REVIEW OF MONETARY CONDITIONS

In this article Terry Creighton reviews developments in monetary conditions over the three months to mid-May.

Background

Real economic indicators prior to the sharemarket crash suggested that the domestic economy was approaching the trough of a fairly shallow recession. The impact of the crash, however, was expected to deepen the recession owing to its adverse impact on business confidence, investment and consumption.

Although a range of indicators suggested that domestic activity held up well over the December quarter, more recent data are giving clearer signals of a definite weakening in economic activity. Retail sales (seasonally adjusted) fell significantly in February following falls on average over the three months to January. In seasonally adjusted terms, registered unemployment increased sharply over the March quarter, while the number of residential building permits issued (previously one of the few favourable indicators) fell in both February and March.

The Bank's latest forecasts issued in late March (and detailed more fully elsewhere in this *Bulletin*) point to a slightly deeper recession than had been forecast in October 1987. However, the forecast recession is still shallow when considered in light of the extreme pessimism that developed in many quarters during the period of falling share prices up to the end of February. There appears to have been some recovery in business confidence over recent months from the immediate post-crash trough, although it is still too early to judge whether this recovery will be sustained.

Developments in Monetary Indicators

Liquidity conditions remained stable but only moderately firm over the first weeks of February. This stability was achieved despite a higher than usual degree of political and economic uncertainty (particularly regarding the status of the Government's December 1987 economic package and the sale of Petrocorp), as well as the further complication of coping with the first major February tax flow. Call money traded at rates averaging around 15 per cent, below rates of 16.5-17.0 per cent on 30 and 90 day bank bills. However, conditions tightened over the second half of the month. Short-term rates firmed slightly while longer-term rates fell, with the benchmark July 1992 stock falling from around 15 per cent at the start of February, to around 14.2 per cent by 26 February. As a result the yield curve steepened and the 90 day-5 year yield gap increased from around 2 percentage points at the beginning of the month to peak at 3 percentage points on 25 February. The exchange rate remained strong and stable over February despite the downward movement in longer-term interest rates, and traded within the narrow range of 66.4-67.9 on the Bank's nominal trade-weighted index.

The decline in longer-term rates was not sparked by any particular piece of news, and appears to have been largely attributable to continued falls in inflation expectations. Indeed, following the announcement of the December quarter Consumer Price Index (CPI) in mid-January, and the return to single digit inflation, a range of commentators and forecasters announced predictions of inflation over the coming year in the 4-7 per cent range. The firming in short-term interest rates, on the other hand, appears to have been primarily attributable to seasonal factors, relating to uncertainty over the timing and magnitude of remaining tax and State Owned Enterprise (SOE) payments due in March, complicated by imperfections in the interbank market which reduced the effective liquidity of the system.

The Bank acknowledged that the pressures were short-term in nature. However, in view of the very high short-term rates which had been experienced during previous March tax flow periods and the perceived underlying weakness of confidence, credit demand, and real economic activity, any accentuated seasonal pressure on short-term interest rates was considered undesirable. Accordingly, on 26 February, an increase in the daily cash target from

