Reserve Bank Bulletin

QUARTERLY REVIEW OF MONETARY CONDITIONS[1]

The main indicators of monetary conditions showed a marked slowdown in the growth of the money supply during the March quarter of 1985. However, lending to the private sector continued to grow rapidly over this period. The future control of liquidity should be enhanced by a number of major policy developments which were announced in the quarter. As a result there should be some slowing in the growth in lending over the following quarter.

Introduction

The March quarter was characterised by a steady tightening in domestic liquidity conditions over January and February, culminating in a short period of extreme tightness following the floating of the New Zealand dollar on 4 March. These conditions resulted in unprecedented money market interest rates during March. In addition to the move to a floating exchange rate, other policy developments during the quarter included the introduction of Treasury bill tendering as from 29 January, the abolition of all compulsory ratios on financial institutions with effect from 11 February[2], and the announcement of the Government stock tender programme for 1985/86. This article examines these developments, beginning with a review of liquidity conditions.

Liquidity Conditions

The March quarter began with liquidity at relatively satisfactory levels. The Reserve Bank's working definition of primary liquidity[3] stood at around $1,200 million in early January, compared with averages of $1,000 million and $1,200 million during November and December respectively. However, liquidity began to tighten in January due to a turnaround in the private capital account. There was a net outflow of about $270 million which followed the strong inflows of $470 million and $530 million recorded in November and December respectively. This turnaround appeared to reflect market expectations that the New Zealand dollar was likely to weaken in the short term, and contrasted with the strong expectations of a revaluation in the December quarter. The capital outflow was an important factor behind primary liquidity falling by around $450 million over January. Other factors were Government stock tender settlements of $330 million and an OET current account deficit of $120 million. The tightening of liquidity over January was reflected in higher short-term money market rates, with the 90-day commercial bill rate increasing from around 15 per cent in mid-January to 19 per cent by the end of the month.

The 16th Government stock tender, held on 17 January, sought $400 million. It was consistent with the

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

2 This move was discussed in detail in an article in the April *Bulletin*.

3 Trading bank demand deposits at the Reserve Bank and private sector holdings of government securities with less than six months to maturity. See discussion in the article entitled Liquidity Management Policy in the May 1985 *Bulletin* for more details.

previously announced debt sales programme of $1,600 million in the four tenders scheduled to be held between December 1984 and March 1985. Bids received totalled over $1,300 million and yields were generally up on those received in the previous tender, particularly for the shorter dated stocks.

The fiscal deficit for February amounted to $224 million but this injection was more than offset by a combined current and private capital account outflow of $280 million, and Government stock tender settlements of $320 million. As a result liquidity conditions tightened further in February, particularly over the last week. Primary liquidity averaged $930 million for the month but had fallen to around $640 million at the end of February compared with around $730 million at the end of January. In response to these trends, money market interest rates rose gradually throughout the month before jumping quite sharply in the last week. Wholesale 30 and 90-day rates reached 30 and 26 per cent respectively on 28 February, compared with rates of 19 and 20 per cent one week earlier.

Government stock tender number 17, held on 14 February, offered $400 million of stock. Bids received totalled $1,040 million with the average yields on successful bids showing a further significant increase, compared to Tender 16, of between 0.2-0.4 per cent over all maturities.

On 2 March the Minister of Finance announced that the Reserve Bank would cease to set the New Zealand dollar exchange rate as from 4 March 1985. The Reserve Bank's foreign exchange market activities would in future be limited primarily to purchases of foreign currency required to fund the Government's current account deficit. Liquidity conditions tightened further immediately following the float, as a result of the settlement of foreign exchange contracts entered into on 28 February and 1 March. Net purchases of foreign exchange from the Reserve Bank over the first three working days of March totalled over $450 million and, as a result, primary liquidity fell to around $360 million by 5 March. Money market rates rose sharply in response, but with the Reserve Bank's foreign exchange window now closed to the market, the high interest rates did not induce a net foreign exchange inflow to relieve the liquidity shortage. Overnight rates of several hundred per cent were reported, while 30 and 90 day rates reached levels of 40 and 35 per cent respectively by 8 March (see figure 1).

