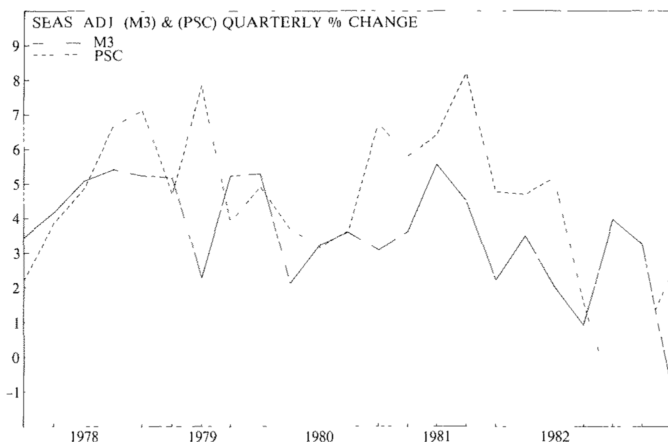
QUARTERLY REVIEW OF MONETARY CONDITIONS AND POLICY

Monetary conditions in the June quarter 1983 were characterised by a general slowdown of monetary growth, although toward the end of June there were signs that conditions were beginning to ease slightly. The broadly defined money supply (M3), which had grown by 3.2 per cent (seasonally adjusted) in the March quarter, declined by 0.9 per cent in the June quarter. The decline in the narrow money supply (M1), was even more marked —M1 grew by 3.1 per cent (seasonally adjusted) in the March quarter followed by a fall of the same magnitude in the June quarter. Some easing, however, was suggested by the estimates for M3 for the month of June, which showed a positive growth of 0.7 per cent (seasonally adjusted).

In contrast to this overall monetary tightening, credit growth has expanded a little in recent months. Private sector credit (PSC) grew by 0.7 per cent (seasonally adjusted) in the March quarter and by 2.4 per cent in the June quarter 1983. To try and ensure that the growth in credit remains at a sustainable level all major lending institutions are now subject to a quantitative lending guideline, designed to limit the month to month lending growth of each institutional group to 1 per cent on a seasonally adjusted basis.

A feature of monetary and credit conditions over the last few quarters has been the divergent growth patterns of M3 and PSC. This divergence is highlighted in figure 1 below which presents the quarterly percentage change in each aggregate, seasonally adjusted.

FIGURE 1

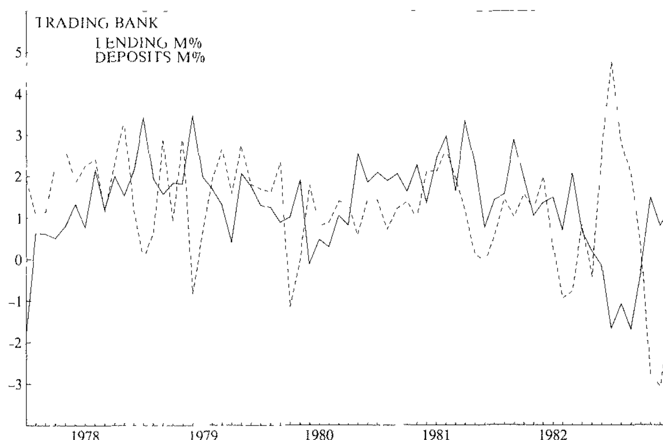


The increased rate of monetary growth in the December 1982 and March 1983 quarters resulted mainly from injections from the foreign sector and from the official domestic sector (the Government and the Reserve Bank) while the decline recorded in the June quarter can be attributed to the strong withdrawal from the domestic economy caused by an active Government debt programme (notably the effect of the Kiwi Savings Stock), which more than offset the growth in the monetary aggregates from other sources, including a strong injection from the external sector.

The slowdown in private sector credit growth in the December 1982 and March 1983 quarters was mainly due to the weak demand for loans resulting from the downturn in real economic activity, and from the emergence of positive real lending interest rates. However, by the end of the June quarter 1983, the demand for loans was increasing, probably due in part to the improvement in the balance of payments, and the continued strengthening of the U.S. recovery, which were producing expectations of some improvement in international domestic and economic activity.