Figure 1
Interest Rates
government stock and bank bill rates

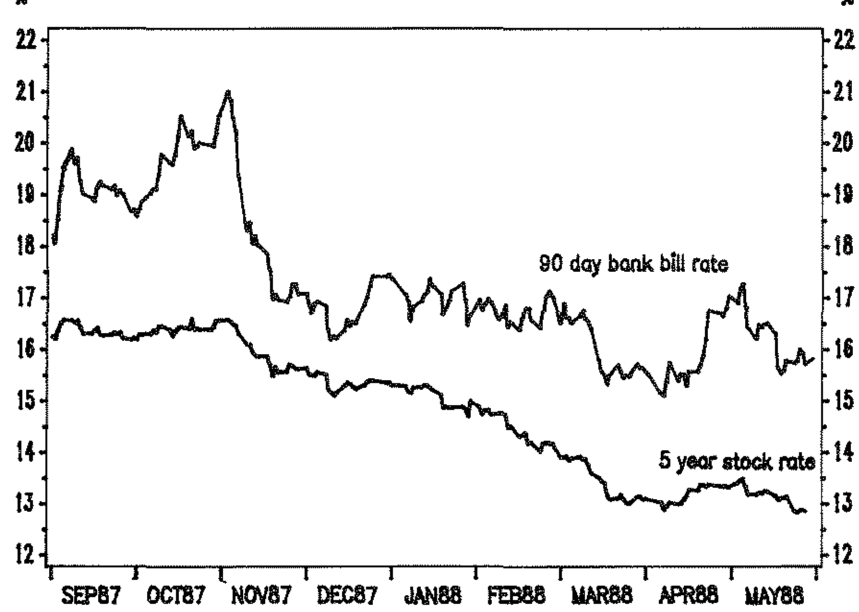
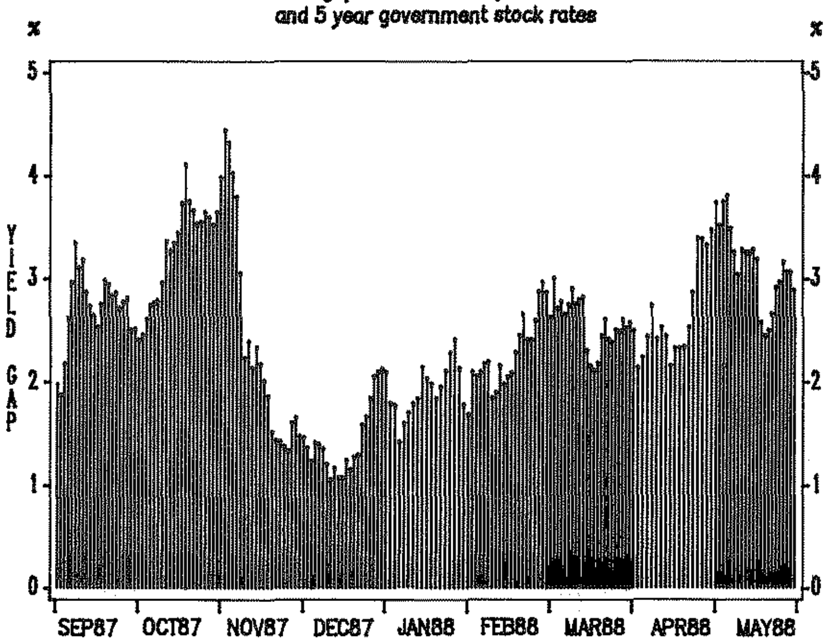


