MONETARY CONDITIONS AND POLICY[1]

In this article, prepared mainly by Bernard Hodgetts, developments in the monetary indicators over the three month period to early June are reviewed. The monetary policy stance is assessed in light of recent developments in the monetary and inflation indicators.

Executive Summary

The period reviewed in this article has been the first in which the Bank has been operating under the formal monetary policy framework laid down in the Reserve Bank of New Zealand Act 1989. Under that regime the monitoring of the monetary indicators has focused increasingly on the consistency or otherwise of overall monetary conditions with the disinflation track set out in the first Monetary Policy Statement published in April. Given this framework, the Bank judged that monetary conditions had remained broadly appropriate over the period to early May, despite a gradual but significant narrowing in the yield gap from 1.8 percentage points in mid-February to 1.1 percentage points by early May.

During May, however, this assessment changed. There was a deterioration in the short-term inflation outlook, with the likely Consumer Price Index (CPI) outturn for the June quarter in particular rising quite strongly. Also, after trading within a relatively narrow range for some months, the exchange rate fell by around 2.5 per cent, reaching a low of 59.5 on the Bank's trade-weighted index. The Bank was receiving increasing comment from the financial markets that they believed there had been an easing of monetary policy. These factors led the Bank to judge that monetary conditions had become a little soft. The Bank signalled this concern to the financial markets in a number of market operations, designed to reaffirm its commitment to the disinflation objective. The various signals prompted an increase in short-term interest rates and a modest firming in the exchange rate.

The recent deterioration in the short-term outlook for inflation has resulted from the influence of unseasonable growing conditions on fruit and vegetable prices, local authority rate increases, transport fare increases and house price inflation. Despite the various temporary price pressures, however, the Bank remains confident that, following its actions in late May, inflation for the December 1990 year will remain within the 3-5 per cent indicative range published in April.

1 Date and text finalised on 12 June 1990

Introduction

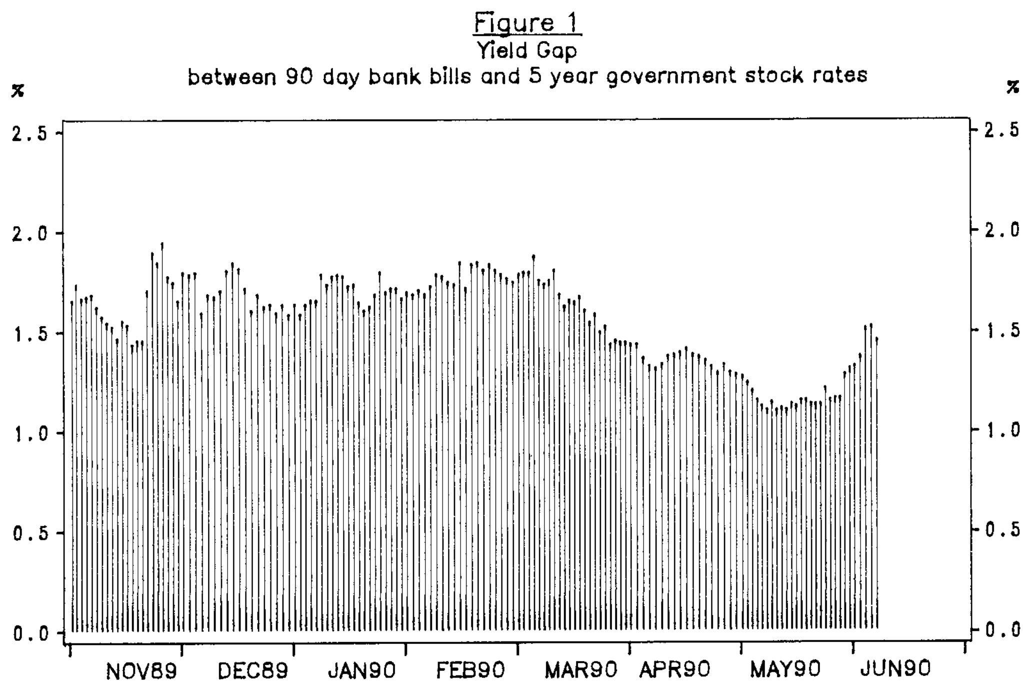
The Reserve Bank of New Zealand Act 1989 came into effect on 1 February 1990 and the subsequent signing of the Policy Targets Agreement and the publication of the first Monetary Policy Statement have completed the establishment of the new monetary policy framework. Under that framework, the assessment of the monetary indicators must be clearly focused on the Bank's inflation objectives. This article is the first of the Bank's regular review articles to cover the period since the new regime was put in place.