The Reserve Bank injected substantial amounts of liquidity into the system through purchases of short-dated private paper in order to relieve the tight conditions. Close to $300 million was injected over the week ended 8 March, with a further $600 million over 11-13 March. However, short-term rates fell only slowly due to concerns in the market over forthcoming drains from the system associated with the March tax collection period and the next Government stock tender scheduled for 21 March.

TABLE 1
NEW ZEALAND GOVERNMENT STOCK SALES BY TENDER

Tender number	*Date held*	*Stock offered*	*Maturity date*	*Total amount offered $m*	*Total bids submitted $m*	*Over-subscriptions accepted $m* [1]	*Total successful bids $m*	*Allotment Yield % p.a.* [2]
8.	7/6/84	N.Z. Govt. Stock	15.04.86	50.0	2.9		0.2	10.00
		Index Linked	15.09.87	100.0	35.0		11.4	5.00
			15.09.93	100.0	117.3		72.0	5.00
9.	27/7/84	N.Z. Govt. Stock	15.06.87	100.0	78.7		68.7	15.00
			15.06.90	100.0	78.2	57.6	15.6	15.50
		Index Linked	15.12.87	150.0	158.0		139.8	5.00
			15.12.91	150.0	212.4	30.0	180.0	5.00
10.	16/8/84	N.Z. Govt. Stock	15.06.86	150.0	157.9		123.9	15.50
			15.11.92	50.0	220.7	7.8	57.8	15.25
		Index Linked	15.06.89	100.0	92.7		73.7	6.00
			15.06.92	100.0	133.2	20.0	120.0	6.00
11.	30/8/84	N.Z. Govt. Stock	15.05.90	100.0	155.6		100.0	15.49
			15.05.94	100.0	226.0		100.0	15.25
		Index Linked	15.06.88	50.0	64.6		50.0	6.00
12.	20/9/84	N.Z. Govt. Stock	15.09.86	80.0	94.0		75.0	15.97
			15.05.90	60.0	138.2		60.0	15.60
			15.05.94	60.0	187.1	5.0	65.0	15.45
13.	18/10/84	N.Z. Govt. Stock	15.10.90	100.0	238.2		100.0	17.40
			15.10.94	100.0	211.6		100.0	16.96
14.	15/11/84	N.Z. Govt. Stock	15.11.87	100.0	259.0		100.0	17.36
			15.05.90	150.0	489.3		150.0	17.05
			15.05.92	150.0	550.1		150.0	16.95
15.	13/12/84	N.Z. Govt. Stock	15.11.87	150.0	383.4		150.0	17.31
			15.05.90	200.0	530.2		200.0	17.04
			15.10.94	150.0	485.2		150.0	16.85
16.	17/1/85	N.Z. Govt. Stock	15.03.87	150.0	385.3		150.0	17.91
			15.03.90	150.0	471.1		150.0	17.46
			15.10.94	100.0	460.5		100.0	17.09
17.	14/2/85	N.Z. Govt. Stock	15.12.88	100.0	260.8		100.0	18.38
			15.03.90	150.0	424.2		150.0	17.76
			15.10.94	150.0	354.7		150.0	17.35
18.	18/4/85	N.Z. Govt. Stock	15.10.90	150.0	292.8		150.0	18.99
			15.04.95	100.0	188.5		100.0	17.95

Note:

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

[2] The figures for tender 12 and following are the weighted average yield under the yield bid system. In tenders 7-11 stock was allotted on a uniform yield basis.