Figure 2
Yield gap between 90 day bank bills
and 5 year government stock rates

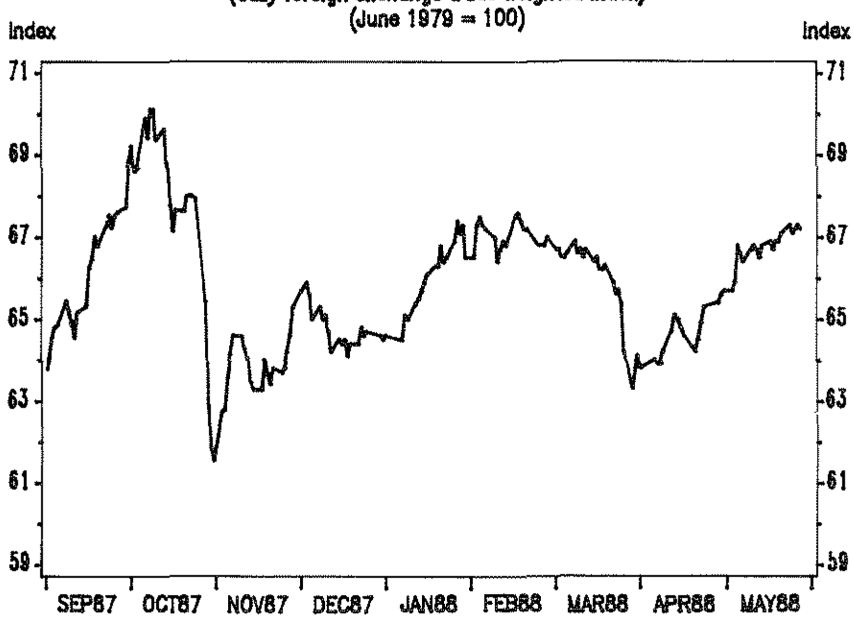


$30 million to $40 million was announced, effective from 29 February. It was emphasised at the time that this measure was a response to seasonal pressures, that a reversal could be expected once those pressures passed, and that the change did not represent any alteration to the basic stance of monetary policy. Both short and long-term interest rates eased following the change to the cash target.

Interest rates fell across all maturities in March. Several factors were involved. Foremost of these were lower inflation expectations, particularly on the part of financial market participants, and the successful handling of the March flows to the Government which avoided any abnormal liquidity pressures. Short-term interest rates fell markedly over the middle weeks of March, with call rates falling from 16.3 per cent on 7 March to around 12.8 per cent on 22 March, while 90 day bill rates fell from 16.7 to 15.6 per cent over the same period. Long-term rates also fell steadily with July 1992 stock rates down by 0.8 percentage points to around 13.1 per cent by 22 March. Owing to the broadly similar movements in both long and short rates the yield gap remained relatively stable, easing to 2.4 percentage points from around 2.7-2.8 per cent earlier in the month. Over most of the period, call rates were below other short rates, reflecting the ease with which the tax flows were handled and the temporary easing of the cash target. As a result of the lower than expected seasonal pressures, the cash target was returned to $30 million on 23 March, a little earlier than originally envisaged. This move had been widely expected in the markets and evoked no immediate response in interest rates, other than the call rate.

The exchange rate eased back slightly over mid-March, but then fell sharply over the period 24-28 March, losing almost 5 per cent of its value and reaching 62.4 on the Bank's trade-weighted index. There had been a noticeable build-up in negative sentiment regarding the prospects for the New Zealand dollar over the preceding weeks, reinforced both by political comment that a lower exchange rate would be desirable, and by widely publicised forecasts that an easing in monetary policy over coming months would lead to a significant fall. Since the float the New Zealand dollar has undergone several periods of sharp correction and the March incident was less severe than most of these. The exchange rate stabilised relatively quickly at around 64 on the

Figure 3
Nominal Exchange Rate
(daily foreign exchange trade weighted index)
(June 1979 = 100)



Bank's index over the last few days of March.

The lower cash target, combined with the volatility of the exchange rate and some increase in uncertainty concerning the strength of end-of-month flows to the Government contributed to some renewed pressure on short-term rates. Call rates rose above 30 and 90 day rates, although both the position and the slope of the yield curve between 90 day bills and 5 year stock were largely unaffected. Although it had been widely expected that conditions would ease following the end of the financial year, particularly in view of the large fiscal injections forecast for the June quarter, the reductions which did occur proved to be short-lived. 90 day bill rates fell briefly as low as 14.9 per cent on 6 April and the July 1992 bonds to as low as 12.9 per cent.

Bond rates increased over the remainder of April to reach 13.3 per cent by the end of the month, while 90 day bill rates rose more sharply to 17 per cent. Call rates ended the month at around 22 per cent. As a result, the yield gap increased markedly to around 3.7 percentage points, the largest yield gap since the cash target was raised from $20 million to $30 million on 6 November 1987. High domestic interest rates, continuing buying support for the NZ dollar over the end of the major export season, and two Eurokiwi bond issues totalling $120 million contributed to a strengthening of the exchange rate, which reached 65.5 on the Bank's index by the end of the month.

