

REVIEW OF MONETARY CONDITIONS AND POLICY

This article, prepared by Keith Lloyd, reviews developments in the monetary indicators over the three month period to the end of August. Monetary conditions are assessed in the light of the recent fall in interest rates.

Executive Summary

After a year of relatively little progress in lowering interest rates, monetary conditions took a favourable turn over the second half of the review period. Interest rates declined sharply and the exchange rate firmed over the last two weeks of July and into August as both domestic and foreign investor confidence in New Zealand's economic prospects improved. Bond rates fell from a peak of 13.16 per cent in mid-July to around 11.85 per cent by the end of August while the exchange rate strengthened to around 62.0 on the Trade Weighted Index (TWI) from an average of 59.6 in the month prior to the Budget. The 90 day rate fell to a low of 12.75 per cent, although cash-distribution problems at the end of August saw the rate firm temporarily to over 13 per cent.

As the sustainability of the lower yield curve and lower funding costs became apparent, financial institutions responded by announcing reductions in retail lending rates in mid to late August. Average first mortgage interest rates were dropped to below 15 per cent for the first time since September 1984. Reductions in base lending rates have been somewhat slower to come, leaving a widening gap between the marginal cost of new wholesale funds and business lending rates.

Continued support for the exchange rate at the lower interest rate levels indicates that the falls have been sustainable and not inconsistent with the desired stance of monetary policy. The magnitude of the decline in bond rates relative to short rates, and the consequent widening of the yield gap, has been appropriate in the context of improved medium-term macroeconomic confidence and a change in some structural factors affecting the yield curve. In particular, the reaffirmation of the inflation targets in the Budget, increased certainty about the financial deficit, a perception of favourable real sector developments, and the resolution of the leadership issue within the Government have had a significant impact on investor confidence. The reduction in the supply of bonds which resulted from the Government's decision to repay domestic rather than foreign debt this year also suggests that the steeper, but lower, yield curve is appropriate in the current environment and is unlikely to fuel an inflationary pick-up in demand.

There are, however, still risks to the success of the disinflation process. In the immediate future these risks relate principally to high export prices and the impact of GST on settlements in the forthcoming wage round. The Bank has frequently stated that it will not accommodate the second-round effects of the rise in GST, such as compensation in wage settlements, nor will it tolerate any increase in the underlying rate of inflation as a result of widening margins on the back of higher commodity prices or the increase in GST. The Bank is firmly committed to achieving price stability by the end of 1992 and will continue to operate monetary policy in a manner which will achieve that objective.

The downward trend in interest rates resumed in late July and continued throughout most of August. After a sustained period of interest rate stickiness (extending over more than a year in the case of bonds), a number of factors combined to push both short and long-term rates to new five-year lows, despite the temporary uncertainties engendered by a change in Prime Minister during the period. The reduction in interest rates lowered the cost of funds to financial institutions and, as the sustainability of the lower yield curve became apparent, significant cuts were made in retail lending rates (particularly mortgage rates), which had been largely stalled since August 1988. Developments in the monetary indicators since mid-May are reviewed in the first half of this article while the latter half assesses the current stance of monetary policy in light of the recent reductions in interest rates.

Developments in Monetary Indicators

The highlight of the review period was clearly the falls in interest rates which commenced in late July. However, there were also noteworthy developments over the first eight weeks of the review period. In particular, in early June there was an

excessive tightening of short-term liquidity conditions due to cash distribution problems in the domestic money market; a tightening which prompted Reserve Bank action. Then in early July a premature easing in short interest rates prompted signals from the Bank which effected a moderate firming of conditions. Between mid-May and mid-July, bond yields traded in a narrow range

of 13.01 to 13.16 per cent (see figure 1), the exchange rate moved between 58.7 and 62.7 on the Bank's TWI (see figure 2), and the 90-day bank bill interest rate remained between 13.15 and 13.70 per cent. The yield gap between the 90-day bill rate and the 5-year government stock rate likewise fluctuated between 0.1 and 0.6 percentage points (see figure 3).

