

RESERVE BANK ANNUAL REPORT

The following are extracts from the Reserve Bank Annual Report for the year ended 31 March 1985.

The statistical information included in this Report was finalised on 21 June 1985, and any subsequent revisions have not been incorporated. All amounts are in New Zealand dollars unless otherwise specified.

Introduction

The year in which the Reserve Bank of New Zealand marked the 50th Anniversary of its foundation was also a particularly notable one for the New Zealand economy, in two principal respects. The expansion in domestic demand, in output and employment proved to be the strongest for a decade. But, of more importance from a longer term perspective, the radical changes in economic policy which followed the change of Government in July 1984 constitute a concerted attack on the structural imbalances in the New Zealand economy, imbalances which have been apparent for many years. The major policy changes included a 20 per cent devaluation immediately following the change of Government; removal of the remaining elements of the 'freeze' (notably interest rate controls and wage controls); the acceleration of moves to eliminate, phase-out, or reduce various export subsidies and quantitative restrictions on imports; measures to reduce sharply the large fiscal deficit; comprehensive deregulation of the financial system and the foreign exchange market (including the abolition of the long-standing exchange control system); and adoption of a commitment to a firm and consistent approach to monetary policy. Of course, many of these ingredients are strongly inter-related. Major items on the agenda for the year ahead are tax reform, and an associated review of welfare programmes.

Economic Conditions

The International Economy

The recovery in the international economy that commenced in late 1982 accelerated and became more broadly based during 1984, although some signs of an easing in growth rates emerged towards the end of the year. Over the 1984 calendar year, output in the OECD member countries is estimated to have expanded in real terms by 4.9 per cent. This was well up on the 2.7 per cent growth recorded in 1983, and was the highest rate of growth experienced since the last major recovery about a decade earlier.

Much of this growth was concentrated in the economies of New Zealand's main trading partners. In

particular, the USA, Australia and Japan each experienced robust growth over 1984, with real output expanding by 6.8 per cent, 6.2 per cent and 5.8 per cent respectively.

One of the more unusual features of the current recovery, particularly given its strength, was the extent to which a resurgence in world inflation was avoided. In 1984, consumer prices in OECD member countries are estimated to have risen by an average of 5.3 per cent. This was the same rate of inflation as recorded in the preceding year, which was the lowest since 1972. To a large extent, the low inflation rate can be attributed to the nature of the recovery which, unlike many previous upturns, was driven mainly by supply side factors. In particular, the American and Japanese economies have undergone a period of sustained and strong investment growth, and an accompanying expansion in productive capacity. As a result, output was able to grow significantly without putting pressure on resources, and therefore prices, to the same extent as may have occurred with a demand led expansion.

Domestic Activity

The domestic recovery, which began in early 1983, continued strongly through at least the first half of 1984/85, under the influence of an expansionary fiscal policy, a continuing good export performance, and relatively easy monetary conditions. The most recent indicators suggest that the boom may have been easing by late 1984 but, using the quarterly seasonally adjusted data, real GDP in the December quarter was 6.7 per cent higher than a year earlier, and 12.2 per cent higher than the March 1983 trough.

Given the effects of the wage freeze on disposable incomes for wage and salary earners during 1983/84 and into 1984/85, the strength of the domestic expansion was somewhat surprising. In part the upturn in domestic expenditure was underpinned by a fairly sharp increase in non-wage and salary incomes, but there was also a fall in private saving and a strong expansion in private sector credit. Over the first part of the year, interest rate controls drove the real cost of borrowing down and the surge in expenditure was most marked in consumer durables and on investment in houses. Expenditures were also buoyed by 'precautionary' purchases of

consumer durables motivated by the ending of the price freeze in February 1984, and also later in the year by price increases which were anticipated to follow the July 1984 devaluation. However, real retail turnover (after adjustment for seasonal factors) fell in both the December and March quarters, by 2.7 per cent and 1.8 per cent respectively.

The recovery in investment was originally confined to residential building. Easier money and credit conditions, the constraining effects of the wage-price freeze on building costs, and of interest rate controls on mortgage servicing costs, were primary factors in the upturn in this area. By late 1984 however, the number of building permits issued had levelled off, suggesting an impending slowdown in the rate of construction.

Private fixed (non-residential) investment increased from late 1983. Surveyed import orders for plant and machinery, which provide an indication of the level of planned investment, and business opinion surveys had both been signalling a strengthening of private fixed investment intentions from early in 1983. However, it was not until later in the year that indicators of actual investment, such as wholesale sales of machinery and non-residential building activity, began to pick up.

The rise in both domestic and export demand was translated through to production relatively quickly, as domestic stocks were at relatively low levels at the beginning of the cycle. Real GDP in the 1984 calendar year (the latest available provisional data) was 7.6 per cent higher than in 1983. The increase in output was most pronounced in the manufacturing sector, which grew by 14 per cent over this period, but the upturn was quite broadly based with the construction, and the transport, communications and services sectors also growing particularly rapidly. Capacity utilisation appears to have remained high throughout 1984/85, at the highest level for a decade.