The increase in bond rates appears to have been largely a reflection of higher short-term funding costs. The short rates rose in response to a number of factors, which were primarily institutional and temporary in nature. The firming occurred against a background of actual Primary Liquidity (PL) levels around the underlying target level of $360-380 million for the first time since October. The possibility of a strike at Databank in late April threatened to suspend settlement facilities for several days and this possibility sparked concerns over access to liquidity. These concerns were reinforced by some disquiet about both the level and maturity structure of PL, the impact on the demand for PL of the entry of new settlement institutions and uncertainty surrounding the impact of the introduction of the new float tender scheme (to replace the previous two-day BNZ float on government revenues). The Bank responded to a perceived increase in the demand for PL on account of the new settlement institutions by announcing a higher average PL target, of $420 million, for May.

However, conditions tightened further over the first few days of May. Call rates reached 25 per cent (the highest for over a year) and 90 day bill rates 17.3 per cent. As a result, some corporate overdraft rates were raised rapidly and substantially. However, on 5 May pressures began to ease, and call and 90 day rates fell to around 18.1 per cent and 16.2 per cent respectively by 9 May. Long-term rates followed a similar, though less marked, pattern falling from 13.5 per cent in the first week of May to around 13.2 per cent by 9 May. As a result, the yield gap which peaked at around 3.9 percentage points early in the month fell to around 3 percentage points. As the high short-term interest rates persisted the exchange rate continued to firm, reaching 66.9 on the Bank's index.

The movements in rates over April and early May were relatively large – the most significant since March/April 1987. However, the increases were not policy-induced, contrary to some market speculation of a covert tightening of policy. Nor were the pressures due to fundamental economic reasons. Apart from the modest increase in the PL target to meet the demand arising from the new settlement institutions, the Bank chose not to respond. Monetary policy is not concerned with closely targeting short-term interest rates, especially when, as was the case in April/May, those rates are perceived to be moving largely in response to temporary factors. The Bank has endeavoured as far as possible to maintain a transparent and consistent approach, and this position appears to have been generally accepted in the financial markets.

Although short-term conditions were relatively firm over the review period, the January and February monetary and credit aggregates were only moderately encouraging. Both M3 and Domestic Credit (DC) recorded low growth rates in January (0.5 per cent and 0.2 per cent, seasonally adjusted, respectively) while the annual growth rates fell from 16 per cent and 13.3 per cent in December, to 13.1 per cent and 10.5 per cent for the year to February 1988. However, Private Sector Credit (PSC) continued to increase rising (in seasonally adjusted terms) by 1 percent and 1.6 percent for January and February respectively, resulting in a slight increase in the annual growth rate to 18 per cent.

The PSC figures to February do not appear to have been significantly distorted by any recent substitution of SOE or public corporation debt for government debt. The first major facilities publicly announced (Electricorp and Government Property Services) did not occur until March. However, the financing of asset purchases by SOEs will have an impact on the PSC figures for March and subsequent months. Any net increase in holdings of SOE debt will increase PSC. However, such increases, to fund asset purchases from the Government, should clearly not induce a monetary policy response, as they will simply result from substitution of SOE for government debt, without any change in the total borrowing requirement of the domestic spending sectors. If M3 institutions hold a larger proportion of SOE debt raised for their asset purchases than of the Government debt it replaces, this substitution process will also inflate Domestic Credit.

The monetary and credit aggregate data for March were somewhat less encouraging. M3 and DC growth recorded relatively large monthly increases, in seasonally adjusted terms, of 1.6 percent and 0.9 percent, respectively. These increases contributed to rises in annual rates of growth to 16.1 per cent and 13 per cent for the year to March. PSC (inclusive of SOE financing) grew strongly with monthly seasonally adjusted growth of 1.7 per cent contributing to annual growth of 17.7 per cent.

Banks have attracted considerable criticism in recent months for their perceived lag in reducing retail lending rates in line with reductions in the measured inflation rate and wholesale interest rates. In fact, however, retail interest rates have followed wholesale rates fairly closely (see Figure 5). Weighted average base lending rates for the four largest registered banks fell by around 3 percentage points since the second half of 1987, broadly in line with the reduction in wholesale rates over the same period. By the end of April, the lowest first mortgage rate available was 16.75 per cent, similar to prevailing short-term wholesale rates. Aggressive advertising campaigns have been undertaken over recent months by some financial institutions. While these campaigns are not cause for concern in themselves, they are indicative of a ready availability of funds to lend on the part of those institutions. Given an environment where lending rates have fallen markedly and inflation expectations in the household sector remain relatively high, there is a risk that any easing of monetary policy could contribute to a resurgence of house price inflation. In order to prevent such a development from inhibiting the achievement of the Government's inflation objectives, the Bank has made it clear that it is intent on maintaining the current firm policy stance.