Figure 1
Interest Rates
government stock and bank bill rates

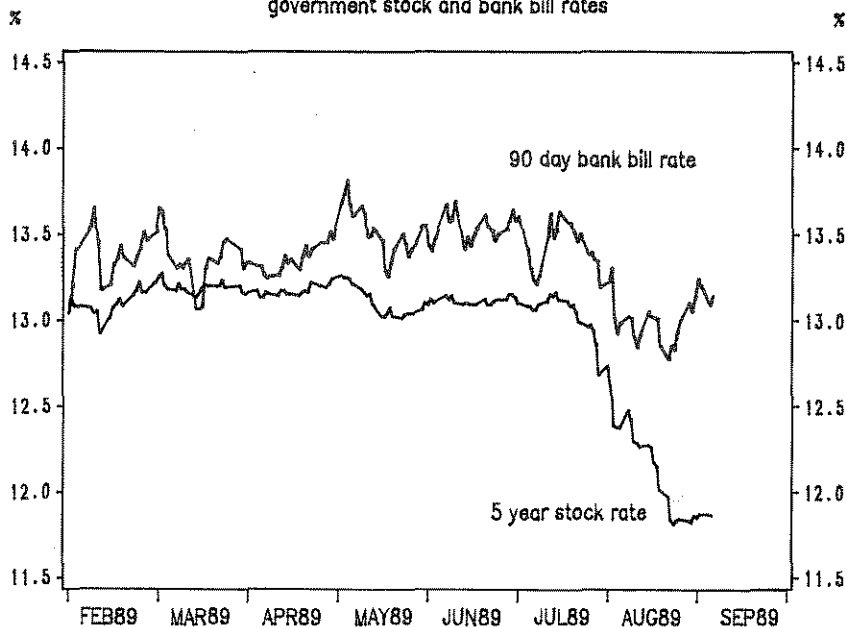
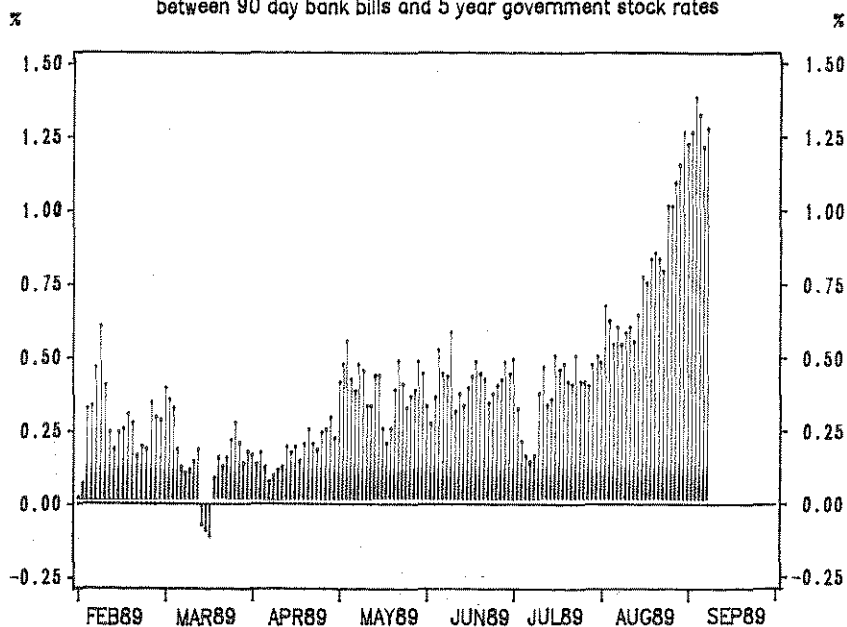


Figure 2
Yield Gap
between 90 day bank bills and 5 year government stock rates



From a peak of 62.9 on the index in mid-May, the exchange rate depreciated by 5 per cent to a low of 59.5 on 8 June amid volatile overseas trading in the US dollar and a fall in domestic short-term interest rates relative to overseas rates (following interest rate rises in both Australia and the United Kingdom). However, the fall in the exchange rate in early June coincided with tightening domestic liquidity conditions as cash distribution problems once again disrupted the market.

The distribution problems arose from one settlement institution cornering the cash market and undertaking a 'cash play'. As a result, the call rate rose to a peak of 14.7 per cent and the 90-day rate peaked at 13.7 per cent on 9 June. In response, the Bank announced that the daily cash target would be increased temporarily to \$50 million. The Bank's move, which was reversed after one day, was specifically designed to counter cash market manipulation of the sort which has persistently hindered the efficient operation of the market. The cash target change eased the distribution problems and led to an immediate fall in the call rate of around 1 percentage point. The Bank's move was a reflection of the gradual change in emphasis over the last year or so which has seen the Reserve Bank grow less tolerant of undue volatility in short-term interest rates and the exchange rate.