Labour Market

The wage freeze, which was originally imposed in June 1982, was the dominant influence on the level of wage and salary payments until the resumption of collective bargaining late in 1984.

The lack of significant movement in wage rates over most of the year led to a decline in relative labour costs which, in combination with the expansion of domestic output, contributed to increased employment. In the year to February 1985 full-time employment grew by 3.5 per cent. As a consequence of this higher employment and the slower labour force growth, there was a substantial fall in the number of unemployed. The number of registered unemployed in March 1985 was 50,928 (3.6 per cent of the labour force) compared with 68,252 a year earlier, while the total of those on special work schemes declined from 38,473 to 37,562.

The annual rate of inflation, under the strictures of the wage/price freeze which ended in February 1984, reached a 15-year low of 3.5 per cent for the year to March 1984. Although a three month price freeze was again imposed as an interim measure following the July 1984 devaluation, subsequent quarters reflected the effects of increases in import and export prices, Government charges, and adjustments following the end of the prolonged freeze flowing through to the domestic price level. By the March quarter 1985, the annual rate of inflation had risen to 13.4 per cent.

Government Accounts

The 1983/84 Government budget deficit outcome was lower than forecast, due to higher levels of revenue (particularly from indirect taxation) and lower than anticipated expenditure on some industry support programmes. Nevertheless, it still represented 8.9 per cent of GDP. Because the 1984 Budget was delivered relatively late in the year, any policy changes could not materially affect the deficit for 1984/85. The deficit outcome was \$2,784 million, very close to the budgeted figure of \$2,761 million, although both net expenditure and revenue were significantly below the estimates.

The 1984 Budget did contain several measures which will allow for appreciable reductions in the fiscal deficit in subsequent years. The estimated deficit for 1985/86 contained in the Budget delivered in June 1985 was \$1,285 million (less than 3 per cent of forecast GDP).

Balance of Payments

Despite the robust and sustained nature of the international recovery, New Zealand's balance of payments current account deteriorated sharply over the year. Measured on a balance of payments basis the current account deficit was \$2,706 million in the year to March 1985 (6.9 per cent of GDP), compared with just \$1,614 million in the preceding year (4.6 per cent of GDP). Much of this deterioration occurred in the balance on merchandise trade, which fell from a surplus of \$241 million in 1983/84 to a deficit of \$275 million in 1984/85. The invisibles deficit increased from \$1,855 million to \$2,430 million.

The main factor underlying the trade account turnaround was very strong growth (14.2 per cent) in import volumes — growth which would have been even stronger had there not been a sharp fall-off in major project imports.

Export volumes also expanded over the year, by 7.3 per cent. Although overall export growth was only half that of imports, this reflected weak volume growth for pastoral commodities: the non-pastoral sectors (particularly manufacturing and 'other primary' products) experienced a vigorous surge in exports.

The year also saw significant developments in New Zealand's capital account. Over the year to March 1985, net private capital inflows (measured on an overseas exchange transactions basis) amounted to \$1,899 million compared with \$432 million in the preceding year. Private capital flows fluctuated widely throughout the year in response to the market's perception of exchange rate risk adjusted interest rates in New Zealand relative to those elsewhere, especially around the time of the devaluation in July 1984 and the floating of the New Zealand dollar in March 1985. Although erratic, a significantly larger net private capital inflow was recorded overall in 1984/85 than in the previous year. An important development underpinning this outcome was the higher level of domestic interest rates that followed interest rate deregulation in July 1984 and the subsequent adoption of a firm monetary policy.

Despite the size of the net private capital inflow over the year, it was insufficient to cover the current account deficit. In order to fund the private sector external deficit, it was therefore necessary to utilise net official borrowing. The need to borrow was reinforced by the relatively low level of overseas reserves that

characterised the earlier part of the year, and the need to refinance maturing debt.

Reflecting the growth in official overseas debt over 1984/85, debt servicing costs (defined as repayment of principal plus interest payments) increased sharply to represent 41.2 per cent of goods and services export receipts compared to 17.9 per cent a year earlier. The large increase was mainly attributable to the refinancing of maturing debt and to the repayment of short-term Reserve Bank overseas borrowing drawn over the month preceding the devaluation. The interest component of the debt servicing ratio increased to 8.2 per cent in 1984/85, up from 6.9 per cent in the previous year.

Economic Policy

Past Experience

Previous Annual Reports have discussed, in some detail, the accumulation over a lengthy period of a number of significant structural imbalances in the economy. These included the persistently large external current account deficit, and the resulting accumulation of external debt; a large, and generally growing, fiscal deficit; monetary growth rates which were both unacceptably high (on a number of occasions) and undesirably variable; and a marked mis-match between supply and demand conditions in the labour market. These imbalances were associated with, on any measure, a poor economic performance — real growth rates were very low, unemployment climbed inexorably, and the inflation rate was generally high.

