ECONOMIC NOTES

21st Government Stock Tender

Government Stock Tender No. 21, held on 19 July 1985, offered $150 million in each of two stocks maturing in 1991 and 1995. The $300 million tender was well subscribed, with total bids submitted totalling $1,220 million compared with $1,129 million in the previous tender (which also sought $300 million). Bids for the shorter-dated 1991 stock were approximately five times the volume of stock on offer while bids for the 1995 stock were around three times the amount on offer.

The weighted average yield on successful bids for the 1991 stock was 18.2 per cent, very close to the rate for the same stock in Tender No. 20. The weighted average yield on the longer-dated stock increased from 17.3 per cent in Tender No. 20 to 17.9 per cent in Tender No. 21.

Treasury Bill Tenders and Open Market Operations

July commenced with strong cash withdrawals from the financial system. This reflected the normal flow of sales and customs tax receipts to Government which occur around the beginning and end of each month. As a result $213 million of predominantly short-dated government securities were discounted over the first week in July. Discounting occurred on four further days during the month, but in each case the amounts involved were relatively small.

$120 million of Treasury bills were offered for sale in Tender 23 on 2 July. The offering reflected expectations of a strong net fiscal injection over the settlement week. During the following two weeks a total of $275 million of Treasury bills were sold in Tenders 24 and 25, including $125 million of early March 1986 bills. The sale of March bills reflected a desire to shift liquidity into a period where large withdrawals from the system associated with the tax payments would occur. No bills were offered for sale in Tender 26, reflecting a forecast tightening in liquidity conditions due to large net flows to Government. The final tender during the month, Tender 27 on 30 July, offered $100 million of bills, including $25 million of March maturities.

Open market operations over July involved the sale of $50 million of early March 1986 Treasury bills over 11 and 12 July. This action supplemented the regular weekly bill tender and reflected the larger than anticipated net cash injection during that week.

Government Stock Tender 20 settlements were completed on 19 July. As has been the pattern in recent tenders, the major portion of settlements occurred on the final few days of the settlement period; $117 million out of total settlements of $293 million occurred on the final day.

Primary liquidity, after beginning the month at $1,357 million, fluctuated around this level during the first half of the month before reaching a peak of $1,467 million on 24 July. Over the final week in July, primary liquidity declined to around $1,200 million, reflecting strong net flows to Government.

TREASURY BILL TENDERS AND OPEN MARKET OPERATIONS

Treasury Bill Tenders

Tender	*Amount Offered $m.*	*Term*	*Amount Sold $m.*	*Weighted Average Rate %*
23	50	21 days	50	21.264
	70	63 days	70	21.337
24	50	21 days	50	21.225
	50	56 days	50	22.094
	75	238 days	75	22.423
25	50	42 days	63	22.652
	50	231 days	37	22.892
26	Nil			
27	75	21 days	75	21.552
	25	217 days	25	22.567

Open Market Operations

	Amount Offered $m	*Term*	*Amount Sold $m*	*Amount Purchased $m*
11 July Treasury Bills	25	238 days	25	—
12 July Treasury Bills	25	238 days	25	—

Both short-term (30-90 day) commercial bill rates and longer term (5-10 year) government stock rates tended to rise over the month. The 90-day commercial bill rate rose by around 2 per cent to end the month at 25 per cent, while the 5 and 10 year government stock rates rose by 0.4 and 0.8 percentage points during the month to reach 17.8 and 17.5 per cent respectively.

June 1985 Budget

The Budget was presented to Parliament by the Minister of Finance, the Hon. R.O. Douglas on 13 June 1985.

