ECONOMIC NOTES

Reserve Bank Econometric Forecasts

These forecasts, released on 27 June 1985, cover the period up until the end of March 1987 and incorporate the policies contained in the recent Budget. The forecasts do not, however, include the effects of the proposed Goods and Services Tax (GST). It is intended that the GST will be incorporated in the Bank's forecasts when a decision has been made on the rate at which it will be applied. It should be noted that, based on currently available information, it is thought that the inclusion of GST would not alter the pattern of the present forecasts, apart from causing a one-off increase in the Consumers Price Index.

The latest forecasts show that economic activity in New Zealand, as indicated by the Reserve Bank's measure of real Gross Domestic Product (GDP), reached a peak in the first half of 1985. Thereafter the forecast profile of activity is essentially flat, with a slight decline over the remainder of 1985/86 offset by a moderate rise through 1986/87. Real domestic expenditure is predicted to fall in both the 1985/86 and 1986/87 years, but these falls will be offset by an improvement in the external balance as export volumes continue to grow strongly and import volumes decline. The current account deficit (on a balance of payments basis) is forecast to fall from about $2,700 million in 1984/85 to about $200 million in 1986/87. Consumer price inflation is forecast to have peaked, at an annual rate of just over 16 per cent, in the year to June 1985, and is forecast to fall steadily over the forecast period, reaching an underlying rate of around 9.5 per cent for the year to March 1987.

Full-time employment is forecast to grow by 1 per cent over the year to March 1986 and to increase by a further 0.5 per cent over the year to March 1987.

The Government's budget deficit for the year to March 1986 is forecast to be around $1,250 million. This represents a significant downward revision from previous forecasts and arises primarily as a result of large increases in forecast revenues, particularly company tax receipts. A further fall in the budget deficit to about $930 million is forecast for 1986/87. No allowance has been made either for the GST or for possible income tax cuts in that year.

Real personal disposable incomes are forecast to fall by just over 4 per cent in 1985/86 as a result of declining farm incomes, slower employment growth and a large increase in personal tax payments. In 1986/87, as inflation diminishes, the fall should be reversed to give a rise in real personal disposable incomes of about 2 per cent. However, an expected return to more normal levels of saving in 1986/87, together with a return to more normal consumption patterns following the recent distortions caused by special factors such as the devaluation, imply that real consumption expenditures should decline in both the forecast years.

Private investment is expected to fall slightly over 1985/86 and then more strongly over 1986/87 in response to the slowing economy. This trend in private investment is obscured in the total gross investment figures by an expected high level of central government investment in 1985/86 followed by a sharp reversal in 1986/87.

With consumption and private investment weakening, real final domestic expenditure is expected to fall in both 1985/86 and 1986/87 (although the rate of decline slows towards the end of the forecast period). Stockbuilding is also expected to make a negative contribution to the growth in real output. In both years, however, the effect of these reductions in domestic demand should be offset by the positive contribution from the external sector. The rapid expansion in the volume of exports of goods and services which has been apparent over the last two years is expected to continue in 1985/86. While this growth is likely to moderate in 1986/87, import volumes should contract significantly due to the downturn in domestic demand and the import substitution effect of the energy based major projects moving into production.

Although the real GDP profile is essentially flat over the forecast horizon, growth in annual average terms for 1985/86 is projected to be about 1.5 per cent. This reflects the fact that economic activity at the end of 1984/85 was higher than the average recorded during that year.

Comment on Money and Credit Aggregate Estimates for April 1985

The Governor of the Reserve Bank, Mr Spencer Russell, commented on the money and credit aggregate estimates for April which were released on 28 June 1985.

Mr Russell said that certain special factors were likely to result in a temporary increase in the rate of growth of the broad money supply, M3, over the June quarter.

The first factor was the large purchases of private sector securities carried out by the Reserve Bank in March to restore liquidity to more sustainable levels following the floating of the New Zealand dollar. The foreign exchange drain prior to the float was partly responsible for the low monetary growth rates recorded in the March quarter. With the public debt programme aimed at maintaining stable but firm liquidity conditions over 1985/86, the allowance in the debt programme for these securities to mature will result in stronger monetary growth in the June quarter.

