

MONETARY AND ECONOMIC DEVELOPMENTS

In this article by Karen Browning and Darren Gibbs, key monetary and economic developments for the three months to 15 November 1991 are reviewed.

This article comments on recent monetary and economic developments, and covers the period since the release of the August 1991 Monetary Policy Statement.

The past three months have been marked by further positive results on the inflation front. With inflation falling faster than expected, the Reserve Bank was able to ease monetary policy further. This has fed through to lower interest rates and a lower exchange rate. Following the Bank's easing and the subsequent exchange rate fall, *underlying* annual Consumer Price Index (CPI) inflation is now expected to be around 2 per cent in December 1991 - below the 2.5-4.5 per cent indicative range for that time - and is likely to be in the upper half of the 1.5-3.5 per cent indicative range for December 1992.

Allowing for certain one-off price effects, *measured* CPI inflation is expected to be above the level forecast for underlying inflation in December 1992, but is nevertheless forecast to fall within the 0-2 per cent inflation target for December 1993.

Appendix 1 provides a chronology of events during the review period which have had significance for monetary policy.

Monetary Policy Indicators

90 day bank bill rates and five year Government bond yields both fell further during the review period, reflecting ongoing progress in eliminating inflation. An explicit easing of monetary policy, on 25 September, accentuated this downward trend in interest rates, which has seen 90 day and five year rates fall around 6.5 and 4.5 percentage points, respectively, in the past 12-14 months.

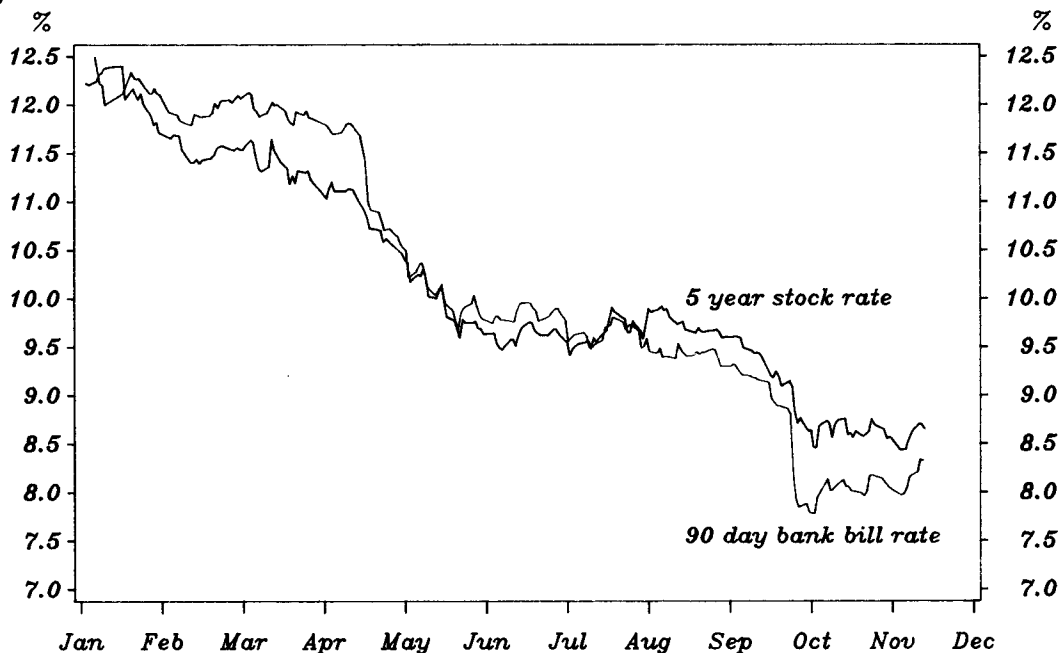
- The downward trend in 90 day bank bill rates, which had been evident since late 1990, stalled following the Budget and the August Monetary Policy Statement. This seems to have occurred because market participants had already anticipated all that the policy statements were interpreted as delivering, if not more. To some extent, bank bill rates were also underpinned by attempts to corner available cash in the call market, until the Reserve Bank moved in mid- August to alleviate the pressures. This led to a resumption of falls in interest rates. The Bank's easing of monetary policy on 25 September gave added impetus to the downward trend in rates. Over the full review period, 90 day rates fell more than one percentage point, to around 8.3 per cent.

