RESERVE BANK ANNUAL REPORT

The following are extracts from the Reserve Bank Annual Report for the year ended 31 March, 1984 (The statistical information included in this report was finalised on 22 June 1984, and any subsequent revisions have not been incorporated All amounts are in New Zealand dollars unless otherwise specified)

GENERAL REVIEW

In a year characterised by economic recovery in the international economy, led by strong growth in the United States of America, Canada and Japan and hesitant but accelerating real rates of growth in other industrial countries, 1983/84 saw only a slight improvement in New Zealand's overall economic performance The international recovery has not as yet benefited New Zealand to any great degree The terms of trade have not picked up — in fact they have remained depressed since the substantial fall in 1979/80 Intensified protection of domestic agriculture in most developed countries and the resultant excess supply conditions in world markets have depressed prices for New Zealand farm exports, which still comprise about 70 per cent of the country's total exports The slow recovery of developing countries from the two oil shocks of 1973/74 and 1979/80 has also constrained export growth — countries which appeared to offer good prospects as markets a decade ago have had to cope with mounting external debt problems and as a consequence much lower growth

The world recession of 1981/82 arose largely from the effects of the second oil shock, and the greater urgency for countries to correct their imbalances During this period both nominal and real interest rates rose sharply, while world trade contracted, prompting a number of countries to adopt more widespread protectionist measures As a result, recovery from the recession has been restrained and tentative in many countries These developments have had a serious impact on the non-oil developing countries in particular, and a number of them face financial difficulties

These problems have led to a concern by the New Zealand Government that the nature of the international recovery and the process of evolution of the international financial system will not be sufficient in themselves to solve permanently the present trading difficulties, and that more fundamental changes are required in the international trade and payments systems Although the system coped with the immediate problems which emerged in 1983, support in international financial circles is gathering for an examination of these longer term issues

In New Zealand, the Government's economic strategy over the last year has been to consolidate the substantial reduction in the rate of inflation which was secured by the freeze on incomes and prices, while limiting the extent of contraction in the domestic economy This strategy has involved the continuation of controls on incomes and prices, a widening of the fiscal deficit, and a variety of monetary policy measures

On the basis of the available indicators, the year was one of progressive transition into renewed growth A number of key indicators — retail and wholesale turnover, stocks in the distribution sector, residential building activity, and the level of business opinion — suggest that the recession reached its trough around December 1982 However, some other indicators have been more sluggish, and it was not until the September quarter 1983 that clear evidence of recovery had appeared in all the major indicators, including the volume of manufacturing production and non-residential investment Signs of the benefits of the recovery flowing into the labour market were clearly apparent by early 1984, when both registered and assisted employment started to fall, and notified vacancies had picked up significantly In the year to February, total employment increased by about 12,000 or 1 1 per cent, and average hours worked also increased

The recovery in consumption spending was particularly strong Real retail sales (seasonally adjusted, and including automotive sales) in the March quarter 1984 were 12 6 per cent higher than the low-point reached in the December quarter 1982, more than reversing the earlier decline from the March 1982 peak A number of factors have contributed to this increase, and to the pick-up in residential construction First, after a decline of about 4 per cent in 1982/83, real personal disposable income probably rose by about 1 per cent in 1983/84, with the October 1982 personal income tax adjustments making a significant contribution to the turnaround Secondly, as discussed later, money and credit conditions were relatively easy for part of the year, and nominal interest rates fell Finally, demographics have played a role After six years of net emigration, 1983 saw a return to a large net inflow of migrants (in part attributable to the international recession), peaking at about 25,000 in the year to September 1983

The effects of the recovery on investment, except for residential construction, seem to have been relatively weak so far The available indicators suggest that total private investment may have bottomed-out during the year, although it was bolstered by major project investment — without this, a continuing decline would have been recorded Data from the NZIER Business Opinion Survey suggest, however, that capacity utilisation increased rapidly in the second half of 1983, reaching the level of recent peaks by March 1984, and that investment intentions have risen correspondingly

The pick-up in final demand during the year was initially met by substantial destocking, and output and imports did not respond immediately Manufacturing output first rose slightly in the June quarter and then more rapidly in subsequent quarters, and demand also started to spill-over into higher imports about the middle of the year

Given the relatively steady terms of trade, and more stable export growth rates, the cycle in imports has had a dominating effect on the external deficit — the deficit fell with the contraction in imports caused by the recession, and then started to widen again On an Overseas Exchange Transactions basis, the current account deficit was $992 million, or about 3 per cent of

GDP, in the year to March 1984, compared with $1,643 million in the previous year. The deficit low-point was $699 million in the year to August 1983.