Developments in the monetary indicators over the three months to mid June are reviewed in the first section. The second section discusses the policy stance in light of these developments, and, in particular, the circumstances which led the Reserve Bank to reaffirm its anti-inflationary monetary policy stance in late-May.

Developments in Monetary Indicators

The yield gap between 90 day bank bills and 5 year Government bonds gradually narrowed from 1.8 percentage points in mid- February to reach as low as 1.1 by early May (see figure 1). This outcome, representing the smallest yield gap in eight months, was the combined outcome of an easing in short-term rates, and a modest firming in bond rates. The easing in short-term rates, which had been particularly evident since

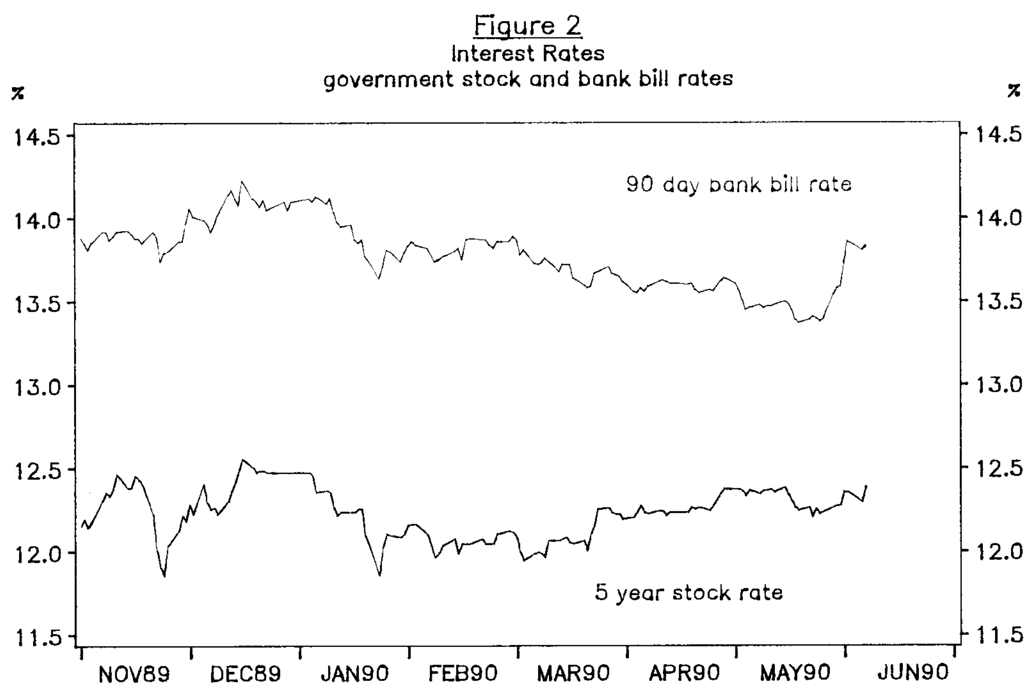
Figure 1
Yield Gap
between 90 day bank bills and 5 year government stock rates



mid-March, saw the 90 day bank bill rate fall from 13.9 per cent in mid-February to around 13.5 per cent by early May. This downward trend in short-term rates (shown in figure 2), was partly due to a relatively stable call market. The fairly even distribution of cash among the settlement banks resulted, in part, from the precautionary stance adopted by the banks in anticipation of the possibility of a strike at Databank. Moreover, an improvement in inflation sentiment, following favourable CPI outcomes for both the December 1989 and March 1990 quarters, and an easing in short-term Australian interest rates, both contributed to the downward trend in the 90 day rate. The slight easing in short-term rates represented a further lowering in the funding costs faced by financial institutions, after the sharp increases at the end of last year. 90-day rates eased further in mid-May, reaching a low of 13.35 per cent.