The trend in deposits and lending are shown clearly in the trading banks' balance sheets. Trading bank lending declined 1.6 per cent and 3 per cent in the December and March quarters, but grew by 3.5 per cent in the June quarter 1983, reflecting the pattern of private sector credit growth. Trading bank deposits declined in seasonally adjusted terms during the entire June quarter after a five month period of sustained growth, following a generally similar pattern to that of the M3 aggregate. The divergent trends in trading bank deposits and lending are shown in figure 2 below:

FIGURE 2



The strong upturn in the monetary aggregates reflected in the growth in trading bank deposits during the December and March quarters was seen as inconsistent with current Government policy, which is oriented towards a sustained reduction in inflation. Strong monetary growth was one of the factors that prompted the Government to introduce Kiwi Savings Stock on 21 March 1983. The attractive interest rate of 15 per cent per annum, reduced to 13 per cent on stock redeemed within twelve months, and the liquid nature of the stock (it was available at seven days' notice after being held for one month), ensured that the issue would be successful in achieving the Government's principal objective of restraining the rate of growth of the monetary base and thereby minimising the risk of an unwarranted credit expansion in the short term.

During the three months it was available on the market, total Kiwi Stock sales rose to $1,405.1 million ($350 million more than total subscriptions to date of Inflation Adjusted Savings Bonds). Since the closing of the stock on 16 June 1983 there has been a steady flow of redemptions which reached $307.7 million by 15 July 1983, with a further $128 million in prospect, but not yet paid out.

While the eligibility of companies for Kiwi Stock and

SUBSCRIPTIONS AND REDEMPTIONS OF INFLATION ADJUSTED BONDS AND KIWI SAVINGS STOCK

$ million

1983 Month Ended	*Inflation Adjusted Bonds*		*Kiwi Savings Stock*	
	Subscriptions	*Redemptions*	*Subscriptions*	*Redemptions*
March	14.6	9.1	72.9	—
April	14.8	10.6	267.9	6.4
May	12.5	14.5	613.2	70.4
June	7.8	21.2	436.8	164.6
July 15[1]	2.3	13.8	14.3	66.3[2]

1 Although the issue terminated on 16 June 1983 the large number of applications (130,500) caused processing delays These in turn resulted in $14 3 million of Kiwi Stock being recorded in July.
2 In addition, redemptions totalling $128 million have been advised but not yet paid out

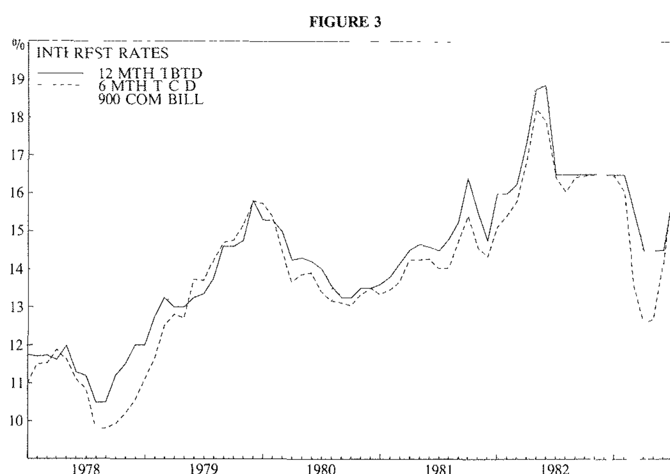
the absence of a maximum holding limit no doubt boosted total sales, the most important factor in the success of the issue appears to have been the broadly based participation by the general public. At the same time, sales of Inflation Bonds have slowed and redemptions have increased, reflecting a change in investor preferences during the period that Kiwi Stock was on issue.

The increase in redemptions of Inflation Bonds was probably due also to a perceived sharp reduction in their return as a result of the decline in the rate of increase in the Consumer's Price Index (CPI) and reduced marginal tax rates for some investors.

The temporary consequence of the public debt sales policy, centred primarily around Kiwi Stock, was some upward pressure on the shorter-term deposit interest rates. As an illustration of this, figure 3 plots monthly data showing recent movements in the interest rates offered on three market instruments:

1. 12 month trading bank term deposit rates (maximum for month)
2. 6 month transferable certificates of deposits (average for month)
3. 90 day commercial bill rate (maximum for month).