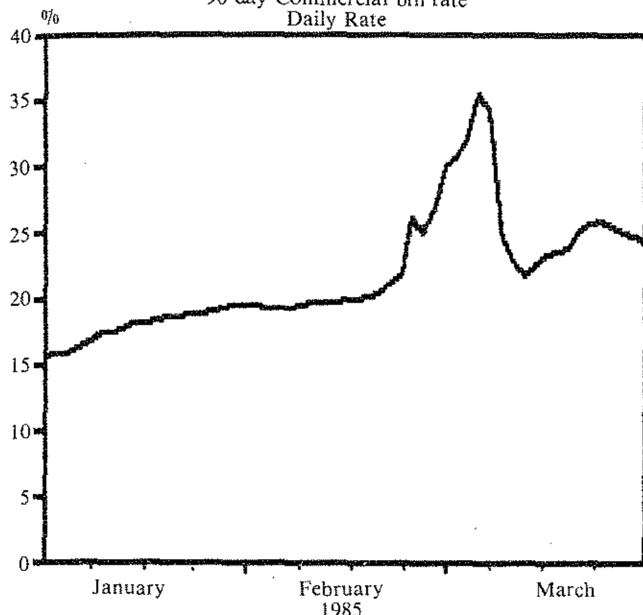


Figure 1
INTEREST RATES
90 day Commercial bill rate
Daily Rate

To help ease these concerns, the Reserve Bank announced on 12 March;

— that the interest rates charged on Compensatory Deposits placed with trading banks over the March tax drain period would be set at 19.5 per cent, rather than in relation to average 60 day commercial bill rates over the period as had been previously announced; and

— that the stock tender scheduled for March would not be held.

The former change was undertaken in recognition of the highly unusual liquidity situation in early March. It avoided locking-in extremely high short term interest rates over the period until compensatory deposits were repaid. The cancellation of the March Government stock tender reflected the fact that a tender was no longer necessary for monetary control purposes following the sharp tightening in liquidity in late February and early March.

The combined effect of these actions was to return a greater degree of confidence to the market. Call rates dropped markedly from over 100 per cent to around 35 per cent by 13 March, while the 90 day commercial bill rate fell to 23 per cent from around 35 per cent two days earlier. By the middle of March, liquidity conditions had eased, with primary liquidity fluctuating around the $1,000 million mark. Over the latter part of the month, short-term money market rates continued to gradually fall as the market adjusted to the new operating environment.

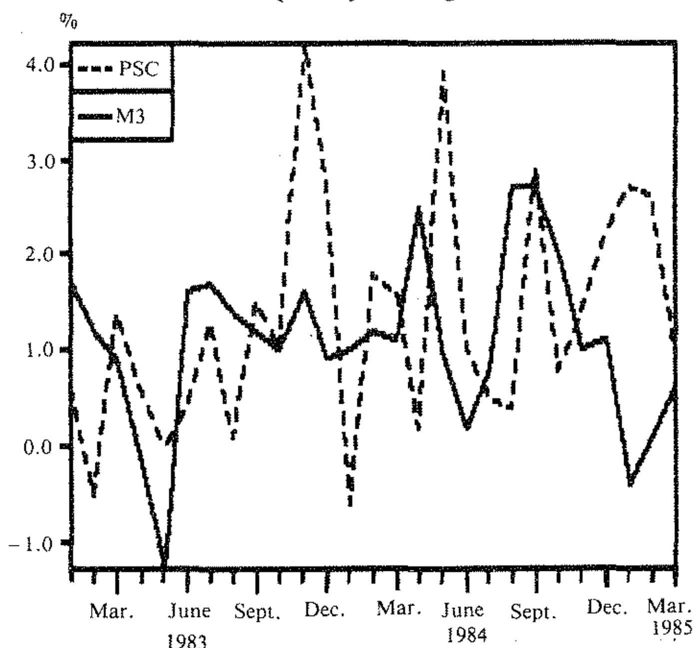
Monetary and Credit Aggregates

Estimates of the monetary aggregates for the March quarter indicate a significant slowing in monetary growth rates but also a continuation of the wide disparity between growth in the narrow and broad money aggregates. In contrast, lending to the private sector by M3 institutions grew strongly during the March quarter.

The broad monetary aggregate, M3, is estimated to have declined by 0.4 per cent in January followed by increases of 0.1 per cent in February and 0.6 per cent in March. This compares favourably with the average growth rate during the December quarter of 1.4 per cent. Over the March 1985 year, M3 expanded by 15 per cent, down from 18.5 per cent for the year ended December 1984. The lower rate of monetary growth in the March quarter resulted from two main factors: firstly, the Government's firm monetary policy stance as reflected in an aggressive stock tender programme; and secondly the turnaround in foreign exchange flows during the quarter.