Long-term rates, however, resisted the downward trend, and firmed a little over the period despite relatively encouraging news on inflation in March and April. The 5-year bond rate rose gradually from 11.9 per cent on 2 March, to reach 12.4 per cent by early-May (see figure 2), eased to around 12.2 per cent and then, following Bank actions in late May, ended the review period at around 12.35 per cent.

The most important factors putting upward pressure on New Zealand bond rates appear to have been concerns about worsening balance of payments data and, most importantly, the general upward movement in overseas bond rates that began in late 1989. These factors have offset the favourable impact of falling inflation expectations in New Zealand. That the increases in overseas bond rates, evident among most of New Zealand's major trading partners, have not raised New Zealand rates further is probably a reflection of slowly improving confidence in New Zealand's medium-

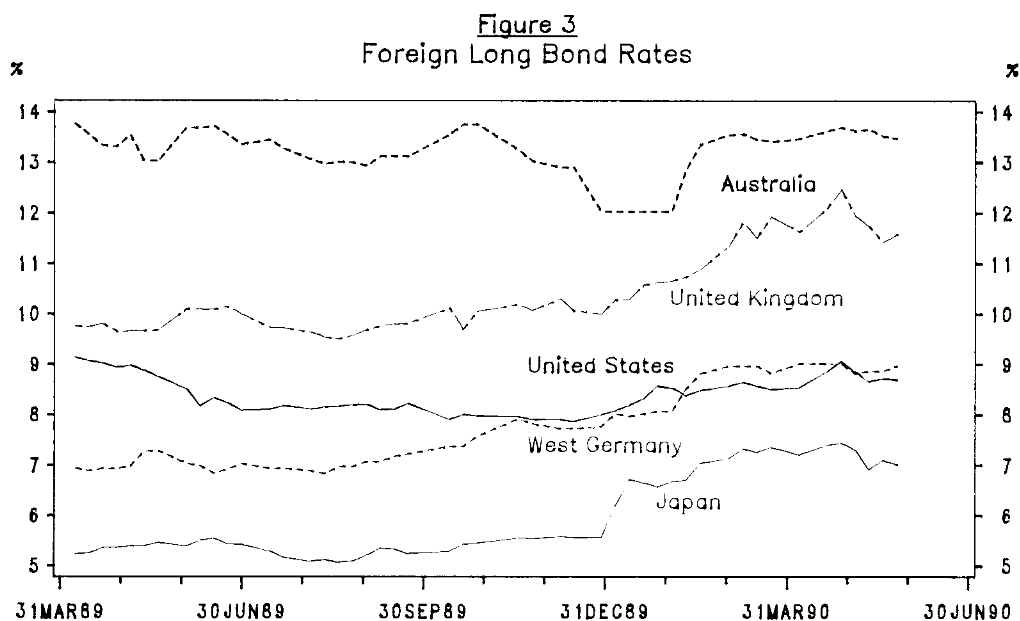


term economic and inflation outlook. Developments in the Australian bond market are typically the most important direct foreign influence on New Zealand financial markets. The outlook for Australian inflation and the balance of payments led to medium-term Australian bond rates firming from 12 to 13.7 per cent between February and April. Australian bond rates have, however, also been affected by the widespread increase in world rates.

These increases have been particularly noticeable in Japan, West Germany and the United Kingdom - each for different reasons. For example, in Japan, where the 5 year bond rate has risen from 5.5 to 7.4 per cent since late 1989, the recent increases in inflation, together with concerns over the slump in the Japanese sharemarket, both appear to be major factors lying behind the increase in bond rates. In West Germany, the prospect of political and economic reunification with the East - with associated fears of a resurgence in inflation following monetary union and an increase in the West German fiscal deficit - has contributed to bond rates firming from 7.7 per cent in late 1989 to 9 per cent. Real interest rates throughout the world have been pushed up by the expected increase in the demand for investment funds arising from the redevelopment of Eastern Europe, a demand not likely to be matched by an increased supply of savings in the short term.