As the pressure came off the short end, the call rate traded lower over the following weeks and, at times, dipped under 10 per cent. The decline in call rates pulled the short end of the yield curve down and the 90-day rate fell to 13.15 per cent by early July – at that time its lowest level since March. With bond rates largely unchanged, the easier liquidity conditions narrowed the 90-day – 5-year yield gap to only 0.1 percentage points and reinforced the weakness in the exchange rate evident since early June.

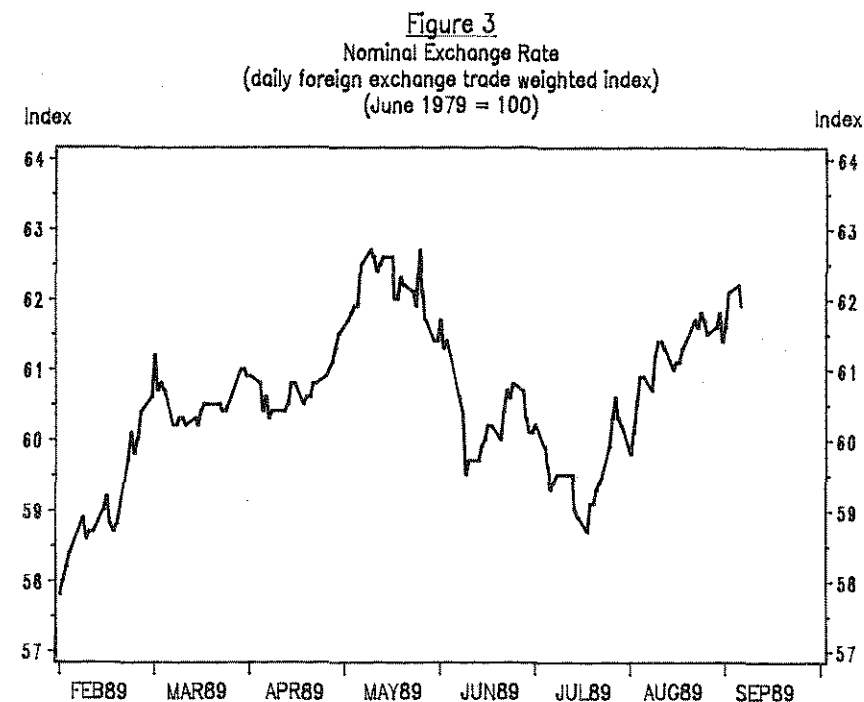
This easing in conditions coincided with the events following a meeting on 30 June between the Reserve Bank and representatives of

the interest rate lobby group. Following that meeting, a misinterpretation of a Reserve Bank statement led one bank to announce a reduction in its base rates and challenge other banks to join it. The Reserve Bank took the view, however, that the easing in short-term interest rates represented an inappropriate easing in monetary conditions. In particular, the exchange rate had been easing and, moreover, the stability of the long bond rates suggested that the reduction in short-term interest rates did not reflect reduced longer-term inflation expectations. The Bank gave a signal to this effect in its open market operation of 6 July and the 90-day rate subsequently rebounded to 13.6 per cent, widening the yield gap to around 0.5 points.

In summary, then, the first eight weeks of the review period saw a continuation of the pattern of monetary conditions evident from the early part of the year. Most indicators fluctuated within relatively narrow ranges and only relatively minor episodes of interest rate fluctuations disturbed the calm.

Over the last two weeks of July and into August, financial market conditions began to change markedly. Interest rates fell sharply and the exchange rate firmed, amidst a widespread improvement in investor confidence (both within New Zealand and overseas) in New Zealand's economic prospects and indications that key overseas interest rates may have peaked.