- Five year bond rates, which had reached just under 10 per cent in early August, continued their general decline over the review period. Though usually less sensitive to changes in monetary conditions, bond rates nevertheless dropped substantially following the Reserve Bank's 25 September monetary policy easing - by around 0.6 percentage points, to a low of 8.5 per cent, before settling at around 8.7 per cent by the end of the review period.

Figure 1

Interest Rates

government stock and bank bill rates

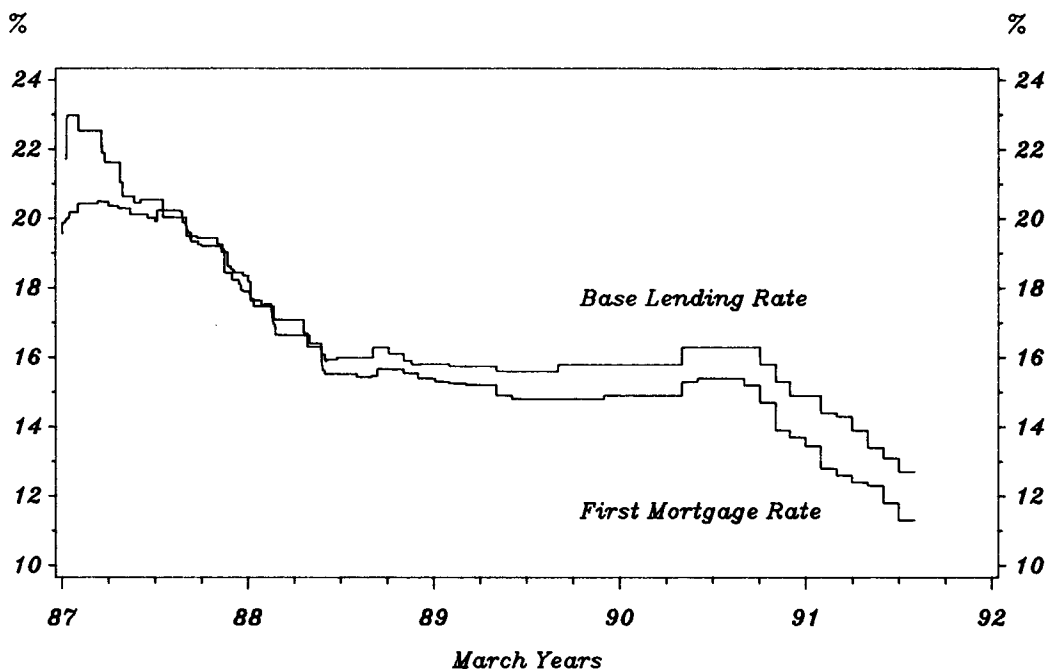


- Bond rates embody, amongst other things, market expectations of inflation over the longer term. Their continued decline probably reflects market confidence that price stability will be achieved; a confidence reinforced by the fact that the Bank felt able to ease policy as the inflation outlook improved.
- The Bank's 25 September monetary policy easing seems to have been regarded by financial market participants, including offshore investors, as consistent with the price stability objective, as reflected in the interest rate and exchange rate responses.
- Bond rates showed increasing volatility over the period, as financial market participants reacted to announcements on a variety of fronts, including fiscal.
- Declining wholesale interest rates have led to further reductions in retail lending rates over the review period. In early August, base lending and first mortgage

interest rates averaged 13.4 per cent and 12.3 per cent, respectively. By the end of October, base lending rates had fallen to 12.7 per cent, while first mortgage rates had been reduced to 11.3 per cent. These average lending rates are lower than has been recorded for thirteen years.