The Minister began by noting that just under a year ago New Zealand faced an almost unprecedented exchange rate crisis. But although decisive action was essential, the crisis was itself only a symptom of a deeper economic malaise. The economy had clearly reached a point where its well entrenched structural problems could no longer be glossed over, and his Government had made the decision to confront the difficult issues at the root of the country's relatively poor economic performance after the immediate crisis had been dealt with. This had been done with a set of policies based upon a medium-term strategy for economic adjustment. It was clear that such an approach might not be widely popular, since the adjustment process would necessarily involve uncomfortable constraints on average living standards and would involve a redistribution of resources between productive sectors. The Government had nevertheless decided that the challenge had to be met, and in particular that the adjustment would need to be as rapid as possible. Its social objectives could only be achieved in a strong and growing economy, which in turn would only be obtained when the economy was better able to respond and adapt to changing economic conditions.

The Minister indicated that the economy had moved significantly towards this goal over the past year, with the response thus far mainly from the exporting sector. The full benefits would only come when the policies had worked through the entire structure of the economy, and the success of the strategy therefore could not be judged by events over the immediate future, but needed to be regarded over a more extended time horizon.

Resource Allocation

The Government's intentions with regard to industry assistance policies were set out in the Budget. Assistance policies which contributed towards inefficient and unproductive use of resources had since been significantly scaled down, with an equivalent impact on the magnitude of government expenditure. In the area of non-traditional exports, all performance based export incentives are to be phased out by 1987, and assistance to the primary sector is being reduced according to a similar schedule.

The Minister stressed his Government's concern to ensure that assistance to import competing industries did not lag behind other sectors. The policies announced last year of steadily widening access for goods subject to import licensing would continue, and the Government would consult the interested parties on means of phasing down high tariff rates on goods not covered by industry plans.

The public sector would also play a part in ensuring the economy was able to deliver sustained growth in incomes and employment. As well as the close scrutiny to which Government spending programmes were being subjected, the Government was also looking for increased efficiency in the operations of state owned enterprises. As part of this process, the possibility of restructuring the trading activities of some departments, including the major land using departments and the Ministry of Energy was being examined. Government agencies were to move towards charging on a full cost recovery basis, including depreciation and a return on capital, for all goods and services provided to specific users or user industries.

Tax and Benefit Reform

The 1984 Budget included a number of interim measures designed to spread the burden of taxation more evenly, but no major tax changes were included in this Budget. The Minister instead announced that a further economic statement would be made later in the year on the issue of tax reform. This statement would set out the Government's intentions in the area of tax and benefit reform, and would incorporate the results of the consultative process undertaken by the Task Force on Tax and Benefit Reform. It would also provide details of the Goods and Services Tax (GST).

Social Policies

The major initiatives introduced in the Budget were concentrated mainly in the field of social policy — in particular, in education, employment and training programmes, and housing. The Minister confirmed that despite difficult economic conditions and the need to constrain expenditure, the Government had been able to direct significant additional resources to areas where its social and other priorities lay. Savings sufficient to finance the new policies had been made in areas where the Government's priorities were not relatively high.

Provision was made in Vote Education for expenditure of $1,920 million in 1985/86. This included additional finance for 1,021 additional teachers for kindergartens, primary, secondary and other schools; further resources for bilingual and multicultural education, for the special needs of disabled pupils, and for support services in other areas of education — including teacher training and tertiary education.

The significant and sustained reduction in unemployment had allowed the Government to reassess expenditure on a number of employment related programmes. The Minister stated that the general intention was to shift the emphasis away from the short-term, towards the needs of the longer-term unemployed. Transition education and training options available to school leavers joining the workforce are to be increased. In the employment subsidy area, a new Job Opportunities Scheme will be introduced from 1 August. A job subsidy of $75 per week will be available to a private or public sector employer hiring a person who has been unemployed for 10 weeks or more. A subsidy of $120 per week (reducing to $75 per week after three months) will be available for a person unemployed for 20 weeks or more. This scheme will replace an

existing programme due to expire on 31 July 1985. Finally, special assistance will be provided to increase the employment prospects of specific groups within society that face the most severe employment problems.

A number of housing policies foreshadowed just prior to the Budget, were outlined in more detail by the Minister. These included more flexible lending terms by the Housing Corporation, increased Family Benefit Capitalisation limits, additional houses constructed for sale to modest income families and for rental, and additional funds for mortgage refinancing to assist modest-income families with special needs.

