QUARTERLY REVIEW OF MONETARY CONDITIONS AND POLICY

This article is the first of what is intended as a quarterly series of articles to appear in the *Bulletin* on recent developments in monetary conditions and policy. The focus will be on developments in the immediately preceding quarter, but reference to preceding events and likely future developments will also be made from time to time. All monthly and quarterly growth rates and ratios referred to have been seasonally adjusted unless otherwise stated.

OVERVIEW

The principal feature of monetary conditions in the March 1983 quarter was a continuation of the marked differences in the rates of growth in the monetary aggregate and the credit aggregate statistics, the broadly defined money supply and selected liquid assets series (M3) having risen by 3.3 per cent, while private sector credit grew by only 0.5 per cent. In the preceding quarter, however, the difference between the growth rates had been even sharper, with M3 having increased by 4 per cent, while private sector credit fell by 1.2 per cent. But, towards the end of the March quarter, indications were that the divergent growth rates for M3 and private sector credit were beginning to converge again. M3 in the month of March for instance grew by only 0.3 per cent, while private sector credit growth is estimated at 0.5 per cent.

Looking at the more recent trading bank lending and deposit figures, which represent around half of the respective private sector credit and M3 aggregates, this reversal of the earlier trends appears to have accelerated in the early part of the June quarter. In April, trading bank lending growth of 1 per cent was recorded, whereas deposits (excluding compensatory deposits) fell by 2.5 per cent, and early indications for May are that deposit growth will fall well short of lending growth again in that month.

The corollary to these developments has been some very strong swings in liquidity, and some quite large movements in short term interest rates. For instance trading bank certificate of deposit and commercial bill interest rates for 90 day terms at the end of March were 3.5 — 4 percentage points lower than in November 1982, but by the end of the third week of May had moved back up by up to 1.5 percentage points.

A number of factors have been responsible for this pattern of events. So far as the slowdown in credit growth is concerned, it is reasonably clear that at least initially it was the result of financial institutions exercising firm control over their lending in an attempt to reduce the extent to which they were overlent in relation to the amount of liquidity available. Some of the demand for credit which emerged in this period was satisfied through overseas borrowings, but the firm financial conditions which prevailed in late 1982 may have contributed to the downturn in real economic activity that was already occurring at that time. In turn, slower economic activity has undoubtedly contributed to the reported easing in the demand for credit from local financial institutions in the first three to four months of 1983, although again, the most recent indications are that the situation is perhaps changing, with some evidence pointing to a pick-up in the demand for loans.

The increased rate of monetary growth recorded for the December and March quarters, rather than being generated from private sector credit expansion, resulted from injections from the foreign sector and from the official domestic sector (the Government and the Reserve Bank). In some respects the external influence has been quite closely related to domestic credit markets. For example, the New Zealand Meat Producers' Board has taken over the exporting of all sheepmeats for the current season as a method of market support, and has accordingly taken over the financing of the season's export production. This has been arranged mainly from offshore sources, and the normal seasonal increase in lending from domestic sources to the meat exporting companies has been correspondingly reduced this year.

In addition, the tight domestic credit conditions in the third and fourth quarters of 1982 seem to have resulted in a more general increase in private offshore borrowing; a trend assisted by the lower level of interest rates now available to many borrowers on offshore markets. The latter factor has made overseas borrowing more attractive than it has been for many years, especially for those exporting companies which can apply future export receipts to the repayment of their external debts and thereby reduce the risks from exchange rate fluctuations. These factors, together with the large amount of overseas borrowing undertaken to finance the 'major project' developments, have resulted in an upsurge in the overall amount of overseas borrowing by the private sector. This has had a dual effect in terms of easing pressure on domestic financial markets: to the extent that credit requirements have been satisfied from overseas sources, the demand for credit from domestic sources has been correspondingly reduced, and, as the proceeds of overseas borrowing have flowed into the New Zealand economy, they have contributed to the deposit and reserves growth of domestic financial institutions, and hence increased their capacity to lend. In the year ended March 1983, the net private overseas capital inflow amounted to $1,284 million, with $918 million having been concentrated in the second half of the year. By comparison, the 1981/82 full year net private capital inflow was only $143 million on an overseas exchange transactions (OET) basis.

External transactions had a further impact on domestic monetary and credit conditions. The OET current account deficit, which on an annual basis had widened sharply in the first half of 1982/83, stabilised at around $1,600 million — $1,800 million for the second half of the year, with signs of some improvement near year end. This development has contributed further to the easing of pressures in domestic financial markets.