From a two-month peak of 13.16 per cent on 13 July, the combined impact of a favourable June quarter Consumer Price Index (CPI) outturn (1.2 per cent) and market expectations of a small financial deficit and some form of compulsory superannuation scheme in the Budget took the 5-year bond rate down to 12.84 per cent prior to the Budget. The delivery of the Budget on 27 July, with its projected 1989/90 financial deficit of 1 per cent of Gross Domestic Product (GDP) and a clearly stated recommitment to the price stability objective, appeared to



enhance confidence in the Government's commitment to responsible medium-term financial policies. This growing confidence, together with the projected large Table 2 surplus and the announcement of a zero net debt programme for the 1989/90 year (resulting from the decision not to reduce the level of overseas public debt this year), provided the trigger for a further fall in interest rates. Bond rates fell significantly over the following days although the fall was stalled by a dispute over the impact on New Zealand's credit rating of the debt repayment decision. The fall quickly recommenced following statements from the key international rating agencies that the change in the pattern of debt repayments was not of concern. By 4 August the 5-year bond rate had fallen to around 12.35 per cent. Neither the bond rate nor the other monetary indicators were substantially affected by the Prime Minister's resignation on 7 August and his subsequent replacement.

The bond market received an-

other boost in mid-August with the release of balance of payments statistics indicating, inter alia, a provisional annual current account surplus for the first time since December 1973. The yield on the new 2/95 stock traded down over the following two weeks to a low of just over 11.8 per cent and the yield on the previous 5-year benchmark stock (11/93) fell to around 11.9 per cent. Offshore interest in the domestic markets was strong throughout this period, increasing demand for bonds and contributing to the sharp rise in sharemarket indexes. Foreign investment in both markets has been partly responsible for the general strength in the exchange rate, which firmed over August to stabilise at just over 61.5 on the TWI, compared with 59.8 at the end of July.

The easing in bond rates was followed by a less-marked but nevertheless significant easing in 90 day rates. The New Zealand 90 day rate fell to its lowest recorded level since January 1984 of 12.75 per cent on 21 August, and the gap between for-

eign and domestic short-term rates continued to narrow (see figure 4). The significance of the declines is best illustrated by the fact that the 90 day rate has been lower in only four other months during the last decade. Temporary cash-distribution problems in the last week of August saw the 90 day rate subsequently firm briefly to around 13.25 per cent (still below the average experienced in recent months). As a consequence, the 90-day-5-year yield gap had widened to around 1.4 percentage points, the largest recorded since late 1988.

The fall in short-term interest rates allowed retail interest rate cuts towards the end of the review period, following a long period where there had been little adjustment in bank lending rates (see figure 5). Although some farm lending rates had been considerably lowered earlier in the review period, reflecting the improved state of the agricultural sector, there was a renewed upsurge of public dissatisfaction with high mortgage lending rates. However, following the reduction in the level of wholesale rates, financial institutions responded in mid to late-August by lowering their retail lending rates. First mortgage interest rates were dropped to below 15 per cent for the first time since September 1984; the lowest available rate is now 14.25 per cent. Announced cuts in base lending rates, however, have been somewhat less, leaving a widening gap between the marginal cost of new wholesale funds and business lending rates.

From mid-June, the Reserve Bank had generally been unsuccessful in selling at acceptable yields all the Reserve Bank bills put out for offer at the twice-weekly tenders. It was acknowledged at the time of the introduction of Reserve Bank bills last year that the level of Primary Liquidity (PL) would probably need to be adjusted from time to time to accommodate structural changes in the demand for PL. A number of factors have combined over recent months to reduce market demand