FIGURE 3



Transferable Certificates of Deposit (TCD) and trading bank term deposit (TBTD) rates generally moved upward as the withdrawal of liquidity from the system intensified, and the trading banks bid for deposits to shore-up their respective liquidity positions. The effect of the withdrawal on the trading banks is illustrated by the fact that in mid-March the volume of TCDs outstanding stood at around $850 million. By early June, however, they had declined to a low point of $470 million despite the increase in yields offered. By the end of June (two weeks after Kiwi Stock had been taken off the market), TCDs outstanding had climbed back up to around $700 million. During this period the 90-day TCD rate climbed from 13 percent to 16.5 per cent toward the end of June and by late-July had dropped back to around 14 per cent. These rates were all within (or at) the maxima prescribed under the Interest on Deposits Regulations 1983.

Inspite of the general tightening of liquidity, commercial bill rates remained relatively flat throughout March and April. In early May bill rates started to climb from a base of around 14 per cent and, by the end of June had peaked at 17 per cent. Rates on this instrument however had, by late July, dropped to between 13 and 14 per cent with further reductions expected.

Over the last eighteen months trading bank reserve assets have displayed a high degree of volatility. For example, system reserves dropped from $1,352 million in January 1982 to a low point of $855 million in October and then surged to $2,546 million by the end of March 1983. The statutory reserve asset requirement set monthly was moved to accommodate this volatility, given unchanged ratio policy. However, in April 1983 growth in the reserve base was unexpectedly flat. This resulted in a reserve asset shortfall for the system as a whole and penal borrowing for some of the trading banks.

A substantial drop in reserve assets ($2,548 million to $1,989 million) was recorded during May. Just as the rapid improvement in the reserves position between October 1982 and March 1983 contributed to the fall in bank deposit interest rates over that period, so this contraction in the reserves base contributed to the higher interest rates experienced in April and May and the early part of June.

Although average reserves fell by $453 million over June compared with May (from $1,989 million to $1,536 million) towards the end of June the reserve base was starting to grow with sustained foreign exchange inflows and, at the end of the month, a large end of season Dairy Board payout to suppliers. During July this trend continued with average reserve assets held over the month being $290 million higher than the average for June, reaching $1,826 million.

SUMMARY AND OUTLOOK

After a period of rapid expansion in the monetary base during the December quarter 1982 and the March quarter 1983, the attendant risk of an unsustainable expansion in private sector credit was temporarily averted during the June quarter largely by an active government debt sales programme. This programme caused the overall liquidity position within the financial sector to tighten considerably, reflected in a decline in M3 for the June quarter and temporary upward pressure on short-term deposit interest rates.

Indications which began to emerge toward the end of June suggested that monetary and credit conditions were beginning to ease. The main factors supporting this view were:

1. The M3 estimate for the *month* of June was positive (+0.7 per cent) for the first time in three months.
2. Short-term interest rates across the financial sector as a whole had fallen significantly.
3. A continued improvement in the external sector was forecast for the September quarter; and
4. A large increase in the fiscal deficit for 1983/84 was announced by the Minister of Finance on 28 July.
5. The system's reserve base had demonstrated steady growth over June and July.

POLICY ANNOUNCEMENTS

Three recent announcements give an indication of both the immediate outlook for the financial sector and the direction of the Government's monetary policy. These were:

1. The speech delivered by the Prime Minister to the New Zealand Bankers' Association (NZBA) on 27 July 1983.
2. The Minister's Budget address to the House of Representatives delivered on 28 July 1983; and
3. The release of details regarding the proposed tender scheme for government stock.

In his NZBA speech, the Prime Minister announced a number of measures designed to reduce interest rates. He emphasised that the current low annual rate of inflation meant that a significant downward revision in the market's interest rate structure was now warranted. To lead the way, he announced that the Government's tap stock was being withdrawn from the market. He also announced an immediate reduction in interest rates on Treasury bills, from 12 per cent for 91 day bills and 12.5 per cent for 182 day bills to 7.8 and 7.9 per cent respectively. These yields were broadly in line with a Government Stock rate of 8 per cent. Mr Muldoon warned the financial sector that if a general downward adjustment of interest rates was not forthcoming during the month of August, the Government would consider bringing rates down by regulation or by introducing various taxation measures. This statement set in motion a general reduction in most deposit and some lending interest rates across the whole financial sector, accelerating a trend that was already evident.