It is to be noted, of course, that, as with the capital account, this improvement in the current account position is not unrelated to the very tight domestic credit conditions which prevailed in the second half of 1982. In brief, to the extent that tight credit contributed to the slowdown in economic activity it will have also contributed to the decrease in import payments which occurred in late 1982. These recent external account developments provide a clear illustration of the interdependencies between domestic monetary conditions and the balance of payments.

The other principal cause of the easing in monetary conditions in the March 1983 quarter and to some extent the preceding quarter, was a large monetary injection from the official sector (Government and Reserve Bank). The October 1982 income tax cuts represent a monetary injection of around $200 million a quarter, and Reserve Bank lending to the primary production sector on account of both Supplementary Minimum Prices and other stabilisation and export financing activities, added a further $284 million and $225 million (net) to the reserve base and the money supply (M3) in each of the last two quarters. These injections were not offset by public debt sales to the non-M3 sector to any significant extent, at least not until 21 March, when Kiwi Savings Stock was introduced. Excluding Kiwi Stock sales, debt sales to the non-M3 sector in the March quarter amounted to about $100 million, about the same amount as in the December 1982 quarter, but considerably less than for the March quarter of 1982 when Inflation Adjusted Savings Bonds were selling strongly, and non-M3 debt sales amounted to $450 million.

To summarise, therefore, virtually all the factors which influence domestic liquidity — the external accounts, the Government accounts, Reserve Bank lending to the private sector and public debt policy contributed to an easing of monetary conditions in late 1982 and early 1983. The extent of the easing in conditions is highlighted by the fact that the reserve assets held by the trading bank system in March 1983 were nearly double the level of a year earlier, and three times their October 1982 low point.

With liquidity having increased to such an extent, the potential for a resurgence in lending growth by financial institutions was clearly emerging. Indeed, on the basis of the most recent credit growth figures available, some early signs of a pick-up in lending growth rates are already evident. Trading bank credit limits in the March quarter increased by 2.5 per cent, and the 1 per cent increase in trading bank lending in April follows five consecutive months of no or negative growth. Similarly, savings bank lending is estimated to have increased by 1.3 per cent in the March quarter, the largest quarterly increase since June 1982. For finance companies, lending growth, after having slowed to 1.8 per cent in the December 1982 quarter, picked up to 2.6 per cent in the March quarter.

The prospect of credit growth accelerating at an unacceptable rate has resulted in a number of policy measures having been implemented in recent months. These measures were described in the April *Bulletin*, and accordingly, only a brief summary of the main measures will be given here. First on public debt policy, Kiwi Stock has been introduced as a replacement for Premium Stock, and on 17 March, the yields on ordinary Government securities and Treasury Bills were also increased. The objectives of these measures were essentially threefold: to contain the deposit growth, and hence the lending capacity of financial institutions; to encourage non-bank institutions to hold excess liquidity in the form of Government securities rather than as bank deposits; and to provide financial institutions with more incentive to hold Government investments rather than lend to the private sector. Obviously Kiwi Savings Stock is making a major contribution to the first of these objectives, with net sales up to 20 May 1983 having reached $766 million. At this stage, it is a little early to judge whether the other public debt measures are achieving what was hoped of them.

On ratio policy, two changes were made in the March quarter, both affecting only the finance companies. These entailed a change in the basis of the calculation of the ratio, including a switch in the base from 'borrowings' to 'investments' and the introduction of a monthly rather than quarterly reporting requirement. These changes took effect from 1 April 1983. From 1 May 1983, the ratio was increased from 18 per cent of investments to 20 per cent. This action was taken mainly because of the comparatively low ratio that finance companies had (and to some extent still have) and the correspondingly greater scope they have to lend to the private sector from any increase in deposits. The comparatively rapid rate of growth in their lending and deposits over the past year also had a bearing on the decision.

As a further restraint on unwarranted credit expansion, financial institutions have subsequently been advised that the maximum rate of credit expansion to the private sector which will be considered acceptable by the authorities is 1 per cent a month, after allowing for normal seasonal patterns. Subject to some minor variations which take account of the particular circumstances for each institutional group, this guideline has been issued to all those deposit-taking institutions which are also important lending institutions.

