March 1980

(All amounts are in New Zealand dollars unless otherwise specified)

General Review

In the Bank's view, the economic policies adopted during the past year marked a turning point for the longer term development of the New Zealand economy. The essence of these policy initiatives was to stimulate increased production of internationally marketable goods and services; to encourage generally increased competition and efficiency within the domestic economy; and to promote the development of New Zealand's own indigenous energy resources.

Major changes in policy included the introduction of a flexible exchange rate system and considerably widened forward exchange arrangements; the rationalisation of export taxation incentives; the adoption of a more positive attitude towards foreign investment and some liberalisation of policy in this area; more flexible administration of import licensing; relaxation of detailed price controls and their replacement by a more generalised surveillance system; the adoption of the first significant decisions under the industry studies programme, involving a major rationalisation of the textiles industry; and approval for a range of large scale energy related investment projects.

These policy developments not only constituted moves of considerable substance in their own right, but also seemed to the Bank to represent a significant progression in attitudes towards resolving the fundamental problems still facing the economy. This is because many of the benefits of the new policies will only accrue over a relatively long time, whereas in the short run there are likely to be some significant transitional disadvantages. Change takes time and it does have its costs. In the short run, devaluations may add to domestic price increases, but the new exchange rate system is the only effective way in which exporters can be assured that their profitability will not be eroded by domestic inflation. Rationalisation of domestic industry may lead to some short term loss of jobs but is necessary to restore the long run viability of the economy and hence ultimately increase employment opportunities. In the energy field, the large projects will initially require considerable imports and overseas finance, but over the long haul should help us resolve our underlying balance of payments difficulties.

Moreover, if these short term adjustment costs are considered within the context of the current economic situation, it will be clear that although real progress has been made in the field of structural economic policies, much remains to be done. The events of 1979/80 demonstrate all too sharply that there is no cause to be sanguine about current economic conditions.

Although the economy grew by about 2 per cent in real terms in 1978/79, partly because of expansionary domestic policies and partly because of favourable export prices, the available indicators suggest that economic activity levelled off again in 1979/80. In real terms, consumption was little changed from the previous year, private capital formation again fell, although there was evidence that the rate of decline was easing, and public authority expenditure was also slightly reduced. On the other hand, some inventory rebuilding took place and this was associated with a strong increase in import volumes during the year (itself partly a spillover from the higher levels of demand in 1978/79).

Undoubtedly, the most favourable developments were the continued rise in export volumes (growth has averaged 4 — 5 per cent per annum over the last two years) and a significant increase in gross farm incomes. The fact that both agricultural and manufacturing exports have increased strongly in each of the past two years not only augurs well for the future but also indicates that the policies to encourage export production have borne some fruit. These policies include export incentives of various kinds, farm income stabilisation arrangements, and more recently the new exchange rate regime. They played a significant part in the improvement in the trade balance over the last two years from $327 million in 1977/78 to $807 million in 1979/80.

Unfortunately, the invisible deficit has continued to expand and in the year ended March 1980 this expansion was greater than the improvement in the trade surplus so that the current account deficit grew from $426 million in 1978/79 to $482 million in 1979/80. The major element in this continued problem on the invisibles account is the servicing of the borrowing that has been required over the last six years and continues to be required to finance the presistent current account deficit.

Against the background of a relatively stable level of overall internal economic activity, and with net external migration running at much the same level as in the previous year, unemployment persisted at around 50,000 (including 20,000 persons engaged on various

temporary employment schemes), or in total about 3.8 per cent of the overall labour force.

Following the recovery of economic activity in 1978/79, monetary and fiscal policies were initially directed towards containing the rapid increases which had occurred in both the Budget deficit before borrowing and the monetary aggregates during that period. As 1979/80 progressed, the dominant consideration underlying short term macroeconomic policy became the desire to maintain a relatively steady level of domestic economic activity.