Over recent years a number of policies were implemented to try to address these imbalances. But past policy often tended to focus on the most critical or pressing contemporary problem, relegating others to a lower priority, and did not always address the underlying causal factors. Thus, although progress was made at times in particular areas — for example, the freeze was substantially successful in reducing the measured rate of inflation — such progress was too often achieved at the cost of an offsetting deterioration in other important objectives. Moreover, there was room for real doubt as to whether some of the apparent gains achieved were permanent in any case.

The 'Economic Summit' Conference held by the new Government in late 1984 highlighted the fact that the economy performed poorly over recent years, and that one of the most important reasons for this was a failure to adjust promptly and effectively to major changes in the international environment. Industry-specific development assistance together with attempts (at times) to shield the domestic economy from externally generated 'shocks' resulted in the proliferation of subsidies, tax concessions and other protective measures for particular sectors or groups. Government intervention in both the financial and the 'real' sectors became deep and pervasive. The problems this caused received a degree of recognition over recent years and some changes involving deregulation were made in the transport area, in foreign exchange dealerships, and in protection policy (particularly under the umbrella of the Australian/New Zealand CER trade agreement), for example. But more generalised attempts to move away from this regime were inhibited by the lack of consistent progress in other policy areas, particularly with respect to exchange rate policy and the accompanying

fiscal/monetary policy mix. As long as New Zealand maintained an over-valued exchange rate, pressure groups were able to argue, with apparent justification, for the retention of various subsidies and protective devices which they saw as 'compensating' them for the over-valued rate. The particular measures taken, however, were generally an inefficient and inequitable way of providing such 'countervailing assistance'.

The New Government's Approach

The new Government's general philosophy of economic management has a number of inter-related strands. First, the Government has said that it does not intend, as a general rule, to intervene in the detailed decisions regarding production, investment and resource allocation. Instead, its objective is to use economic policy to create and maintain a climate in which investment in productive assets is encouraged and in which resources, including financial resources, are free to flow to those areas where the most productive use can be made of them. This approach has been well illustrated in the monetary policy area by a marked switch away from the use of direct and selective intervention in the activities of financial institutions.

Secondly, the Government has given emphasis to the need to pursue an integrated and balanced approach to economic policy. It is accepted that the conventional goals of economic policy — growth, employment, price stability, the balance of payments and income distribution — are all of importance, and must all be given due weight in the design of policy. Moreover, it is recognised that the most desirable point in the trade-off amongst these objectives is likely to be reached by attacking, as far as possible, the root causes of problems and imbalances, rather than their symptoms.

Thirdly, the Government has deliberately chosen to give emphasis to medium-term considerations in formulating its policies. This approach reflects the now widely-held view that attempts to operate short-term 'fine-tuning' stabilisation policies can often do more harm than good. It is also believed that the private sector is more likely to pursue growth opportunities in a relatively stable policy environment where the Government's intentions are well understood than in an environment where the rules and policies are continually changing.

In line with this general approach, the Government has moved on a range of fronts to address the accumulated imbalances and distortions from the past. The devaluation, and subsequent floating, of the New Zealand dollar; the deregulation of the financial sector and the foreign exchange market; and the return to an orthodox monetary policy have all been particularly significant elements of this package. These are discussed in detail in subsequent sections.

In respect of other parts of the package, the Government set in place in the 1984 Budget the blueprint for its medium-term economic strategy. A first priority for fiscal policy is to reduce the size of the fiscal deficit, since it is now recognised that over the medium-term this is essential if inflationary expectations are to be dampened and nominal interest rates lowered. The measures implemented prior to and contained in the 1984 Budget have the potential to effect a substantial reduction in the deficit over the next two years, a reduction which the Bank believes is necessary

for a better balance to be achieved in the macro-economic package.

The second thrust of the Budget was a series of measures designed to improve resource allocation in the economy. The devaluation of the New Zealand dollar by 20 per cent in July 1984 facilitated a major review of assistance measures for the exporting and import-competing industries, and enabled substantial steps to be taken towards removing artificial barriers to competition and encouraging the movement of resources within the domestic economy. A broad aim in the Budget was therefore to expose the domestic economy to a much greater extent to the discipline which competitive market forces bring to production, investment and pricing decisions, and to ensure that key prices in the economy provide a more appropriate measure of the true costs and benefits of resource use. The Government continued with the liberalisation of import licensing and moves toward a lower, more uniform, tariff-based protection for import-substituting industries. A range of tax exemptions, subsidies and other assistance measures for land-based industries were withdrawn or set to phase-out over the next two years, several implicit subsidies to groups within the transportation sector were removed by the adjustment of relevant Government charges, and prices for various forms of State-supplied energy and other services were increased (in some cases substantially), and rationalised, in order to better reflect the production costs involved.

These changes will be complemented in the coming year by moves in the area of taxation reform. A comprehensive review of the personal taxation system is underway, integrated with a review of welfare benefits in order to better achieve equity objectives. A shift away from income to expenditure taxation has already been decided, with the implementation in 1986/87 of a 'value added' type Goods and Services Tax. Reform of business taxation is also on the agenda for future action.