Figure 4
Money and Credit Aggregates
Annual Percentage Changes

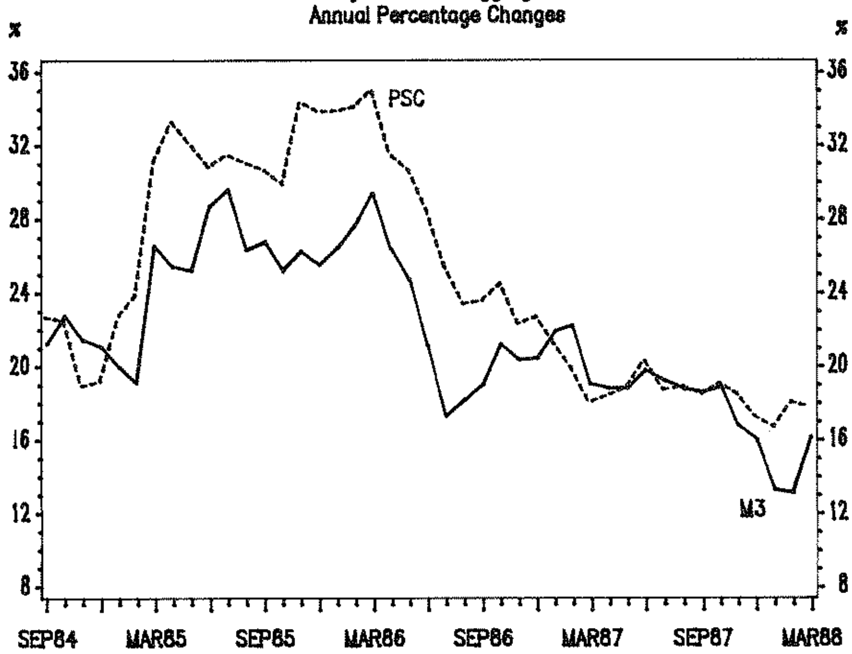
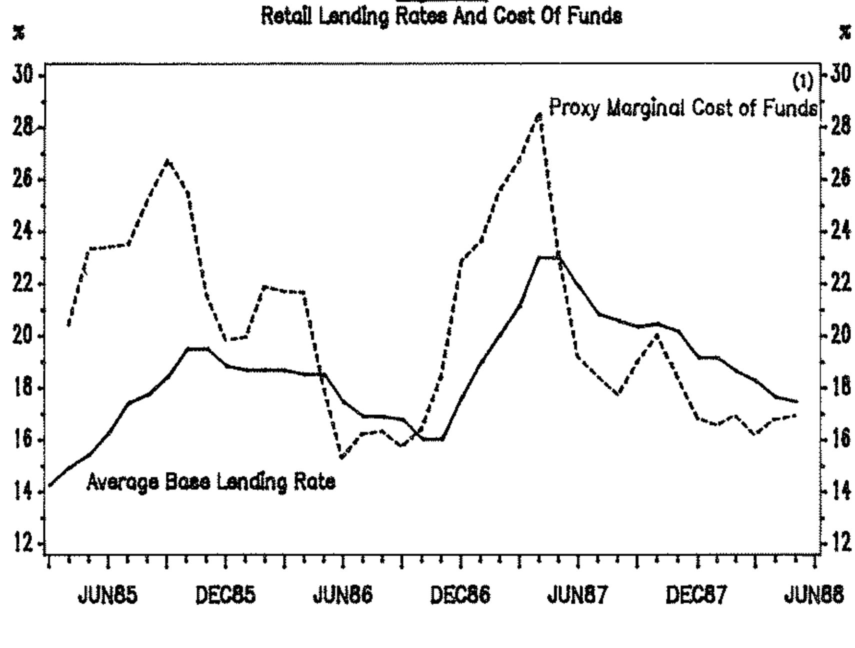


