# REVIEW OF MONETARY CONDITIONS AND POLICY

*In this article, prepared by Roger Greville and Michael Reddell, developments in the monetary indicators over the period March to mid-May are reviewed. The change in the roles of the various indicators is discussed.*


## Executive Summary

The monetary indicators proved to be very stable throughout the review period; unlike much of 1988, they were not buffeted by new waves of political turmoil, and were not significantly influenced by economic news, including the 21 March Economic Statement. There were no significant developments in the monetary indicators in March and the first half of April. However, over late April and early May a period of relatively high short-term interest rates developed as cash-play activity occurred in the money markets. This firmness in short interest rates and increased overseas buying of New Zealand bonds, contributed to a significant firming in the exchange rate, which rose to a peak of 62.9 on the Bank's index.

The stability of conditions over the review period was reflected in the lack of movement in retail lending rates. This stickiness in rates and further progress in reducing inflation – down to 4 per cent for the year to March – prompted an increase in public concern over bank margins and real interest rates.

In assessing monetary conditions the weights attached to the various indicators have moved with changing economic circumstances. Over the past 18 months the weight placed on the slope of the yield curve has diminished considerably, and the Bank has come to place greater weight on the exchange rate and the level of real interest rates. There are difficulties in interpreting any of the indicators but in the Bank's judgment, the relative information content of the interest and exchange rate indicators has changed over time in favour of the exchange rate. Using this framework of indicators, the Bank judged that monetary conditions generally firmed over the review period, and continued to impose a significant degree of disinflationary pressure, consistent with the pursuit of the objective of price stability by the early 1990s.

The potential threat to the smooth pursuit of this objective which emerged over the quarter was the 21 March announcement that the rate of GST would increase to 12.5 per cent on 1 July. The challenge to monetary policy over the next year is therefore to ensure that the impact of the GST increase on the price level is limited to the first-round effect; in particular, to minimise the chances that the GST increase will be passed on into higher wage settlements in the forthcoming wage round. Provided such restraint is achieved, there is every prospect that measured inflation will resume rapidly the downward trend observed in 1988.


After a year characterised by a number of sharp, generally politically-induced, fluctuations in the key interest and exchange rate indicators, the period since the end of February 1989 has been relatively stable. Even the 21 March Economic Statement, which was the dominant economic news of the period, failed to evoke a significant reaction in any of the monetary indicators. During the second half of April and early May, monetary conditions firmed somewhat and, in conjunction with an upsurge in overseas interest in the New Zealand bond market, prompted a rise in the exchange rate. Developments in the monetary indicators since the end of February are reviewed in the first part of this article. The changing emphasis placed on the various monetary indicators is then discussed in the next section. The article finishes with an assessment of the stance of monetary policy in light of the forthcoming increase in GST.

## Developments in Monetary Indicators

During the first six weeks of the review period, to mid-April, there were no significant developments in the main monetary indicators. 90 day bank bill rates and 5 year government stock rates traded in ranges of 13.05-13.45 per cent and 13.15-13.25 per cent respectively (see Figure 1) giving a yield gap range of 40 basis points (see Figure 2). The exchange rate fluctuated within the 60.2-61 range on the Bank's trade-weighted index (TWI) (see Figure 3). Over this period, the smallest yield gap and the lowest exchange rates were recorded in early to mid-March, and the largest yield gap and highest exchange rates over this period occurred in late March. The slight firming in monetary conditions which occurred over March reflected the normal pressures associated with the end of the financial year and a moderately firmer stance in the Bank's open market operations.