A second factor had been stronger than expected fiscal injections from the Government sector over the June quarter. Mr Russell noted that this was primarily a timing factor and that the recent Budget estimates implied that the fiscal deficit would be roughly neutral in its liquidity impact over the remainder of the year. This would mean much slower growth in financial institutions' deposits after June.

Mr Russell said that financial institutions would need to take account of this slowing in their deposit base in formulating their lending policies. The impact of the Government's firm monetary policy stance will be reflected in lower monetary growth rates beyond the June quarter, once the special factors associated with the transition to the post-float policy environment have been removed. This will necessitate much slower private sector credit growth than was recorded over the first four months of 1985.

Public Debt Programme

The Minister of Finance on 13 June 1985 announced a reduction in the public debt programme for 1985/86, resulting from the downward revision in the Budget deficit. The borrowing programme for the year has been reduced from the $2.7 billion announced in March to $2 billion.

The Hon. Roger Douglas said that this reduction should not be interpreted as a relaxation in the stance of monetary policy. The public debt programme would continue to be aimed at fully offsetting the monetary injections coming into the economy as a result of the fiscal deficit and other public sector activity over the current financial year.

The decline in the borrowing programme is not as large as the reduction in the deficit because other influences are now expected to make higher contributions to the net liquidity injection over 1985/86. In particular, the withdrawal associated with repayment of compensatory deposits was lower than originally expected, though this was partly offset by a higher withdrawal resulting from the run-off of the private sector securities held by the Reserve Bank. A further influence came from higher redemptions of retail debt instruments such as Kiwi Stock I.

The Minister added that the debt programme would continue to be reviewed in light of developments over the course of the year. The latest projections suggested that the lower deficit may impact most heavily in the March 1986 quarter. Liquidity injections were still expected to be strongest in the December quarter and the timing of stock tender sales would reflect this pattern.

The Minister said that the stock tender programme had been brought forward slightly to allow for the higher than expected Reserve Bank and Government injections in the June quarter. This would also reduce the volume of debt sales required in the lead up to the September tax period. In particular, no tender would now be held in August, and the tender scheduled for 20 June would be for $300 million, a higher amount than previously indicated. Current projections suggested that a combined amount of $500 million (settlement value) would need to be raised in the two tenders now scheduled for 18 July and 19 September. Settlement of stock sold in the September tender should begin after the provisional tax payments have ceased.

Mr Douglas indicated that the Reserve Bank would shortly be releasing greater detail on expected liquidity flows over the September quarter. Details of the stocks to be offered in the June tender would be released at noon on 14 June 1985.

20th Government Stock Tender

Government Stock Tender No. 20 was held on 20 June 1985. A total of $300 million of stock was offered for sale, comprising $50 million of stock maturing in March 1987, $150 million of stock maturing in March 1991 and $100 million of stock maturing in April 1995. Total valid bids received in the tender amounted to $1,129 million, well up on the $488 million of bids received in the previous tender for a slightly lower amount (a total of $250 million of stock was offered in the 19th tender). For both the 1987 and 1991 maturities, total bids were approximately four times the volume of stock on offer, while total bids for the 1995 stock were around three times the amount on offer.

The average yields on successful bids declined sharply from those recorded in tender 19. The weighted average yields on the 1987 and 1995 maturities, at 19.6 per cent and 17.3 per cent respectively, were 2.3 and 1.8 percentage points lower than for the same maturities in the May tender. A March 1991 maturity had not been offered before. However, the weighted average yield, at 18.2 per cent was 2.2 percentage points lower than the average yield on the October 1990 stock offered in May.

See table E1 for the results of this and previous Government stock tenders.

Treasury Bill Tenders and Open Market Operations

$50 million of Treasury bills were offered for sale in Tender 19, which was held in the first week of June. The relatively small offering reflected the low levels of cash balances in the period prior to the tender and expected cash withdrawals over the first few days of the settlement week. In response to strong cash injections over the following two weeks, $200 million of bills were sold in Tender 20 and a further $100 million of bills were sold in Tender 21. A forecast tightening of liquidity conditions over the end of June saw $30 million of Treasury bills offered for sale in Tender 22.