Figure 5
Retail Lending Rates And Cost Of Funds



1. Monthly average of call rates, 30, 60, & 90 day bill rates

OPEN MARKET OPERATIONS
Period: 16 February 1988 - 12 April 1988

Date 1988	Transaction	Maturity	Volume Offered $m	Volume Bid $m	Total Amount Sold $m	Total Amount Purchased or Advanced $m	Range of Bids Received %	Range of Successful Bids %	Average of Successful Bids %
16 February	Sellbacks	24/02/88	55	196		55	16.56-17.55	17.45-17.55	17.47
17 February	Sellbacks	22/02/88	120	60		20	17.77-18.85	18.52-18.85	18.60
		2/03/88		178		85	17.00-18.18	17.61-18.18	17.90
18 February	Sellbacks	23/02/88	105	75		20	18.07-18.60	18.60	18.60
		29/02/88		105		48	17.05-17.60	17.47-17.60	17.52
		2/03/88		85		25	17.05-17.75	17.50-17.75	17.64
19 February	Sellbacks	1/03/88	120	92		20	17.18-17.92	17.62-17.92	17.72
		9/03/88		120		100	17.12-17.47	17.12-17.47	17.28
22 February	Sellbacks	24/02/88	40	30		25	16.57-17.25	17.25	17.25
		1/03/88		34		15	16.87-17.43	17.25-17.43	17.29
23 February	Sellbacks	29/02/88	20	42		15	17.11-17.41	17.41	17.41
		2/03/88		60		5	16.98-17.33	17.33	17.33
24 February	Sellbacks	29/02/88	25	109		25	17.27-17.57	17.53-17.57	17.55
		2/03/88	20	61		15	17.27-17.52	17.45-17.52	17.48
25 February	Sellbacks	1/03/88	50	175		50	17.56-18.44	18.29-18.44	18.37
		8/03/88	35	91		35	17.51-18.20	17.93-18.20	18.04
		14/03/88	70	220		40	17.21-18.16	17.80-18.16	18.03
26 February	Sellbacks	29/02/88	10	30		10	17.71-18.55	18.07-18.55	18.31
29 February	Sellbacks	2/03/88	10	35		10	16.00-16.72	16.72	16.72
1 March	Sellbacks	9/03/88	20	51		20	16.57-17.50	17.03-17.50	17.25
3 March	Sellback	10/03/88	35	155		35	15.78-16.82	16.82	16.82
4 March	Sellback	7/03/88	30	80		30	14.50-15.25	15.25	15.25
		15/03/88	80	245		75	15.21-16.61	16.26-16.61	16.37
7 March	Sellback	9/03/88	40	110		40	15.92-16.47	16.40-16.47	16.44
8 March	Treasury Bills	7/06/88	20	116	20		15.30-16.70	15.30-15.32	15.32
9 March	Sellback	11/03/88	100	175		80	15.70-16.31	15.90-16.31	16.12
		18/03/88	100	333		100	15.55-16.81	16.75-16.81	16.76
10 March	Sellback	15/03/88	150	203		123	15.21-16.40	15.79-16.40	16.03
14 March	Sellback	15/03/88	60	29		29	15.45-15.65	15.45-15.65	15.56
		16/03/88	100	63		54	15.18-15.65	15.34-15.65	15.53