Overall, the Bank considers that the current policy approach is a responsible one which, if carried through with determination, has real prospects of returning New Zealand to a growth path which is both sustainable and acceptable. The magnitude of the accumulated imbalances, and the particular market pressures which emerged at the time of the change of Government, implied that the time for a gradualistic approach to structural adjustment policy had passed. Decisive action was essential.

The Government therefore embarked on a programme of economic reform which is probably the most radical in New Zealand's history — notable for both the pace of change and the comprehensive and integrated nature of the approach. The essential ingredients — direct attacks on the major imbalances, the adoption of a medium-term orientation for macroeconomic policy, and a welcome emphasis on the need to improve resource allocation and efficiency — are all endorsed by the Bank. Inevitably, progress has been more rapid in some areas than in others, and it will be important to ensure that the approach is fully carried through into all areas of economic activity.

However, some of the changes have had a significant effect on prices which is unavoidable but unwelcome, and it will be necessary to maintain a firm anti-inflationary policy so that these effects do not feed into a renewed wage/price spiral. More generally, both the speed and the magnitude of the required adjustments have undoubtedly proved uncomfortable for some sectors. The costs of structural change, while relatively

short-term in nature, can be quite severe in some cases, and also tend to be localised. The benefits of structural reform will take longer to appear, and may be more diffuse, although there can be little doubt that they will substantially outweigh the short-term costs in due course. It is therefore important that the policies are applied consistently over a reasonably long period; and that people do not lose sight of the benefits which will result from this, throughout what may be a difficult and, in some areas, lengthy period of transition. It is also proper for the Government to act, where warranted, to ensure that the costs are not borne disproportionately by particular sectors, and that the eventual benefits are also shared fairly throughout the community.

Foreign Exchange Market and Exchange Rate Policy

A wide range of new policy initiatives were taken in the foreign exchange market during the year. To some extent, these reflected a continuation of the change in policy direction that first became evident in April 1983 when the previous Government announced that suitably qualified institutions (in addition to the trading banks) would be allowed to act as foreign exchange dealers. Although developments over the latter half of 1984 and first quarter of 1985 accelerated the rate of change, they did not alter its basic direction — that of encouraging the development of a more efficient foreign exchange market and improving the services available to New Zealand's international traders. In this sense, the changes that have taken place are consistent with the broader economic objectives of reducing government intervention in the market-place and of promoting a more efficient allocation of resources.

Devaluation

There had been for some time a widespread market perception that the New Zealand dollar was overvalued and that an adjustment was likely to occur at some point. While there was no consensus on the likely timing of that adjustment, the surprise announcement of an early election became the trigger for a large outflow of foreign exchange as financial institutions, exporters and importers sought to protect themselves from the adverse effects of a probable devaluation. The outflow was \$256 million on 15 June alone, the first trading day following the announcement of the election.

Once the election had been held, it became essential that an unequivocal resolution to the foreign exchange crisis be effected. The low level of reserves at that time, coupled with the very high level of capital repayment and forward market commitments and the prospect of further market outflows, forced the suspension on 15 July of foreign exchange dealing in New Zealand dollars pending a decision on the exchange rate. That exchange rate decision was taken on 18 July, when the incoming Government devalued the New Zealand dollar by 20 per cent and removed most of the interest rate controls then in force. These moves enabled foreign exchange dealing to be resumed and allowed the Reserve Bank to withdraw from the forward market on the same day. Over the following three days, large foreign exchange inflows occurred and over the period 18 July to 31 July foreign currency worth \$1.5 billion was purchased by the Reserve Bank.

Market Development

The experience over this period, together with the recognition by the new Government of the need for more rapid adjustment in the economy, led to a number of further policy initiatives being taken in the foreign exchange market. The aim of these initiatives was to reduce impediments to foreign exchange flows and to enhance the depth and efficiency of the foreign exchange market.

An important step in this direction was taken in October 1984 when the limits that applied to foreign exchange dealers' holdings of spot foreign currency balances were relaxed. Further liberalisation occurred in December 1984, when the Exchange Control Regulations were effectively abolished and the limits on spot balances were removed. The only controls now binding on the dealers are of a prudential nature, as part of their conditions of consent to operate as authorised foreign exchange dealers. These controls provide exposure limits on overall foreign currency positions. The moves taken together confer much greater flexibility on authorised foreign exchange dealers to operate in the forward market and to assume and manage foreign exchange risk.

The Government is also encouraging dealers to increase their capitalisation so as to enhance their ability to manage and carry foreign exchange risk.

Borrowing Restrictions and Exchange Control

As well as the moves to provide greater depth in the foreign exchange market, a number of other measures were implemented over the year aimed at reducing impediments to dealings in foreign exchange. The first of these moves was the abolition on 31 October 1984 of the rules which had previously limited private overseas borrowings to a fixed term of at least twelve months and to an interest rate not greater than 2 percentage points above the London or Singapore inter-bank rates. Similarly, on 21 November 1984, a major relaxation in the Overseas Investment Regulations was announced whereby overseas owned companies operating in New Zealand were given unrestricted access to the New Zealand capital market. In addition, restrictions prohibiting New Zealand financial institutions from borrowing overseas were modified, allowing them to borrow more freely to fund their day-to-day operations.