The rate of inflation remained steady throughout the year — the Consumer Price Index increased at an average rate of 0.9 per cent per quarter, reflecting the continuation of the freeze on incomes and prices, and the lack of any excessive demand pressures. In the year to March 1984, the increase was 3.5 per cent, compared with 12.6 per cent in the previous year, only part of which was affected by the freeze, and 15.8 per cent in the year to March 1982, prior to the freeze. In early 1984, the controls on prices were relaxed to some extent; but the wage freeze was extended again — at the same time, the Government decided on a cost of living allowance of $8 per week (for adult full-time employees) effective from 1 April 1984, in order to provide some assistance to lower-paid workers. This increase was estimated to increase the national wage bill by about 2.9 per cent.

The fiscal deficit widened to 9 per cent of GDP in 1983/84, the second highest figure on record. On the expenditure side, rapid growth in capital formation reflected Government involvement in major project investment, an effect which is temporary and will earn a return in due course. However, other significant elements of expenditure growth such as social welfare payments and debt servicing will not be self-reversing to the same extent. As far as taxation is concerned, the October 1982 tax adjustments were some compensation for the absence of a wage increase in that year. While they also substantially reduced the amount of progression in the tax scale, the wider reform of the tax system proposed by the Task Force on Tax Reform was not pursued, partly, at least, because of the effects that increased indirect taxation could have had on inflation.

Overall, the Government's strategy has been to give priority to reducing inflation and interest rates, and to maintaining the level of economic activity as far as possible. This has implied acceptance, in the meantime, of an increase in the fiscal deficit; a current external deficit which is substantial and deteriorating, with an accompanying increase in overseas debt; and, as discussed later, money and credit growth rates which were excessive in relation to nominal GDP growth for most of the fiscal year. Nevertheless, unemployment increased — and, while it started to ease towards the end of the year, its magnitude remains worrying.

Two inter-related conclusions can be drawn from the current situation. First, if the emerging recovery in the real economy is to be sustainable and if the conditions for sustainable non-inflationary growth are to be restored, the continuing process of transition out of the freeze will require an appropriate balance between too tight a policy stance which could abort the recovery, and the re-establishment of control over the fiscal deficit and monetary conditions in order to reduce the risk of inflation re-accelerating.

Secondly, improving our longer-run growth prospects requires that a high priority must continue to be given to achieving structural adjustment in the economy. Growth over the last decade has been relatively low — a little over 1 per cent per year, on average, in the 10 years to 1983/84, compared with nearly 4 per cent in the previous decade. This slowdown was precipitated by the first oil shock, and the downward shift in the terms of trade which this entailed (and which has not been subsequently reversed). However, the income loss implied by the terms of trade shift served to throw into sharper relief some deep-seated structural problems which dated from much earlier, but which had not been perceived as so serious in a period of increasing affluence. The magnitude of the income loss which has been experienced implies the need for a considerable degree of adaptation throughout the economy if we are to return to full employment and acceptable growth rates, without renewing inflation or causing unsustainable balance of payments pressures.

The adjustment process in New Zealand seems to have been much slower than in most other developed countries — hampered by a series of institutional and structural rigidities which have prevented markets from working freely. While many of these rigidities can be attributed to past and present Government interventions, it is also fair to say that the private sector has created rigidities of its own, and has acquiesced in, or actively sought, much of the Government intervention which has taken place. One of the most difficult, but important, problems of the day — for both the Government and the private sector — is how to replace those interventions from the past which have become barriers to economic progress, and now seem misguided or no longer appropriate, with a framework which is more conducive to promoting economic efficiency and enhancing future growth prospects — while at the same time seeking to minimise the costs of adjustment which this process may entail.

Useful progress towards these aims has been made in recent years — the industry studies programme, the Closer Economic Relations agreement with Australia, the steps to deregulate the transport sector, and the recent agreement between the Government and manufacturers on the phasing out of import controls, are all good examples of structural policies which should reap substantial benefits in time. They will also involve some transitional difficulties, which will need to be handled with appropriate care. These examples also suggest that the need for a more rapid pace of structural change is now being more generally accepted throughout the community, and that there is a greater willingness to face up to some hard decisions.