This objective reflected a dilemma which has now become all too familiar to policymakers in many countries. On the one hand, there was a desire to maintain an acceptable level of real activity and, in particular, to avoid further adverse effects on employment. On the other hand, the economy continued to face the constraint of a persistent overseas current account deficit.

In addition, there was heightened concern about the re-emergence of rapidly rising rates of inflation, a situation which represented a disappointing reversal from the improvement recorded in 1978/79. In that year, consumer prices rose by 11 per cent. In 1979/80 the increase was 18 per cent, with the trend accelerating through the year. Several factors explained this deterioration, including higher rates of increase for wages and salaries, import prices (especially oil), farm product prices (reflecting favourable export prices), increases in government charges and the reduction or abolition in subsidies.

Given the principal short-term objective of preserving a reasonably steady level of domestic activity, monetary and fiscal policies could in general be judged to have been more successful during 1979/80 than had been the case for some time in the past. The fiscal deficit before borrowing was reduced from $1,446 million to $1,027 million, or from about 8 to 5 per cent of gross domestic product. The broadly defined money supply and selected liquid assets series (M3) rose by 15 per cent in the year to March 1980, or at a little less than the rate of inflation. This was down on the 23 percent figure for the previous year. At the end of the year under review, some further contraction in the monetary aggregates was expected, as illustrated by the fact that the narrow money supply (M1), normally a leading indicator of monetary conditions, was only 7 per cent up in the year to March 1980.

As a result, monetary policy shifted during the course of the year from being relatively tight to a more or less neutral position. For much of 1979/80 the cumulative budget deficit ran at higher levels than in 1978/79 but this trend was reversed in the latter part of the fiscal year and over the year as a whole the stance of fiscal policy was firmer than in the previous year.

At year end then, the immediate prospects seemed to be for some further moderate easing in real activity, a persistence of high inflation rates and a difficult employment situation, and an almost certain deterioration in the external current account. The latter problem reflected the likelihood of a reduction in the terms of trade, especially because of higher oil prices and a generally weak international economy.

This situation throws into sharp relief the need to pursue more vigorously the sort of long-term structural policies which were introduced in 1979/80. It also confirms the need to avoid the sharp swings in fiscal and monetary policies which have occurred at times in the past. More stability is required in the application of these policies in order to provide a suitable environment within which the process of structural change can take place.

The essence of this process should be the adoption of a set of policies designed to enhance production of internationally marketable commodities so that export volumes can be increased and imports displaced by efficient domestic output. The justification for such an approach, and the policies required to achieve it, were outlined in the Bank's 1978/79 Annual Report. Some of the moves suggested have since been adopted, although there remain important areas which need further attention. These include such matters as:

- the need for continued progress under the industry studies programme in order to facilitate a more positive overhaul of our system of protection with the ultimate objective of defining more clearly the most suitable areas for industrial development and the most appropriate means of encouraging this development. As part of this process, it must be recognised that there is also a need to study closely the broader implications, including the social consequences, which may result from any rationalisation of the industrial sector;
- the review and relaxation of those controls and regulations which inhibit enterprise, efficiency, and competition;
- the implementation of programmes for the retraining, relocation, and assimilation back into the workforce of people displaced by the process of adjustment;
- the introduction of more permanent and stable machinery under which wage negotiations can take place, including the development of national level consultative arrangements aimed at achieving agreement, or at least broad understanding, on appropriate income levels; and
- a review of the taxation system to examine such issues as the possibility of indexing the tax schedules to avoid excessive 'fiscal drag', the 'double taxation' of business incomes (profits and dividends being taxed separately), the treatment of interest as wholly income when it should perhaps be regarded in large part as simply preserving the capital value of financial assets in times of high inflation, the taxation of 'false' profits from inventory appreciation, and the incidence of taxation on part-time incomes.

Underlying many of these policy issues, and a matter which lies at the heart of preserving our international competitiveness generally, is the problem of inflation. It is of fundamental concern because its solution holds the key to resolving so many of the other difficulties faced by the economy.