Fiscal and Monetary Developments

The major focus of attention in the Budget was the projected fiscal deficit for 1985/86. In the Budget, the Minister had noted that the fiscal deficit inherited by his Government, if left unchecked, would have left it with an unpalatable choice between allowing extremely high interest rates to be embedded in the domestic economy or of allowing the deficit to feed through into inflation. Either outcome could undermine the adjustment effort which had been set underway.

The projected deficit, at $1,286 million (2.8 per cent of estimated GDP), was considerably lower than previously forecast. The three year fiscal projections, which were released in March 1985, and which were based on forecasts of the economy prepared in November 1984, had estimated that the deficit for 1985/86 would be around $2,200 million, or 5.3 per cent of GDP.

Of the difference between the two estimates, $176 million is due to lower estimated expenditure, with the major differences being on the revenue side. The fringe benefits tax is estimated to yield $80 million more than previously thought, while a higher estimate of company profits in 1984/85 adds $70 million to company taxation this year. The estimate of personal income tax is up by $760 million. There are several reasons for this. First, the three year projections assumed that fiscal drag — the increased tax take due to income inflation placing taxpayers in higher tax brackets — would be offset by a tax reduction. As there was only a partial offset to fiscal drag in the November 1984 Budget and none in the latest Budget, the forecast tax take for 1985/86 will be correspondingly higher. Secondly, the 1984/85 wage assumption used in the projections (5 per cent) was lower than the actual outcome; and thirdly, the economy has proved to be stronger than previously expected with higher employment, and higher self-employed incomes resulting in an increased tax yield. Total revenue is budgeted at $16,096 million, an increase of 28.4 per cent on revenue in 1984/85.

The Minister stated, however, that the reduction in the projected deficit had not been achieved only because activity over the rest of the financial year was expected to remain relatively high, but also because of the expenditure decisions taken in the 1984 Budget, and because of the Government's success in constraining expenditure over the current financial year.

Budget Table 2, as set out below, provides a breakdown of expenditure into its main categories.

1. The 22.3 per cent rise in net spending on administration is the result of a number of factors, but particularly additional spending by the Department of Inland Revenue as a result of recent changes and other planned changes to the taxation system.
2. The main factor in the 17.7 per cent rise in expenditure on Foreign Relations has been a move to reverse a rundown in the country's defence capabilities.
3. Social Service expenditure is estimated to increase 14.6 per cent, largely as a result of policies introduced in this Budget, and also reflecting the first full-year cost of the Family Care Benefit introduced in the 1984 Budget.
4. The rise in net spending on communications is the result of a programme of capital expansion by the Post Office.
5. The rise in the debt services category reflects the build-up in the stock of debt over recent years.
6. The large (44.2 per cent) decline in expenditure on land use reflects policies implemented in 1984, and in particular in the 1984 Budget. These include the phasing out of the Supplementary Minimum Prices Scheme and the termination of the Forestry Encouragement Grants Scheme.
7. The reduction in net spending on fuel and power largely reflects policy changes to particular operations of the Minister of Energy.
8. The reduction in Miscellaneous Investment Transactions reflects a decline in the Loans Account funding requirements of the Rural Bank and the Housing Corporation.

Immediately following the Budget, the Minister announced that the public debt programme for 1985/86 had been revised downward, from $2,700 million to $2,000 million. The decline in the borrowing programme was not as large as the reduction in the deficit because other public sector influences were expected to make larger positive contributions to primary liquidity.

Conclusion

The Minister concluded by reaffirming the Government's commitment to its economic adjustment programme. He noted that results would not be apparent immediately, and that no 'miracles' would be worked. Although the Government recognised that some sacrifices would be necessary over the short-term, he stressed that it had not abandoned its fundamental social equity objectives. It was determined to ensure that these sacrifices would be required from all. It remained convinced that ultimately New Zealanders would recognise and acknowledge the need for the return to economic reality which the Government's policies represented.