However, the most significant of these moves was the effective removal of the Exchange Control Regulations. Over time these had become relatively ineffective as a means of moderating foreign exchange flows. They were also no longer necessary in the new environment of market determined interest rates and a more realistic exchange rate. Moreover, the regulations imposed high costs in terms of compliance and enforcement of the rules. The abolition of the regulations removed these costs and gave added flexibility to the New Zealand corporate sector in terms of funds management and the deployment of resources.

Floating the Dollar

The decision to float the dollar from 4 March 1985 was consistent with the Government's approach to economic management, as outlined in the previous sec-

tion. The float should ensure that the exchange rate does not again depart from its equilibrium level for a lengthy period, thus making a valuable contribution to the restoration, and maintenance, of overall external balance; and also improving resource allocation since the market value of foreign exchange, rather than an administratively determined value, is now used in private sector decision-making. Changes in international competitiveness and in the terms of trade, for example, should be signalled more rapidly to domestic producers; and exporters' profitability should not be adversely affected by the long-term maintenance of an inappropriate rate. The float will also give a greater degree of independence to monetary policy — as discussed more fully in the next section, the fixed exchange rate (or, more particularly, the willingness of the Reserve Bank to buy and sell foreign exchange on demand) enabled the private sector to avoid the strictures of a relatively firm monetary policy by borrowing overseas.

In addition to the resource allocation and monetary policy effects, a floating exchange rate will allow greater control over the Government's external debt; remove the possibility of speculators securing large windfall gains at the expense of the taxpayers (which can occur when the authorities try to defend a fixed rate); and mean that some of the impact of internal and external shocks which, under a fixed regime, are borne by overseas reserves, interest rates and liquidity movements can now be shared also by exchange rate movements.

However, the Reserve Bank continues to have a role in the foreign exchange market. As the Government's banker, it is active in the market on a day-by-day basis to satisfy the Government's need for foreign exchange to meet its current payments. These transactions are undertaken purely on a commercial basis within the general constraint that the market should not be unduly influenced by them. The Bank may also, from time to time, enter the market in order to monitor trends and to conduct market testing. Moreover, the Bank retains the right to intervene by selling or buying foreign exchange to counter disorderly market conditions. It is expected that this latter right will be exercised by the Bank only rarely and with reluctance.

Monetary Conditions and Policy¹

Introduction

The 1984/85 year was a particularly turbulent one for the financial sector. There were major changes to the environment in which financial institutions operate, including the removal of a wide range of controls and a switch towards the use of more market-based intervention. 1984/85 was also characterised by substantial fluctuations in liquidity levels and considerable variability in monetary and credit conditions. The year encompassed the pre-election drain on overseas reserves and domestic liquidity, the subsequent devaluation of the New Zealand dollar and rapid foreign exchange inflow, further large capital outflows in late February and early March, and the very tight post-float liquidity situation. Interest rates as a consequence have shown dramatic variability over the year.

¹ All quarterly and monthly percentage changes are based on seasonally adjusted data.

Changing Policy Approaches

The new Government's commitment to a medium-term, broad-based approach to macroeconomic management involves the linking of monetary, fiscal and exchange rate policies, together with other policies for structural change, within an integrated package. A firm monetary policy is seen as an essential prerequisite for lower, more stable interest rates and inflation rates over the medium-term. It is also a complement to a range of other macroeconomic policies introduced or under consideration.

Implementation of the new approach commenced immediately when the interest rate controls which were imposed during the freeze by the previous Government were abolished on the day of the devaluation, in order to support the resolution of the foreign exchange crisis. From that point on, monetary policy underwent a major shift in emphasis and direction and there followed a series of policy initiatives which culminated with the float of the New Zealand dollar on 4 March 1985. Essentially there were two main thrusts to the Government's monetary policy decisions. The first was to move towards re-establishing monetary control — an essential component of any medium-term strategy to attain an acceptable and sustainable level of price stability; and the second was to ensure that financial markets operate competitively and as efficiently as possible. A monetary policy which operates as neutrally as possible with respect to different institutions and different markets was seen as the most appropriate way to achieve this.

The policy package which progressively emerged therefore had two inter-related aims, which are discussed in succession: first, the implementation of a market-based approach to monetary control, reflected particularly in the resumption of an active public debt sales programme in July, but also in the introduction of new liquidity management arrangements, and in exchange rate policy; and secondly, a process of comprehensive deregulation of the financial sector — taking it, in short order, from among the most regulated of the OECD countries to probably the least regulated.