15 March	Sellback	17/03/88	40	145		40	15.15-15.63	15.45-15.63	15.51
16 March	Treasury Bills	31/03/88	40	178	40		15.56-16.61	15.56-15.75	15.67
17 March	Sellback	18/03/88	25	95		25	13.95-14.55	14.55	14.55
18 March	Treasury Bills	20-26 July	10	13		10	13.85-14.07	14.05-14.07	14.06
21 March	Sellback	22/03/88	40	136		40	15.16-16.05	16.05	16.05
		29/03/88	130	398		130	14.57-16.02	15.50-16.02	15.83
22 March	Treasury Bills	24/5/88	40	163	30		13.24-15.85	13.24	13.24
		7/06/88	40	142	20		13.34-15.60	13.34	13.34
23 March	Treasury Bills	25/08/88	30	190	30		13.18-15.22	13.18	13.18
		11/11/88	75	180	45		13.78-15.22	13.78-13.93	13.89
24 March	Sellback	11/04/88	100	210		75	15.37-16.21	15.86-16.21	15.95
		15/04/88	75	135		75	15.37-16.02	15.86-16.02	15.90
25 March	Treasury Bills	29/08/88	40	95	40		13.33-15.35	13.33-13.35	13.34
		10/11/88	40	67	15		13.73-14.06	13.73-13.77	13.74
		14/11/88	40	90	35		13.68-15.25	13.68-13.77	13.72
28 March	Treasury Bills	26/08/88	30	50	30		13.54-14.99	13.54-13.64	13.59
		10/11/88	35	64	31		13.93-14.99	13.93-13.98	13.96
		11/11/88	30	58	17		13.94-14.99	13.94-13.98	13.96
29 March	Treasury Bills	10/11/88	4	20	2		14.05-14.19	14.05	14.05
		14/11/88	15	6	5		14.05-14.19	14.05	14.05
30 March	Sellback	5/04/88	65	358		65	16.25-17.22	17.01-17.22	17.14
31 March	Sellback	5/04/88	70	226		70	18.55-19.87	19.87	19.87
		6/04/88	70	195		70	18.55-19.60	19.25-19.60	19.52
		7/04/88	70	174		70	18.00-19.30	19.05-19.30	19.16
		15/04/88	150	171		56	16.05-17.55	16.83-17.55	17.48
		22/04/88	100	164		100	15.85-16.82	16.25-16.82	16.58
5 April	Treasury Bills	5/10/88	75	142	75		13.79-14.51	13.79-14.03	13.95
		6/10/88	40	75	25		13.96-14.50	13.96-14.00	13.98
		25/10/88	60	113	35		13.96-14.51	13.96-14.00	13.98
		14/11/88	10	32	10		13.93-14.58	13.93	13.93
6 April	Treasury Bills	3/08/88	30	122	30		13.08-15.05	13.80-13.92	13.83
		6/10/88	50	82	27		14.05-14.25	14.05-14.12	14.08
		25/10/88	25	47	25		14.09-14.65	14.09-14.13	14.11
		26/10/88	50	62	43		14.05-14.65	14.05-14.13	14.09
11 April	Treasury Bills	6/10/88	23	81	10		14.00-14.75	14.00-14.16	14.08
		27/10/88	17	61	10		13.98-14.62	13.98-14.16	14.07
12 April	Sellback	15/04/88	40	30		10	16.80-17.31	17.14-17.31	17.23
	Treasury Bills	19-31 July	40	50		30	13.65-13.90	13.81-13.90	13.85

