REVIEW OF MONETARY CONDITIONS AND POLICY[1]

This article, prepared by Terry Creighton, reviews developments in the monetary indicators over the three months to late November. The stance of monetary policy is assessed in the light of current risks to the price stability objective.

Executive Summary

Interest rates firmed significantly over the review period from late August, with the post-Budget reduction in short-term rates more than fully reversed. Short-term interest rates initially firmed in response to cash-distribution problems, but the persistence of the higher rates appeared to reflect growing concerns over potential inflationary pressures and, to a lesser extent, rising world interest rates. Long rates also firmed over most of the period, although activity in the futures market resulted in a sharp fall in bond rates over the last few days of the period.

The Bank judged that inflationary concerns and higher world interest rates were the dominant factors behind the firming in short rates and the widening of the yield gap over the period. Poor inflation outcomes in the September quarter, despite being influenced by a number of temporary factors, significantly dented market confidence in the short-term course of inflation. In these circumstances the Bank felt it inappropriate to intervene to keep short-term interest rates down. The relatively steady exchange rate suggested that, despite the steepening of the yield curve, monetary conditions had firmed only slightly over the review period.

Risks to the price stability objective remain; the most critical of which is the course of wage-setting behaviour. Given the importance of wage restraint, developments to date in the wage round have been somewhat disappointing. Both the level of settlements and the lack of further progress towards more flexible work practices will make it more difficult to achieve price stability without putting pressure on the current relatively fragile recovery.

Nevertheless, despite the reinforcement of growing inflation concerns provided by the September quarter CPI increase and current wage settlements, the Bank remains of the view that the annual rate of inflation will fall significantly over the December 1990 year. Most of the factors contributing to the recent increase in underlying inflation are expected to be relatively short-lived and, despite the likely outcome of the current wage round, unit labour costs are expected to grow by only 3 per cent over the coming year. The inflation outlook at this stage is not, therefore, judged to be so unfavourable as to require a tightening of policy in the immediate future, particularly given the continuing relatively weak state of domestic activity. Nevertheless, monetary conditions will have to remain firm over the next year in order to be consistent with achieving an inflation rate of around 4 per cent by December 1990, and further progress towards price stability thereafter.

Interest rates firmed across the maturity spectrum during the three months from late August, with the pressures concentrated at the short end, leading to a further steepening in the slope of the yield curve. The dominant factor over the period as a whole, however, was the apparent strengthening of underlying inflationary pressures. The September quarter CPI outturn and the level of wage settlements over the period helped focus attention on the degree of disinflationary pressure required to ensure that monetary policy remained on track for the achievement of 0-2 per cent inflation by December 1992.

[1] Text and data finalised on 22 November 1989

Developments in monetary and inflation indicators over the three months to late November are reviewed in the first section of this article, while the second section assesses the appropriateness of the current stance of policy in light of the risks to the price stability objective.

Developments in Monetary and inflation Indicators

90 day bank bill rates, which had fallen to a 5-year low of 12.75 per cent on 21 August, firmed markedly over September reaching a peak of 14 per cent on 19 October. 90 day bills then traded in a range of 13.8-13.95 per cent over most of the remainder of the review period, before dropping back to around 13.7 per cent in late November (see Figure 1). These rates were the highest observed since January 1989.

The firming was attributable to a number of factors. Cash distribution problems and their associated liquidity pressures appeared to be the dominant factor influencing movements in short-term interest rates early in the review period. These cash distribution problems were associated in part with the lower level of Primary Liquidity that prevailed over the period (see Figure 2). That lower level of Primary Liquidity was due to the Bank's earlier inability to sell at acceptable yields all the Reserve Bank bills on offer from June to mid-August, presumably reflecting market perceptions at the time that the volume of bills then on offer was unnecessarily large.