The need for thorough scrutiny of the role of government intervention is as apparent for the financial sector of the economy as any other. The reasons are straightforward — first, it is an important sector in its own right. National accounts data show that about 10 per cent of GDP originates in the Financing, Insurance, Real Estate and Business Services sector, making it, on this measure, one of the largest sectors of the economy — larger, for example, than the agricultural sector, and twice the size of either the construction or the transport sectors. Secondly, the financial sector is more pervasive in its effects on the economy than any other (except the Government), because it enables virtually all economic transactions between agents in the economy to take place in an efficient and orderly manner, and because it channels resources from sectors willing to provide them to sectors which require them. Thus, the efficient and reliable functioning of the financial sector in general, and financial institutions in particular, is in the interests of the whole community. It is also clearly important that the institutions should be able to respond flexibly to changes in the economic environment, technology, and the preferences of their customers.

It is a widely held view that the best way to promote efficiency and flexibility in the financial sector is through market competition, where the various participants are on equal terms, and where restrictions on entry to the market are minimal. This is not to say

that all government intervention is undesirable or unnecessary. What it does mean is that such intervention should be kept to a minimum in order to allow the institutions as much flexibility as possible to meet the evolving needs of the community, and that where it does occur it should ideally apply equally to all institutions engaging in the activity which is the subject of intervention. This principle of 'competitive neutrality' is fundamental to the evaluation of government intervention in the financial sector.

In common with most other countries, New Zealand's interventions are not neutral at present. Probably the main reason for this is that different classes of financial institution have developed at different stages in our history and each class has tended to be given a unique statutory and regulatory basis as it has developed. Interventions (whether imposing duties or conferring privileges) have thus tended to be aimed more at the legal entities involved than at types of activities, and different institutional groups have often been treated differently because of perceptions of their particular role in the system.

This evolution has had predictable results. On the one hand, institutions have continually lobbied to obtain 'privileges' or access to particular activities which were available to their competitors and not to them — in many cases, with eventual success. On the other hand, where the Government has imposed costs of one sort or another on particular activities, disintermediation has occurred — the activities have tended to move to areas where the costs are not imposed, eventually requiring the extension of the intervention if its purpose was to be achieved.

Pressures to break down the barriers between different types of financial intermediaries have also emerged for other reasons, in many other countries as well as in New Zealand. The vast technological progress which has occurred since most of our financial institutions were established has both enabled, and encouraged, organisations to offer a wider range of services than before. At the same time, the emergence of increased competition, the implied need to achieve greater efficiency, and the increasingly sophisticated demands of the private sector for new, and better, financial services have compelled the institutions to utilise the available technology to the full, and to combine with other institutions (both nationally and internationally) in order to achieve economies and meet the market demands.

This process of convergence has led, on the one hand, to agreements and/or legislative changes which have allowed additional institutions to undertake activities previously proscribed, such as offering cheque accounts and, in the year under review, dealing in foreign exchange. It has also meant that new activities, particularly those resulting from technological developments and which have often not been explicitly regulated, have been undertaken by a wide range of institutions — the introduction of credit cards and automatic tellers, and the moves towards electronic funds transfer, are examples of this. There has also been a general move towards more flexibility and diversity in services offered, as illustrated by the variety of deposit accounts now offered by the various institutions. The competitive pressures underlying these changes have meant that they have led to better and/or cheaper services being available to institutions' customers.

The process of change has also meant that the legislative approach to the financial sector has started to be activity-based rather than entity-based. For example, the Securities Act 1978 imposed obligations on anyone raising funds from the public, irrespective of their legal status (although it was still not neutral, in the sense that some institutional groups were exempted from compliance with some aspects of the Act). This approach was repeated in the Credit Contracts Act. While it has not been possible to avoid further entity-based legislation within this period as well, it is likely that activity-based legislation will become the future standard since it is more neutral and reduces the problems of disintermediation.

In recent years there has been a growing recognition of the need for central banks to upgrade their supervisory activities of financial institutions. Indeed the 'Basle concordat' has led to a greater obligation on the part of central banks to undertake such surveillance and the Bank is considering to what degree it should increase intervention in the prudential area. The financial system relies heavily on public confidence and with increased volatility of interest rates, exchange rates and capital flows, and with rapid technological and institutional changes, the Bank is of the view that there is a need to reinforce existing surveillance of financial intermediaries.