Figure 4
NZ 90 Day Rate vs Weighted Average of Foreign 90 Day Rates

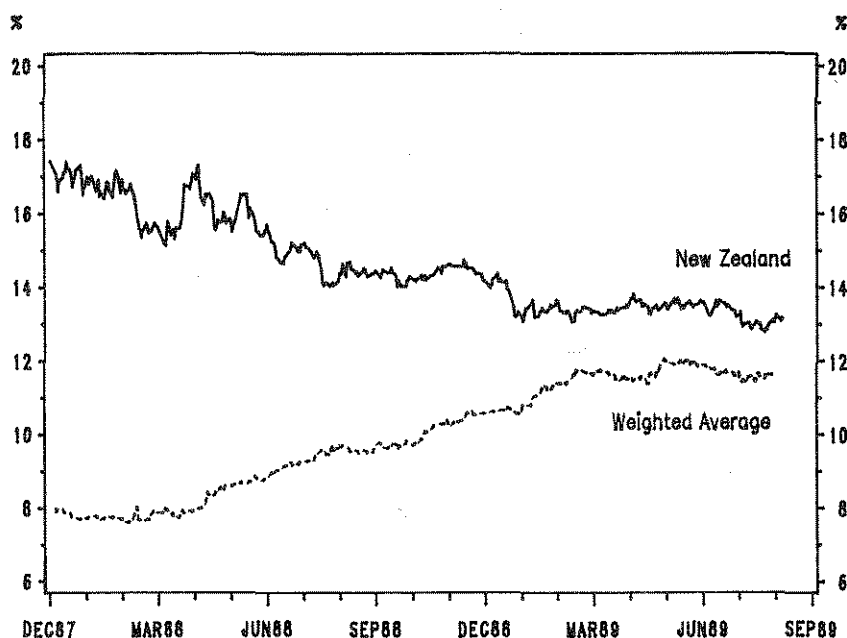
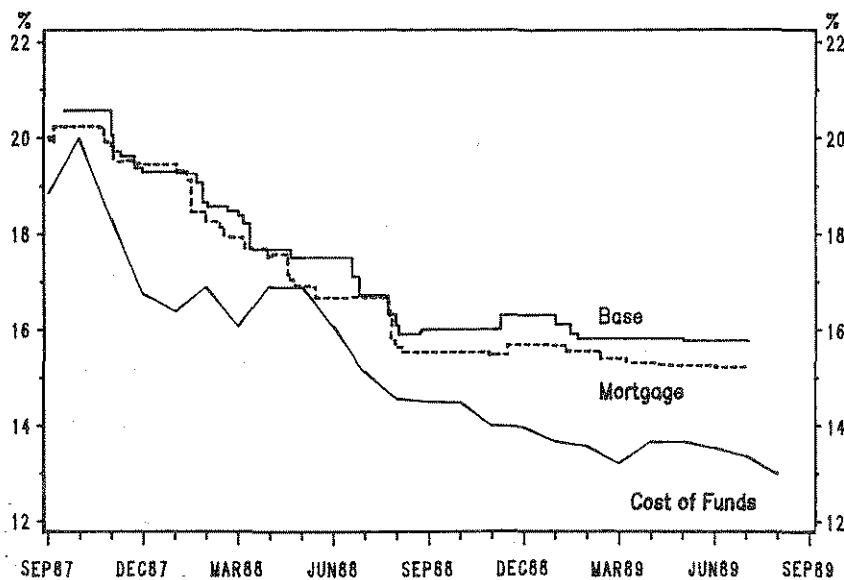


Figure 5
Proxy Cost of Funds, Base Lending Rates and First Mortgage Lending Rates



for Reserve Bank bills, and the Bank responded in mid-August by reducing from \$50 million to \$45 million the size of each tender. The recent reduction in tender size will eventually reduce the basic level of PL from \$430 million to \$390 million, although the failure to fill earlier tenders will take PL to as low as \$310 million during October. The reduction in the amount of bills on offer did not represent any change of policy; simply an adjustment of the supply to the revealed demand for bills.

The broad money aggregate M3 grew by approximately 2 per cent in the June quarter bringing the annual growth rate to 5.5 per cent. The June quarterly increase in M3 was down on the 3.4 per cent recorded in March and mirrors similar quarterly trends in M1 and currency in the hands of the public. Likewise, private sector credit grew by a modest 1.7 per cent over the June quarter bringing the annual rate of growth to 6.7 per cent. Sectoral lending data indicates that most credit growth is still occurring in the household sector, with the financial sector's outstanding claims on households increasing by 26.5 per cent in the year to end June 1989. Lending to the corporate sector, on the other hand, appears to have continued to decline.

Policy Issues and Assessment

A reduction in interest rates of the magnitude experienced since late July inevitably forces consideration of the continued appropriateness of the stance of monetary policy. However, in terms of the Bank's indicator framework – as discussed in the June 1989 *Bulletin* – monetary conditions at the end of the period were judged to be somewhat firmer than had been the case during much of June and July, and consistent with the desired rate of disinflation, and with the ultimate objective of 0-2 per cent annual increases in the CPI by December 1992. The exchange rate has remained relatively firm despite the

easing in interest rates – averaging 60.9 on the Bank's index over the month following the Budget, compared with 59.6 over the previous month. Similarly, the yield curve maintained and then increased its negative slope during the review period, reaching over 1 percentage point in late August, the largest recorded since October 1988.