Increases in overseas rates appear to have levelled off recently (see figure 3), minimising the risks of further upward pressure on domestic bond rates from this source. The possibility of additional increases in overseas real bond rates now seems unlikely. In particular, the extent of the increase in West German bond rates appears

Figure 3
Foreign Long Bond Rates



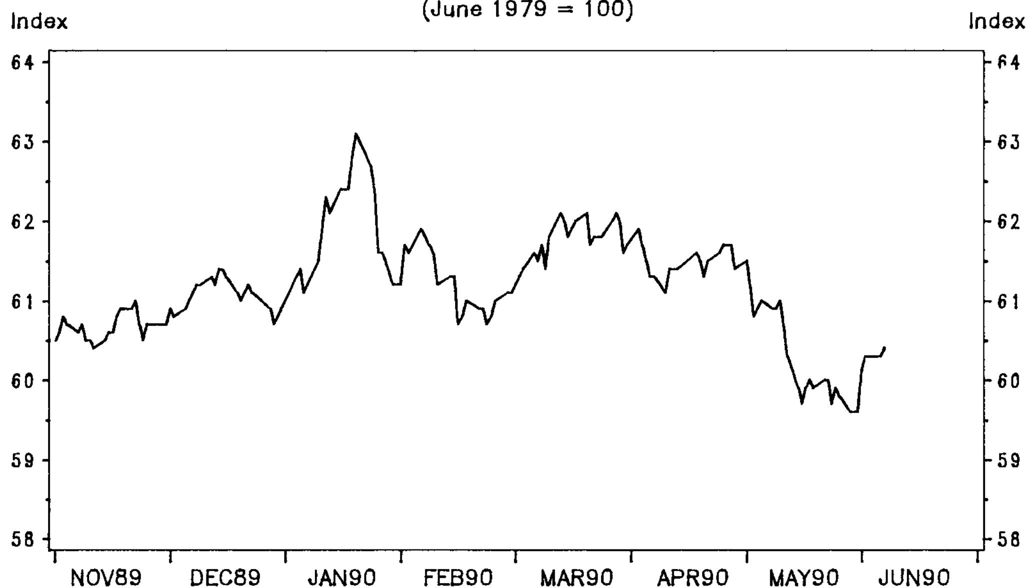
Source: The Economist

to have been an over-reaction, with the initial estimates of the impact of monetary union, in particular, having been widely overstated.

Despite the narrowing in the yield gap in the period to early May, the Bank considered monetary conditions to have remained appropriately firm over the period. The inflation outlook appeared to remain favourable, and the exchange rate traded within a relatively narrow range over the entire period to early May. The exchange rate eased slightly over mid-February, falling from around 61.5 on the Bank's Trade Weighted Index (TWI) to a low of 60.4. By mid-March, however, the exchange rate had firmed again to reach a peak of 62.2 on the index (see figure 4). The exchange rate continued to trade within a range of 61 - 62 on the index for the period to late April.

Then, in early May, the exchange rate eased by around 2.5 per cent, falling from 61.0 on the TWI on 4 May to 59.5 by mid-month. The easing followed misinterpretation of comments by the Governor and the Minister of Finance regarding exchange rate policy. However, the reduction in the exchange rate was reinforced by the emergence of worries about short-term inflation prospects and relatively easy short term liquidity conditions as discussed above.