Overall, while it seems likely that New Zealand's arrangements for prudential supervision will evolve further in time, several things are clear. First, any realistic enhanced arrangements would only reduce the risk of failure, and not eliminate it. Secondly, supervision is no substitute for good management, and the management of each institution must remain fully responsible for its own decisions. Finally, there is scope for self-regulation to develop in the market, if the institutions perceive that there would be advantages in doing this.

An important requirement for Government intervention in the financial system, of the sort which is intended to modify behaviour, is that the intervention should be carefully tailored in order to best achieve the objectives being sought, while minimising undesirable side effects. This requires first a thorough analysis of why intervention is required — i.e. to establish in what respect market behaviour departs from national objectives, and the reasons for this departure. Such analysis should enable the root causes of problems to be addressed, rather than the symptoms.

Secondly, the appropriate form of intervention must be considered. The point that activity-based rather than entity-based intervention is normally better has already been made. Beyond this, a basic decision is whether the best remedy for a problem is provided by changing market incentives in order to influence behaviour, or by forcing a change in behaviour through direct controls. The direct control option has often been preferred by Governments, perhaps because it may seem easier to implement than market-based interventions, or because it is thought to have a rapid and direct impact on the immediate objectives, rather than the more diffuse impact of changed incentives. However, the side-effects of controls, particularly if they remain in force for a long period, can themselves become a source of further problems. For example, they may limit the ability of institutions to adapt to changing economic circumstances; they can encourage the diversion of business into less-preferred activities, or new activities; and to the extent that new activities, or new ways of doing old things, develop, the controls may become increasingly irrelevant. Controls can also become out-of-touch with market realities unless frequently revised — the specification of dollar amounts, and interest

rates, in different regulations are simple examples of this. Finally, the economic costs and benefits of direct controls are usually difficult to assess, making it hard to judge their ultimate value.

Market-based interventions may be more difficult to design and implement than direct controls, but are likely to avoid many of the problems with controls: they allow greater flexibility, they can be kept up to date more easily, and the costs and benefits of intervention are more visible.

One market-based development during the year was the introduction of tendering of government stock. The main feature of this system is that it should enable the Government to pursue its domestic borrowing programme in a steady manner by maintaining government stock interest rates at the levels consistent with this borrowing programme. The change did not affect the government security ratios on the institutions. In structural terms, the tender approach has some important advantages over the previous 'tap' issue system: first, because the effects of the Government's borrowing requirements are transmitted through interest rates, the effect on the financial system is pervasive (or neutral), rather than being confined to those institutions compelled to hold government stock. Secondly, the fact that government security interest rates will remain at the market levels consistent with the Government's borrowing requirements implies both the removal of the disguised tax on the captive institutions which effectively applied under the previous arrangement (i.e. a further move towards neutrality), and that the cost of government funding is fully visible, rather than being obscured by this disguised tax. Finally, if the implementation of tendering enables, in due course, some de-emphasis of the role of government security ratios, this would allow individual institutions greater flexibility in their portfolio management, whilst not impairing the Government's ability to raise the funds it required from the market as a whole.

Another move which reduced the extent of market intervention occurred in the foreign exchange area, when the Bank withdrew from the forward exchange market in August 1983. The Bank had offered limited forward dealing facilities for many years, and in 1979 the coverage was widened substantially to allow dealing in respect of all classes of transactions, with both residents and non-residents. As a result of the 1979 moves, the forward market grew substantially, with the support of heavy involvement by the Bank. From early 1983, the Bank had started to widen its trading margins, in order to progressively reduce its involvement. When a number of additional foreign exchange dealers were authorised to commence business in August 1983, the Bank ceased quoting in the market. It is hoped that the combination of the market development which had occurred with Reserve Bank underpinning, and the entry of new participants, will mean that the market now has sufficient depth to function efficiently without central bank support. The transition seems to have gone smoothly, and business has remained active.

Overall, while innovations in the financial sector and the changing shape of some Government interventions have contributed to improving the efficiency and competitiveness of the financial system, progress has not been without its setbacks, and a good deal remains to be done. However, transition from New Zealand's long-standing structure of statutorily-segmented institutional groups, and a relatively high level of government intervention involves numerous complications and some adjustment costs. While the pace of deregulation and reform may reflect these factors, there can be little doubt that the benefits would be worthwhile, for both private sector efficiency and for the effective conduct of monetary policy.

MONETARY CONDITIONS AND POLICY

(All half-yearly, quarterly and monthly percentage changes have been seasonally adjusted).