Strong cash withdrawals over late May — early June were accompanied by some $129 million of discounting by the banking system. The Reserve Bank intervened on 5 June to moderate the impact of expected cash withdrawals on that and following days, with $21 million being injected through purchases of commercial securities.

The final settlement of Stock Tender 19 settlements (completed on 14 June) was accompanied by a further $73 million of discounting. Reserve Bank action was considered unnecessary because of a large forecast cash injection immediately following this period on account of the usual monthly government stock interest payment.

In response to a temporary increase in levels of cash balances following the government stock interest payment the Reserve Bank moved to supplement the regular Treasury bill tender with sales of $95 million short-dated bills from portfolio over 19-24 June.

The main components of primary liquidity (discountable securities and settlement balances of the banking system) fluctuated around the $1,250-$1,350 million level over 1-14 June, and subsequently increased to around $1,500 million following the government stock interest payment on 17 June.

Market interest rates remained stable over the end of May and after a slight firming during the first week in June, eased steadily throughout the rest of the month. The weighted average yield on Treasury bills increased for both Tenders 19 and 20 (with rates of 21 per cent and 22.756 per cent respectively). A slight decrease in rates was recorded in Tender 21 (and 22 with a weighted average yield on bills sold of 22.52 per cent and 21.76 per cent respectively), however a much closer parity with market rates has been achieved and this should significantly assist the development of an active secondary market in Treasury bills.

Treasury Bill Tenders and Open Market Operations

Treasury Bill Tenders

Tender	*Amount Offered $m.*	*Term*	*Amount Sold $m.*	*Weighted Average Rate %*
19	50	28 days	50	21.0
20	50	14 days	52.5	22.509
	50	28 days	35	23.097
	75	42 days	75	22.886
	25	91 days	37.5	22.525
21	25	14 days	25	22.44
	25	28 days	25	22.61
	25	42 days	25	22.77
	25	91 days	25	22.236
22	30	28 days	30	21.76

Open Market Operations	*Amount Offered $m.*	*Term*	*Amount Sold*	*Amount Purchased*
5 June Commercial Bills	20	30-70 days	—	22
19 June Treasury Bills	50	7-12 days	50	—
24 June Treasury Bills	45	4- 7 days	45	—

OECD Economic Outlook

The OECD recently published its Economic Outlook which gives a summary of developments in the international economy and projections for 1985 and 1986. This note provides a brief summary of the major points contained in that report.

Output growth was maintained in OECD countries during the first half of 1985, although at a slower and possibly more sustainable pace than over the past year. The Japanese economy continued to grow briskly while growth in Europe, although slower than in most OECD countries, has been associated with an improvement in underlying macroeconomic conditions. A considerably slower rate of growth in the United States enhances prospects for continued inflation control. Overall in the OECD, inflation is expected to continue its general downward trend, falling from five per cent in 1984 to a forecast 4.8 per cent in 1986. Contributing to this decline have been moderate wage settlements, productivity gains and weak commodity prices.

There are however some less satisfactory features of the present recovery. Unemployment continues to be high in most OECD countries, particularly in Europe where it has reached its highest rate for more than fifty years. Trade in the OECD area has decreased with both import and export volumes dropping significantly. In addition the prevalence of discriminatory trade interventions has increased markedly. The large and growing United States current account deficit is also considered to be a major concern. High real interest rates, high rates of return on United States investments and a high growth of domestic demand have all assisted in maintaining the strength of the United States dollar. Attention has now focussed on the adjustment process with emphasis on the need for a 'soft landing'. The difficulty lies in the major trading role played by the United States economy. Hence United States authorities have the task of adopting a programme of adjustment which provides balance between the domestic and the international economy.

A general improvement in the debt problems of developing countries was reported with non-oil exports increasing by 12 per cent. However, these gains were distributed unevenly, accruing in the favour of manufactured goods exporters. The poorer developing countries' prospects were further clouded by weakening commodity markets. While these poorer countries' debts are not large enough to threaten international financial markets, many of them face serious economic distress.