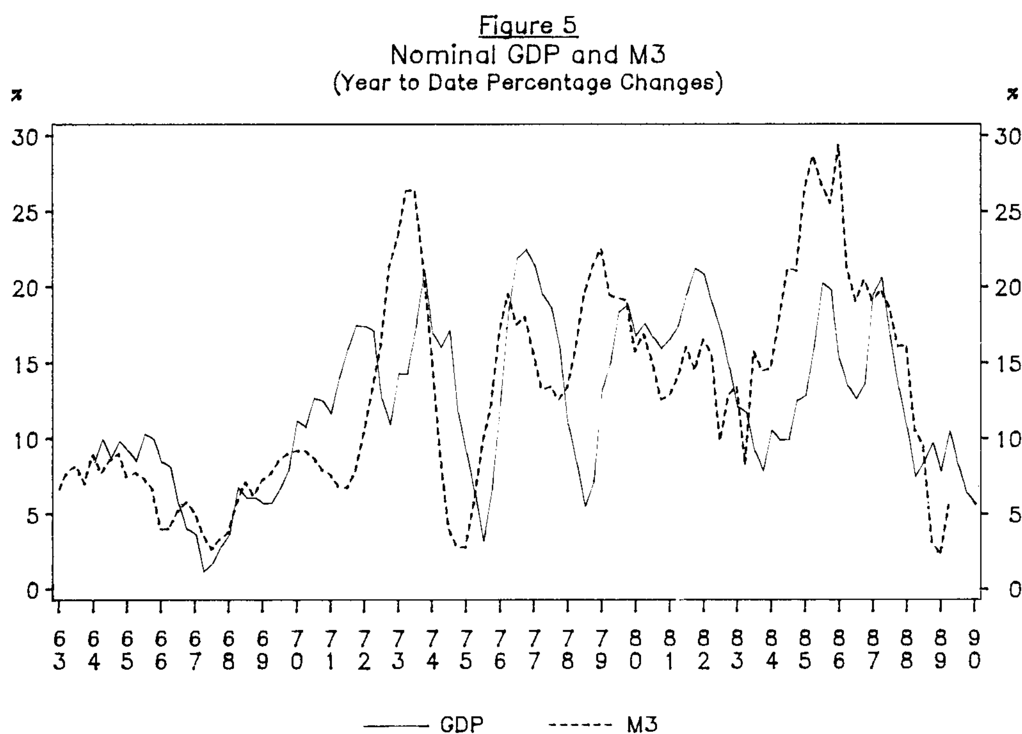
In late May, the Bank judged that some reaffirmation of its firm policy stance would be necessary to remain on course for the Bank's inflation objectives. On three separate occasions, during the course of its regular commercial operations, the Bank signalled its intention to keep monetary policy firm. (The context of these actions is discussed below in more detail.) This action prompted the 90-day bank bill rate to firm to 13.8 per cent by 31 May, in turn reversing much of the earlier narrowing in



the yield gap. By 12 June the exchange rate had firmed to reach 60.6 on the index, and the yield gap had widened to 1.45 percentage points.

One other development in the monetary indicators which has captured the interest of some commentators over recent months, is the very low rates of growth of the broad monetary aggregate M3. Growth in M3 fell to a record low of 0.3 per cent for the year to February, before rising to 3.5 per cent in the year to April. On the other hand, growth in private sector credit stood at 13.9 per cent for the year to April, slightly up from 10.4 per cent for the calendar year 1989. The high growth rates for Public Sector Credit (PSC) reflect a period of strong household demand for mortgage funding (up over 35 per cent in the year to March) and the switching of the direct source of State Owned Enterprise (SOE) funding from the public to the private sector. The divergence between growth rates in M3 and PSC also substantially reflects a $2 billion increase in the net overseas liabilities of the registered banks over the last year - made up of a $4 billion increase in foreign funding and a $2 billion increase in lending to non-residents. Overseas assets and liabilities are not included in the M3 and PSC aggregates.

Although the downward trend in M3 growth over the past eighteen months has been broadly consistent with the relatively low underlying inflation rate and weak levels of real activity that have been experienced, the growth rate of M3 of only 1.9 per cent for the March year is clearly below growth in nominal activity over the same period, with an inflation rate of 7.2 per cent, and nil estimated growth in real activity. This discrepancy highlights the absence of a close relationship between growth in the M3 aggregate and nominal activity. There continues to be only limited empirical grounds for attaching much weight to short-run fluctuations in the aggregates. For example, although recent research by Bank staff[2] has revealed some preliminary evidence that



2 See Cruse, P.F.J., Monetary Aggregates as Targets for Monetary Policy, RBNZ Working Paper W90/1, March 1990.

M3 and nominal Gross Domestic Product (GDP) may have a long-run relationship, as shown in figure 5, it is equally clear that there is not yet a strong identifiable linkage between the two in the short run.