However, in addition to these short-term liquidity pressures, inflation concerns also contributed to the firming in short rates. In particular, the August increase in the food price index reinforced the high food price increase in July, and added to the growing impression in the financial markets that domestic inflationary pressures were stronger than had been allowed for. These concerns continued to develop over the remainder of the review period. The relatively high GST-exclusive September quarter CPI out-turn and disappointingly high wage round outcomes both added to concerns about the degree of monetary pressure the Bank would have to continue to apply to remain on track for the price stability objective. Meanwhile, the strength of inflationary pressures in some overseas economies led to increases in overseas short-term rates during the review period (see Figure 3) and the impact of these disinflationary measures on overseas real short-term rates is likely to have been reflected in New Zealand short-term rates.

Long-term interest rates, which had fallen markedly from mid-July to late August in response to strong overseas interest following the July Budget, firmed over the review period, with 5-year bond rates rising from around 11.9 per cent in early September to a peak of around 12.45 per cent before drifting back to around 12.15 per cent in early November. Subsequently, bond rates again firmed to 12.45 per cent before falling sharply over 20-22 November to around 11.9 per cent. These movements appear to have been heavily influenced by futures market activity, and at the end of the period it was unclear where bond rates would settle. Amid these movements in bond rates it has been difficult to assess the relative or

Figure 1
Interest Rates
government stock and bank bill rates

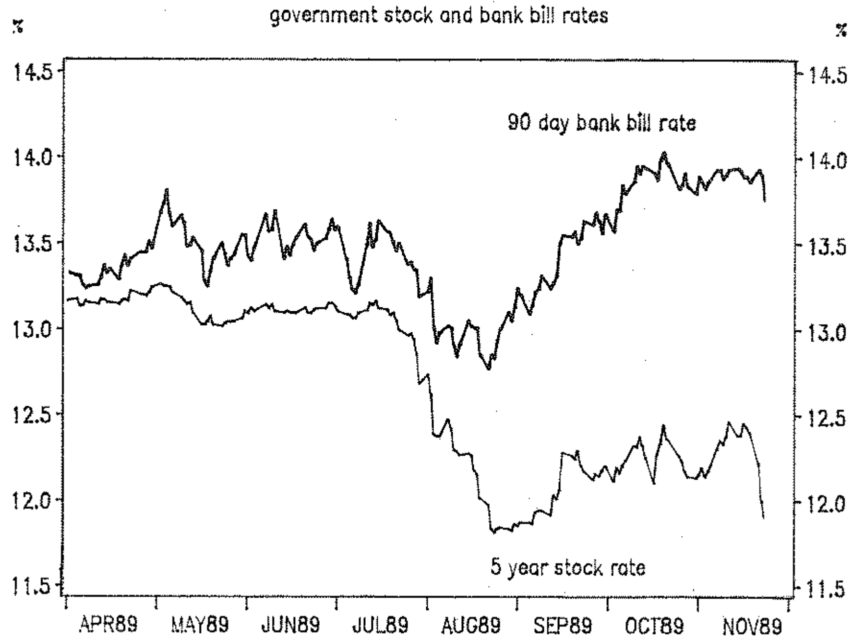


Figure 2
Primary Liquidity (Monthly Averages)