The narrow monetary aggregate, M1, grew by only 2.5 per cent over the year ended March 1985. However, M1 is becoming increasingly less meaningful as an indicator of monetary conditions. First, technological developments in the financial sector, such as the growing use of credit cards, electronic funds transfer, the introduction of ATMs and telephone access to interest-bearing call accounts, have served to reduce the need to hold cash balances or cheque account deposits. Secondly, financial sector deregulation, and in particular the removal of restrictions on banks offering interest on short-term deposits, have increased competition for short-term savings or transactions balances; interest bearing call and short-term deposits are excluded from M1.

Figure 2
Seasonally Adjusted M3 and PSC
Quarterly % Change



Lending to the private sector by M3 institutions grew strongly during the March quarter, despite rising nominal interest rates. Private sector credit is estimated to have grown by 2.7 per cent, 2.6 per cent and 0.9 per cent in January, February and March respectively, compared with an average of 1.5 per cent for the December 1984 quarter and 1.3 per cent for the September quarter. The annual growth rate for the year ended March 1985 was 21.1 per cent, up from 17 per cent in the year to December 1984.

TABLE 2
LENDING GROWTH[1]
(in percent)

	Nov.	*Dec.*	*Jan.*	*Feb.*	*Mar.*
Trading Banks[2]					
— Monthly	− 1.6	+ 2.4	+ 4.9	+ 3.3	+ 4.4
— Annual	+ 18.7	+ 16.9	+ 23.1	+ 23.2	+ 27.5
Finance Coys					
— Monthly	+ 2.3	+ 2.2	+ 1.4	+ 1.6	+ 2.2
— Annual	+ 24.0	+ 22.2	+ 22.6	+ 21.6	+ 22.3
Trustee Savings Banks					
— Monthly	+ 1.3	+ 1.1	+ 1.3	+ 0.9	+ 1.1
— Annual	+ 13.5	+ 14.0	+ 13.7	+ 13.2	+ 13.2
Private Savings Banks					
— Monthly	− 0.4	− 1.0	− 1.4	− 1.3	− 1.2
	− 9.4	− 9.3	− 10.0	− 10.0	− 10.5
POSB					
— Monthly	+ 2.7	+ 1.8	+ 3.9 (P)	+ 2.1 (P)	+ 3.0 (P)
— Annual	+ 67.1	+ 62.0	+ 61.4 (P)	+ 57.1 (P)	+ 51.8 (P)

[1] Monthly figures are seasonally adjusted, except for building societies whose lending display no stable seasonal pattern.
[2] Monthly averages.
[3] March lending statistics for building societies are not directly comparable with those for other months.
(P) Provisional.

Trading bank lending growth accounted for a large part of the growth in PSC over the March quarter (see table 2). One factor behind this may have been overdraft financing associated with the large pre-float foreign exchange outflow. Average trading bank lending in March was 16 per cent higher than in December, with roughly 70 per cent of the increase coming from overdraft lending and discounts. This category of bank lending peaked in the week ended 6 March, coinciding with the timing of the float, and then fell over the remainder of March by approximately 5 per cent.

Trading bank term lending also grew strongly over the March quarter by approximately 10 per cent. This suggests that factors unrelated to the float, such as continued buoyancy in economic activity and the financing requirements associated with higher stock levels, also contributed to the rapid growth in bank lending. A further factor may have been the sluggish adjustment of lending interest rates, creating the potential for bank customers to take advantage of higher deposit rates by drawing down on existing low cost credit lines. The tax deductibility of interest rates for commercial borrowers may also have contributed to the seemingly slow impact of higher nominal interest rates on the demand for credit.

With the exception of the POSB, the lending growth rates of the other major M3 institutions appear to have slowed somewhat over the March quarter, though for the finance companies this has been from a very high base level. The POSB is in a special situation in that it has taken over some mortgage lending business from the Housing Corporation.

A degree of caution is required when interpreting the growth of the monetary and credit aggregates. An upsurge in activity in the inter-institutional market during the March quarter, which is not fully reflected in official statistics, means that the growth rates of some of the major aggregates may be overstated. This was particularly important during the period immediately following the float when the tight liquidity situation which prevailed caused inter-institutional deposits and lending to increase.

Treasury Bill Tenders

The method of issuing Treasury bills was changed during the March quarter from the previous tap issue method to a system of weekly tenders. This change was part of a package of liquidity management policy measures announced on 21 December 1984 and is discussed in more detail in an article in the May *Bulletin*.