The major economic news item of the review period was the Minister of Finance's 21 March Economic Statement. The package, which generated net fiscal savings of around \$1,500 million, was designed to demonstrate the seriousness of the Government's intention to achieve its publicly-stated financial deficit target for the 1989/90 year of around 1 per cent of Gross Domestic Product (GDP). The major components of the package were increases in the rates of company tax and GST, and expenditure cuts, which are generally to be achieved by across-the-board reductions in the real resources available to departmental chief executives. However, the package had little or no impact on any of the monetary indicators either prior to or following the announcement. There are three main potential explanations for the package's lack of impact in financial markets. First, there were few surprises in the package. The GST and company tax rate increases were certainly widely anticipated. Government expenditure cuts were also expected, although their nature and extent were more difficult to predict then the tax increases. Secondly, concern about the inflationary effect of the GST increase may have offset any reduction in interest rates attributable to a lower financial deficit. Thirdly, doubts about the Government's ability to achieve the across-the-board expenditure cuts probably meant that the markets' views of the actual net fiscal savings likely to be achieved were somewhat less than the estimated savings announced by the Minister.

There was a little more movement in the main monetary indicators over the final month of the review period – from mid-April to mid-May.

Monetary conditions generally firmed for most of this period. Settlement cash distribution problems took call rates to over 14 per cent from 11 April. Market comment had suggested that these distribution problems related to uncertainties over the settlement of the Air New Zealand sale. However, following the Air New Zealand settlement in mid-April, call rates continued to firm as a result of 'cash-plays' in the interbank market (in which one settlement institution attempted to hoard a large pool of cash and then force other settlement institutions to borrow from it at high rates). The call rate reached a peak of 16.5 per cent on 3 May, prompting some banks to raise their corporate overdraft rates.

The high call rates had initially not been expected to persist but by late

**Figure 1**
**Interest Rates**
**government stock and bank bill rates**

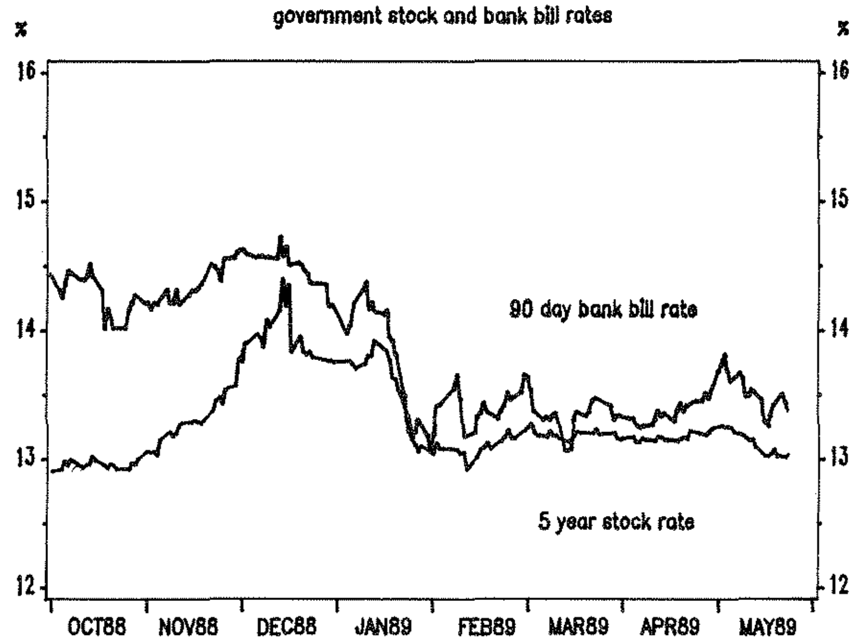
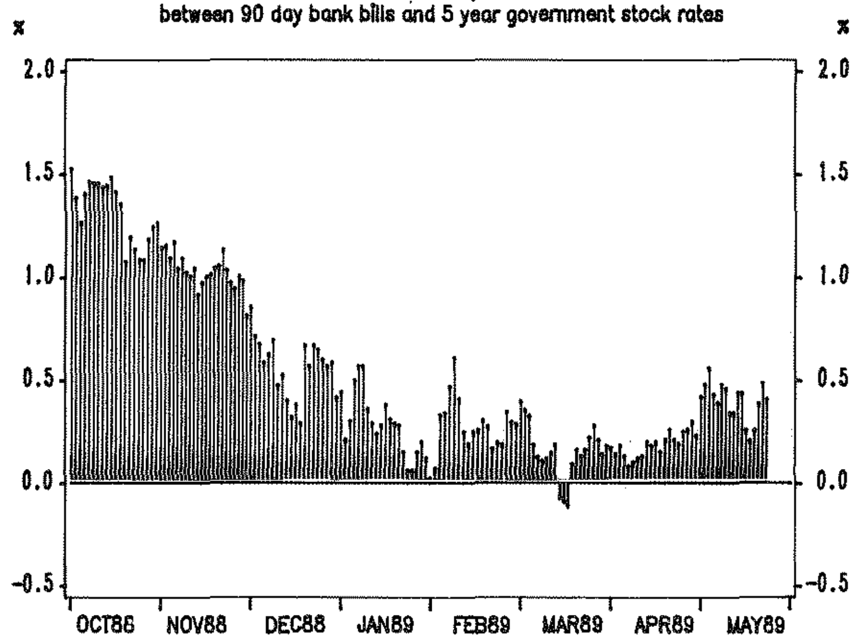