The exchange rate is, at present, a key monetary policy indicator, and the stability and strength of the exchange rate following the recent interest rate reduction is the main consideration distinguishing the sustainability of this fall from that of the easing in interest rates in late June and early July. In late June and early July the exchange rate weakened as interest rates fell. By contrast, the recent fall in interest rates across the maturity structure has been facilitated by slightly lower overseas interest rates and strong overseas demand for New Zealand assets, factors which have tended to keep the exchange rate firm. As the foreign demands slow, the exchange rate may ease back slightly (a pattern which has been observed before), but by late August it appeared that the lower interest rate structure could be sustained without any noticeable adverse impact on the exchange rate.

A further important monetary indicator is the term structure of interest rates and, in particular, the 90 day-5 year yield gap. More recently, the yield gap has been monitored largely in terms of its implications for the future course of the exchange rate, but the yield gap has also some independent information value and therefore warrants assessment independently of the exchange rate.

It is again useful to compare the interest rate reduction since mid-July with that in late June and early July. In the earlier instance, short rates eased with little appreciable impact on long rates, but more recently long rates have led short rates down and have fallen more sharply than short rates, steepening the negative slope of the yield curve. In the Bank's opinion, this pattern of re-

duction in interest rates and the consequent widening in the yield gap is appropriate in the current environment. A number of factors account for this view, quite apart from the continuing strength of the exchange rate.

General medium-term macroeconomic confidence appears to have improved over the last couple of months. The clear macroeconomic targets enunciated in the Budget (including the reaffirmation of the inflation target) and the achievement of a Budget-night financial deficit of 1 per cent of GDP have helped to increase confidence in the future direction of macro policy, in turn tending to lower longer-term inflation expectations and the risk premiums attached to those inflation expectations (and thus to all New Zealand dollar investments). These effects appear to have been reinforced by reasonably favourable real economic developments, including the balance of payments and employment outcomes, and by the resolution of the leadership issue within the Government. All these factors will have tended to lower interest rates across-the-board, but they have limited bearing on short-run inflation outcomes relative to the impact on perceptions of the longer-term outlook. Accordingly, such an improvement in confidence is consistent with a larger fall in long-term interest rates than in short rates. As discussed in the June *Bulletin*, the importance of these effects is difficult to quantify, but the likely direction is relatively clear.

Another factor recognised in the June article as contributing to the flatness of the yield curve since late last year was the range of structural factors affecting the markets for longer-term debt. The Budget announcement that no net foreign debt repayments would be made this year and that the proceeds of the \$3 billion Table 2 surplus would be used entirely to fund domestic debt repayment appears to have reversed the earlier upward pressure on bond rates. The projected repayment of a net \$3 billion of government stock

will result in a significant reduction in the volume of tradeable stock (approximately \$14 billion was outstanding at the end of June). Similar large fiscal surpluses in the United Kingdom and Australia have led to substantial reductions in the supply of domestic government bonds in those countries, and particularly in the United Kingdom appear to have contributed to a relatively low level of real bond rates. An easing in long bond rates relative to shorter-term private rates which results from such structural factors clearly does not represent a change in the stance of either monetary or fiscal policy.

Nevertheless, the importance of short-term supply and demand conditions in the bond market should not be overplayed – there is a relatively high degree of substitutability between New Zealand and foreign securities and between different assets within the New Zealand market; any fall in bond rates is therefore unlikely to last unless supported by an improved assessment of the outlook for the medium-term fundamentals. Again it is difficult to quantify the effects, but in the Bank's assessment the psychological triggering effect of the debt programme announcement was probably more significant than the direct market impact of the reduced level of Government debt sales. (The decision to repay domestic rather than foreign debt this year is discussed further in Appendix 1).

The final major consideration regarding the sustainability of the lower interest rate structure is the impact of lower retail rates on domestic demand and inflationary pressures (as distinct from pressures arising from the level of the exchange rate). One aspect which has been of recurring concern in past years has been activity in the housing market. Lending to households over the review period has remained strong, but over the last year house price inflation has been very modest, residential building activity appears to have increased only moderately, and consumption, excluding expenditure on cars, has been re-

latively flat. Moreover, in the corporate sector the evidence of any risk of resurgent inflation from the modest reductions in lending rates experienced to date is, at best, limited. Considerable excess capacity still characterises many industries, despite the gradual recovery in activity over the last year, giving little scope for businesses to successfully widen margins and increase profits to compensate for the lower returns over the last 12-18 months.