The primary role of liquidity management policy is to moderate instability in the short-term money markets while maintaining conditions consistent with the medium-term stance of monetary policy. Treasury bill tender amounts are determined each week largely on the basis of expected liquidity flows over the forthcoming week. However, an attempt is made to maintain a minimum flow of bills into the market provided that this does not imply excessive pressure on short-term interest rates.

The first Treasury bill tender, held on 29 January, offered $80 million of 42 day bills and $20 million of 91 day bills. The tender was fully subscribed with the over-subscription facility being applied to accept more of the shorter dated bills in preference to the 91 day bills. The weighted average yield accepted on 42 day bills was 17.02 per cent. However, bids received at the second bill tender on 5 February for $100 million of 42 day bills, ranged from 17.8 to 19.83 per cent, substantially higher than those received in the previous tender. This suggested that the market was basing its bids on current liquidity conditions, which had been tight, rather than on expected flows which, in the Bank's view, suggested that liquidity conditions would ease over the week ahead. As a result, all bids at the tender were rejected. In the event liquidity did ease as the week progressed, and the Bank was subsequently able to sell bills out of its portfolio at lower rates than had been bid in the tender.

The third Treasury bill tender, held on 12 February, offered $120 million of 42 day bills and was fully allotted. However, the subsequent liquidity drain over the second half of February and early March meant that there was a significant period with little demand for new

TABLE 3
TREASURY BILL SALES BY TENDER DURING MARCH 1985 QUARTER

Tender Number	Date Held	Term to Maturity (days)	Total Amount Offered[1] ($m)	Total bids submitted ($m)	Total successful bids ($m)	Allotment yield (% p.a.)
1.	29.1.85	42	80	147.2	99.95	17.02
		91	20	47.55	0.05	8.0
2	5.2.85	42	100	206.9	—	—
3	12.2.85	42	120	174.05	120.0	17.0
4	19.2.85	—	—	—	—	—
5	26.2.85	—	—	—	—	—
6	5.3.85	—	—	—	—	—
7	12.3.85	—	—	—	—	—
8	19.3.85	—	—	—	—	—
9	26.3.85	28	50	105.5	50.0	18.98
		63	20	67.5	20.0	18.98

[1] Subject to a 50 percent over-subscription facility.

issue bills. As a result, no bills were offered in tender numbers 4 to 8. The initial build-up in liquidity following the post-float shortage was accommodated by selling bills out of Reserve Bank portfolio, and Treasury bill tenders did not resume until tender number 9, on 26 March, with an offering of $50 million of 28 day bills and $20 million of 63 day bills.

Retail Debt Policy

Redemptions of retail debt instruments exceeded new subscriptions during the March quarter by $223 million, more than double the net redemptions recorded during the previous quarter. This reflected the general rise in interest rate levels over the period, which made existing retail instruments less competitive.

On 27 February 1985 the third issue of Kiwi Savings Stock was closed, having raised a total of $64.4 million since it was introduced on 26 November 1984. It was replaced on 28 February by a fourth issue, which offered 17 per cent per annum for two year and four year stocks, as compared with the 16 and 15.5 per cent offered respectively in the third issue. The fourth issue cannot be redeemed prior to 15 January 1986 and offers a lower interest rate of 10 per cent if redeemed prior to maturity. Subscriptions of KSS IV during March totalled $22 million.

The rate of redemptions of existing retail debt instruments rose sharply during the March quarter to $269 million, some 40 per cent higher than for the December quarter. Redemptions totalled a relatively low $34 million in January, but then jumped to $93 million in February, and $142 million in March. The bulk of this increase reflected redemptions of KSS I and II, and it was noticeable that redemptions of Inflation Adjusted Savings Bonds fell during the March quarter to a low $11 million, continuing a downward trend which has been evident over the past year.

1985/86 Debt Programme

On 19 March 1985 the Minister of Finance, the Hon. R.O. Douglas, announced the Government's stock sales objectives for the year to March 1986. For a discussion of the role of and principles underlying the tender programme the reader is referred to the article 'Monetary Policy in New Zealand' in this issue.

