Reserve Bank Bulletin

QUARTERLY REVIEW OF MONETARY CONDITIONS[1]

The various indicators of monetary developments provided a somewhat mixed picture over the June quarter. Monetary growth was strong, but most financial institutions increased their lending more slowly than in the March quarter. There was a general firming in both domestic interest rate levels and the exchange rate. This was the first quarter in which the full effects of previous monetary policy measures were operating and developments in a number of areas still reflected the process of transition to the new policy environment.

Introduction

The June quarter was the first quarter in which the full effects of monetary policy measures taken over the previous nine months were operating. These included the move to a floating exchange rate in March, which provided the authorities with much greater control over domestic liquidity conditions than had previously been the case. There were no additional major policy changes during the quarter.

Developments in a number of areas continued to reflect the effects of transition to the new policy environment. The main features of the quarter were:

- Strong growth in the monetary aggregates.
- Some slowing in the rate of credit expansion, compared with the very strong growth in the March quarter.
- A significant increase in the level of primary liquidity.
- A firming in both short and long term interest rates over much of the quarter, though long term rates fell back again in June.
- Relative stability in the exchange rate.

1 All monthly and quarterly growth rates given in this article are seasonally adjusted unless otherwise stated.

Monetary Policy Stance

At the beginning of the June quarter, the Government announced that the public debt programme for the 1985/86 year would aim to fully fund net public sector injections into primary liquidity[2] by selling medium-term debt through the stock tenders.[3] The timing of debt sales partly reflected the expected pattern of liquidity injections during the year. Early forecasts of the influences on liquidity suggested that about $2,700 million of debt would need to be raised during 1985/86. Around $700 million was intended to be raised in three tenders scheduled for the June quarter.

Primary Liquidity

Table 1 shows the actual influences on primary liquidity over the June quarter compared with initial forecasts. Although the public debt programme for the June quarter was initially based on fully funding the ne

2 Primary liquidity is defined here as trading bank and Post Office Savings Bank deposits at the Reserve Bank and private sector holdings of government securities with less than six months to maturity. See discussion in the article entitled 'Liquidity Management Policy' in the May 1985 *Bulletin* for further details.

3 For a discussion of the role and principles underlying the tender programme the reader is referred to the article 'Monetary Policy in New Zealand' in the June 1985 *Bulletin*.

public sector injections, primary liquidity actually increased over the quarter by a net $767million. The main reasons for this increase were:

- A net injection from the Government for the quarter of $1,724 million, some $624 million higher than expected. This differs from the $1,294 million fiscal deficit reported for the same period due mainly to timing factors.
- Lower than projected stock tender settlements due to timing influences, with the bulk of the June tender not being settled until July.

Reflecting these influences, the average daily level of primary liquidity increased in successive months over the June quarter from approximately $940 million in April to $1,150 million in May and $1,360 million in June[4] (see figure 1).

Figure 1
DAILY MOVEMENTS IN
PRIMARY LIQUIDITY OVER JUNE 1985 QUARTER

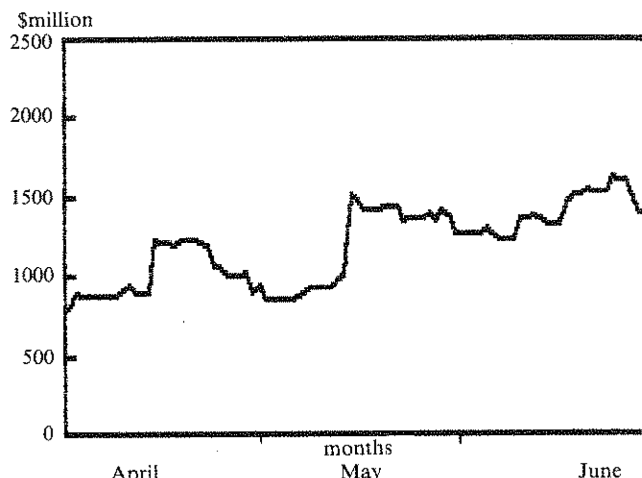


TABLE 1
INFLUENCES ON PRIMARY LIQUIDITY[1]
OVER THE JUNE QUARTER 1985

($ million)

	Total June Qtr	*Projected June Qtr*
Government Influence		
Fiscal Deficit	+ 1,294	+ 1,100
Other[2]	+ 430	—
Reserve Bank Influences		
Compensatory Deposits	− 502	− 500
Open Market Operations	− 680	− 740
Other[3]	− 24	—
Public Debt Transactions		
Stock Tenders	− 524	− 700
Securities Approaching Maturity[4]	+ 718	+ 720
Retail Debt.	+ 167	+ 120
Residual	− 112	—
Changes in Primary Liquidity	+ 767	—

Notes

1 For the purposes of this table, primary liquidity is defined as total private sector holdings of discountable government securities (not including retail securities) plus settlement balances held at the Reserve Bank by the trading banks and Post Office Savings Bank. Discountable securities are those with six months or less to maturity.