**Figure 2**
**Yield Gap**
**between 90 day bank bills and 5 year government stock rates**



April the pressures in the call market began to be reflected in 90-day rates. The 90-day bill rate rose from around 13.4 per cent on 20 April to peak at 13.8 per cent on 3 May – the highest rate recorded since late January. With the 5 year bond rate trading almost unchanged at around 13.2 per cent, the 90-day-5 year yield gap widened, reaching a maximum of about 0.6 percentage points. The rising short-term wholesale rates and lending rates prompted renewed calls from various representatives of the corporate sector for the Reserve Bank to adopt a more active policy of interest rate smoothing. However, as expected, the cash-play activity eventually ended without the need for any specific actions on the part of the Bank and short-term interest rates began to ease back on 4 May.

As the short-term interest rates increased the exchange rate also began to rise. Over a period of less than two weeks the exchange rate rose by almost 4 per cent to reach 62.7 on the TWI by 8 May. Over the following week, the exchange rate remained firm, despite a gentle OMO signal from the Bank that conditions had become too tight, and peaked at 62.9 on the index on 15 May. The exchange rate then eased back slightly over the following few days amid volatile overseas trading. The relatively high domestic short-term rates in relation to comparable foreign rates were probably the major initial factor accounting for the rise in the exchange rate (see Figure 4). However, there also appears to have been some upsurge in overseas interest in investment in New Zealand dollar bonds, particularly following the favourable OECD report on the New Zealand economy, which provided an additional impetus to the dollar. The upsurge in foreign investment in New Zealand dollar bonds was probably also a factor explaining the 0.2 percentage points decline in 5-year bond rates to around 13 per cent in mid-May.