The most significant features of the monetary sector during 1983/84 were the substantial increases in the growth rates of money and credit aggregates, the sharp swings in monetary and credit conditions, several important public debt policy measures and various Government measures, including regulatory controls, aimed at reducing interest rates.

Over the previous year (to March 1983) the monetary and credit aggregates had grown at quite moderate rates. Private sector credit grew by 4.1 per cent, M1 (the narrowly defined money supply) by 4.3 per cent and M3 (the more broadly defined money supply and selected liquid assets) by 11.8 per cent. Prices over the same period had increased by 12.6 per cent, so that all the main monetary aggregates had grown at a rate slower than the inflation rate. However, several developments in the second half of 1982/83, taken together, resulted in much more liquid monetary conditions during that period. M3 grew by 7.8 per cent in this half-year, and trading bank reserve assets tripled from the very-low average of $855 million in October 1982 to $2,546 million by March 1983. It was apparent that the potential for a resurgence in financial institutions' lending growth was emerging.

The Government therefore introduced several policy measures aimed at maintaining relatively firm monetary conditions, to ensure that the lower inflation rate would not be jeopardised. Interest rates paid on the Treasury bill and Government Stock tap issues were increased, Premium Stock was replaced by the highly attractive first issue of Kiwi Savings Stock, and a guideline for the maximum rate of credit expansion by individual institutional groups of 1 per cent a month was adopted. Although these measures were introduced near the close of the 1982/83 fiscal year, they had their main impact in 1983/84.

The first Kiwi Stock issue was very successful. By the time it closed in June 1983, a gross amount of $1,405 million had been raised. Financial institutions, most notably the trading banks, experienced a rapid and substantial loss of deposits and reserves as a consequence, and monetary conditions firmed appreciably. M3 fell by 0.8 per cent in the June quarter, the first quarterly fall in M3 recorded since 1961; and trading bank reserve assets fell to an average of $1,536 million in the month of June. Interest rates, which had been falling since January in the face of high liquidity and a low demand for credit, held steady for some time, but rose significantly towards the end of the quarter, particularly in the market for short-term funds, as financial institutions began to feel the pressure.

The lift in the yields offered on tap issue Treasury bills and Government stock, and the relatively weak demand for credit, combined to give a slow rate of private sector credit growth in the first half of 1983. Tap stock sales in the period up to the end of July (when the tap stock issues were withdrawn pending the introduction of Government stock tendering) were particularly strong, with many financial institutions in this period investing

in Government stock well beyond the levels required to satisfy their ratio obligations. A slow rate of credit expansion resulted — private sector credit grew by only 1.3 per cent in the June quarter.

The 1 per cent per month credit guideline was initially advised to the trading banks in July 1982, essentially as a guide to the banks as to the maximum rate of overall lending growth that the authorities considered consistent with the freeze. In April 1983 the guideline was restated in a more formal manner and, in subsequent months, extended to apply to most other financial institutions. These steps were taken with a view to ensuring that the Government's objectives would be clearly understood in financial markets well before the expected increase in the demand for credit from the private sector eventuated.

With the above measures having all been implemented in the first half of the 1983 calendar year, monetary conditions and policy by June were in most respects appropriately firm. In short, the surge in liquidity up to March 1983 had been dealt with and credit growth appeared to be held in check.

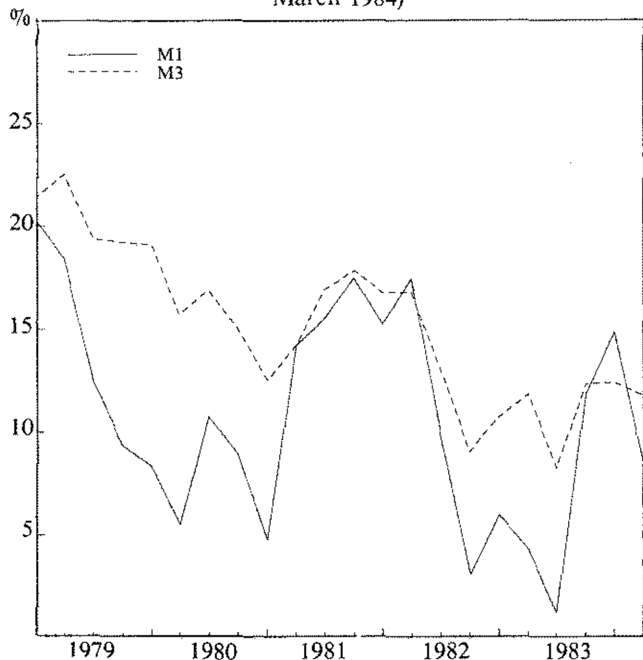
However, in the September quarter, the Government was not nearly as active a borrower from the domestic markets. On 27 July, the tap stocks were withdrawn, leaving a period of six weeks when the Government was effectively absent from the market altogether. While this was partly due to the transition to tendering of government stock, it also reflected heightened Government concern about the level of nominal interest rates. When combined with ongoing primary liquidity injec-