Inflation distorts the pattern of income distribution and the incidence of tax, favours debtors at the expense of creditors and borrowers at the expense of savers, discriminates against fixed income earners, impairs the profitability of exporters and promotes an excessive demand for imports, encourages speculation and distorts resource allocation, and by generally undermining business confidence, contributes to the shortage of employment opportunities.

Clearly, the preferred course of action would be to reduce inflation to tolerable levels. But history shows just how intractable the problem can be and some

endeavour should be made in the meantime to cope with the inequities and inefficiencies which arise from the inflationary process.

Some of these inequities and inefficiencies arise because high inflation rates seriously impair some of the traditional functions of money. While money may continue to offer a convenient albeit depreciating means of facilitating the exchange of goods and services, its usefulness as a store of value and a unit of account is greatly diminished by the process of inflation. In order to highlight these problems and to promote more widespread realisation of their dangers, the Bank has during the past year published a series of articles in its monthly *Bulletin* which outlined the nature of these problems and offered proposals based on the concept of a unit of account of constant purchasing power.

A variety of problems arise as a consequence of money having an unstable value over time.

First, many complications emerge for borrowers because of the fact that interest is a current revenue item payable in cash each year whereas the loan itself is usually repayable over a lengthy period. Conventional loan contract arrangements imply that in times of rapid inflation and thus high interest rates, there is a shift in the burden of debt repayments in real terms towards the earlier years of a loan.

This can be particularly burdensome to low or single income families repaying house mortgages. Business entities suffer from a similar sort of problem since they rely heavily on borrowed funds. Although there is some mitigation in the form of interest deductability for tax purposes, high interest rates, themselves induced by inflation, increase the rate of payback of loans in real terms, aggravate business cash flow difficulties, and thus add to the deterrents to investment.

Secondly, savers and providers of loan money find that inflation depreciates the purchasing power of the dollar amount lent, a problem which is only partly overcome by the high interest rates which prevail in inflationary circumstances. Conventional interest rate arrangements may fail to compensate them for this deterioration in the real value of their financial assets both because changes in nominal interest rates often lag behind changes in the rate of inflation (leading to negative real interest rates) and because interest income is taxable i.e. is treated as income even though it may be doing no more (or less) than maintaining the capital value, or the real purchasing power, of the savings balances. In other words, in this context, interest receipts up to the rate of inflation should be regarded as a capital item rather than as current revenue.

Thirdly, the taxation of interest may induce savers to invest in real assets where any appreciation in the value of the asset, whether it be land or antiques, represents a tax free capital gain. This process encourages speculative activity, distorts resource allocation, and may diminish the pool of funds available for investment in more productive purposes.

Fourthly, inflation can create a variety of distortions in financial markets. The use of interest rates to compensate for the depreciation of the principal of debt, associated with the continued widespread use of fixed interest, fixed maturity securities may result in wide variations in the market value of securities held by savers and institutions. This impairs the attractiveness of financial assets to savers, and may create problems for the overall stability of financial institutions.

Inflation, by changing the value of the basic unit of account, the dollar, over time, also causes difficulties in fixing the price of contracts for transactions to take place in the future. This leads to ad hoc indexation of various forms, such as the insertion of escalation clauses. These really only serve to transfer the uncertainty generated by inflation from one party (say the lender) to the other party to the contract (say the borrower) and they can cause problems of interpretation and settlement.

If these various distortions are to be eased, then a number of policy implications can be drawn.

One of the major changes required is the introduction of an appropriate form of inflation accounting. Disappointingly slow progress has been made since the publication in 1976 of the Report of the Committee of Inquiry into Inflation Accounting (the Richardson Committee), despite the fact that an increasing number of companies is now likely to present accounts on the basis of both historical and current cost accounting, following the suggestion of the New Zealand Society of Accountants.