Although the developments over the month to mid-May represented

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

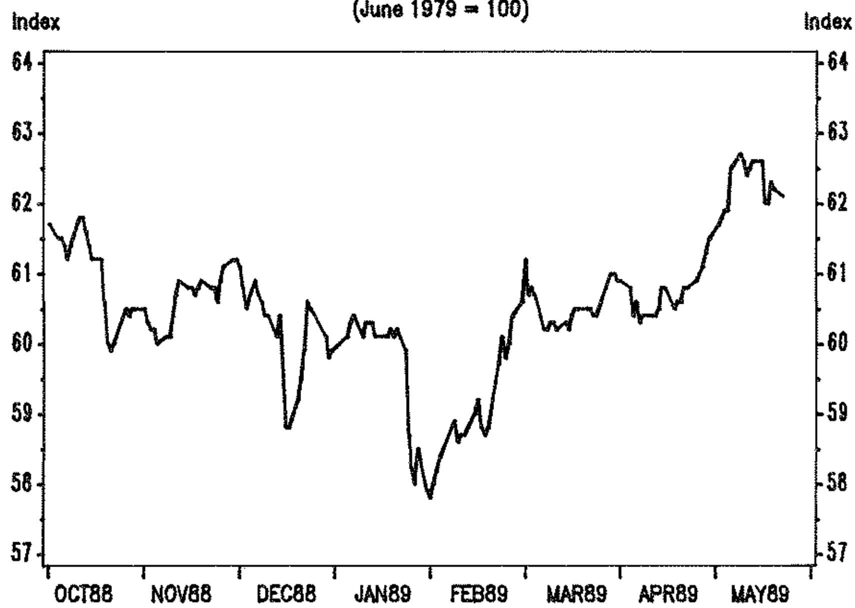
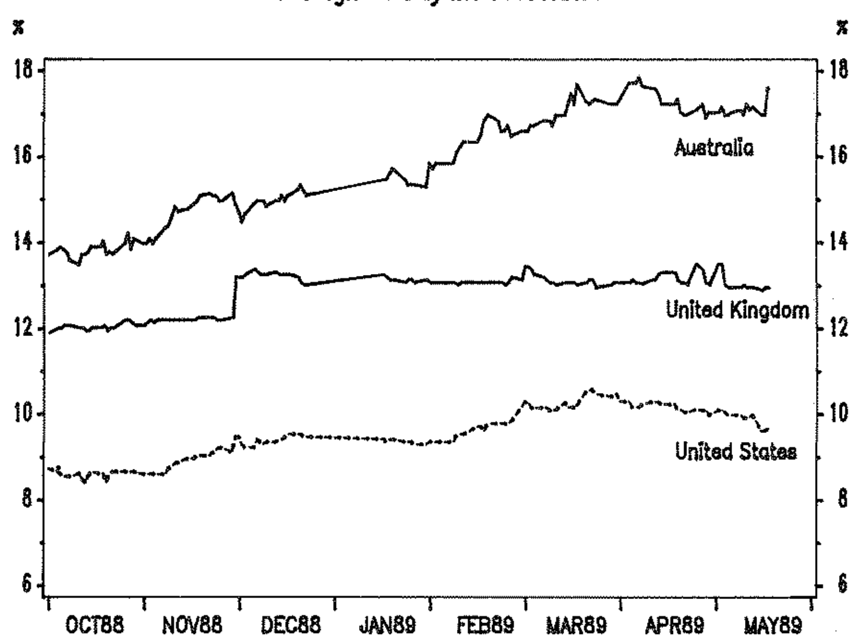



Figure 4
Foreign 90 Day Interest Rates

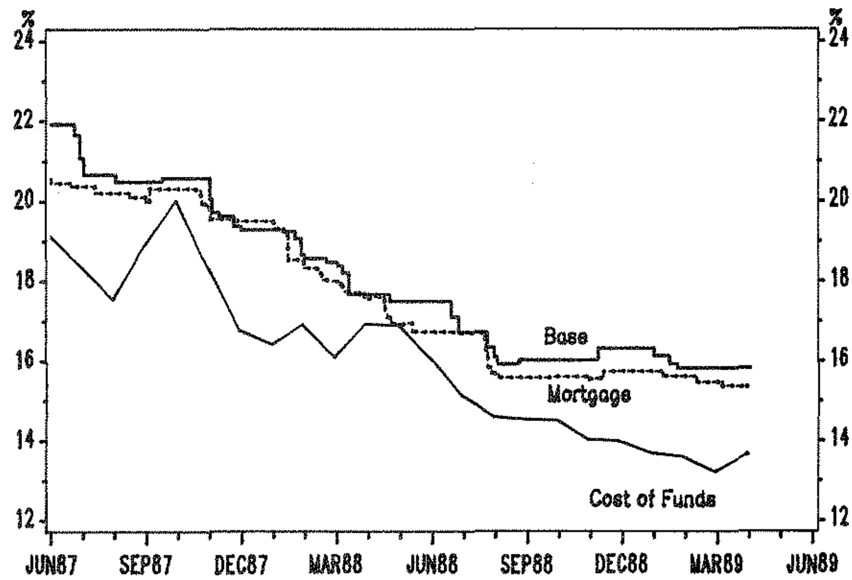


the only significant movements in the monetary indicators in the review period, it is important to keep even these developments in perspective. The magnitude of the fluctuations in interest and exchange rates was very small in comparison with the variability experienced in recent years. For example, when monetary conditions firmed during the same period a year ago, the call rate rose by around 8 percentage points to 24 per cent and the 90-day bill rate rose by over 2 percentage points. By contrast, over recent weeks the call and 90-day rates have only moved by around 3 and 0.4 percentage points respectively.