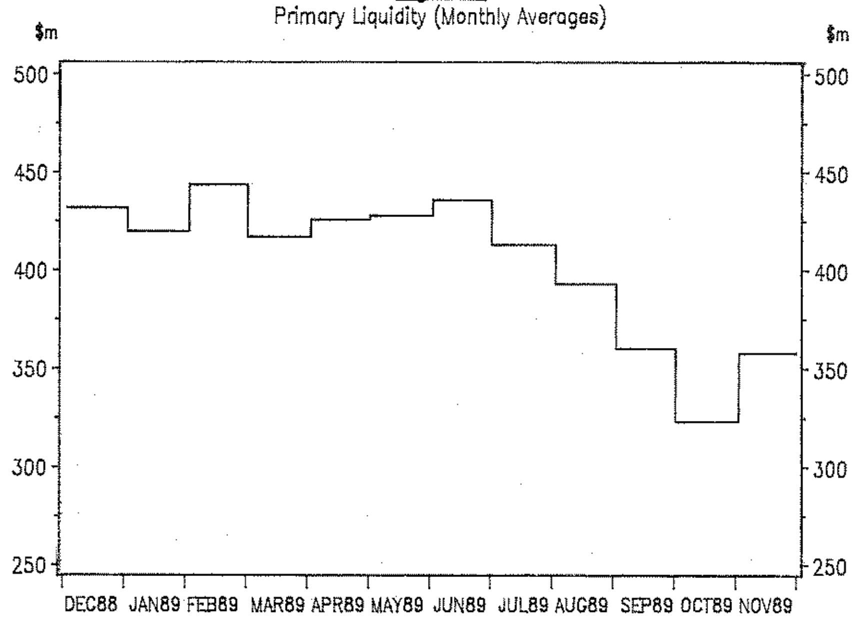


Figure 3
NZ 90 Day Rate vs Weighted Average of Foreign 90 Day Rates

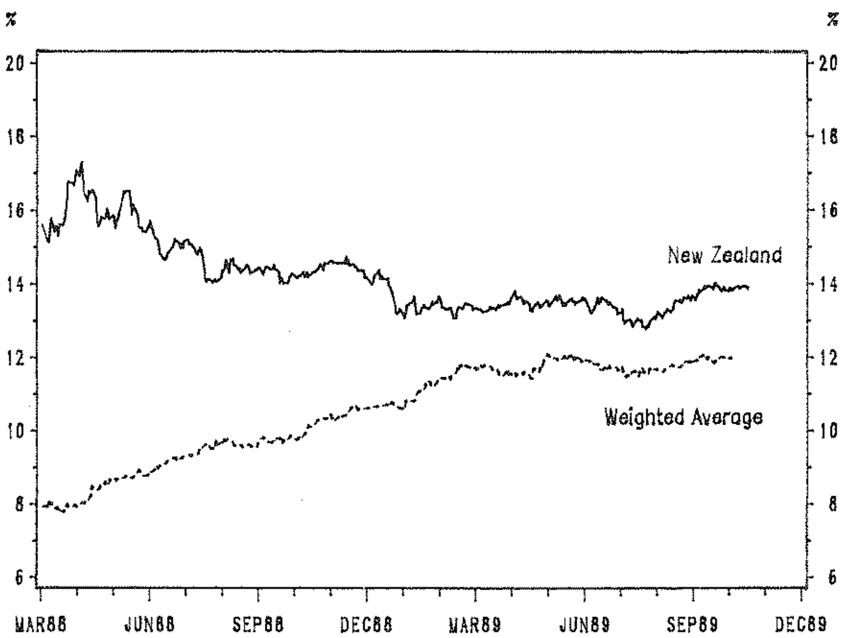
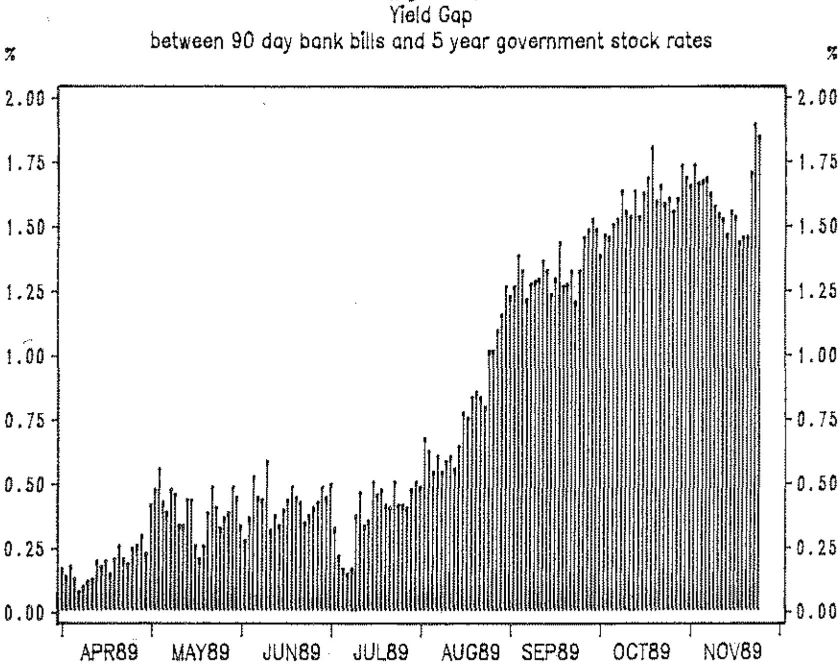


Figure 4
Yield Gap
between 90 day bank bills and 5 year government stock rates



absolute importance of the various adverse influences such as the mounting inflationary concerns and the impact of the announcement on 3 October that DFC New Zealand Limited had been placed in statutory management.