Within the context of inflation accounting, the Bank has suggested that serious consideration should be given to the use of a constant value unit of account, i.e. a constant unit of purchasing power. This would avoid many of the distortions inherent in present accounting procedures, would assist the cash flow positions of commerical enterprises, and would facilitate appropriate accounting treatment of monetary assets and liabilities (an area which has always presented problems for inflation accounting methodologies).

Consideration could also be given to altering the taxation arrangements so that the proportion of interest income equivalent to the inflation rate (i.e. the effective adjustment of the capital of debt to allow for inflation) would be non-assessable for tax purposes. In essence, this would give savers a better chance of maintaining the real purchasing power of their financial assets. If a constant value unit of account were to be introduced, interest rates would still be determined by market forces but actual interest rates would be comparable with those prevailing in non-inflationary circumstances.

As far as the tax system is concerned, the corollary would be that interest payments would no longer be deductible for tax purposes. The cost of this to the business sector would have to be considered in the context of the taxation gains that sector would achieve under inflation accounting. In particular, depreciation charges would be higher, since they would be calculated on the basis of the current value of fixed assets, and the increase in the money value of inventories would not be taxed in the way which prevails at present under historic cost accounting.

The concept of a constant value unit of account is of course simply a form of financial indexation. As such, it would enable savings balances, other deposits, loans, mortgages, and indeed the full range of financial assets and liabilities, to be expressed in real terms, rather than being eroded by inflation. Such an arrangement would also make explicit the distinction between the two components which contribute to nominal interest rates under present circumstances: the income portion and the capital maintenance (the inflation adjustment) component.

It should be emphasised that these proposals are not the same as automatic indexation of prices and incomes.

The expression of asset values in a unit of constant purchasing power does not alter the fact that the prices at which assets are bought and sold would still be determined by market forces. So too would real interest rates be freely determined by the forces of demand and supply in financial markets. And profits would not be indexed in the sense that they would be automatically linked to inflation; instead profits would depend, as they do now, on efficiency and appropriate pricing policies.

Neither does the proposal imply or advocate that the incidence of taxation be shifted from the corporate sector to wage and salary earners. The tax rates applied to profits would need to be reconsidered. Any change in the incidence of tax on profits would be a distinct and deliberate decision, not an integral part of this proposal.

The difference would be that profits would more fairly reflect the current worth and efficiency of the enterprise, that tax would fall on the income and not the capital portion of savings, that borrowers would repay debts on the basis of fully maintained purchasing power and not in terms of depreciated dollars, and that the profile of loan repayments would be more stable as a proportion of income than is the case under fluctuating rates of inflation.

The use of a constant value unit of account would ease the distortions from inflation and the concept could have a place in other contracts that involve time, such as wage agreements. Further, by easing the distortions which arise from inflation, the concept should facilitate the adoption of more effective and equitable policies in all areas aimed at reducing the rate of inflation itself.

In the Bank's view the key policies needed to reduce inflation are:—

— income determination procedures that reward and encourage increased output, thus laying the foundation for genuine and lasting increases in incomes and living standards;
— more stable and moderate fiscal and monetary policies;
— policies designed to ensure that economic growth is concentrated in those industries that are internationally competitive (i.e. both exports and import substitution) as these are the industries that are, by definition, most efficient.

If by the implementation of such policies the domestic elements of inflation could be moderated so that New Zealand's costs of production rise more slowly than those in the rest of the world, the present exchange rate system would tend to reduce the transmission of overseas inflation to the domestic economy. Fundamentally, it is only by reducing inflation that we can create an appropriate environment for equitable and sustained growth.

Monetary Conditions and Policy

1979/80 opened with monetary conditions generally easy but with monetary policy adopting a firmer line than had been the case throughout most of the preceding year. Monetary and credit conditions had eased significantly during 1978/79. In large part this easing was deliberate as the government had taken both fiscal and monetary actions in late 1977 and into 1978 aimed at maintaining a reasonable level of domestic economic activity.