Briefly, the objective of the stock tender programme for 1985/86 is to fully offset the expected liquidity injections into the economy arising from the fiscal deficit and from other public sector activity. Early forecasts of these influences suggested that about $2,700 million of debt would need to be raised domestically during 1985/86.

The considerable degree of uncertainty surrounding forecasts of the net public sector injection mean that the estimated government stock sales requirement is only tentative. In addition, adjustments to the debt sales programme may be made as the year progresses in light of developments in the various indicators such as the broader monetary and credit aggregates.

TABLE 4
SUBSCRIPTIONS AND REDEMPTIONS OF RETAIL DEBT INSTRUMENTS: COMPARISON OF DECEMBER 1984 AND MARCH 1985 QUARTERS

	December 1984			March 1985		
	Subscriptions ($m)	Redemptions ($m)	Net ($m)	Subscriptions ($m)	Redemptions ($m)	Net ($m)
Inflation Adjusted Bonds	+ 43.4	− 19.5	+ 23.9	...	− 10.8	− 10.8
Kiwi Savings Stock I	...	−111.3	−111.3	...	−203.5	−203.5
Kiwi Savings Stock II	...	− 36.3	− 36.3	...	− 12.9	− 12.9
Kiwi Savings Stock III	+ 40.5	...	+ 40.5	+ 23.9	...	+ 23.9
Kiwi Savings Stock IV	...	...	...	+ 22.0	...	+ 22.0
Our New Zealand Bonds	+ 10.7	− 0.4	+ 10.3	...	− 2.6	− 2.6
Other Savings Stock	...	− 27.0	− 27.0	...	− 39.4	− 39.4
Total	**+ 94.6**	**−194.5**	**− 99.9**	**+ 45.9**	**−269.2**	**−223.3**

The timing of debt sales should reflect the expected pattern of liquidity injections during the year. It is intended that the bulk of the tender programme will fall in the first three quarters of the fiscal year to allow for the absence of the Compensatory Deposit scheme next March. In addition, average tender sizes will be largest in the December quarter when strong liquidity injections are forecast.

Details of the Minister's announcement on the debt programme and background information from the Governor of the Reserve Bank were published on pages 179 and 180 of the April *Bulletin*.

Conclusion

The March 1985 quarter saw a continuation of the major monetary policy initiatives which have been undertaken by the Government since its election in July 1984. Most important of these were the floating of the New Zealand dollar from 4 March 1985 and the abolition of all compulsory ratios on private sector financial institutions from 11 February 1985. These developments are discussed in greater detail elsewhere in this and previous issues of the *Bulletin*.

The events of the quarter provided an important learning experience for the various participants in the financial sector in several respects. First, it appeared that the full implications of the Government's firm monetary policy stance were only beginning to become apparent to market participants towards the end of March, following the initial post-float experience of very tight domestic liquidity conditions. Prior to then, the rapid growth in private sector credit suggested that many financial institutions were still basing their lending decisions and forward commitments primarily on their current liquidity position and on the assumption that liquidity would subsequently be made available to fund this lending. This occurred regardless of Government warnings over the need to look beyond the immediate availability of funds for lending and to take greater heed of the stated objectives of monetary policy.

The experience in March is likely to have been costly for those financial institutions that increased lending in excess of the expansion in their deposit base over the preceding period. It would therefore be hoped that this experience will be reflected in more prudent policies being adopted by the financial sector in their lending activities over 1985/86.

The March quarter was also a significant period in the development of liquidity management policy. A tendering system for issuing Treasury bills was introduced in late January. Though this has operated relatively smoothly in a technical sense, there is considerable further progress yet to be made in developing an active Treasury bill market. This development has unfortunately been hindered by the sustained period of tightening liquidity that followed so soon after the introduction of the tender system, giving rise to a series of nil tenders over a period of several weeks.

Prior to the floating of the exchange rate, the other main instrument of liquidity management policy, Reserve Bank open market operations, were largely inoperative, as private capital flows provided a ready mechanism for satisfying liquidity demands. In the post-float environment, however, Reserve Bank market operations became the most important discretionary influence on day-to-day domestic liquidity conditions. This required a substantial learning process on the part of both the Bank and the market; a process that will continue for some time.