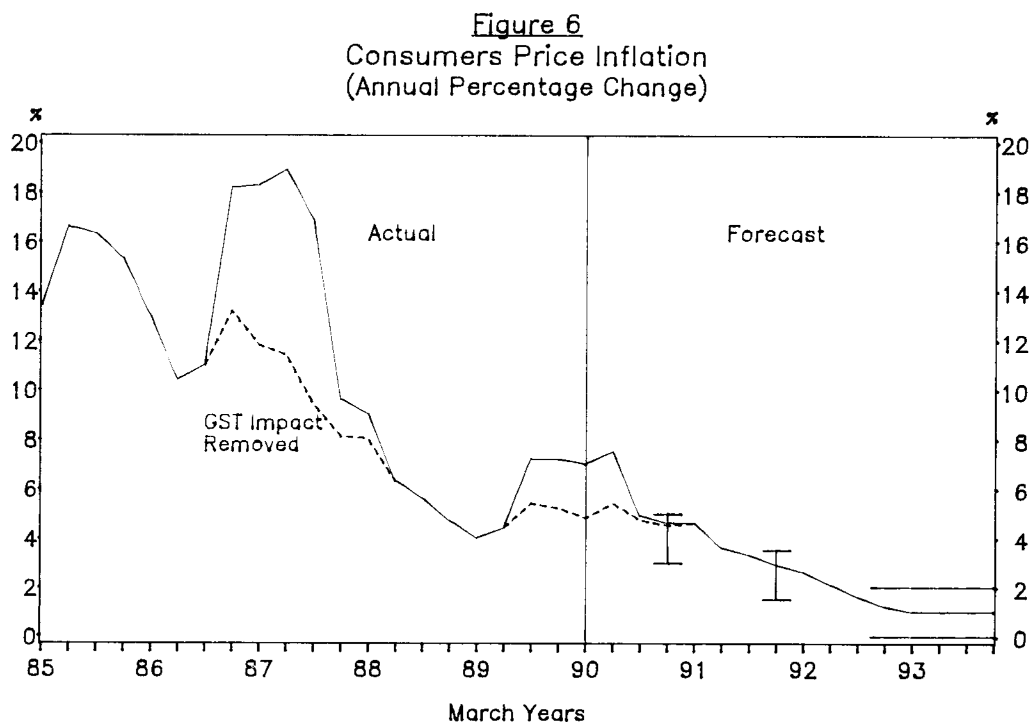
Policy Assessment

As stated in the introduction to this article, recent months have seen the formalisation of the new monetary policy arrangements. The Bank is now formally obliged to implement monetary policy to achieve price stability by the end of 1992, and has set out an indicative track for disinflation which would see a 3-5 per cent CPI inflation rate being achieved for the 1990 calendar year, and a 1.5 to 3.5 per cent inflation rate next year. Monetary policy is formulated and assessed with this objective and pathway firmly in view.

Aggregate economic activity has remained flat in recent months with the indicators continuing to portray a weak and variable outlook for both retail activity and investment. Of particular note, business confidence has continued to weaken over the first half of 1990, an outcome partly due to the inevitable uncertainty of an election year. Nevertheless, the weakness of overall activity has not meant that inflationary pressures have been quiescent.

Evidence of some renewed inflationary pressures appeared over the second half of the review period, arising from several distinct sources. Whereas at the time of the Monetary Policy Statement the Bank had been forecasting an inflation rate for 1990 of 3.7 per cent, this forecast has now been revised up to 4.6 per cent (see Figure 6).

Figure 6
Consumers Price Inflation
(Annual Percentage Change)



The deterioration in the inflation outlook reflects both the influence of several discrete price increases and some slight worsening in underlying inflationary pressures. First, food price inflation has been running higher than originally anticipated at 9 per cent for the year to April, reflecting the impact of recent unseasonable growing conditions on fruit and vegetable supplies and the continued strength of export meat prices. Second, local authority rate increases for the transitional quarter for the move to a June financial year have on average been significantly higher than might otherwise have been expected on the basis of recent inflation out-turns.

House prices have also been rising relatively strongly, despite the continuation of mortgage interest rates at around 15 per cent. Mortgage lending has risen sharply in the last two years as banks have reoriented their business towards the more secure household market, and although mortgage loans are now used much more widely than simply to finance a house purchase, this lending growth appears to have been reflected in stronger house prices in many regions. Other factors to lead to the deterioration in the inflation outlook include some recently announced large increases in airfares and public transport fares, and the sharp increase in tertiary study fees.

The worsened outlook for inflation meant that the Bank became more sensitive to the easing of monetary conditions and the inflationary effects of the fall in the exchange rate. This combination of factors prompted the Bank's modest actions at the end of May. The signals were not intended to represent a substantial change in the policy stance but simply to re-establish the earlier firm conditions, and to reinforce the recent reductions in inflation expectations.

