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**MONETARY POLICY AND THE
NEW ZEALAND SYSTEM:
AN HISTORICAL PERSPECTIVE**

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I. INTRODUCTION

In the last 140 years New Zealand has operated under four monetary policy regimes. The first, in place until 1914, linked New Zealand to the international gold standard. Under this regime the trading banks issued paper money which was convertible on demand into a legally defined amount of gold, but they faced few other legislative restrictions. The potential for arbitrage served to fix the exchange rate within a narrow band around the parity automatically defined by the gold values of the currency in New Zealand and that in any other gold standard country. This system was characterised by marked fluctuations in prices and economic growth and, in the absence of a central bank, government intervention was used to stabilise the banking system in the crisis of the early 1890s.

With the suspension of the gold standard in 1914 and the decision not to return to a gold basis for regulating the currency and the exchange rate in the 1920s, a second monetary policy regime emerged. This was characterised by the use of a managed floating exchange rate and a fiduciary monetary system. However, this regime was poorly understood by contemporaries, and, especially after the Great Depression of the early 1930s, proved incompatible with government fiscal policy and the increasing concern for macroeconomic stability.

From the 1930s onwards New Zealand adopted a third monetary policy regime focused on direct control of monetary instruments, mandated low interest rates, management of the current and capital accounts of the balance of payments and regulation of the asset portfolios of financial institutions. But mandated low interest rates combined with expansionary fiscal policies and a desire to minimise unemployment were incompatible with price level stability. It was also the case that the complex of direct controls on monetary institutions and instruments distorted and inhibited the operation and development of New Zealand financial markets.

As a result, by the early 1980s the consensus of opinion was that price stability and the efficient operation of the financial system could best be achieved by the use of monetary policy instruments which minimised the distortion to the financial system and made maximum use of market forces in the determination of macroeconomic equilibrium. These attitudes underpinned the emergence of the fourth monetary policy regime from July 1984. This regime is characterised by a concentration on price stability as the objective of monetary policy, with policy to be operated within a context of deregulated financial markets.

Each of these monetary policy regimes was designed to provide for the operation of the financial system in a manner which contemporaries considered most likely to promote sustained real economic growth and rising standards of living. This essay surveys the history of the financial system and of monetary policy in New Zealand since the middle of the nineteenth century. Section II focuses on the history of the financial system, while Section III focuses on explaining the origins, implementation and eventual demise of the highly regulated monetary policy regime associated with the five decades before 1984. (Each of these sections can be read independently.) Section IV concludes.

II. THE FINANCIAL SYSTEM AND INSTITUTIONAL ARRANGEMENTS

STRUCTURE OF THE FINANCIAL SYSTEM

The first trading bank began operation in New Zealand in 1840. By 1880 there were six trading banks, each with significant branch networks, although four of these had their head offices outside New Zealand and three were primarily Australian institutions. Together with the stock and station agents, they were the most important financial institutions in nineteenth century New Zealand (Table 1) reflecting the focus of economic activity on farming and trade. The subsequent institutional evolution of the financial system reflects

both the development of new instruments and markets by the private sector and the impact of direct government participation in the financial system. Government participation involved the creation of distinctive institutions designed (at least initially) to provide state control over aspects of the operation of financial markets or to fill perceived market gaps.²

The long run relative decline in the share of financial intermediation accounted for by the trading banks and stock and station agents resulted from the increase in the demand for financial services that they could not efficiently provide competition from government institutions (particularly the Post Office Savings Bank and the State Advances Corporation) as well as the impact of regulation on the banks. Because of the pivotal role of the trading banks in the monetary system, they were the focus of financial system regulation until the 1970s. As a result, the ability of the trading banks to compete with other intermediaries was impaired by regulatory restrictions, reducing their share of total intermediation to historically low levels by the early 1960s.