The Prime Minister's Budget address (extracts from the section on Monetary Policy of which are reproduced below), expanded on the structural adjustment required in the context of the economy as a whole:

"Monetary Policy

The primary role of monetary policy over the coming year and beyond will be to restrain money and credit growth to rates consistent with a low rate of inflation...

The Government's expenditure and revenue decisions, together with the influence of the external sector, initially determine the growth in the supply of money. The Government's own debt sales programme focuses primarily on limiting the growth in the money supply and the reserves of the financial institutions. This restrains the ability of the financial sector to expand its lending. In addition, the major financial institutions have been given guidelines as to the rate of lending growth which will be acceptable over the coming year. They have further been warned that reserve ratio policy will not accommodate increases in excess of those guidelines.

The aim is not a credit squeeze. Sufficient lending will be available to finance real economic growth at low rates of inflation, but not enough to permit unwarranted increases in prices. Easy money can only lead to excessive imports and inflation.

The Government is determined to adhere to a policy of monetary restraint. Rapid growth in the monetary base in the last two quarters of 1982/83, partly due to the large private capital inflow and partly to the increase in the dairy industry overdraft and supplementary minimum prices, was met with the introduction of the Kiwi Savings stock on 21 March 1983. The competitive interest rate and associated terms ensured that the Kiwi Stock was highly successful and, having achieved its immediate objective, it was withdrawn. As I said at that time, further Government security issues will be made as required to achieve the desired monetary control.

In addition, I announced recently that the Government is to move to a tender system of selling Government Stock. The main feature of this method is that it will give the Government an enhanced ability to achieve the debt sales it wants, at the time it wants. Once we have decided the volume of debt sales needed for monetary policy, the bids will determine the rate of interest needed to sell that volume.

The result of the Government's monetary policy has been a substantial reduction over the past year in the growth rates of both the money supply and private sector credit, which are now consistent with the lower rate of inflation and should contribute also to an easing of inflationary expectations.

I acknowledge that interest rate levels have generally fallen, in many cases substantially. Deposit interest rates, and increasingly now lending rates also, have been adjusting downwards as a result of a reduced demand for credit at existing interest rates. This is a reflection of the downward adjustment in peoples' expectations of future inflation. My concern, however, is that some of these interest rate adjustments are lagging too far behind the actual fall in the inflation rate. I

hope that continued reductions in nominal interest rates can be achieved without further controls, but the result is finally more important than the means. The outcome of continued monetary control over the coming year should be both low inflation and a structure of interest rates commensurate with it."

In July the Reserve Bank released details of the proposed tender scheme for Government stock, which will replace the existing 'tap' sales system. The first tender is expected to take place in early September 1983. At this stage it is envisaged that about eight tenders will be held each year. Treasury bills will not be tendered in the meantime, and will continue to be available on a 'tap' basis. In addition, Inflation Bonds and (from time to time, or perhaps continuously) a savings stock issue will continue to be available on a 'tap' basis alongside the tender.

The Reserve Bank has prepared an information paper, available on request, which details the operation of the stock tendering scheme. Briefly, the scheme will be centred around competitive bids (minimum $20,000) being lodged for predetermined amounts of stock in several maturities. The amount of stock offered in each maturity will then be allocated to successful participants in order of ascending yields, at the yields actually bid, until the amount is fully allotted.

In addition to accepting competitive bids, a facility where non-competitive bids for up to 5 per cent of the amount offered in each maturity will also be available. Under this facility, such bids will specify the amount of stock only (with a maximum of $100,000, and the issue yield will be determined as the weighted average of the successful competitive bids. Allocation to successful participants will be on a pro rata basis if the bids exceed the 5 per cent limit. Local authority stock yields will be related directly to yields on Government stock determined under tender.

The objective in moving to a tendering system is to endeavour to ensure that the Government is able to achieve the amount of debt sales that it wants, at the time that it wants, at minimum cost. If successful, this would represent a significant improvement over the 'tap issue system', where the Government has not been able to control directly the amount of sales.

EXTERNAL ECONOMIC STRUCTURE AND POLICY

A reminder, that this book incorporating 26 articles on balance of payment's policy, is available from the Reserve Bank at a cost of $NZ10.00 per volume.

Orders to the Reserve Bank should enclose a cheque or postal note and be addressed to:

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