- Nonetheless, retail rates continue to respond slowly to falls in wholesale rates. While some explanations are available for the relative sluggishness of falls in retail lending rates (see the article in this *Bulletin*, entitled "Business Borrowing Costs"), it would seem that retail rates are historically high relative to wholesale rates at present.

Figure 2
First Mortgage Housing and Base Lending Rates



The interest rates of most of our major trading partners have also drifted down over the review period. These reductions have contributed to, but have been exceeded by, the falls in New Zealand's interest rates.

- Movements in world interest rates will tend to be reflected in movements in New Zealand's wholesale interest rates (and/or the exchange rate), as mobile international capital responds to the best opportunities. However, New Zealand's progress on the inflation front over the past year has led to larger declines in our wholesale rates than have been recorded by our major trading partners, as table 1 shows. In contrast to the position a year ago, New Zealand's rates are now lower than those of Australia, and the United Kingdom, and similar to those of Germany.

TABLE 1

**COMPARISON OF INTERNATIONAL LONG-TERM
WHOLESALE INTEREST RATES¹**

	Oct 90 (%)	Oct 91 (%)	Difference (% points)
New Zealand	12.9	8.9	-4.0
Australia	13.4	10.0	-3.4
Germany	9.0	8.6	-0.4
Japan	7.9	5.9	-2.0
United Kingdom	11.3	9.6	-1.7
United States	8.8	7.9	-0.9

1 Monthly averages benchmark long term government bond yields.

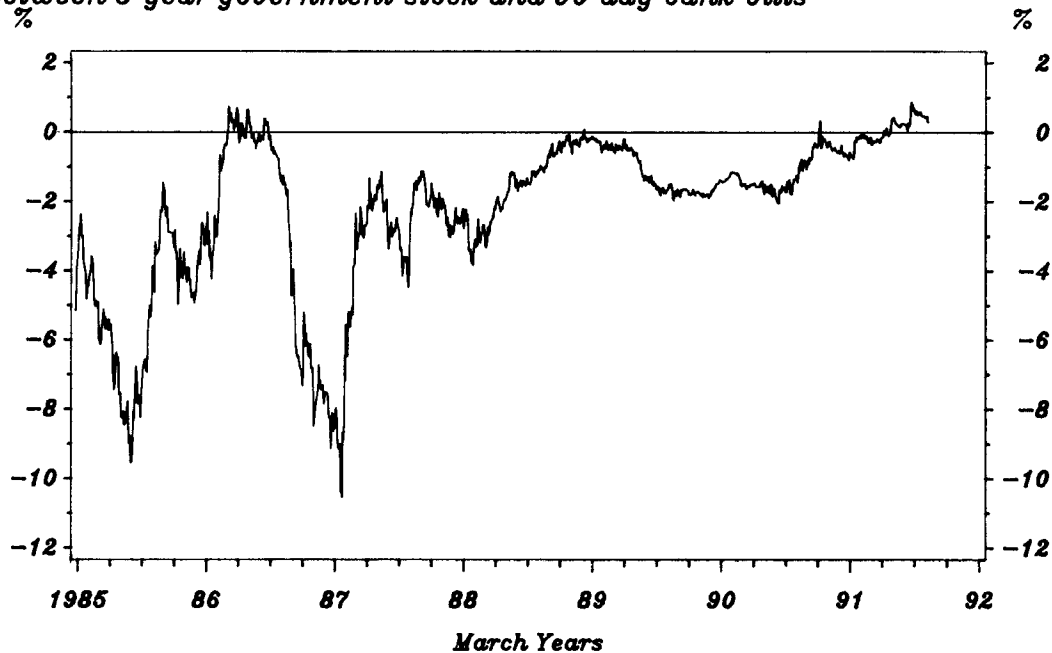
The 'yield gap' (the differential between long-term and short-term wholesale interest rates), often a useful indicator of the tightness of monetary conditions, drifted down over much of the period, but widened again following the 25 September monetary policy easing.