The development of new institutions and markets in the 1970s and early 1980s also resulted from the institutional controls which were key instruments of monetary policy. Increasingly stringent controls on the interest rates and balance sheets of the largest established institutions promoted disintermediation at the core of the financial system by removing the ability of banks to offer competitive services to their customers. This trend is most notable for the Post Office Savings Bank, where government policy held deposit interest rates at levels providing extremely low or negative returns for over 40 years, with the result that its share of total intermediation fell dramatically (Table 1). In turn, this encouraged the search for means of avoiding mandated low interest rates. The problems of rationing and prioritisation of lending which regulations forced the core intermediaries to adopt, stimulated financial innovation in the form of increasing use of international financial markets and new types of domestic institutions.

CENTRAL BANKING POLICY

Modern central banking functions include the issue of currency, prudential supervision of the banking system, supervision of bank clearing, management of the exchange rate and the implementation of monetary policy. The first central banking institution in New Zealand was the Colonial Bank of Issue, which was established in 1847 and opened in 1850. It arose, in part, out of the perceived shortage of currency that often characterised newly established colonies which had limited private banking facilities. The most important trading bank, the Union Bank, issued notes payable in specie on demand only in Sydney, and operated only a small number of branches in New Zealand, so there was widespread dissatisfaction with the facilities it provided. During the 1840s government debentures with values as small as 2 shillings were used as legal tender. However over-issue associated with poor fiscal management reduced public confidence in them even though they were declared legal tender.

More importantly, the establishment of the Colonial Bank of Issue was closely linked to debates about monetary policy in Britain. Lord Grey, the Colonial Secretary in Britain, was an advocate of the strict link between metallic money and the issue of notes which had been enshrined in the English Bank Charter Act of 1844, and believed that this could only be achieved if the issue of notes was kept separate from the business of commercial banking. Grey's response to the currency problems of the government was therefore to urge the establishment of a state bank of issue which would ensure the specie backing of all paper currency issued.

The Colonial Bank of Issue operated until 1856, when it was wound up. It had performed its currency issue function without serious difficulties, but failed to meet criticism from a number of different quarters. Its monopoly of the note issue was considered to inhibit the extension of commercial banking facilities in the colony because the note issue was an important source of funds for banks in this period. In addition, its reserves were invested

in British consols earning a much lower rate of interest than the debt of the colony. Many settlers considered that both of these factors reduced the availability of credit in the colony, and viewed the provision of a state guarantee of the currency as providing inadequate compensation for this. Moreover, the over-issue of debentures in the 1840s had prompted a strong sentiment opposed to state control of the currency, and merchants, in particular, always viewed the Colonial Bank of Issue with suspicion.

The costs and benefits of central banking were regularly debated in subsequent decades, with considerable confusion between the notion of a commercial bank operated by the state (either as a basis for ensuring competition or to provide cheap credit) and concerns with overall management of the monetary and credit system and the issue of notes.

The Bank of New Zealand had enjoyed a very close relationship with the government since 1862, when it acquired the government banking business. Following the government bailout of the shareholders in the Bank of New Zealand in the 1890s, debates about central banking became even more complex because it was clearly possible for the state to use the Bank to influence interest rates and credit policy, as well as to undertake some central banking functions. These ideas were widely discussed when the Labour government purchased the private shares in the Bank of New Zealand in 1945, but no explicit 'state banking' functions were ever imposed upon it.

The Reserve Bank of New Zealand emerged out of debates about macroeconomic management between 1929 and 1933, particularly related to exchange rates, monetary policy and fiscal policy. The original blueprint for central banking in New Zealand was provided in a report completed by an official from the Bank of England, Sir Otto Niemeyer, in 1931. The Reserve Bank of New Zealand was authorised by statute in November 1933 and began operations in August 1934. The legislation followed the guidelines provided by Niemeyer in large measure, providing what were at the time considered to be the normal functions of a central bank associated with the note issue, government debt management, management of the banking system and the holding of its reserves, and the provision of discounting facilities. The powers of the bank to make or underwrite loans to the government were tightly constrained, and in line with the widely held view that a central bank could be operated with minimal political interference, the majority of the shares in the Reserve Bank were privately owned.