2 Includes additional liquidity impact of the Government's transactions which are not captured in the fiscal deficit due to timing factors, plus Reserve Bank purchases of foreign exchange on behalf of Government.

3 Includes changes in producer board account balances, notes in circulation, interest received on Reserve Bank government security holdings, and Reserve Bank Indemnity.

4 Given the definition of primary liquidity, government securities approaching maturity are counted when they become discountable on demand with the Reserve Bank, rather than when they actually mature.

Government Stock Tenders

Three Government stock tenders were held during the June quarter, raising a total of $800 million in nominal value. This was slightly higher than originally intended, reflecting the strong fiscal injections during the quarter. The liquidity impact of settlement for government stock during the quarter amounted to only $524 million. The difference between nominal and settlement values reflected two factors: first, a significant part of the June tender was not settled until July; and secondly, the weighted average yields on successful bids in the tenders exceeded the coupon rates on the stock offered, meaning that the stock was sold at a discount.

Total bids submitted in the April and May tenders were down substantially on bids received in previous tenders relative to tender sizes. Average yields on successful bids also increased quite sharply in both tenders. However, the June tender, held one week after the Budget, saw a reversal of both these trends, with a much higher level of subscriptions and a sharp fall in rates. The decline in interest rates, of between 1.9–2.3 percentage points relative to the May tender (refer to table 2), was in line with previous movements in secondary market rates for government stock. And in the case of the longer maturities these reductions took rates back to the levels prevailing in February prior to the float.

Expectational factors appear to have been the main influence behind the movements in government stock rates over the June quarter. In the initial post-float environment, there was considerable market uncertainty over likely developments in both interest rates and the exchange rate. This resulted in a lower level of overseas interest in the stock tenders, and the rates at which investors were willing to bid for stock rose sharply. Market sentiment appeared to change later in the quarter, however, and the announcement of a substantial reduction in the Budget deficit coincided with a marked decline in rates. There also appeared to be a resurgence of overseas interest in investing in New Zealand, both directly and indirectly through the rapidly growing Euro-Kiwi bond market.

Over the June quarter as a whole, secondary market government security rates eased by around 0.5–1.0 percentage points. However, the yield curve at the end of June was more negatively sloped. Rates on 2–3 year government stock were up around one per cent on the rates recorded in January and February, possibly reflecting higher short-term inflationary expectations.

Short-term money market rates had declined over the last few weeks of March from the very high levels immediately following the float and this trend continued during the first two weeks of April. Wholesale 30 and 90 day commercial bill rates declined from around 22.5 per cent and 24.3 per cent at the end