The favourable inflation news of the first few months of 1990 had assisted in lowering inflation expectations considerably. Indeed, the Reserve Bank Survey of Expectations undertaken in May showed that since February 1990 the one year and two year ahead inflation expectations had fallen from 4.9 to 4.4 per cent and 4.4 to 4.0 per cent respectively - record lows since the survey began in 1987. As shown by the May Reserve Bank Survey, the two year ahead inflation expectation still lies above the level the Bank would consider appropriate for the achievement of price stability in the same year. Nevertheless, the gains in credibility which have produced such low expectations are very encouraging to the Bank, and give some basis for optimism that the additional costs of pursuing price stability need not be high if expectations remain low, and are translated into actual behaviour.

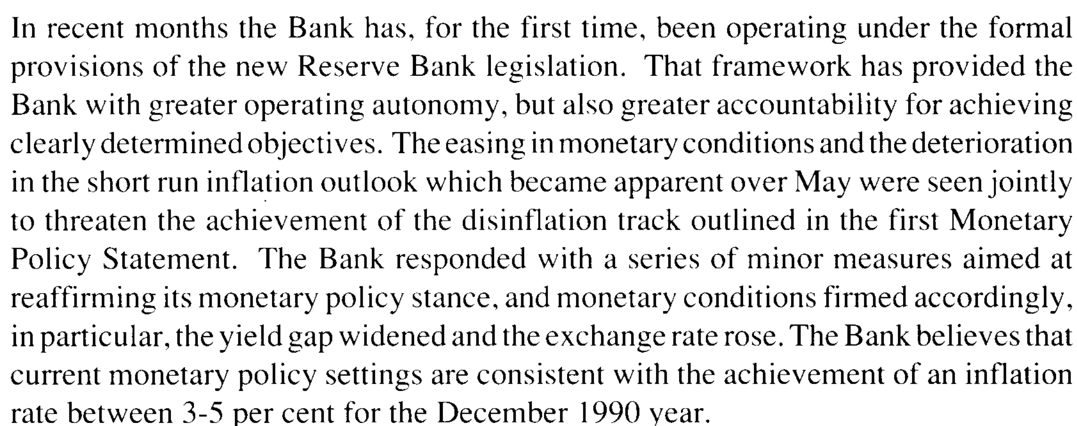
Over the coming year, movements in the monetary indicators are likely to depend on developments in a number of areas. In particular, the outlook will depend on inflation prospects, and possible pre-election uncertainty regarding future developments in general economic policy. In addition, uncertainty surrounding the balance of payments has become important during the review period, and together with a range of fiscal matters is likely to provide a continuing source of nervousness over coming months.

Balance of payments statistics for the year to December 1989 show the current account deficit to have widened to $3.5 billion compared to a deficit of $0.9 billion for the year ended December 1988. The increase in the current account deficit has been due chiefly to a large merchandise trade deficit as a result of rapid growth in imports and a slowing in export earnings. More recently, estimates for the merchandise trade balance for the March 1990 quarter indicate that the rate of increase has started

to slow, although the Bank does not expect a significant reduction in the current account deficit until 1991/92.

Although there is some dissent regarding the outlook for the balance of payments and the interpretation of recent developments, recent out-turns have led to the perception in some quarters that the real exchange rate has become over-valued and has therefore been acting to hinder the competitiveness of the traded goods sector. The evidence does tend to suggest that further competitiveness gains are needed. Such gains will require further improvements in productivity and efficiency, and further cost restraint in the product and labour markets. In this respect, further wage moderation and enhanced productivity growth would both help to achieve price stability at minimum cost and contribute to improving the competitiveness of New Zealand industries. With inflationary pressures still evident, there is no scope for an easing in monetary policy, and little prospect, in any case, that such an easing would lead to a sustained improvement in competitiveness.

Conclusion


In recent months the Bank has, for the first time, been operating under the formal provisions of the new Reserve Bank legislation. That framework has provided the Bank with greater operating autonomy, but also greater accountability for achieving clearly determined objectives. The easing in monetary conditions and the deterioration in the short run inflation outlook which became apparent over May were seen jointly to threaten the achievement of the disinflation track outlined in the first Monetary Policy Statement. The Bank responded with a series of minor measures aimed at reaffirming its monetary policy stance, and monetary conditions firmed accordingly, in particular, the yield gap widened and the exchange rate rose. The Bank believes that current monetary policy settings are consistent with the achievement of an inflation rate between 3-5 per cent for the December 1990 year.