MONEY SUPPLY AND SELECTED LIQUID ASSETS OF THE PUBLIC

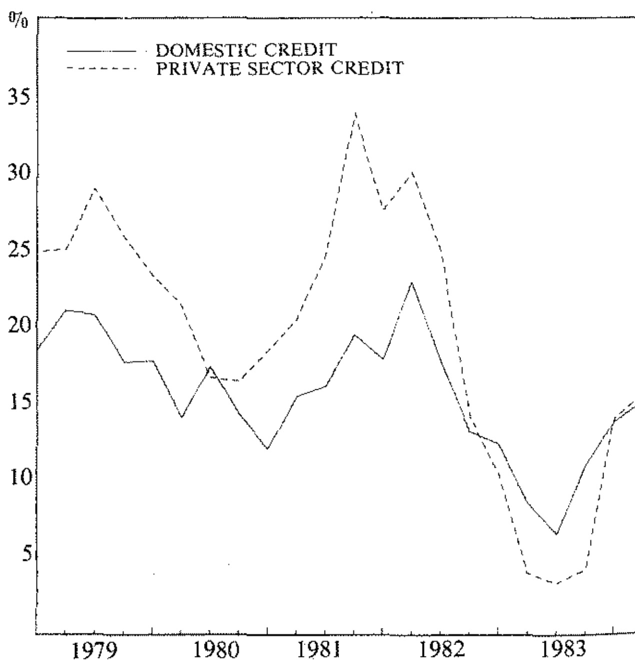
	Money Supply (M1)			Money Supply (M3)			Private Sector Credit[1]		
	$m	Annual % Change	Qtly % Change[2]	$m	Annual % Change	Qtly % Change[2]	$m	Annual % Change	Qtly % Change[2]
1981									
Mar.	2,452	14.2	4.6	12,336	14.2	3.4	7,958	20.4	5.7
June	2,650	15.5	6.9	13,310	16.9	5.8	8,272	24.6	6.5
Sept.	2,566	17.5	3.8	13,750	17.9	4.7	9,336	33.8	8.4
Dec.	2,861	15.2	−0.4	14,448	16.8	2.1	9,421	27.6	4.6
1982									
Mar.	2,878	17.4	5.7	14,403	16.8	3.1	10,344	30.0	4.5
June	2,906	9.7	0.3	15,025	12.9	2.4	10,327	24.8	5.2
Sept.	2,643	3.0	−2.4	14,984	9.0	1.1	10,654	14.1	1.8
Dec.	3,030	5.9	2.6	16,004	10.8	3.9	10,407	10.5	−1.3
1983									
Mar.	3,002	4.3	3.6	16,107	11.8	3.3	10,764	4.1	1.5
June	2,940	1.2	−2.5	16,261	8.2	−0.8	10,670	3.3	1.3
Sept.	2,955	11.8	8.0	16,826	12.3	5.0	11,102	4.2	2.6
Dec.	3,480	14.8	5.4	17,985	12.4	3.9	11,867	14.0	8.1
1984									
Mar.	3,250	8.3	−2.6	17,996	11.7	3.1	12,434	15.5	2.8

[1] Includes holdings of local authority securities.
[2] Seasonally adjusted. Private sector credit figures also adjusted in September 1981 and March 1982 for interest debits.

Monetary Aggregates
Money Supply and Selected Liquid Assets (M3) (Annual Percentage Changes at Quarterly Rests from March 1979 to March 1984)



Credit Aggregates
Annual Percentage changes at Quarterly rests from March 1979 to March 1984



tions (mainly from the fiscal deficit), this absence resulted in a resurgence of strong monetary growth in the September quarter (8 per cent for M1 and 5 per cent for M3). The build-up in liquidity created again the potential for private sector credit growth to accelerate at an excessive rate. The risks of this occurring were heightened by the signs that the pick-up in the economy was well underway, and by the fall in many interest rates set in train by the Minister of Finance's 27 July statement on interest rate policy.