But towards the end of 1978/79 the main policy issue became one of establishing and maintaining a reasonable balance between competing economic objectives. There was concern that monetary conditions were becoming too liquid and that this could, if sustained, jeopardise the Government's efforts to moderate inflation and contain the balance of payments deficit. Measures were announced in January 1979 that tightened the reserve requirements of trading banks and finance companies.

The firm policy line applied in early 1979 was assisted significantly by public debt policy. The first cash loan of the financial year opened in late April, offering a peak rate of 13 per cent for five years, and this proved to be attractive. The loan raised a total of $428 million of which approximately $73 million represented net new investment from holders other than 'M3 financial institutions'. A second issue of the New Zealand Government Savings Stock opened in mid-May, with the same features as the highly successful 1978 issue. However, competing interest rates had risen in the intervening period and the second savings stock issue was much less popular than the first, though in raising $47.5 million it was still a reasonably successful issue.

The rates of growth (in seasonally adjusted terms) of M1, M3 and overall domestic credit during the first quarter of 1979/80 were lower than they had been for a year. Private sector credit growth, however, accelerated significantly to 8.9 per cent in seasonally adjusted terms for the June quarter, after falling markedly in the previous quarter.

While there were a number of factors that provided some justification for this surge, growth at that rate was clearly incompatible with the guideline for private sector credit growth of 8 per cent to 12 per cent for the year ended March 1980 which the Minister of Finance had announced in April. The guideline had been intended to give financial institutions an indication of an appropriate growth rate for lending to the private sector and the institutions had been informed that the Government expected them to adopt a responsible approach and to move quickly on to the path indicated by the guideline. The opposite occurred in the June quarter of 1979.

In response to this, reserve requirements applied to trading banks and finance companies were raised for the second time in 1979. The trading bank free reserves margin was reduced from $50 million to zero, as from July 1979. This was the tightest application of the reserve asset ratio system since its introduction in 1973. The Government security ratio applying to finance companies was raised from 20 per cent of borrowing to 22.5 per cent as from 1st October. This was also the highest level that this ratio had reached since its introduction in 1969.

Private sector credit growth did slow again in the September quarter to a rate that was, when seasonally adjusted, only just above the guideline range. Stronger growth reappeared in the December quarter but growth in the March 1980 quarter was again more reasonable. By the end of the year the annual growth rate was down to 22 per cent, a rate of growth that was significantly above the guideline range but was well down from the

peak annual growth rate of 29 per cent that followed the surge in the June 1979 quarter.

The growth rates of the monetary aggregates when seasonally adjusted were higher in the second half of the 1979 calendar year than in the first half. The major reasons for this were the pattern of Government expenditure and revenue and the pattern of Government's financing transactions. Government's budget deficit before borrowing was lower in 1979/80 than in the previous year — $1,027 million as compared with $1,446 million. But for a large part of 1979/80 the cumulative budget deficit for the year was running at higher levels than in the previous year and this was only reversed in the latter part of the fiscal year.

The pattern of financing was also markedly different between the two years. Sales of Government debt to the non-bank private sector in 1978/79 fell most heavily in the December quarter when the successful Savings Stock No. 1 was issued. Sales in 1979/80 were heaviest in the June quarter because of a successful cash loan and Savings Stock No. 2.