4 The average daily level of primary liquidity includes weekends.

TABLE 2
NEW ZEALAND GOVERNMENT STOCK SALES BY TENDER

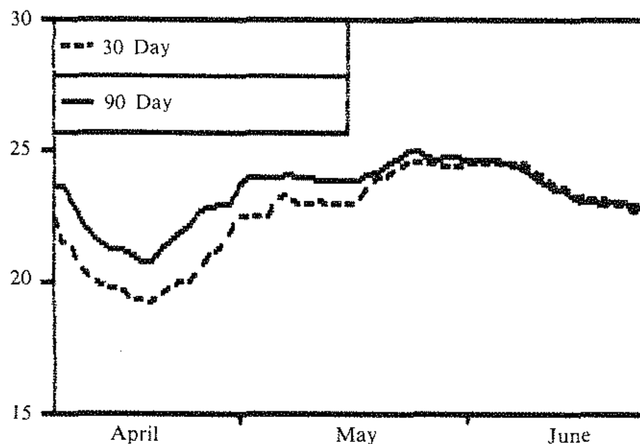
Tender number	*Date held*	*Stock offered*	*Maturity date*	*Total amount offered $m*	*Total bids submitted $m*	*Over-subscriptions accepted $m* [1]	*Total successful bids $m*	*Allotment Yield % p.a.* [2]
16.	17/1/85	N.Z. Govt. Stock	15.03.87	150.0	385.3	—	150.0	17.91
			15.03.90	150.0	471.1	—	150.0	17.46
			15.10.94	100.0	460.5	—	100.0	17.09
17.	14/2/85	N.Z. Govt. Stock	15.12.88	100.0	260.8	—	100.0	18.38
			15.03.90	150.0	424.2	—	150.0	17.76
			15.10.94	150.0	354.7	—	150.0	17.35
18.	18/4/85	N.Z. Govt. Stock	15.10.90	150.0	292.8	—	150.0	18.99
			15.04.95	100.0	188.5	—	100.0	17.95
19.	16/5/85	N.Z. Govt. Stock	15.03.87	75.0	153.3	—	75.0	21.85
			15.10.90	100.0	180.9	—	100.0	20.39
			15.04.95	75.0	153.7	—	75.0	19.18
20.	20/6/85	N.Z. Govt. Stock	15.03.87	50.0	198.3	—	50.0	19.60
			15.03.91	150.0	642.6	—	150.0	18.15
			15.04.95	100.0	287.7	—	100.0	17.33
21.	18/7/85	N.Z. Govt. Stock	15.03.91	150.0	735.6	—	150.0	18.18
			15.04.95	150.0	484.1	—	150.0	17.86

Note:
[1] As from the fifth tender over-subscriptions of up to 20% of the amount offered in any maturity may be accepted subject to the overall amount accepted not exceeding the amount of stock offered in the tender (this facility was announced on 2 February, 1984 and was covered on page 18 of the January/February 1984 *Bulletin* (Vol 47)).
[2] The weighted average yield under the yield bid system.

of March, to 19.3 per cent and 20.8 per cent, respectively, by 16 April (see figure 2).

Despite the rise in the average level of primary liquidity, however, short-term money market rates then firmed steadily between mid-April and the end of May, settling in the 24–25 per cent range. Rates eased back again by 1–2 per cent over the latter half of June in line with the fall in longer term rates, but still remained well above the levels experienced prior to the pre-float foreign exchange outflow in late February.

Figure 2
SHORT TERM INTEREST RATES OVER JUNE 1985 QUARTER
90 day and 30 day Commercial Bill rates

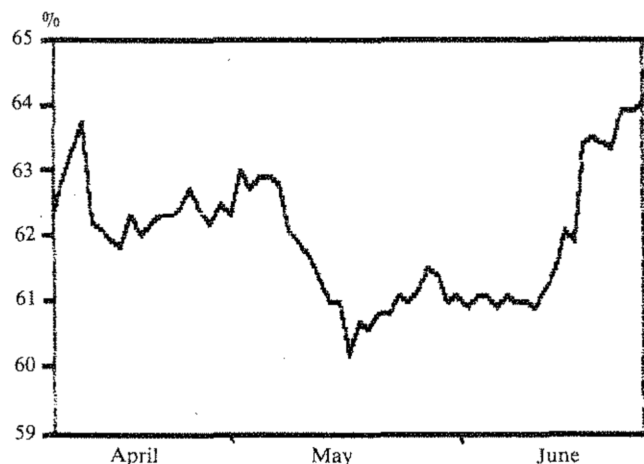


Exchange Rates

Movements in the exchange rate provide a further indicator of domestic monetary conditions. All other things being equal, a tightening in domestic monetary conditions would tend to put upward pressure on the exchange rate as private capital flows respond to higher nominal interest rates in New Zealand relative to overseas. This indicator needs to be treated with caution, however, since the exchange rate will also be influenced by other factors such as trade flows and investor expectations regarding the medium-term prospects for the New Zealand economy.

At the end of the June quarter the Reserve Bank index of exchange rates was up slightly compared with the end of March. The average daily rate during the final week of June was 63.7, compared with 63.1 in the final week of March. During much of April and the first week of May the Bank's exchange rate index averaged 62.4. Over the remainder of May and the first half of June the index averaged 61.1 but then increased steadily during the last two weeks of the quarter (see figure 3).