Monetary and Credit Aggregates

The Governor of the Reserve Bank, Mr Spencer Russell, on 12 August 1985 released provisional figures for the monetary and credit aggregates as at the end of June 1985. Although strong growth was recorded in both the broad money supply and private sector credit aggregates, Mr Russell cautioned against reading too

much into the June quarter figures as an indicator of underlying monetary conditions.

There had previously been a fall in monetary growth over the March quarter, partly a result of the foreign exchange outflow early in the year. Mr Russell explained that the Reserve Bank had injected substantial amounts of liquidity into the financial system to restore more normal conditions in the immediate post-float period, and this had a delayed effect on the broad monetary aggregates. As a result, the significant pick up in monetary growth over the June quarter had to some extent been anticipated.

Mr Russell said that several other factors had added to the monetary growth rates over the June quarter. These included earlier than expected fiscal injections from the Government sector and continued strong lending growth from the main financial institutions. In addition, both the money and credit aggregates were currently being distorted by the shifts in market shares of the various institutional groups that has resulted from de-regulation and other changes in the financial system. This was partly reflected in the recent strong growth in trading bank deposits and lending relative to that of other institutional groups, Mr Russell said.

The statistics indicate that, during the year to June 1985, the broad money supply (M3) increased by 22.5 percent, compared with 15.1 percent for the year to March 1985. In seasonally adjusted terms, M3 is estimated to have grown by 9.6 percent over the June quarter. Although this was up substantially on the 0.4 percent increase in the March quarter, the Bank noted that because of the distortions associated with the foreign exchange drain in March, it was more correct to look at growth over the six month period ended June, rather than to compare the March and June quarter increases. The overall increase in M3 seasonally adjusted for the June half-year was around 10 percent.

Similar influences affected the annual growth rate of the narrow money supply (M1), which for the year to June was 9.2 percent, up from 2.1 percent for the March 1985 year. In seasonally adjusted terms, M1 is estimated to have risen by 7.4 percent over the June 1985 quarter, following a decline of 9.1 percent in the March quarter.

The annual growth rate of private sector credit (PSC) for the year ending June 1985 was 20.5 percent, which compared with 20.3 percent for the March 1985 year. In unadjusted terms, private sector credit grew by 3.2 percent over the June quarter, well down on the 8.2 percent rise recorded in the March quarter.

A decline in lending growth compared with the March quarter increase had been expected, since the previous rapid increase partly reflected lending associated with the pre-float foreign exchange outflows. Nevertheless, the underlying rate of credit growth in the June half year remained strong. The Bank again cautioned against placing too much emphasis on the quarterly seasonally adjusted Private Sector Credit statistics at present, as the seasonal pattern of PSC appears to have been significantly altered by recent changes in the regulatory framework.

Mr Russell also commented on the underlying stance of monetary policy. He said that the Government had for some time been pursuing an active debt sales programme consistent with maintaining firm monetary conditions. However, more effective control over the liquidity base of the financial system had only been obtained since the move to a floating exchange rate in March. It was therefore too early to expect the firm policy stance to be reflected in the monetary and credit aggregates. Slower underlying rates of growth in deposits should become apparent over future months and institutions that did not take account of the implications of this in their current lending policies may find themselves short of liquid funds later in the year.

Regarding the current liquidity situation, Mr Russell said that public sector injections had been more concentrated in the first half of the financial year, with the result that primary liquidity had temporarily been higher than intended. Indications were that current liquidity levels would be more than adequate to fund the September tax drain. Accordingly Mr Russell said that liquidity management operations had recently been directed at reducing primary liquidity to be more in line with the path previously envisaged. This had involved the sale of Treasury bills with March 1986 maturities through recent bill tenders and out of Reserve Bank portfolio. Mr Russell indicated that such operations had the effect of altering the timing of liquidity flows between now and March when substantial amounts of liquidity would be needed to fund the end-of-year tax flow.