In this statement, the Minister initiated a major thrust directed at achieving a substantial reduction in nominal interest rates following the decline in the inflation rate, in order to avoid an unacceptable increase in real interest rates. All financial institutions were told to adjust both their borrowing and lending interest rates downwards, failing which further regulations would be imposed. The major financial institutions responded quickly on the deposits side, with short-term wholesale and retail interest rates coming down virtually immediately — for example, trading bank short-term wholesale rates fell from the June peak of over 16 per cent to 10 per cent or less in August. While lending interest rates were not adjusted down as rapidly, some significant moves were announced quite soon after the Minister requested this action, and were implemented in a progressive manner.

The Government returned more actively to the domestic loan markets on 5 September 1983, when the second Kiwi Stock issue was introduced. This issue was initially successful, attracting $124 million (net) in the first two months, but the inflow was not sustained. The interest rate, which had been pitched in line with the market rates prevailing at the time it was launched, became unattractive as the market edged upwards again partly in response to higher demand for credit from the private sector. The issue was closed on 9 February, when the net amount subscribed stood at $125 million.

The difficulty of achieving an appropriate level of debt sales while at the same time pursuing a lower interest rate objective became more apparent when the Government stock tendering system was launched. Only the first two tenders were allotted without any rejection of bids (although the second tender was undersubscribed). After the third tender the decisions of the Government to reject large numbers of bids at interest rates out of line with current Government attitudes, and to change the allotment method, reduced the attractiveness of the tenders to many market participants, and problems arose in covering the amounts offered. These problems were alleviated, to some extent, by the introduction of index-linked stocks in the December tender, but debt sales still fell well behind the level required to restore monetary stability.

With this combination of factors — a build-up in liquidity, a pick-up in economic activity and falling nominal interest rates — an acceleration of the private sector credit growth rate was to be expected. However, the strength of the resurgence in credit — over 8 per cent growth in the December quarter — was such that it very seriously threatened the Government's monetary policy objectives. This increase was far in excess of the credit growth guidelines. The Government therefore took several steps to increase the public sector ratio requirements on some financial institutions. The ratios for building societies and finance companies were increased by 3 percentage points and 5 percentage points respectively, and the free reserves margin allowed when setting the trading banks' monthly reserve asset ratio was reduced from $100 million to $50 million. All of these measures were announced in December and took effect early in 1984.

As the excessive trend rate of growth in lending was confirmed by each subsequent month's figures, especially those for trading banks' and finance companies' lending, further ratio policy measures were introduced. The finance company ratio was increased by a further 5 percentage points (to 30 per cent) effective from April 1984, and the trading banks' free reserves margin was lowered a further $50 million in both February and March, giving a minus $50 million margin for March. Additionally, the effective penalty imposed on those banks not able to meet their reserve asset requirements without borrowing from the Reserve Bank was increased from a minimum of 4 per cent of any deficiency to a minimum of 7 per cent. Ratio policy in respect of trading banks, finance companies and building societies at the end of 1983/84 was probably as stringent as it has ever been for these institutions.

Reflecting in part the initial impact of these measures, the rate of growth in lending in the March quarter of 1984 was significantly lower than the exceptionally

CHANGES IN ASSETS OF SELECTED FINANCIAL INSTITUTIONS
($ million)

Year Ended	Government	Marketing and Stabilisation	Private[1]	Total Domestic Credit	Overseas	Residual	Total
1981							
March	+ 311	+ 70	+ 1,350	+ 1,732	+ 140	− 335	+ 1,536
June	+ 320	+ 7	+ 1,636	+ 1,963	+ 112	− 152	+ 1,923
September	+ 145	− 93	+ 2,359	+ 2,410	− 136	− 191	+ 2,083
December	+ 285	+ 36	+ 2,037	+ 2,758	− 75	− 208	+ 2,075
1982							
March	+ 473	+ 105	+ 2,386	+ 2,964	− 796	− 101	+ 2,067
June	+ 195	+ 254	+ 2,055	+ 2,504	− 908	+ 120	+ 1,715
September	+ 312	+ 318	+ 1,318	+ 1,948	− 924	+ 211	+ 1,234
December	+ 598	+ 338	+ 986	+ 1,922	− 551	+ 186	+ 1,556
1983							
March	+ 408	+ 540	+ 420	+ 1,368	+ 242	+ 95	+ 1,704
June	+ 472	+ 273	+ 344	+ 1,088	+ 227	− 80	+ 1,235
September	+ 1,152	+ 231	+ 448	+ 1,832	+ 326	− 316	+ 1,842
December	+ 914	+ 32	+ 1,461	+ 2,407	+ 77	− 504	+ 1,980
1984							
March	+ 1,168	− 239	+ 1,670	+ 2,598	− 358	− 352	+ 1,889