- The yield curve has been negatively sloped (that is, 90 day rates have exceeded five year rates) for most of the disinflation process. 90 day rates fell faster than five year rates over the period to July/August 1991, in response to favourable inflation outcomes and expectations of continuing progress. A positively sloped yield curve was firmly established by early August.
- The positive yield gap narrowed from around 0.4 percentage points in early August, to 0.25 percentage points by late September. Following the 25 September easing, however, the yield gap increased briefly to as wide as one percentage point, reflecting the initial reaction of 90 day bill rates to the monetary policy easing.
- Subsequently, the yield gap settled at around 0.4-0.5 percentage points. This gap is somewhat wider than that prevailing at the start of the period, probably reflecting the easier stance of monetary policy.

Figure 3

Yield Gap

between 5 year government stock and 90 day bank bills



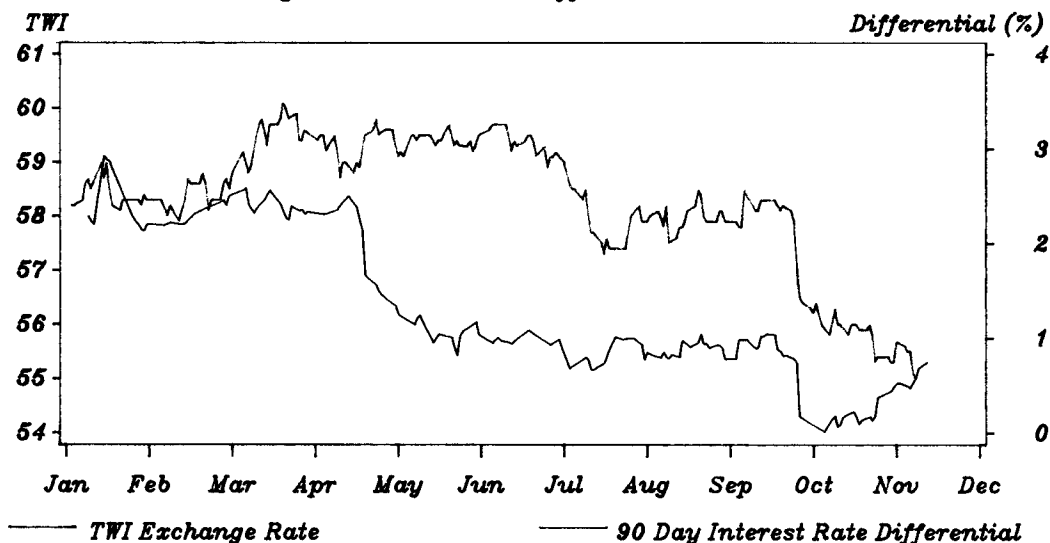
The New Zealand dollar, which had displayed surprising strength over the past year, fell by nearly 5 per cent over the review period, due largely to lower short-term interest rates, though additional uncertainty regarding fiscal policy may also have had some influence.

- The New Zealand dollar began the period at around 57.9 on the trade-weighted index (TWI), having shown particular resilience over the previous six months in the face of a declining differential between New Zealand and overseas interest rates.
- Following the Bank's easing of monetary policy on 25 September and the associated reduction in interest rates, however, the TWI dropped relatively sharply. The TWI settled at around 56 - a drop of 3.3 per cent from the level prevailing immediately before the easing.
- Since then, the exchange rate has fluctuated between 55 and 56 on the TWI, coupled with a slight tendency for short-term wholesale interest rates to rise. Announcements of revisions to the Government's Budget decisions may have contributed to the rise in wholesale interest rates and the slight further decline in the exchange rate, although the movements have not been substantial.
- At the end of the review period, the TWI stood at around 55.2, having fallen around 4.7 per cent over the review period.

Growth rates of the broad monetary and credit aggregates have slowed considerably in the past few months. Although less weight tends to be placed on the aggregates as indicators of economic activity and inflation than on other indicators, very long-term trends in monetary aggregate growth rates may nevertheless contain some useful information.