Recent Developments in the World Oil Market

Over recent years the international price of oil has been subject to considerable downward pressure, falling from a peak of US$35 per barrel immediately after the second oil shock in 1979/80, to US$26.90 per barrel in June 1985. The major factor contributing to this pressure has been significant growth in the world's oil producing capacity together with a decline in the demand for oil products. While an expansion in total world oil production has been avoided over the last 3–4 years this has only been achieved through a reduction of OPEC's oil production levels. As a result OPEC's share in total world oil production fell from 59 per cent in 1979 to 42 per cent in 1984.

TABLE 1
OIL PRICES
(US$, Saudi Arabian Light)

		Official/Contract	*Market*
1982	March	34.00	30.5
	June	34.00	32.8
	September	34.00	32.3
	December	34.00	31.5
1983	March	34.00	28.6
	June	29.00	28.8
	September	29.00	28.8
	December	29.00	28.4
1984	March	29.00	28.6
	June	29.00	28.3
	September	29.00	27.6
	December	29.00	27.8
1985	March	28.00	27.8
	June	28.00	26.9

In January 1985 ministers representing OPEC's thirteen member countries met in Geneva to formulate a solution to the problems OPEC members had encountered as a result of this erosion in their share of total world oil production. However, they failed to

reach a consensus view on the appropriate policy response with most OPEC members favouring an overall reduction in the official OPEC oil prices while Algeria, Iran and Libya refused to accept a price reduction. OPEC Ministers, nevertheless, agreed to adhere to the production ceiling of 16 mbd set in October 1984.

TABLE 2
OIL PRODUCTION
(mbd)

Year	*1982*[1]	*1983*[1]	*1984*				*1985*	
			Mar	*Jun*	*Sept*	*Dec*	*Mar*	*June*
OPEC	19.8	18.4	19.1	18.8	17.9	18.0	17.5	16.4
Non OPEC	24.7	26.2	26.9	27.3	27.8	28.1	27.6	28.1
Total	44.9	44.6	46.0	46.1	45.7	46.1	45.1	44.4

1 quarterly average for the year.

Contrary to expectations of a continuing fall in the price of crude oil, oil prices remained firm in the March quarter of 1985. This outcome was largely due to Saudi Arabia reducing its production, thereby ensuring OPEC's total output did not exceed the October ceiling, and an expectation of increased demand as oil company reserves declined steadily. In the June quarter there was renewed downward pressure on oil prices as greater quantities of crude oil were sold at a discount through the spot market. In addition, Mexico, which although not an OPEC member had formerly aligned its oil prices with OPEC, announced an official cut in its crude oil prices in early July.

Within OPEC, two factions have emerged to present differing views on the appropriate response to these circumstances. The first, spearheaded by Saudi Arabia, argues for a significant price reduction in an attempt to maintain relative market share. The second, consisting of Algeria, Libya and Iran argues for a reduction in production quotas to maintain OPEC's official price structure, but ignores the general downward trend of oil prices and the increasing quantities of oil sold below official prices through the spot market. These views were discussed at an OPEC meeting in late July and although the meeting concluded by announcing a US50 cent cut per barrel in heavy crudes and a US20 cent cut per barrel in medium and light crudes with present production quotas unchanged, OPEC's official prices still remain above current market prices. As expected Algeria, Libya and Iran dissociated themselves from the accord.

The short-term outlook in the oil market is somewhat uncertain. Following the recent depreciation of the United Stated dollar the non-United States currency of oil could fall, leading to an increase in the demand for oil products. However, while such an increase in demand may exert an upward influence on the United States dollar price of oil, it is expected that downward pressures associated with the expansion in the world's oil producing capacity in recent years will dominate oil price behaviour during 1985. Given this increased world production capacity, OPEC's share in total output would decline further if its members were to continue to observe the current official oil price. This outcome is likely to be unacceptable to many members of OPEC who are likely to respond by offering unofficial price discounts in order to support an increase in output, thereby reducing oil prices.