[1] Includes local authorities.

strong increase in the preceding quarter (down from 8 1 per cent to 2 8 per cent) While this was a more satisfactory quarterly result, the March figure nevertheless still represented a growth rate which, if allowed to persist, would undermine medium term monetary policy objectives This pointed to the need for the maintenance of firm credit restraint policies

The growth rate of M3 also slowed, to 3 1 per cent in the March quarter The reduced rate of growth in private sector credit was a major factor behind this moderation in the M3 growth rate, although this was still not sufficient to offset the underlying injection from a passively financed budget deficit This was also reflected in trading bank reserve assets, which in March 1984 reached $2,519 million, a level very close to the March 1983 figure, but nearly $1,000 million above that recorded for June 1983

The slight easing in deposit inflows in the March quarter, combined with the increased pressure resulting from the need to fund increased ratio requirements, led to short-term deposit interest rates rising markedly in these months For example, 90-day commercial bill rates rose from 11 75 per cent at the end of December 1983, to 14 25 per cent at the end of March 1984

Interest Rate Policy

The Government made several moves during the year on interest rates At the beginning of the year the Financial Services Regulations were in operation These regulations provided that charges for financial services (including lending interest rates), by suppliers with $10,000 or more of loans outstanding, could not be increased without the approval of the Reserve Bank In line with Government policy, the Bank objected to any increase above that being charged for transactions of a like kind In addition, the Interest on Deposits Order specified a schedule of maximum rates payable on deposits accepted by financial institutions In June 1983, as part of the extension of the Government's wage/price freeze, both sets of controls were effectively extended

During the course of 1983, the Interest on Deposits controls represented a constraint on deposit interest rates only for the brief period in June when the first Kiwi Stock was generating liquidity pressures At other times, most deposit rates were at levels significantly below the ceilings, particularly following the Minister of Finance's 27 July statement on interest rates referred to previously In these circumstances, the controls were seen as having no effect, and accordingly were revoked on 10 November 1983

This did not, however, represent a generalised easing in policy on controlling interest rates Rather, there was a switch of focus from deposit interest rates to lending interest rates Following a period of two to three months during which the Minister of Finance repeatedly warned that policy action to force reductions would be taken if lending interest rates were not moved downwards more rapidly, the Government on 10 November 1983 introduced controls on all mortgage lending interest rates, limiting the rate of interest on first mortgages to 11 per cent and on subsequent mortgages to 14 per cent These restrictions were to apply to interest rate reviews made pursuant to mortgage contracts, and on the refinancing or the extension of the term of a mortgage, as well as to all new mortgages The controls were, however, shown to contain some anomalies, and they were replaced on 7 December 1983 by the Economic Stabilisation (Mortgage Loans) Regulations which were backdated to 10 November 1983

When the mortgage rate controls were introduced, the Minister of Finance said that, although they would initially apply only until the end of the wage/price freeze (29 February 1984), they would be extended if the overall interest rate structure had not by then settled down to a level the Minister considered consistent with the lower inflation rate In the event, they were extended on 20 February 1984 to apply until 31 August 1984, together with the Financial Services Regulations which governed all other lending interest rates and charges for financial services The Economic Stabilisation (Mortgage Loans) Regulations were unaltered, while a number of changes were made affecting the administration of the Financial Services Regulations These changes provided for justifiable increases in charges for financial services (other than interest rates) to occur up to the current movement in the Consumer Price Index, and the appeal procedures were streamlined Interest rate increases are allowed only where severe financial hardship can be proved

A further intervention by the Government in relation to interest rates occurred in early February 1984 Following the sharp upward movement in the interest rates offered by the finance companies and trading banks in late January and early February, the Minister of Finance again warned that further controls would be imposed if rates did not fall back quickly Following this warning, the banks and large finance companies decided that interest rates offered on deposits would not normally exceed 11 per cent This was acceptable to the Minister of Finance, although he also indicated that interest rates should move downwards further over the longer term Other institutions were also requested to take similar action