Figure 3
EXCHANGE RATE INDEX OVER JUNE QUARTER 1985
Trade Weighted Average



Monetary and Credit Aggregates

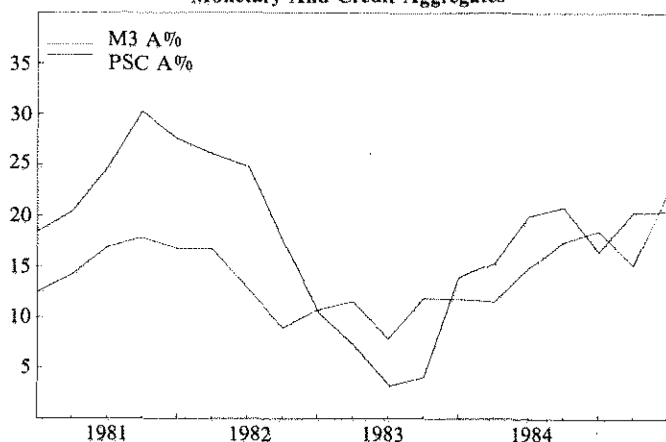
The broad monetary aggregate, M3, grew by an estimated 9.6 per cent during the June quarter compared with an increase during the March quarter of 0.4 per cent. Over the June 1985 year, M3 expanded by 22.5 per cent, up from 15.1 per cent for the year ended March 1985. The strong M3 growth in the June quarter reflected three factors:

— The delayed effect of Reserve Bank injections in March. In the immediate period following the float, the Bank purchased around $800 million of private sector securities (mainly TCDs) to restore liquidity to more sustainable levels. This added to the liquid reserves of financial institutions initially, but was not reflected in the money supply figures as Reserve Bank purchases of TCDs are classified as 'inter-institutional' deposits and as such, are excluded from the M3 definition. Because the stock programme was reduced to accommodate the liquidity drain as these securities matured these injections were ultimately reflected in the June quarter M3 figures. As a result, movements in the monetary aggregates overstated the degree of tightness in the March quarter and suggested that conditions were somewhat looser than was actually the case in the June quarter. It is therefore better to look at growth in M3 over the six month period ended June, which showed a net increase of around 10 per cent.

— Under-funding of the fiscal deficit over the June quarter, through stock tender sales, due to stronger than expected fiscal injections from the government sector.

— Continued growth in lending to the private sector by M3 institutions. Private sector credit is estimated to have grown by 3.2 per cent over the June quarter (unadjusted[5]). Although this was well down on the 8.2 per cent increase in the March quarter, the latter was inflated by financing associated with the pre-float foreign exchange drain. The annual growth rate for the year ended June 1985 is estimated to be 20.5 per cent, similar to the 20.3 per cent increase recorded for the year ended March 1985.

Figure 4
Monetary And Credit Aggregates



5 Recent changes in the financial sector have temporarily reduced the reliability of the quarterly seasonally adjusted PSC series as an indicator of underlying developments.

In addition to the specific factors noted above, both the monetary and credit aggregates are currently being distorted by reintermediation effects associated with the recent deregulatory changes in the financial sector, though the magnitude of such effects is difficult to quantify.

Lending and Deposits by Institution

Average monthly trading bank lending growth over the June quarter was 1.3 per cent, compared with an average of 4.1 per cent during the previous quarter (see table 3). This slower average growth rate probably reflected a reversal of earlier overdraft lending associated with the pre-float foreign exchange outflow. In particular, average lending actually declined slightly in April.

Of the other main financial institutions, lending growth by the POSB was by far the strongest in percentage terms, primarily reflecting increased mortgage lending for housing. Average monthly finance company lending growth also increased from 1.7 per cent during the March quarter to 2.2 per cent over the June quarter. Lending growth of the trustee savings banks slowed over the June quarter to about one-half of the average monthly rate recorded in the March quarter, while both private savings banks and building societies recorded a decline in their lending over the quarter.

Growth in trading bank total deposits remained strong over the June quarter with a monthly average increase of 3.5 per cent, compared with an average of 2.2 per cent during the previous quarter. As a result the trading bank lending to deposit ratio fell from 80 per cent in March to 76 per cent in June. Growth in total deposits of finance companies also increased substantially in the last two months of the June quarter, while deposit growth of both trustee savings banks and the POSB continued at a more moderate pace. Building society deposits declined over the first two months of the quarter before rising again in June.

Part of the growth in trading bank deposits over the quarter appears to have reflected inter-institutional activity. Non-bank M3 institutions' holdings of TCDs and term deposits with trading banks increased from $400 million at the end of March to around $720 million by the end of June. Over the same period the Reserve Bank ran down its portfolio of TCDs by about $750 million, while total TCDs outstanding remained stable at around $2 billion. This suggests that holdings of TCDs by the non-M3 sector also increased by around $300-$400 million. It is clear then that the strong deposit growth recorded by trading banks in recent months at least partly reflects a more active role being taken by the banks in the wholesale money markets, following the removal of the 30 day rule in August 1984.