Bank lending rates have fallen only slightly over the review period, despite a probable slight fall in the average cost of new funds (see Figure 5). Average base lending rates were unchanged from the end of February at 15.8 per cent. Average first mortgage rates fell slightly to around 15.3 per cent, with the lowest available rate now around 14.5 per cent. In real terms, lending rates remain very high – although now somewhat lower than in Australia – and, in the Bank's assessment, are continuing to exert considerable disinflationary pressure. However, while the risk and uncertainty premia affecting wholesale funding costs persist, there is very limited scope for significant short-term reductions in lending rates. Available data on cost of funds are rather sketchy, but the Bank has no evidence to support the claim made frequently in recent months that bank margins have been systematically widened over the past year to help offset losses sustained following the sharemarket crash.

The classification of lending by sector data show that the sharp reduction in the rate of credit growth in the year to March 1989 has been due to a significant continuing fall in lending to the corporate sector. The absence of any significant upturn in business investment and the continuing downturn in the property sector suggest that this trend is likely to continue over the next few quarters at least. The data for lending to the household sector show a 26 per cent increase in lending to this sector by surveyed financial institutions over the year to March. However, these figures should be interpreted with some caution. In particular, there are difficulties in relating the statistics on lending to households to those covering markets in which households have typically used credit finance. Neither house prices nor the volume of residential building activity appear to have increased significantly over the past year, and consumption of consumer durables, other than cars, has been flat.

Figure 5
**Proxy Cost of Funds, Base Lending Rates and First Mortgage Lending Rates**




## The Indicator Framework

In assessing the state of monetary conditions in terms of the Bank's medium-term objectives it is important to keep under continuous review the relative emphasis attached to the various available indicators. During much of the last four-five years, the slope of the yield curve and, in particular, the size of the 90 day-5 year yield gap, has been seen as the principal indicator of monetary conditions. However, the emphasis placed on the yield gap has diminished considerably since mid 1988, as a variety of new factors have complicated the interpretation of the slope of the curve. Greater weight has come to be placed on the nominal exchange rate and the level of real interest rates as monetary indicators.

As was to be expected for a number of reasons, the yield curve has flattened over the past year. First, as the gap between current and target inflation rates narrowed, the extent to which short-term nominal interest rates could be expected to fall in future periods also diminished.

Secondly, demand by banks for longer-term stock has fallen as the role of government stock in the banks' total portfolios has been reassessed. Thirdly, the weak domestic economy depressed current demand for credit relative to likely future demand when the economy recovers, thereby exerting downward pressure on current short-term interest rates relative to future short-term rates. Fourthly, the major source of credit demand – that from the SOEs – has been concentrated at the longer end of the market, thus tending to raise long rates relative to short rates.

Making a judgment about the extent to which all of these factors have narrowed the appropriate yield gap would have been difficult enough in a politically stable environment. However, the past eighteen months have been characterised by an extraordinary degree of political uncertainty which peaked at the time of the effective dismissal of the Minister of Finance (the Hon. R.O. Douglas) in December 1988. As the tensions between the Prime Minister and the former Minister of Finance periodically spilled over into the public arena during 1988, the political risk premium in interest rates increased. The magnitude of the risk premium has fluctuated, greatly complicating yield curve analysis, and has remained high even following the removal from Cabinet of the Hon. R.O. Douglas. Political uncertainty and doubts about the future direction of the Government's macroeconomic policy have remained crucial factors in interpreting longer-term interest rates and the yield gap. Moreover, the approach of the 1990 elections and the large opinion poll leads enjoyed by the Opposition have given rise to uncertainty over the monetary and fiscal policies which will be pursued beyond 1990.

The impact on bond rates of both of these forms of political uncertainty can of course be seen as an increase in the perceived risk of future inflation and, as such, as matters for concern. However, there is very little that monetary policy can do to lower increased risk perceptions arising from these sources, particularly those relating to the period beyond the next election. In those circumstances, a flattening in the yield curve arising from increased political uncertainty is no basis for a tightening of monetary policy.