The yield gap between 90 day bank bills and 5 year government stock had widened markedly following the impact of the July Budget on bond rates, reaching around 1.3 percentage points at the end of August (see Figure 4). However, the tighter short-term liquidity conditions, and renewed concerns about the strength of inflationary pressures and the implications of these pressures for the Bank's monetary stance, saw the yield gap widen further, to average around 1.6 percentage points over the second half of the review period. The sharp fall in bond rates in late November took the yield gap at times to around 1.9 percentage points.

After falling gradually over September, the exchange rate remained relatively stable over the remainder of the review period (see Figure 5) despite the relatively large movements in interest rates and the advent of the DFC announcement. Indeed, over the three months as a whole the exchange rate averaged 61.0 on the Bank's trade-weighted index, compared with 60.4 over the previous quarter.

The rise in short-term wholesale rates since mid-August has increased the cost of funds to banks, and increased the likelihood of rises in retail lending rates, including home mortgage interest rates (see Figure 6). One bank (National Australia Bank) raised its housing mortgage and other retail rates during the review period, although its mortgage rate, at 14.65 per cent, is still below the market average of 14.8 per cent. A number of other mortgage lenders have cancelled or delayed plans to lower their interest rates. Although some financial institutions may come under pressure to raise retail rates if short-term interest rates remain at their present levels of just below 14 per cent, a generalised round of retail interest rate increases may be avoided if there is no further increase in funding costs.

The rates of growth of the broader monetary and credit aggregates rose somewhat over the three months to September. The increase in the rate of credit growth (PSC grew 4.9 per cent in the September quarter and 2 per cent in the June quarter) appears still to reflect principally household demand for credit, with only limited evidence of any recovery in corporate demand.

Concern about potential underlying inflationary pressures was stimulated by a series of strong increases in the monthly food price indices over the September quarter and was reinforced by the strong September quarter CPI increase. By the end of the September quarter the annual rate of food price inflation had increased to 12.5 per cent, and the 3.3 per cent quarterly increase in the CPI – well above what had been initially expected – took the rate of CPI inflation to 7.2 per cent for the year to September (including the influence of GST).

Most of the factors that contributed to the recent increase in inflation are expected to be only short-lived. These factors include some residual influence from the August 1988 depreciation in the exchange rate, strong international commodity price increases over the past year, the GST increase, and unseasonally poor growing conditions both here and in Australia, the latter contributing to strong increases in fruit and vegetable prices over the September quarter.

Nevertheless, longer-term inflation risks remain. In particular, risks that the recent GST increase, and the September quarter CPI increase more generally, will refuel inflationary expectations and feed into future wage movements. Trends in wage-setting behaviour will crucially affect the costs associated with the transition to price stability over the next few years.

Figure 5
Nominal Exchange Rate
(daily foreign exchange trade weighted index)
(June 1979 = 100)