- A downward trend in the growth rates of the broad aggregates has emerged in the past six months.
- Private sector credit (PSC) grew by 3.6 per cent and domestic credit (DC) by 5.6 per cent in the year to September 1991, down from their respective growth rates of 10.1 per cent and 9.3 per cent a year ago. This slowing is consistent with other indicators of the economy, which point to weak demand in both the household and business sectors.
- M1 fell 3.8 per cent in the year to September 1991, continuing a trend which has been evident for the past year. The declines in M1 over the past year in part reflect weaker retail trade.
- M3 increased by 6.6 per cent in the September 1991 year, having peaked at a growth rate of 13.7 per cent in the year to December 1990. M3 growth is broadly related to nominal activity, although sharp fluctuations in non-resident deposits have caused considerable volatility in the growth rates of M3. For

Figure 4
Trade Weighted Exchange Rate
and Domestic-Foreign Interest Rate Differential



Note: Foreign Interest Rates are a weighted average of New Zealand's five major trading partners

example, the growth rate of M3 has actually increased from August to September this year, mainly attributable to an increase in non-resident New Zealand dollar deposits in September.

- Recent weekly data indicate that growth rates of the broad aggregates have probably slowed further since September. If the downward trend continues, static growth, or even declines, may be recorded in New Zealand's broad aggregates in the near future.

Economic Activity

Economic activity has fallen over the first half of this year. Domestic demand, particularly investment, has been weaker than expected. However, the external sector continues to make a strong positive contribution to growth, and business confidence appears to have stabilised in recent months.

- Real expenditure on *Gross Domestic Product* (GDP) has been weaker than was previously thought. Real GDP decreased, in seasonally adjusted terms, by 3.9 per cent in the June quarter, following a similar fall in the March quarter. The March decline largely offsets the growth recorded in the December 1990 quarter. Economic activity remained virtually static in the year to June, compared with the previous year. Significant reductions in stocks, coupled with the lowest investment expenditure recorded since 1984, have been largely responsible for this outcome. The latter, in particular, is a very substantial turnaround, in light of the record levels of business investment achieved in 1990.
- *Retail sales* have continued to slow, and in the June quarter fell by 2 per cent, in real seasonally adjusted terms. Indicators of building investment have also fallen, with both the number and value of permits issued, of both dwellings and other buildings, considerably lower over recent months than at the same time last year. However, this downward trend in building permits appears to have been halted, and possibly reversed, in September.
- The external sector has continued to perform strongly. In the year to June, *export volumes* are estimated to have grown by around 10 per cent, compared with the previous year, while *import volumes* appear to have fallen by around 4 per cent. In the year to September, the economy recorded a *trade balance* of \$1.2 billion, compared with a deficit of \$400 million in the previous year.
- In the year to March 1991, the *current account deficit* is estimated to be \$2.3 billion, virtually unchanged from the \$2.2 billion recorded in the year to March 1990. However, the deficit is expected to be reduced substantially over the next couple of years, largely due to an expected improvement in the trade balance.
- The improving outlook for the export sector may have been one factor behind the partial recovery in business confidence from the record lows reached in early 1991. The National Bank's October Business Outlook Survey - the latest survey available - reported that a net 17 per cent of respondents expected general business conditions to improve over the next year. This result is

slightly up on that recorded in September, although it is less positive than was the case four months ago.

- Unemployment has continued to increase, with the Household Labour Force Survey official unemployment rate reaching 10.7 per cent in the September quarter. Employment losses over the quarter have been particularly severe in the manufacturing, construction and retail trade sectors.

Inflation and Inflation Expectations

Recent surveys indicate a further fall in inflation expectations.