Monetary Conditions

Liquidity conditions were relatively easy in the early weeks of 1984/85, but the latter part of the June quarter saw a sharp tightening. The settlement of \$600 million of government stock purchased in the May tender, meant that by the end of May the level of primary liquidity² had fallen markedly. After a brief respite, the weeks following the announcement of the general election saw heavy purchases of foreign exchange, reflecting the strong expectation of a devaluation. Given the tight controls on interest rates, the liquidity drains were not fully reflected in short-term money market rates, which rose quickly across the board to the maximum permitted rate of 17 per cent by late June.

Growth in institutional lending to the private sector strengthened over the June quarter, reflecting the influence of several factors including the rise in real activity and the broad spectrum of controls on lending in-

terest rates. In addition, the heavy purchases of foreign exchange in the period leading up to the election were funded in part from drawings on unutilised credit lines. These factors together contributed to a large rise of 5.2 per cent in private sector credit over the June quarter, compared with growth of 2.4 per cent in the March quarter. In the year to June, private sector credit grew by 20.0 per cent, and M3, the broadly defined money supply, by 15.4 per cent.

On 18 July, when the 20 per cent devaluation of the New Zealand dollar and the removal of most interest rate controls were announced, the Government also indicated its intention to accompany these moves with an appropriate public debt sales programme. In the event, the need to adopt a strong public debt sales stance became immediately apparent as the strong inflow of foreign exchange over the second half of July led to a rapid build-up in liquidity. A significant easing of short-term interest rates occurred. Long-term rates (and, to some extent, retail rates), on the other hand, began to climb sharply from the artificially low levels experienced under the previous environment of comprehensive controls on interest rates. The yield curve for interest rates underwent a major transformation and, by and large, the medium and longer-term yield curve was downward sloping over the latter half of the year.

The Government's adoption of an active public debt sales policy (five tenders were held in the three months following the election) contributed to the re-emergence of tight liquidity conditions by the end of September and short-term interest rates rose once more. The rate of growth of the money supply (M3) over the September quarter reflected the reversal of the pre-election foreign exchange outflows, with a quarterly growth rate of 6.3 per cent compared with 3.3 per cent in the previous quarter. The strong growth in lending recorded in the latter part of the June quarter was moderated during the September quarter, with only small increases in lending being recorded by the trading banks and trustee banks, in particular.

The sharp upward pressure on domestic interest rates at the end of the September quarter coincided with the relaxation in the Reserve Bank's stance regarding overseas investment in domestic money markets, and the result was a substantial capital inflow over much of the December quarter. There is some evidence that, over the quarter, the removal of interest rate controls and the reduced restrictions on capital movements led to a degree of stability in both liquidity conditions and short-term interest rates, largely as a result of the apparent responsiveness of private capital flows to movements in domestic interest rates. Primary liquidity fluctuated around the \$1 billion level over this period, while short-term money market interest rates generally remained within a band of 12–16 per cent. The annual growth rates of M3 were largely unchanged over the quarter, rising from 17.7 per cent in September to 18.5 per cent in December, although in seasonally adjusted terms M3 growth slowed significantly from November 1984 onwards. Lending to the private sector by the M3 institutions continued at a relatively strong pace however.

Liquidity conditions began to tighten once again from mid-January, partly reflecting the effect of the on-going debt sales programme through the stock tenders, but also as a result of a renewed private capital outflow. An apparent turnaround in investor expectations regarding the short-term prospects for the New Zealand dollar

2 Primary liquidity represents the level of liquid reserves readily available to the private sector for settlement of transactions with the Reserve Bank. The current operating definition includes trading bank deposits at the Reserve Bank and private holdings of Treasury bills and government stock with less than six months to maturity.