FINANCIAL INSTITUTIONS AND MARKETS

Trading Banks

The divergent trends in lending and deposits referred to in the preceding section has been no more evident than for the trading banks. In the March quarter, trading bank deposits rose by a strong 5.3 per cent which followed an even stronger December quarter 1982 growth rate of 6.9 per cent. Lending, on the other hand, fell by 3.1 per cent, following a 1.4 per cent fall in the December quarter. As a consequence of these movements, the lending to deposits ratio (excluding compensatory deposits) of the banking system fell sharply, from 86.9 per cent in August 1982, to 79.6 per cent in December, and to 72.5 per cent for March 1983. The latter figure is below the long-term average of around 74 per cent, and reflects the scope that existed at that stage for the banks to expand their lending. In April, however, with Kiwi Savings Stock sales running strongly ($285 million in April), the position changed significantly and the lending to deposits ratio rose to 75.5 per cent. Indications are that a further rise in the ratio will occur in May, and accordingly, the scope for any resurgence in credit expansion by the banking system, at least for the time being, has been considerably reduced.

Reflecting the tightening in credit conditions in the second half of 1982/83 was a marked slowdown in the rate of growth in credit limits offered by trading banks. In the half year to March 1983, total credit limits grew by only 2.4 per cent, the smallest half yearly increase since the second half of 1974. Of equal significance is the change in the extent to which bank credit limits are being utilised. Through most of 1982, when the demand for bank credit was running ahead of the ability of banks to lend, the percentage utilisation of credit limits was around 74 per cent but by March 1983 this ratio had fallen back to 69.3 per cent. The long run average for this ratio is about 72 per cent, and the fact that the latest figure is below this is indicative of both the easing in the demand for credit referred to earlier, and the greater capacity the banks had to lend, at least up until Kiwi Stock sales commenced, as reflected in the growth in credit limits issued in recent months.

Other evidence of the relatively slack demand for bank credit in the early part of 1983 is the extent to which the banks curtailed competition for deposits. At the end of 1982, bank deposit rates were typically at the maximum rates allowable under the interest on deposits directive, but in the March quarter significant interest rate reductions occurred, albeit mainly for large short-term deposits. For example, the 90-day transferable certificate of deposit (TCD) rate at the end of December was 16.5 per cent, but by the end of March, this had fallen to around 13 per cent.

While not a cause of the fall in bank deposit interest rates in any fundamental sense, reserve asset ratio policy, at least up until March, certainly facilitated the downward trend. With the surge in reserve asset growth since October 1982 having been greater than expected, large 'free' reserve asset outcomes for the trading banks resulted, notwithstanding that the reserve asset ratio[1] was increased from 10 per cent for October to 30 per cent for March. Accordingly, the banks did not have to compete for deposits at all aggressively in order to meet their reserve asset requirements. The tightening in liquidity in April, however, together with a further increase in the ratio to 31 per cent, resulted in the banking system not being able to meet its requirement in that month and having to borrow from the Reserve Bank under the reserve asset ratio penal borrowing provisions. This occurred despite the Reserve Bank intervening to assist the banks by allowing compensatory deposit repayments due in the second half of April to be deferred until May.

Following the tight reserve asset position in April, the ratio for May was reduced to 23.5 per cent. This reduction, while a large one, does not, however, represent any easing of policy. Rather, it reflects the extent to which liquidity conditions are expected to firm. At the time of writing (mid-May), indications were that the 'free' reserve assets margin for May would not be a large one. Reserve assets in the first 20 days of May fell sharply, from $2,542 million to $1,993 million, and further falls are in prospect.

Savings Banks

Savings banks, taken as a group, exhibited some growth in both lending and deposits in the March quarter; the respective growth rates being 1.3 per cent and 4.2 per cent. By comparison, in the December quarter lending was unchanged, and deposits grew 1.2 per cent. Looking at the different types of savings bank within the overall group, however, performances differ markedly. Trustee savings banks deposit growth was comparatively strong at 5.5 per cent in the March quarter, up on the 3.8 per cent and 2 per cent growth rates recorded for the December and September quarters. The Post Office Savings Bank has also enjoyed some pick-up in deposit growth, with deposits having risen by an estimated 8.4 per cent in the six months to March 1983, compared with a rise of less than 1 per cent in the first half of the 1982 calendar year. In contrast, the deposits held by the private savings banks have continued the steady fall which commenced in late 1981, and by March 1983, were 16.1 per cent below the previous year's level. The fall in the March quarter amounted to 2 per cent.

The reason for these divergent trends in the deposit performance of the different types of savings bank can be largely traced to the differing stances that they have taken on deposit competition. The trustee savings banks introduced their higher interest ('Hit') accounts in early 1982, and have promoted these accounts vigorously. Subsequently, in November the Post Office Savings Bank also introduced a higher interest 'Key' account, but the private savings banks have not responded. Not surprisingly therefore, the latter group of institutions have steadily lost deposits, although it should be noted that some of their deposits have probably been diverted to the trading banks, which wholly own the private savings banks, and which have been introducing more attractive and flexible savings facilities for the so-called 'small saver'. One reason for this trend could be the relatively high Government security ratio (54 per cent) imposed on private savings banks, which probably tends to make the private savings banks the less profitable arm of the banks' total operations.