Liquidity Management Operations

The June quarter was the first full quarter during which the new liquidity management package, discussed in the May *Bulletin*, was operating.

Of the thirteen Treasury bill tenders held over the June quarter, there were three nil tenders in April/May in response to substantial anticipated liquidity withdrawals over the settlement period. In all other tenders, total bids received covered the amount on

TABLE 3
MONTHLY LENDING AND DEPOSIT GROWTH[1]
(in percent)

	LENDING				*DEPOSITS*			
	Average March Qtr.	*Apr.*	*May*	*June*	*Average March Qtr.*	*Apr.*	*May*	*June*
Trading Banks[2]								
— Monthly	+ 4.1	− 0.2	+ 3.6	+ 0.4	+ 2.2	+ 4.0	+ 4.4	+ 2.0
— Annual	+24.6	+26.0	+28.3	+24.3	+20.4	+28.4	+32.1	+32.5(P)
Finance Coys								
— Monthly	+ 1.7	+ 1.9	+ 2.2	+ 2.5(P)	—	+ 0.6	+ 2.6	+ 6.3(P)
— Annual	+21.8	+22.6	+24.6	+26.8(P)	+24.8	+17.8	+19.9	+30.7
Trustee Savings Banks								
— Monthly	+ 1.2	+ 1.2	+ 0.6	+ 0.6	+ 1.0	+ 2.6	+ 1.0	+ 0.6
— Annual	+13.8	+13.6	+13.3	+12.9	+13.2	+15.5	+14.9	+14.1
Private Savings Banks								
— Monthly	− 1.3	− 1.6	− 2.1	− 1.8	− 0.6	− 0.8	− 2.5	− 1.8
— Annual	−10.2	−11.4	−12.3	−13.3	−17.2	−15.7	−16.7	−16.4
POSB								
— Monthly	+ 3.1	+ 3.5	+ 6.9	+15.0	+ 0.6	+ 0.6	+ 1.1	+ 0.7(P)
— Annual	+56.0	+49.2	+52.1	+68.0	+ 9.6	+ 8.5	+ 8.8	+ 8.3(P)
Building Societies								
— Monthly	+ 1.9	+ 0.3	+ 0.8	− 1.4	− 0.3	− 0.9	− 0.5	+ 2.0
— Annual	+18.6	+14.7	+14.4	+11.8	+11.5	+ 7.8	+ 5.6	+ 6.4

[1] Monthly figures are seasonally adjusted, except for building societies whose lending display no stable seasonal pattern and deposits of finance companies which display no stable seasonal pattern.
[2] Weekly averages.
(P) Provisional.

offer, while the over-subscription facility was used only once, in tender 20.[6]

The bill tenders were dominated by the banks during the quarter. Non-bank institutions were successful in obtaining only $5 million of 42 day bills in tender 20 and $8 million of a total of $100 million bills offered in tender 21.

This dominance by the banks reflected the fact that Treasury bill rates remained well below those on commercial paper for much of the quarter. Bill rates fluctuated within a range of 16–19 per cent up until mid-May with the result that the gap between bill tender yields and commercial bill rates of similar maturities became as large as five percentage points. This gap between rates subsequently closed to around 1 percentage point during the latter half of the quarter, as bill rates rose to around 21–23 per cent and rates on commercial paper declined. As a result, there was greater interest in bill tenders from the non-bank financial institutions towards the end of the period. Total bids submitted by non-bank institutions rose from around $5 million in tenders 17 and 18 to over $50 million in tender 21.

The divergent paths followed by rates on Treasury bills and commercial paper during the quarter partly reflected the transition to the new policy environment. Early in the quarter, there was still a high degree of market nervousness following the tight liquidity situation immediately after the float. As a consequence, the trading banks' desired holdings of cash at the Reserve Bank appeared to be quite high and the authorities allowed for this in setting Treasury bill tender amounts. Over the course of the quarter, however, the market became more accustomed to the new liquidity management arrangements and the banks showed a strong preference for holding Treasury bills rather than cash, which currently attracts an interest rate of only 5 per cent, well below other market rates. In response to this, weekly bill tender amounts were set to more fully absorb projected cash injections and bill rates rose closer to rates on private paper of comparable maturities.

Open market operations undertaken by the Bank during the quarter are summarised below.[7] The Bank intervened on two occasions in the quarter to moderate upward pressures on interest rates. Firstly, over 1–2 May, the Bank carried out buyback transactions totalling $75 million to inject cash into the system.