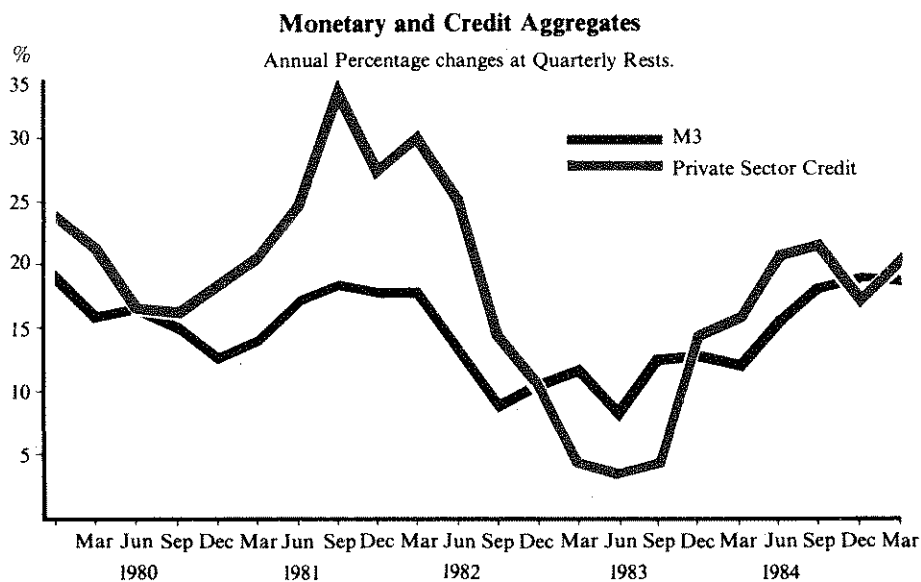
Monetary and Credit Aggregates

	M1 (Narrow Money Supply)			M3 (Broad Money Supply)			Private Sector Credit ¹		
	\$m	Annual % Change	Quarterly ² % Change	\$m	Annual % Change	Quarterly ² % Change	\$m	Annual % Change	Quarterly ² % Change
<i>1982</i>									
Mar.	2,878	17.4	6.3	14,403	16.8	3.5	10,344	30.0	4.5
Jun.	2,906	9.7	0.9	15,025	12.9	2.8	10,327	24.8	5.2
Sept.	2,643	3.0	-2.8	14,984	9.0	0.6	10,654	14.1	1.6
Dec.	3,030	5.9	1.6	16,004	10.8	3.5	10,407	10.5	-0.8
<i>1983</i>									
Mar.	3,002	4.3	4.4	16,107	11.8	4.3	10,757	4.0	1.2
Jun.	2,940	1.2	-1.7	16,261	8.2	-0.2	10,663	3.3	1.2
Sept.	2,955	11.8	7.5	16,826	12.3	4.3	11,094	4.1	2.5
Dec.	3,480	14.8	4.0	17,985	12.4	3.5	11,861	14.0	8.8
<i>1984</i>									
Mar.	3,251	8.3	-1.7	18,001	11.8	3.6	12,416	15.4	2.4
Jun.	3,267	11.1	1.3	18,770	15.4	3.3	12,795	20.0	5.2
Sept.	3,140	6.2	2.7	19,804	17.7	6.3	13,406	20.8	3.2
Dec.	3,866	11.1	8.4	21,306	18.5	4.1	13,811	16.4	4.9
<i>1985</i>									
Mar.	3,338	2.7	-9.0	20,761	15.3	0.8	14,938	20.3	5.6

1 Includes holdings of local authority securities.

2 Seasonally adjusted. Private sector credit figures also adjusted in March 1982 for interest debits.

Source: Reserve Bank.



culminated in late February and early March in a further sharp contraction in domestic liquidity, with primary liquidity falling to a very low level in early March. As a result of this tightening, short-term interest rates firmed steadily over February, with sharp rises recorded in late February and early March. Overnight rates of several hundred per cent were reported in the days following the floating of the exchange rate on 4 March, while 90-day rates reached 30–35 per cent.

In response to the tight liquidity situation in the days following the float, the Reserve Bank injected cash into the system by purchasing substantial amounts of short-term commercial bills and TCDs. In addition, the Government cancelled the stock tender which was to have been held in late March. These moves led to a steady improvement in liquidity and a sharp decline in short-term interest rates. Primary liquidity fluctuated around the \$1 billion level over the latter part of March and money market interest rates continued to ease, although rates generally remained higher than those experienced prior to the float.

Monetary growth continued to slow during the March quarter, but credit growth accelerated in spite of the rise in nominal interest rates. Although M3 grew by an estimated 15.3 per cent in the year to March, most of that growth occurred in the early part of the year. Between October and March, M3 had been growing at an annual rate of about 7 per cent. In contrast, private sector credit grew at an average annual rate of about 25 per cent over that period. Of the main private sector institutions, the trading banks' lending growth was the most rapid, being far in excess of deposit growth over the March quarter.

One factor behind the rapid growth of lending by the trading banks was overdraft financing associated with the large foreign exchange outflow. Another factor may have been sluggish adjustment in lending interest rates in relation to the sharp rise in wholesale deposit rates. In general, the lending growth rates of most other major institutional groups appear to have slowed over the March quarter.

Some caution is required when interpreting recent movements in the monetary aggregates. The general move away from regulation is likely to enable the central institutional groups to boost their share of business as 'reintermediation' occurs. Since many of these groups are included in M3, the growth in these institutions' share of total business will be reflected in faster growth rates of the present money and credit aggregates. This, however, will not necessarily indicate an easing in monetary conditions.

In addition, the narrow monetary aggregate, M1, is becoming less meaningful as an indicator of transactions balances and its growth rate is fluctuating sharply. M1 measures movements in cash and cheque account balances only and therefore does not cover the growth in interest-bearing call and short-term deposits which have taken on increasing importance with the deregulation and increased sophistication of the financial sector.

Public Debt Sales Policy

Since July 1984, wholesale debt sales through the government stock tender programme have represented the main instrument for achieving the Government's medium-term monetary objectives.

For the 1984/85 year as a whole, the debt sales pro-

gramme was sufficiently successful that the net public sector injection to primary liquidity after debt sales was only around \$350 million —but, in the last nine months of the year, debt sales exceeded the injections by \$366 million, as the new Government sought to regain control over liquidity conditions.