- Surveyed expectations of inflation have continued to fall over recent months. The *Reserve Bank's Survey of Expectations* in September suggested that businesses expect the inflation rate to be 2.5 per cent in September 1992 - down from the 4.7 per cent year-ahead expectation recorded a year ago. In a similar vein, the *National Bank October Business Outlook Survey* recorded an expectation of 3.4 per cent inflation in October 1992 - down from the 7.2 per cent recorded a year ago. And a recent consumer survey indicated a continuing downward trend in household inflation expectations, although they remain higher than those of businesses.
- The NZIER's *Quarterly Survey of Business Opinion* for September reported that, on average, firms have not faced cost increases over the quarter. In addition, a record number of respondents reported cutting their prices. Most respondents expect to reduce their prices over the December quarter, and do not expect any increase in their costs, suggesting weak underlying inflationary pressures.

Measured inflation has continued to fall over the period and is expected to fall further by the end of 1991. A number of budget measures and the decline in the exchange rate are expected to push inflation up during 1992. Inflation is forecast to fall again in 1993 to reach the price stability objective by the end of that year.

- The CPI rose by only 0.4 per cent in the September quarter, bringing measured inflation down to 2.2 per cent for the year to September. This is the lowest annual rate recorded since December 1963, and is well below last year's five per cent inflation rate. Measured inflation is now forecast to decline slightly below 2 per cent by December 1991.
- Some increase in measured inflation is expected over 1992, mainly due to the depreciation in the exchange rate experienced over the past three months. The lower exchange rate increases the domestic price of tradeable goods, directly contributing to higher inflation. Some subsequent pass-through to other prices can be expected, with the full effect expected to be evident by the end of 1992. The overall effect of the recent depreciation on inflation is likely to be less than usual, given the present weak state of domestic demand.
- A number of measures announced in the Budget, largely directed towards increased 'user charges', will impact directly on prices. While these factors are

expected to boost measured inflation in 1992, they will drop out of the measure the following year. They are therefore not expected to jeopardise the December 1993 price stability objective.

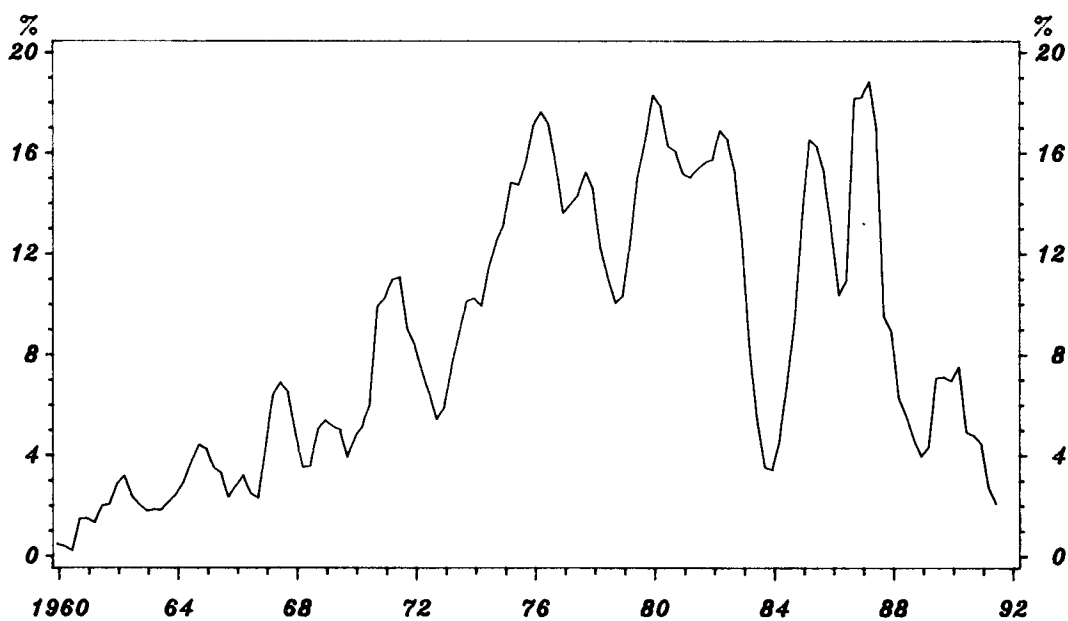
- 'Underlying' inflation, by excluding factors that impact only temporarily on measured inflation, is more relevant for the operation of monetary policy as it conveys information regarding trends in inflation. Underlying inflation is now expected to be in the upper half of the indicative range for December 1992. However, this upward revision in the forecast of underlying inflation does not undermine the prospects of achieving the price stability objective, and inflation is still expected to be within the 0-2 per cent range targeted for December 1993.