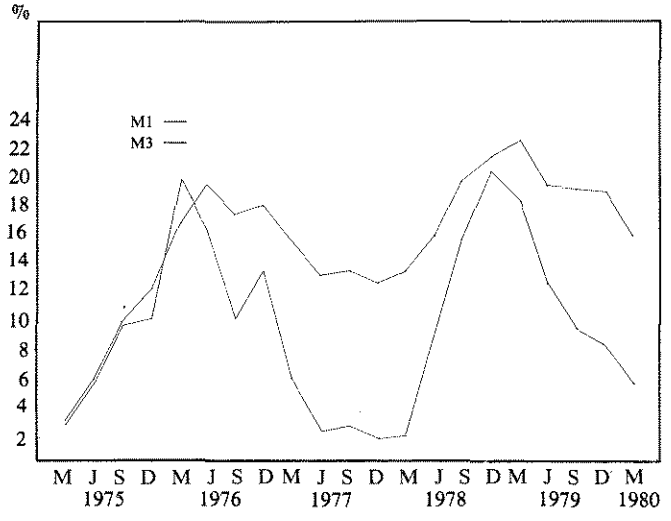
The worsening balance of payments situation brought on by the consumption-led recovery of 1978/79 and aggravated by the latest series of OPEC oil price rises had the effect of reducing monetary growth in the latter part of 1979/80.

The reduced fiscal deficit, a larger balance of payments deficit, some slowdown in private sector

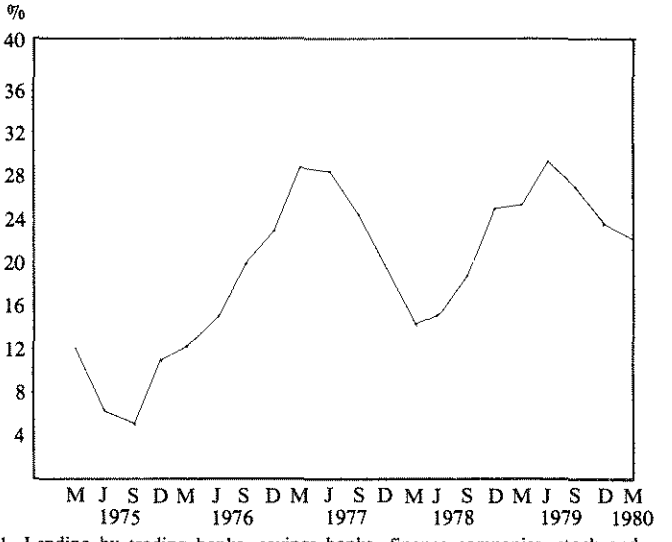
Money Supply and Selected Liquid Assets of the Public

At End of Quarter	Money Supply (M1) $m.	Money Supply (M1) Annual % Increase	Other Demand Deposits $m.	Other Demand Deposits Annual % Increase	Time Deposits $m.	Time Deposits Annual % Increase	Total (3M) $m.	Total (3M) Annual % Increase
1977 — Mar.	1,690	5.9	2,113	5.7	2,923	31.5	6,726	15.6
June	1,692	2.2	2,158	6.2	3,192	25.9	7,041	13.2
Sep.	1,586	2.5	2,109	4.9	3,429	25.8	7,123	13.4
Dec.	1,820	1.6	2,118	2.8	3,675	26.1	7,613	12.5
1978 — Mar.	1,720	1.8	2,161	2.3	3,740	27.9	7,621	13.3
June	1,843	8.9	2,232	3.4	4,085	28.0	8,159	15.9
Sep.	1,834	15.7	2,273	7.8	4,401	28.4	8,509	19.5
Dec.	2,189	20.3	2,378	12.3	4,671	27.1	9,238	21.3
1979 — Mar.	2,035	18.3	2,482	14.9	4,819	28.9	9,336	22.5
June	2,072	12.5	2,477	11.0	5,194	27.2	9,743	19.4
Sep.	2,005	9.3	2,432	7.0	5,705	29.6	10,142	19.2
Dec.	2,371	8.3	2,480	4.3	6,149	31.6	10,999	19.1
1980 — Mar.(Prov.)	2,147	5.5	2,521	1.6	6,139	27.4	10,807	15.8

MONEY SUPPLY (M1)
MONEY SUPPLY AND SELECTED LIQUID ASSETS (M3)
(Annual Percentage Changes at quarterly rests from March 1975 to March 1980)



PRIVATE SECTOR CREDIT[1]
(Annual Percentage Changes at quarterly rests from March 1975 to March 1980)



1. Lending by trading banks, savings banks, finance companies, stock and station agents and the official short term money market to the private sector in the form of advances, loans, mortgages, purchases of local authority securities, leasing and factoring etc., but net of inter-institutional lending.

credit growth and the impact of rising inflation on both the demand for working balances and other forms of credit and on nominal interest rates all combined to lead to a tightening of monetary conditions in the latter part of 1979/80.