There was, however, one very important change to the recommendations provided by Niemeyer, who had placed great stress on the fact that stability of the value of its notes should be the primary duty of the Bank, and that it should be required to exercise control over money and credit towards that end. The Act of 1933 in fact provided that the primary duty of the Reserve Bank would be to exercise control "over monetary circulation and credit in New Zealand, to the end that the economic welfare of the Dominion may be promoted and maintained". The change in emphasis is indicative of the extent to which the great depression had become the primary influence on thinking about the need for a central bank.

Following the election of a Labour government in New Zealand two major changes to the constitution of the Reserve Bank were introduced in 1936. First, the Bank was nationalised and the statement of the general function of the Bank rewritten to provide that it should "... give effect as far as may be possible to the monetary policy of the Government as communicated to it from time to time by the Minister of Finance ...". Second, the original restraints on the government's use of Reserve Bank credit were relaxed and it was given a variety of other powers commensurate with the Labour mandate for more active and expansionary central bank policies. In each of 1939, 1950, 1960 and 1964 there were further amendments to the Reserve Bank Act, and changes of government were invariably associated with revisions of the clauses spelling out the relationship between the government and the Bank. The Reserve Bank Act of 1964 was largely a consolidating measure, but it provided enhanced power to regulate and monitor the whole financial system, and restated the role of monetary policy as being:

"... directed to the maintenance and promotion of economic and social welfare in New Zealand having regard to the desirability of promoting the highest degree of production, trade, and employment and of maintaining a stable internal price level".

Once again, however, the legislation did not offer guidance on the priority to be accorded each of these goals.

As inflationary pressure in New Zealand increased, the regulatory powers of the Reserve Bank were further extended to provide government with a mechanism for extending the web of controls on the financial system. In 1973 amending legislation provided the Bank with the power to issue investment directives to financial institutions (widely defined), to obtain information about their activities, impose (by Order in Council) investment ratios on these institutions, and specify the rates of interest which they could pay. This was particularly important because it removed the requirement for the imposition of controls on the building societies, private and trustee savings banks by amendments to their individual charters.

In 1986 the Act was amended to introduce a bank registration and prudential supervision function, intended to increase the ability of new banks to enter the market provided they met certain prudential standards. The 1989 Act, described in more detail elsewhere in this book, retained this function, but considerably changed the monetary policy role of the Bank to one in which the Bank's primary objective is to achieve and maintain price stability.

REGULATION OF THE BANKING SYSTEM

Free Banking

In the period up to 1930, and in the absence of a central bank, government regulation and control of the trading banks in New Zealand was minimal. However, legislation did not provide for a completely free banking market: entry was regulated by the requirement that a parliamentary charter (Act of Parliament) be obtained by each institution before commencing operations.³ These charters contained, with only minor variations, the requirements attached to the operation of each bank; they provided banks with the sole right to issue notes while requiring that they provide monthly returns on their New Zealand business to the government, maintain convertibility of notes into gold on demand and maintain a minimum gold reserve requirement to secure the note issue. In addition they required that bank shareholders should carry double liability. The charters of the banks contained additional clauses whose intention was to limit the credit structure which could be created utilising a fractional reserve system by requiring that:

- (a) the notes in circulation should not exceed the total of gold coin, gold bullion and public securities held in New Zealand, or more than three times the gold coin held in New Zealand; and
- (b) the 'debts, engagements and liabilities' of the banks should not exceed three times the gold coin, gold bullion and public securities held in New Zealand.

After 1914 these regulations continued in force with the exception that gold convertibility on demand ended and assets other than gold could be used as part of the reserve securing the note issue.

The reserve requirements were not binding for the system as a whole because the banks chose to maintain gold holdings which were often three times the value of the note issue. This policy is best explained by the fact that under the gold standard, gold was both legal tender and the most liquid reserve asset available to the banks. Because of the policy of securing advances against real estate, the loan portfolios of the New Zealand banks were less liquid than they would have been if their lending had been confined to short term

commercial lending (as envisaged in the real bills doctrine). With secondary reserves held in London, the nearest source of minted gold in Australia, and in the absence of a central bank or government rediscount facility, the New Zealand banks found that maintenance of an appropriate level of portfolio liquidity required that they keep relatively large amounts of gold in New Zealand.