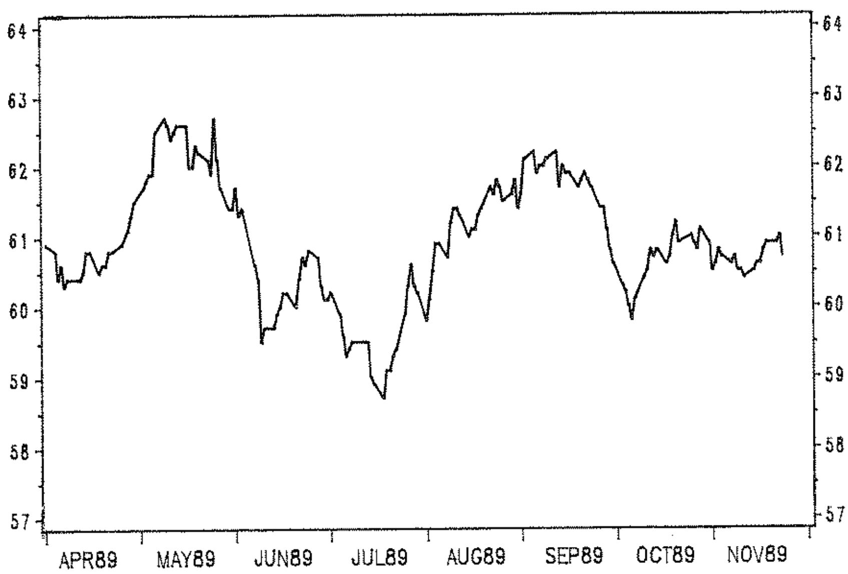


Figure 6
Proxy Cost of Funds, Base Lending Rates and First Mortgage Lending Rates

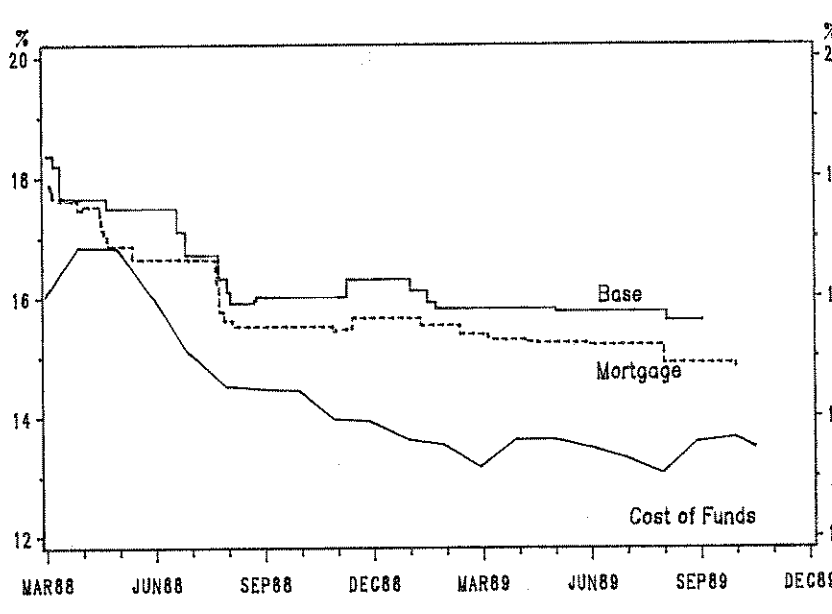
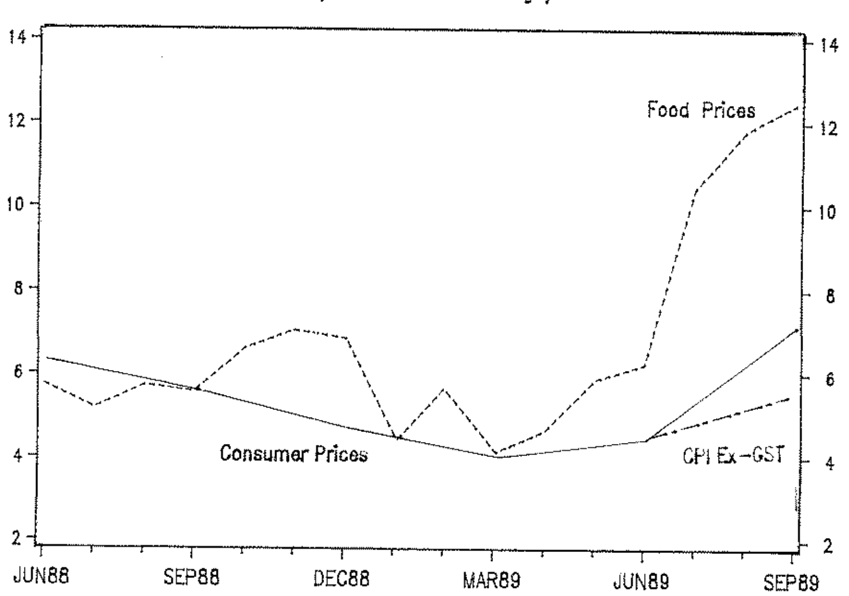