This tightening had been anticipated, and measures to ease monetary policy slightly were announced in December 1979 despite the fact that private sector credit growth picked up again in the December quarter. The trading bank free reserves margin was increased to $50 million again as from January 1980, and the Government security ratios applying to trustee savings banks and private savings banks were lowered by 1 per cent and 2 per cent respectively with effect from February 1980. Because finance company lending was continuing to grow at an unacceptably high rate with no signs of slowing down, the finance company Government security ratio was not reduced.

On three occasions during 1979/80 it appeared likely that there would be sizeable deficiencies in trading bank monthly average holdings of reserve assets. The Reserve Bank acted to reduce the expected shortfalls in order to ease any temporary and unsettling pressure on short-term interest rates. This was done by purchasing private sector securities on the market. The reserve asset ratio system when applied firmly to trading banks, as it was throughout 1979/80, carries with it risks of putting intense but uneven pressure on short-term interest rates at times. Ways to reduce these short-term pressures without unduly weakening the firm impact that the policy stance seeks to apply at such times are under investigation. But the nature of the role of the trading banks in the financial system is such that they are always going to be subjected to large and, to some degree, unpredictable short-term flows. Most financial flows between the Government and the private sector pass through the banks as do most financial flows between the domestic private sector and the rest of the world. There will always be more volatility in short-term interest rates than long-term rates because of these flows but the reserve asset ratio system should not compound this volatility if this can be avoided.

With monetary conditions and monetary policy generally becoming tighter through most of 1979, and with an increasing rate of inflation and expectations of further increases in the near future, interest rates tended to rise up until December 1979. For example, average trading bank TCD rates peaked at almost 16 per cent in November/December, compared to levels of less than 13 per cent at the beginning of the financial year. With the easing of monetary policy in the March quarter of 1980, short-term interest rates generally fell a little. Average TCD rates, for example, were around 14 per cent in February/March.

There was evidence of more reasoned attitudes towards short-term interest rate competition amongst financial institutions. Institutions seemed to take greater account of their own funds position in deciding whether or not to follow interest rate moves by their competitors. As a consequence the spread among the deposit rates paid by trading banks and by finance companies were quite wide at times and varied as the needs of the individual institutions for short-term funds fluctuated.

Longer-term interest rates have continued to rise in nominal terms over the year. The average rate, excluding Government, on new mortgages registered was 13.08 per cent in February 1980 compared with 11.98 per cent a year earlier. These rises in nominal interest rates are less than the increase in the Consumers' Price Index over the year so that for many long-term borrowers 'real' rates of interest probably fell over the year.

There is a continued need to make the network of public sector security ratios applied to financial institutions more equitable. The payment of more market-oriented interest rates on the main reserve assets has

Changes in Assets of Selected Financial Institutions

($ million)