In March 1985, the Government announced the broad details of its debt sales programme for the 1985/86 year. It stated that the intention was to broadly offset the net public sector injection to liquidity. In line with this objective, it was estimated that on the basis of the initial forecasts some \$2,700 million (gross) of debt would need to be raised domestically during 1985/86. Approximately \$700 million of this was intended to be raised in the three tenders scheduled for the June quarter. This announcement was intended to provide a guideline to the market of the stance of monetary policy over the coming year, i.e. the intention to fully fund the net public sector injection.

In addition to the sale of public debt by tender through the wholesale market, specialised debt instruments are also made available directly to the retail market. In the last year, however, a reduced role has been accorded to retail instruments particularly since the new series of Kiwi Savings Stock was launched in December 1984. It is envisaged that retail stocks will continue to be sold at rates somewhat below tender rates to reflect the higher costs involved, so that the Government will maintain a steady but moderate presence in the retail market.

Liquidity Management Policy

On 21 December 1984, details were announced of a new liquidity management package which was intended to complement the medium-term monetary policy stance. Prior to this, various policy actions had been taken by the Government in transitional moves toward the implementation of the new package:

- from 24 July 1984, the margins over selling yields applied by the Reserve Bank in setting discount rates for government securities were doubled — from ½ per cent for securities with less than six months to maturity, and ¾ per cent for securities with a year or more to maturity, to 1 per cent and 1½ per cent respectively. This move effectively made it more expensive for institutions to monetise their holdings of government securities;
- on 15 August 1984, it was announced that the Reserve Bank was to commence dealing on a regular but discretionary basis in the government securities secondary market — a move designed to allow the Bank to have greater influence over liquidity conditions on a day-to-day basis. In addition, the Reserve Bank's discount window was opened to all parties, as was access to the Bank's portfolio of short-term government securities (these facilities had in the immediate past been available to the trading banks only);
- on 6 September 1984, the 'tap' issue of 182-day Treasury bills was closed. The tap issue of 91-day bills remained open;
- on 19 October 1984, new yields for Treasury bills were announced. For 91-day bills, the yield was increased from 7.8 per cent to 13.5 per cent, while 182-day bills were reintroduced to yield 14 per cent (previously 7.9 per cent).

The package announced in December included the following elements:

- the removal of automatic access to the Reserve Bank's discount window for government securities with more than six months to maturity;
- the intention that the Reserve Bank would be more active in its open market operations to smooth out short-term liquidity fluctuations;
- the decision to move to a tender (auction) system for issuing Treasury bills, with the first tender being held on 29 January 1985;
- the payment of interest by the Reserve Bank on trading bank settlement account balances as from 1 January 1985, at an initial rate of 5 per cent;
- the abolition of the compensatory deposits scheme (whereby the Reserve Bank made short-term deposits with the trading banks during major tax-flow periods) after March 1985.

The main advantage seen in shifting to a tender system for Treasury bills is similar to that for the sale of government stock: it allows the Government to determine the quantity of bills it wishes to sell on the basis of short-term financing requirements and expected liquidity developments, and the desired quantity can then be sold at minimum cost through a competitive tender.

Financial Sector Deregulation

The removal of the interest rate controls imposed during the freeze was among the first acts of the new Government. In succeeding months, a whole range of other, generally long-standing, direct controls on the financial sector were examined and, virtually without exception, abolished. These controls had a mixed origin, but were probably seen to have both a macroeconomic (monetary control) function and a structural function. The Government agreed with the Bank's view that they were generally ineffective in maintaining monetary control, and positively harmful in structural terms, through limiting competition, arbitrarily discriminating bet-

ween different institutions and different types of activities, and thus preventing the free flow of resources to the areas of most efficient use.

Accordingly, two long-standing controls on interest rates which prevented trading banks from paying interest on deposits for less than 30 days, and which restricted the savings banks to paying not more than 3 per cent on ordinary savings accounts, were abolished. Both the 1 per cent per month credit growth guideline, and the older 'qualitative' guidelines for trading bank lending were also removed as was Reserve Bank approval of (and last resort loan support for) the four companies operating in the official short-term money market. The most important step, however, was abolition of all compulsory ratios on financial institutions, including the trading banks' reserve asset ratio, public sector security ratios for a wide range of institutions, and the housing/farming investment ratios which had applied specifically to the life insurance companies and pension funds.

Prudential Supervision

The changes in the financial system which will follow from deregulation, technological change and increased international influences have heightened the need for effective prudential oversight and the Bank is currently moving to strengthen its arrangements in this area.

The continued stability of the financial system as a whole is the prime objective of prudential supervision, given the underpinning that this system provides for most forms of transactions both domestically and internationally, and given its function as a repository for savings. It is important, however, that normal market disciplines on institutions' management, shareholders and creditors are not diluted. Therefore, while there will be closer monitoring of institutions by the Bank, this will need to go hand in hand with adequate public disclosure by the institutions so that investors have the opportunity to be well informed about the risks and returns attaching to the range of investment alternatives.