Figure 7
Food Price and Consumer Price Index
(Annual Percent Change)



One of the Bank's major concerns all year, but particularly since the announcement in March of the GST increase, has been to ensure that adequate restraint is achieved in this year's wage round. The Bank has emphasised on many occasions the adverse consequences for real output, employment, and inflation, of relatively high wage settlements. Given the importance of wage restraint, developments to date in the 1989 wage round have been somewhat disappointing. At the time of writing several large and historically significant awards had been settled, averaging around 4.5 per cent, higher than last year. Moreover, although hard information is not readily available, there is little evidence of enhanced flexibility being achieved in many of the awards which have been settled. Although the rate of growth of aggregate unit labour costs over the coming year will remain moderate, this moderation will rely on productivity growth which will arise, at least in part, from further labour shedding.

Policy Issues and Assessment

The central issue over the review period has been the evidence of a resurgence in underlying inflationary pressures, bringing with it concern over the appropriateness of the current stance of monetary policy. Monetary conditions firmed slightly over the review period in the face of this increase in underlying inflation, to ensure a return to a downward inflation trend in the future. In these circumstances it would have been inappropriate for the Bank to have intervened to keep short-term interest rates down.

The September quarter inflation outcome also led to a reassessment in the markets of the degree of policy pressure that will be required to ensure steady reductions in the underlying inflation rate. This reassessment seems to have reversed some of the surge in optimism seen following the July Budget. That reversal in confidence has not, however, reversed the widening of the yield gap that was experienced following the Budget, an indication that the increase in inflation concerns is limited largely to the short-term outlook.

Overall, it is the Bank's judgment that inflationary concerns and higher world interest rates have been the dominant factors underlying the firming in short rates over the review period. Indeed, if short-term liquidity factors had been a major influence then the increase in short-term rates could have been expected to contribute to some more significant firming in the exchange rate. The stability of the exchange rate over the second half of the review period in response to the further firming in short rates suggests, therefore, that the firming was appropriate in the context of a perceived increase in short-term inflationary pressures in the economy, and the increase in some foreign short term rates.

The recent upsurge in inflation and the undesirably high level of wage settlements have taken place against a background of ongoing high unemployment and a modest, but still fragile, recovery. That recovery appears to remain heavily dependent on the export sector, and to be vulnerable to shocks to confidence of the sort experienced after the DFC collapse and the worldwide sharemarket fall in mid-October. Any significant tightening of monetary policy in the near future would therefore pose a significant threat to the weak economic recovery. However, with the firming of interest rates over the past month or two the Bank sees no immediate need for any shift in policy.

Moreover, despite the confirmation of growing inflation fears provided by the September quarter CPI increase, the Bank remains of the view that the annual rate of inflation will fall over the December 1990 year and that the current stance of monetary policy is continuing to exert downward pressure on inflation. Feed-through effects from the 1988 depreciation are all but over, growing conditions have recently improved bringing fruit and vegetable prices down, world commodity prices are expected to grow only slightly – if at all – over the year ahead and, despite the likely outcome of the current wage round, productivity gains mean that unit labour costs are expected to grow by only 3 per cent over the coming year. It is the Bank's view that these factors are consistent with the annual CPI inflation rate falling back to around 4 per cent by December 1990, an outcome which would still be consistent with the achievement of price stability by December 1992.

Conclusion

Short-term interest rates have firmed significantly over the review period. However, in light of the apparent increase in inflationary pressures, arising from both commodity prices and wage settlements, the Bank has been quite comfortable with the recent firming. The inflation outlook at this stage is not so unfavourable as to require any further tightening of monetary policy, particularly given the continuing relatively weak state of domestic economic activity. However, monetary conditions will have to remain firm over the next year in order to be consistent with achieving an inflation rate of around 4 per cent by December 1990, and achieving further reductions in the inflation rate towards price stability thereafter.