Year Ended	*Government*	*Marketing and Stabilisation*	*Private*[1]	*Total Domestic Credit*	*Overseas*	*Residual*	*Total*
1977							
Mar.	+263	+ 31	+ 851	+1,145	− 90	−147	+ 908
June	+194	− 42	+ 838	+ 991	− 19	−153	+ 819
Sep.	+322	− 37	+ 781	+1,066	−163	− 64	+ 839
Dec.	+397	+ 32	+ 647	+1,075	−100	−130	+ 846
1978							
Mar.	+254	+ 33	+ 537	+ 824	+106	− 34	+ 896
June	+316	+ 80	+ 583	+ 978	+183	− 43	+1,118
Sep.	+462	+ 74	+ 752	+1,288	+198	−101	+1,386
Dec.	+446	+104	+1,005	+1,554	+109	− 38	+1,625
1979							
Mar.	+512	+105	+1,087	+1,704	+ 28	− 16	+1,715
June	+457	+ 52	+1,278	+1,788	−102	−102	+1,584
Sep.	+335	+ 60	+1,223	+1,617	+ 41	− 23	+1,634
Dec.	+558	+ 38	+1,177	+1,772	+ 71	− 82	+1,762
1980							
Mar. (Prov.)	+226	− 7	+1,171	+1,389	− 26	+107	+1,471

[1] Includes local authorities.

gone a long way towards reducing the inequities in the ratio system but a rationalisation of the ratio levels is also desirable.

There were some moves during 1979/80 which helped in this process. The large difference between the ratios for the trustee and private savings banks was reduced slightly when their ratios were lowered in February 1980 and the building societies' ratio continued its slow build-up from its relatively low level. If, as the Bank expects, monetary conditions are in better balance with the country's economic circumstances in 1980/81 than they were throughout much of 1979/80, there may be scope for further progress to be made in this area in the year ahead.

The intensified competition within the financial system has continued to exert an influence on the maturity structure of financial assets. The trend noted in last year's annual report for the broadly defined monetary aggregate, M3, to grow more quickly than the narrowly defined money supply, M1, reasserted itself through 1979/80, with M1 growing by 6 per cent over the year, and M3 growing by 18 per cent. The main reason for this trend is that more attractive interest rates have induced depositors to switch to term deposits in order to minimise the impact of inflation on their financial assets. There is no interest return for holding cash or chequeable deposit balances (which are the components of M1), and the opportunity cost of doing so therefore increases as the interest rates on other financial assets rise.

There are also probably other factors at work helping to continue the long-term downward trend in the ratio of money balances to GNP. One that the Bank considers is significant is the relatively easy break facilities many financial institutions currently allow for their so-called fixed term deposits. Such facilities blur the usual distinction between a demand deposit and a term deposit from the point of view of both the saver, who gains flexibility, and the institution, which loses certainty. This raises some important considerations in respect of the interpretation of monetary aggregates and in the management of financial institutions. There has also continued to be a tendency for the maturity structure of term deposits to shorten. While this is not surprising in times of uncertainty regarding the future course of inflation, and hence of interest rates, it also has important ramifications for the interpretation of monetary conditions and the stability of financial institutions.

There was further innovation in the financial system during the year in the form of new services or types of savings instruments. One development that potentially could be of considerable significance was the introduction of credit cards by the trading banks. While the use of such cards is expanding rapidly in several overseas countries, it is too early to say whether New Zealanders will accept and use credit cards on the same scale.

There have also been new types of deposit instruments offered with a number of borrowers offering variable rate instruments in an effort to persuade savers to invest for longer terms.

A Securities Commission was established in 1979 with wide powers to supervise and control the issuing of and dealings in securities. The Commission's functions as set out in the establishment Act are:

— to keep under review the law relating to bodies corporate, securities and unincorporated issuers of securities and to recommend to the Minister of Justice any changes that it considers necessary;
— to keep under review practices relating to securities and to comment on such practices to any appropriate body;
— to promote public understanding of the law and practice relating to securities.

Soon after its establishment the Commission carried out an extensive review of the public interest issues relating to financial advertising. In March 1980 they published a draft report for discussion with interested parties suggesting in essence a more liberal approach to financial advertising but much fuller disclosure requirements in prospectuses.

The Annual Accounts this year have only been prepared on an historical cost basis. However, the Bank's accountancy records are being reorganised to enable inflation adjusted accounting statements to be prepared for the 1980–81 financial year.