Policy Issues

The main monetary policy issue over the past three months has been the Bank's 25 September easing of monetary policy, in the context of a forecast undershoot of the indicative inflation ranges.

- At the time of the August Monetary Policy Statement, underlying inflation was forecast to be around the bottom of the Bank's indicative ranges for both December 1991 (2.5-4.5 per cent) and December 1992 (1.5-3.5 per cent). Despite the likelihood that price stability would be achieved a year ahead of schedule, the Bank considered it inappropriate to ease monetary policy at that stage since inflation was still forecast to be within the indicative ranges for 1991 and 1992, and within the target range for 1993.

Figure 5
Year on Year CPI Inflation
(1960-1991)



- Subsequently, however, the outlook for inflation improved. Expectations of inflation were reported to have fallen further, while the domestic economy appeared to be significantly weaker than had earlier been thought, implying a more rapid easing of inflationary pressures. As a result, underlying inflation was forecast to fall below the indicative range for December 1991 and also seemed likely to be below that for December 1992. Although unable at that stage to alter the December 1991 inflation outcome, an easing of monetary policy in September would have the potential to bring inflation back within the indicative range for December 1992. Further, with inflation forecast to undershoot the indicative ranges, the risk that an explicit easing of monetary policy might lead to an *overshoot* of the ranges was significantly less than had been the case at the time of the August Statement.
- With these considerations in mind, on 25 September the Bank announced an easing in the stance of monetary policy, in the form of a \$5 million increase in the Bank's daily settlement cash target (to \$20 million), which took effect that day. Monetary conditions eased (both wholesale interest rates across the yield curve and the exchange rate fell), while financial market participants appear to have regarded the Bank's action as consistent with the price stability objective - as reflected in the further fall in bond rates.
- The interest rate falls that resulted from the September monetary policy easing were small in relation to the substantial declines over the past year. Monetary policy has, in fact, progressively accommodated easier monetary conditions for some time. Nonetheless, the explicit nature of the 25 September action was regarded by financial market participants as particularly significant.
- The Bank's implementation of monetary policy over the period has reflected the view that the indicative inflation ranges should be treated as clear and symmetrical targets, consistent with steering a steady course for price stability along broadly pre-announced lines.

APPENDIX 1

Main Developments

Events during the period which have impacted upon or had implications for monetary policy and inflation include:

- 12 August - The Reserve Bank released its fourth Monetary Policy Statement.
- 13 August - The Reserve Bank released a statement, saying that it was unhappy with recent pressures in the call market. The Bank was watching the market closely, and was prepared to lend to individual banks - or take other action - if it considered such action to be necessary.

- 21 August - The Reserve Bank announced a temporary cash target increase, to \$30 million, to alleviate recent pressures in the call market, which had previously been described by the Bank as unwelcome.

- 25 September - The Reserve Bank eased monetary policy, by announcing a \$5 million increase in the daily settlement cash target (to \$20 million). A statement was released in conjunction with the easing, explaining that the decision to ease was taken because it appeared likely that inflation would fall below the indicative ranges in both December 1991 and December 1992.

- 4 October - The Government announced its intention to revise changes to superannuation policy which had been announced in the Budget.

- 8 October - Audited figures showed that the Government's fiscal deficit for the 1990/91 financial year was \$513 million less than previously estimated.

- 15 October - The CPI rose 0.4 per cent, in the September quarter, bringing inflation for the year to September 1991 to 2.2 per cent.

- 25 October - The Government called for bids for the sale of Timberlands.