As these difficulties in interpreting the yield curve were recognised, the Bank responded by focussing more attention on other indicators. By mid-1988 the Bank was paying more attention to the level of real interest rates and, in particular, the sharp rise in post-tax short-term real interest rates facing the domestic corporate sector as inflation fell rapidly while interest rates fell only slowly. Real interest rates are themselves difficult to measure and interpret, but the sharp rise in real short-term rates indicated by almost any possible measure of real interest rates suggested to the Bank that a very high degree of disinflationary pressure was still being imposed on the domestic economy. Real short-term rates have eased slightly since mid-1988, but remain high by the standards of most other countries, and those of New Zealand history.

Greater weight has also come to be placed on the exchange rate as a monetary indicator. The exchange rate is, of course, not without interpretation difficulties of its own, but it does have a considerable advantage over some other indicators as a guide to the assessment of the monetary stance. Unlike any of the other indicators, the level of the exchange rate has a direct link to the rate of inflation – in particular through the domestic prices of all traded goods. Economic theory tells us that if the exchange rate is set at a certain level then, with free international movement of capital, domestic inflation will eventually be the same as the weighted average of inflation rates in the countries to whose currencies the New Zealand dollar is pegged.

Ever since the floating of the dollar in 1985, the exchange rate has been a variable taken into account in the assessment of monetary conditions. However, prior to last year the exchange rate was generally allowed to move through a wide range so long as other indicators – such as the yield gap – showed a consistent degree of liquidity pressure. The general strength of the exchange rate between 1985-1988 was seen as a necessary part of the overall disinflationary pressure. Moreover, the approach taken to the exchange rate recognised the extreme difficulty (following the devaluation, the float and the removal of export incentives and farm subsidies) of assessing the relative impact of structural economic changes on the exchange rate. The Bank therefore considered it inappropriate to put too much weight on the exchange rate in guiding its monetary policy actions.

Restructuring, liberalisation and disinflation have of course continued, but the information content of the interest and exchange rate indicators has changed over time, resulting in emphasis moving onto the exchange rate from the second half of 1988. Following the sharp depreciation in August 1988, the Bank's assessment suggested that much of the earlier 'over-valuation' of the real exchange rate had been reversed. Moreover, the Bank was very conscious of the direct price effects of the exchange rate fall, and the threat that any further sharp fall would undercut the disinflationary impact of the other transmissions mechanisms. With disinflation broadly on track, the Bank has also been very aware of the weakness and vulnerability of real domestic activity – and in particular the traded goods sector – to any renewed upward exchange rate movement. The net result has been a reduced tolerance of exchange rate – and indeed interest rate – variability.

However, while the exchange rate may now carry a greater weight in the overall assessment of conditions, there is still no one indicator that dominates monetary policy assessment. The information content of exchange rate and interest rate movements will continue to be assessed against a range of other data, including the state of real economy, direct evidence on inflation expectations, and the monetary and credit aggregates. (An article reviewing recent research results on the money and credit aggregates and discussing the conceptual and empirical difficulties associated with the use of aggregates as indicators will be published in a forthcoming issue of the *Bulletin*.)

## Policy Assessment

Applying this indicator framework to the review period from the end of February to mid-May, the Bank judged not only that the monetary policy stance continued to exert a reasonably high degree of disinflationary pressure, but also that the degree of pressure firmed over the final month of the review period. The exchange rate strengthened to levels which, in conjunction with the other indicators, suggested that monetary conditions were becoming somewhat firmer than necessary to maintain progress towards the medium-term price stability objective.