A further $106 million was injected through buyback transactions over 24–27 May and in addition the Bank purchased $22 million of commercial securities in the first week of June. During several periods of easier liquidity conditions over the quarter, the Bank also sold private paper or short dated Treasury bills out of portfolio in order to reduce cash balances.

6 For details of Treasury Bill sales by tender refer to table E.3 in June and July issue of the *Bulletin*.

7 For details of Reserve Bank Open Market operations refer to Economic Notes, in April, May and June *Bulletins*.

Retail Debt Policy

Redemptions of retail debt instruments exceeded new subscriptions over the June quarter by $178 million, down nearly $50 million on the net redemptions recorded during the previous quarter (see table 4).

Both redemptions and subscriptions were lower over the June quarter compared to the March quarter, with a $66 million fall in redemptions and a $21 million decline in subscriptions. The introduction of KSS IV in the March quarter did not lead to any increase in the subscription rate. Indeed, while the rate of total redemptions declined only slightly in successive months of the June quarter, averaging around $68 million per month, monthly subscriptions actually declined further from $15.6 million in April to $6.4 million in May and $3.5 million in June, a reflection of further increases in comparable market rates over the period.

On 5 July 1985 the fourth issue of Kiwi Savings Stock was closed in accordance with the terms of the prospectus, having raised a total of $47.4 million since it was introduced on 28 February 1985. KSS IV was replaced by a fifth issue on 15 July 1985 at the same interest rates — 17 per cent for either two or four years. KSS V cannot be redeemed prior to 15 May 1986 and a lower interest rate of 10 per cent applies if redeemed prior to maturity.

injections resulting from the fiscal deficit and other public sector transactions. The decline in the borrowing programme primarily reflected the lower fiscal deficit forecast, though this was partly offset by an increase in the net liquidity injection expected from other influences. The debt programme is reviewed periodically over the course of the year.

Conclusion

The various indicators of monetary conditions provided a somewhat mixed picture over the June quarter.

Primary liquidity rose over May and June, due partly to stronger than expected fiscal injections. However, this coincided with a firming in short-term interest rates and, towards the end of the quarter, some firming in the exchange rate. Furthermore, it was expected that the above-track fiscal injections would be offset in subsequent months and therefore it was not considered that the higher level of primary liquidity represented an easing of the underlying liquidity conditions that needed to be offset by a stepping up of stock tender sales.

Monetary growth was also strong over the quarter, though this partly reflected special factors present in the transition to the post-float policy environment and the under-funding of liquidity injections during the quarter.

TABLE 4
SUBSCRIPTIONS AND REDEMPTIONS OF RETAIL DEBT INSTRUMENTS: COMPARISON OF MARCH AND JUNE QUARTERS 1985

	March 1985			*June 1985*		
	Subscriptions ($m)	*Redemptions ($m)*	*Net ($m)*	*Subscriptions ($m)*	*Redemptions ($m)*	*Net ($m)*
Inflation Adjusted Bonds	...	− 10.8	− 10.8	...	− 13.6	− 13.6
Kiwi Savings Stock I	...	− 203.5	− 203.5	...	− 165.7	− 165.7
Kiwi Savings Stock II	...	− 12.9	− 12.9	...	− 11.8	− 11.8
Kiwi Savings Stock III	+ 23.9	...	+ 23.9	...	...	...
Kiwi Savings Stock IV	+ 22.0	...	+ 22.0	+ 25.5	...	+ 25.5
Our New Zealand Bonds	...	− 2.6	− 2.6	...	− 5.4	− 5.4
Other Savings Stock	...	− 39.4	− 39.4	...	− 7.0	− 7.0
Total	**+ 45.9**	**− 269.2**	**− 223.3**	+ 25.5	**− 203.5**	**− 178.0**

Revision to 1985/86 Debt Programme

Following the presentation of the June 1985 Budget, the Minister of Finance, the Hon. R.O. Douglas, announced a reduction in the public debt programme for 1985/86 from the $2.7 billion announced in March to $2.0 billion. This did not indicate any change in the stance of monetary policy as the debt programme continues to be aimed at fully offsetting the monetary

In addition, both the monetary and credit aggregates are currently being distorted by the effects of deregulation on the financial sector. Finally, from a policy perspective, there is no reason to expect a clear *short-term* relationship between the liquidity base and movements in the broader money and credit aggregates. The full implications of the current firm policy stance for money and credit growth are only likely to become apparent over a period of several quarters.