On the lending side, the pattern is much the same for each of the three kinds of savings bank as for deposits. The Post Office Savings Bank after having virtually withdrawn from the lending market for much of 1982, has recommenced lending, and in the March quarter, loans outstanding increased by around 2.1 per cent. The trustee savings banks have kept up a reasonably stable rate of lending, loans outstanding in the March quarter having increased by 2.6 per cent, a similar rate of growth as in the preceding two quarters. Private savings bank lending, on the other hand, has continued on a downward path, much in line with the decline in deposits.

Finance Companies

The most recently available statistics on finance company business show that this group of institutions is continuing to increase its deposits quite rapidly. In the March quarter, deposits with the twenty six largest finance companies grew at the rapid rate of 7.3 per cent, although lending expanded by the lesser amount of 2.4 per cent. The year on year growth rates resulting from these latest quarterly increases were respectively 23.9 per cent and 15.8 per cent, higher than those for any of the other savings institutions. This factor had a bearing on the decision taken in March 1983 to lift the Government security investment requirement imposed on finance companies.

With regard to deposit interest rates, a number of finance companies lowered their rates in the period December to March in response to the influx of deposits that was occurring, and reportedly, a slowdown in the demand for their loan facilities. While at least one company subsequently lifted its rates, following the public debt policy measures introduced in March, finance company deposit interest rates on average still remain a little below the levels prevailing in the third quarter of 1982.

Building Societies

While the rate of growth in building society shares and deposits has slowed a little in recent months, their performance over the past twelve months as a whole has been comparatively steady. In particular, building

1 This ratio has not been seasonally adjusted.

societies do not appear to have suffered as sharp a slowdown in deposit growth in the September quarter of 1982 as most other financial institutions experienced. This, together with the ongoing demand for housing finance, no doubt helps explain why building societies' lending growth, while reduced from a year ago, has not fallen as sharply as for many other institutions. Building societies' loans outstanding at March 1983 were 13 per cent above the March 1982 level, a growth rate only a little down on the 15.6 per cent increase in the previous year. Trustee savings bank lending growth, in contrast, fell from 27.1 per cent for the year to March 1982, to 12.9 per cent for the following year.

Commercial Bill Market

As a consequence of the availability of credit from financial institutions being so restricted in the June and September quarters of 1982, the commercial bill market 'mushroomed', with total bills outstanding in October 1982 being nearly 60 per cent above the level of a year earlier. In the subsequent months, the level of business activity and the demand for credit eased, the bill market contracted, and by March total bills outstanding were only 25 per cent above the 1982 level. However, with liquidity conditions now tightening again, this trend will probably be arrested. The renewed pressure emerging in the bill market is reflected in the recent upward movement in the bill rate, which by mid-May had reached 15 – 15.5 per cent, 1 – 1.5 percentage points above the late March rates, but still below the November 1982 peak of 18.25 per cent.

SUMMARY AND OUTLOOK

During the last six months the shifts in monetary and credit conditions have been particularly large and rapid. From a position of very tight liquidity in October/November 1982, conditions eased rapidly for the next three to four months, as reflected in strong deposit growth, significant short-term interest rate reductions and, towards the end of the period, signs of some pick-up in the rate of credit expansion. It was the prospect of this expansion becoming too rapid which prompted the Government to introduce the series of monetary policy measures announced in March and April — the Government stock and Treasury Bill interest rate adjustments, the introduction of Kiwi Savings Stock, the finance company ratio increase, and the announcement of a 1 per cent a month private sector credit growth rate guideline for most of the major lending institutions. These measures, together with associated statements made by the Minister of Finance and the Reserve Bank, reflect the Government's aim to hold monetary and credit conditions firm throughout the coming year, so as to ensure that the gains that have been made in reducing the inflation rate under the 'freeze' will be retained.

While there has been clear evidence in recent weeks that this is being achieved, it is equally clear that it will be necessary to continue with a reasonably active public debt policy right throughout the coming year given that the indications are that the primary liquidity injections from the Government and external sectors will again be substantial in 1983/84. In this regard, the Government has announced that it is examining a proposal that public sector securities should be sold by tender. One of the main potential advantages of this method of selling public debt is that it may enable public debt policy to be managed more precisely than has proved to be possible under the 'tap' system. If this could be achieved, it would make a major contribution to what is the ongoing monetary policy goal: the maintenance of appropriately firm and stable monetary conditions.