The inflation outcome in the March quarter was certainly viewed as consistent with the medium term objective. The Consumer Price Index (CPI) rose by 1.1 per cent for the quarter (0.9 per cent excluding the 1 January increase in tobacco excise rates), lowering the annual rate of CPI inflation to 4 per cent. This annual rate is the lowest recorded since the December 1969 year, with the exception of only two quarters during the 1982-84 price and wage freeze, and is lower than the annual inflation rates of Australia, the United Kingdom and the United States. The reduction in the measured inflation rate over the last two years – from a peak of 18.9 per cent in 1987 (including the effects of the introduction of the 10 per cent GST) to 4 per cent for the March 1989 year has won considerable public credibility for the Bank's monetary policy and for the seriousness of the Government's resolve to reduce and eventually eliminate inflation.

The 2.5 percentage points increase in GST announced in the 21 March Economic Statement, however, could threaten to disrupt continued smooth progress towards the price stability objective. In particular, if wage and salary earners gain compensation for the GST increase, there will be an increase in underlying inflation (i.e. the measured inflation rate excluding the one-off rise in prices due to the GST increase) which will make more difficult the attainment of price stability by the early 1990s. As the Bank has frequently stated, monetary policy will not accommodate any passing on of the GST increase into higher wages. If wage compensation for the GST increase is achieved, it will be at the expense of more job losses.

Non-official forecasts of inflation following the GST increase vary considerably. However, in the Bank's view, if increases in the price level can be restricted to only those associated directly with the one-off increase in GST, with little or no wage clawback, price stability can still be achieved by the early 1990s on current monetary policy settings. The Bank is forecasting an increase in the annual inflation rate to around 6.2 per cent for the year to December, due to the one-off impact of GST. Subsequently, inflation is expected to fall as the underlying rate of inflation declines and the one-off impact of GST drops out. The rise in the CPI for the year to March 1991 is projected to be just over 3 per cent.

Inflation expectations have risen following the GST announcement, but it appears, at this stage, that the increase in GST has left medium-term expectations largely unchanged. The Reserve Bank's May survey of business and financial expectations (detailed elsewhere in this Bulletin) indicates that inflation for the year to March 1990 is expected to rise to 6 per cent (marginally below the Bank's forecast) but to fall to 4.7 per cent for the year to March 1991 (compared with 4.9 per cent for the year to December 1990 expected in the February survey). The National Bank's surveys showed that year-ahead expectations rose to 6.7 per cent in April, but subsequently fell back slightly to 6.5 per cent in the May survey.

In practice, the decision to accommodate the one-off rise in the price level (see the Governor's 21 March statement, which appears in the Appendix, on the Bank's reaction to the GST increase) means that short-term real interest rates and the exchange rate will not be allowed to rise to offset the initial increase in the price level. Conversely, non-accommodation of any second-round price rises means that the Bank will not step in to ease liquidity conditions if they tighten as a result of excessive wage settlements following the GST increase.

Clearly, there is no room for complacency. The stability of the exchange rate and the level of wage increases will be pivotal in achieving the price stability objective without incurring additional economic and social costs. However, in the final analysis, there is only so much that monetary policy can do to change inflation expectations and wage demands ahead of actual inflation outcomes. The Government and the Bank have made every endeavour to allay fears of a policy U-turn, and the Minister of Finance has repeatedly re-emphasised the Government's commitment to eliminating inflation by the early 1990s. Monetary policy settings have been, and will continue to be, kept at levels which are consistent with ensuring the achievement of the price stability objective.

# APPENDIX 1

# GOVERNOR'S STATEMENT ON THE GST INCREASE

The Governor of the Reserve Bank, Dr Don Brash, says that monetary policy will not change as a result of the increase in GST.

Apart from the direct one-off price effects, Dr Brash says monetary policy will not accommodate any additional inflationary pressures.

Both the Reserve Bank and the Government share a commitment to eliminating inflation, and Dr Brash emphasised that the monetary stance will remain sufficiently firm to ensure the underlying rate of inflation keeps falling. He says this is consistent with the goal of achieving sustainable price stability by the early 1990s.

Price and wage setters must recognise that they cannot avoid the increase in GST by passing it on to someone else. Given the Reserve Bank's intentions to maintain a non-accommodating monetary stance, the Governor says that any attempt to pass on the tax in the forthcoming wage round will simply lead to unnecessary further losses in output and employment.