OPEN MARKET OPERATIONS
Period: 13 April 1988 - 17 May 1988

Date 1988	Transaction	Maturity	Volume Offered $m	Volume Bid $m	Total Amount Sold $m	Total Amount Purchased or Advanced $m	Range of Bids Received %	Range of Successful Bids %	Average of Successful Bids %
13 April	Treasury Bills	6/10/88	13	49	13		14.34-14.75	14.34-14.37	14.35
		27/10/88	7	19	7		14.38-14.75	14.38	14.38
		11/11/88	6	17	6		14.38-14.75	14.38	14.38
		23/11/88	40	102	29		14.37-14.75	14.37-14.39	14.39
14 April	Treasury Bills	26/04/88	5	25	5		12.80-16.15	12.80	12.80
		28/04/88	6	30	6		12.80-16.15	12.80	12.80
		5/09/88	50	140	39		14.38-14.81	14.38	14.43
		22/09/88	40	135	40		14.38-14.81	14.38-14.47	14.45
		3/11/88	20	77	20		14.28-14.81	14.28-14.48	14.43
		24/11/88	40	40	40		14.47-14.81	14.47-14.54	14.50
15 April		4/11/88	25	60	25		14.65-14.97	14.65-14.68	14.67
19 April	Sellback	20/04/88	–	48		28	15.17-15.60	15.55-15.60	15.58
	Treasury Bills	19-31 July	–	67		17	13.80-14.30	14.20-14.30	14.23
20 April	Treasury Bills	9/11/88	40	50	20		14.97-15.34	14.97-15.15	15.08
21 April	Treasury Bills	22/04/88	14	42	14		13.97-16.75	13.97	13.97
		9/11/88	80	125	80		15.24-15.55	15.24-15.49	15.41
22 April	Sellback	2/05/88	–	384		79	16.85-18.82	18.25-18.82	18.41
	Treasury Bills	19-31 July	–	36		16	13.80-14.70	14.30-14.70	14.56
26 April	Treasury Bills	5/05/88	15	35	15		15.75-17.50	15.75-15.85	15.82
		6/05/88	20	55	20		13.26-17.50	13.26-15.48	13.94
27 April	Sellback	9/05/88	–	348		94	17.65-19.34	19.02-19.34	19.22
	Treasury Bills	19-31 July	–	33		21	14.15-14.41	14.35-14.41	14.38
28 April	Sellback	2/05/88	60	249		60	19.26-20.09	20.09	20.09
		9/05/88	50	139		48	19.34-18.02	19.34-19.36	19.35
		13/05/88	60	192		18	17.50-19.10	19.10	19.10
	Treasury Bills	19-31 July	–	34		24	14.20-14.40	14.30-14.40	14.33
29 April	Sellback	11/05/88	65	195		65	19.03-20.10	19.35-20.10	19.69
2 May	Treasury Bills	6/05/88	15	50	15		21.15-23.50	21.15	21.15
3 May	Treasury Bills	24/05/88	20	55	20		18.50-21.15	18.50	18.50
4 May	Treasury Bills	4/11/88	15	19	14		16.19-16.57	16.19-16.29	16.24
		10/11/88	62	102	50		16.10-17.15	16.10-16.29	16.21
		25/11/88	31	54	31		16.08-17.15	16.08-16.29	16.14
5 May	Sellback	13/05/88	40	70		40	19.00-21.58	20.10-21.58	20.29
		16/05/88	40	90		37	18.50-21.64	19.80-21.64	20.19
		23/05/88	70	85		10	18.35-19.44	19.44	19.44
	Treasury Bills	19-31 July	–	28		23	14.20-14.75	14.40-14.75	14.55
6 May	Sellback	10/05/88	50	95		50	18.97-19.00	18.99-19.00	19.00
		23/05/88	80	60		43	16.86-18.37	17.75-18.37	18.18
	Treasury Bills	19-31 July	–	12		12	14.20-14.30	14.20-14.30	14.25
10 May	Govt. Stock	15/09/88	–	65		15	14.51-15.95	15.12-15.95	15.66
11 May	Sellback	16/05/88	30	59		10	16.93-18.10	17.96-18.10	18.03
		23/05/88	50	51		30	16.66-18.02	17.77-18.02	17.83
	Govt. Stock	15/09/88	–	95		20	14.75-15.18	15.18	15.18
12 May	Sellback	16/05/88	35	31		20	16.91-17.37	17.37	17.37
		23/05/88	35	31		15	16.89-17.25	17.25	17.25
13 May	Treasury Bills	8/08/88	30	145	20		15.25-16.65	15.25-15.60	15.45
		7/11/88	40	121	40		15.66-16.18	15.66-15.78	15.72
16 May	Treasury Bills	8/08/88	10	55	10		15.27-16.47	15.27-15.39	15.53
		11/11/88	60	82	20		15.75-16.00	15.75-15.80	15.77
17 May	Treasury Bills	11/11/88	25	117	25		15.38-15.87	15.38-15.46	15.43