The Bank's assessment is that the risks of an inflationary surge prompted by a lower yield curve are relatively low in the current environment. Nevertheless, high real short-term interest rates have been a factor constraining credit growth, and it is still possible that further rapid reductions in nominal interest rates together with the continuing pick-up in demand and a further strengthening in business confidence could prompt an inflationary increase in business margins and/or the demand for credit. Should lower interest rates stimulate domestic inflationary pressures the Bank would have no hesitation in taking appropriate action to ensure that inflation is controlled and that price stability is achieved. Indeed, as the Governor reiterated in a recent speech, it will only be when individuals and businesses cement in very low inflation expectations that, for example, first mortgage rates can reasonably be expected to fall into the 7-10 per cent target range referred to by the Minister of Finance in the Budget.

At present, the Bank expects the annual rate of price inflation to fall back to 3.5 per cent by March 1991 on current policy settings. This inflation path is consistent with the achievement of price stability (0-2 per cent annual increases in the CPI) by December 1992. There are other risks, however, in addition to those relating to domestic demand or the exchange rate. These risks relate particularly to the impact of the high terms of trade, and the impact of GST (among other factors) on settlements in the forthcoming wage

round. Continued strength in the terms of trade, particularly in the prices for beef and other agricultural export commodities, has played a major part in the very high rates of increase in food prices and producers' prices over recent quarters. The terms of trade appear to be near their peak, but the persistence of high prices for agricultural commodities and the relatively high overseas inflation rates suggest that inflationary pressures from overseas may take some time to diminish substantially.

Most important, however, is the forthcoming wage round. As part of the Bank's commitment to achieving its price stability objective, the Bank has repeatedly stated over recent months that it will not accommodate any second-round effects of the GST increase; nor will the Bank allow an increase in the underlying rate of inflation arising from any other factors over coming months. Towards this end, monetary conditions would be allowed to tighten should either the wage round include an element of compensation for GST or margins be widened on the back of GST and commodity price increases. The Bank is determined to achieve its inflation target of 0-2 per cent annual increases in the CPI by December 1992 and will continue to operate monetary policy in a manner which will achieve that objective.

APPENDIX 1

The Debt Repayment Programme: Some Considerations

Reflecting the high level of public debt accumulated over the last fifteen years, the Government adopted a specific debt repayment objective two years ago. Proceeds from the sale of government assets (and eventually financial balance surpluses) were to be used to repay approximately a third of outstanding government debt (some \$14 billion) by the early 1990s.

However, in determining the optimal mix of domestic and foreign debt to be repaid a number of considerations should be taken into account. In particular, the objective of the management operation should be to ensure that the debt portfolio is distributed in such a manner that the expected borrowing costs and the net risks associated with the portfolio are minimised. The optimal distribution of the portfolio will be influenced by the nature of the shocks an economy is exposed to and the length of the planning horizon (e.g. given the short-run variability of the exchange rate, risk measured over a very short time horizon will be much greater for foreign currency borrowing). Over any

reasonable time horizon, however, it is likely that the optimal portfolio will contain a mix of foreign and domestic currency denominated debt.

The decision to use the proceeds of the asset sales to reduce overseas debt in 1987/88 and 1988/89 was in part due to a desire to reduce the risks associated with the very high level of overseas debt (continuing the approach in place since 1984 of increasing the New Zealand dollar share of the public debt) and also in response to the cost advantages of repaying debt while the real exchange rate was high. More recently, the fall in the exchange rate to a lower and more stable level in August 1988, and a combination of the Government's commitment to its inflation targets and the existence of a significant difference between foreign and New Zealand interest rates led to the decision to use this year's fiscal surplus to repay domestic rather than overseas debt. The cost advantages are readily apparent when, for example, US bond rates of between 8 and 9 per cent are compared with New Zealand equi-

valents of between 12 and 13 per cent at a time when the two countries inflation rates are similar. The decision does not alter the Government's 1987 commitment to the principle of debt repayment; total public debt is being reduced more rapidly than in any earlier year. Moreover, after compensating actions from the private sector are taken into account, New Zealand's total foreign debt at the end of the financial year is likely to be only slightly higher than if the Government's Table 2 surplus had been used directly to repay foreign debt.

As expected, the rating agencies have indicated that New Zealand's credit rating will not be affected adversely. Assessments of 'country risk' are affected by a country's ability to consistently meet its external obligations, which is in turn affected by its overall external debt and balance of payments positions. In turn, the Government's contribution to the country's net debt position will depend on its overall financial deficit/surplus – not on the currency composition of any given level of public debt.