The provision that shareholders carry double liability required that, should a bank become insolvent (have assets with a market value less than its liabilities), the shareholders would be liable to contribute an additional amount equal to their subscribed capital to secure the noteholders and depositors. Double shareholder liability was used in New Zealand, Australia, Canada and some parts of the US, and may be interpreted as a device which focused risk bearing and monitoring costs on the shareholders rather than on the noteholders and depositors of the banks, and which secured bank creditors with the personal wealth of the shareholders outside of their interest in the bank. Given the standards of accounting and auditing in the nineteenth century it was more profitable for shareholders to assume the bulk of risk and monitoring costs and accept higher returns in compensation than to adopt the modern form of liability limited to subscribed capital which can be fully paid.

However, the New Zealand legislation did not specify that an insolvent bank should be wound up in the process of calling additional liability, though this was clearly the intent of the legislation. This loophole allowed the Government to call a portion of the double liability of the shareholders in the Bank of New Zealand in the 1890s as part of the process of reconstructing the bank, when liquidation of the bank could have been required. From this time onwards, therefore, the double liability clause in New Zealand must be interpreted as requiring banks to operate with paid-up capital of no more than 50 per cent of the subscribed capital, with the proviso that this capital could only be called if a bank informed the Government that it was insolvent. This interpretation of the legislation ameliorated the impact of double liability on shareholders by allowing them to attempt to recover their lost capital rather than liquidate their bank, but still provided considerable security for bank creditors. Only after World War Two, with the use of independent audits and the gradual development of reserve ratio requirements and other controls on the banking system, did bank shareholders consider that double liability had become redundant and obtained legislation altering their charters to remove it.⁴

Before 1930 the New Zealand financial system exhibited a relatively high level of stability, especially when compared to countries such as the US. However, this cannot readily be utilised as evidence in support of the view that the operation of the financial system is most efficient in the absence of government regulations.⁵

First, the need to obtain charters, monthly government reporting requirements and, after 1894, a government equity interest in the Bank of New Zealand provided for a substantial level of government oversight of the banking system. Second, at least two important financial crises did occur in New Zealand and in each case government action was required to avert major disruption to the financial markets. When a financial crisis occurred in Australia in 1893 the Bank of New Zealand was on the edge of insolvency, and would have failed in the absence of the temporary suspension of the gold standard and direct government involvement in the reconstruction of the bank. Similarly, in 1921 the stock and station agents and loan companies in New Zealand found themselves unable to liquidate assets sufficiently quickly to meet the withdrawal of the deposits that they had built up at the end of World War One by offering higher rates of interest than the trading banks. To prevent their failure the Government introduced legislation providing for a moratorium on deposits in these institutions.

Supervision and Regulation of Trading Banks

Prudential supervision aimed at minimising the risk of the failure of individual financial institutions and financial crises became much more explicit in other countries after the 1920s and 1930s, but in New Zealand this trend has been much less obvious. The Reserve Bank provided close scrutiny of the operations of many institutions through regular reporting requirements, but this was not used as a basis for more extensive supervision except with respect to the foreign currency position of the trading banks, where formal supervisory rules were applied. In many respects, a large range of monetary policy regulations affected the balance sheets of financial institutions although these were not always in line with sensible prudential requirements. Of these regulations, reserve or public sector security ratios were most important, but controls on the composition of lending and credit growth guidelines were also significant at different times.

From 1942 the sectoral composition of the loan portfolios of the New Zealand trading banks was regulated by 'selective advance controls' imposed by the Reserve Bank. These were introduced during the war to reduce the availability of credit for speculation (and thus reduce inflationary pressure) as well as to direct loans into purposes consistent with the war effort. They involved specifying in detail types of advances which were entirely restricted as well as those to which the banks were able to allocate a maximum discretionary amount, but provided for the Reserve Bank to exercise some discretion in some cases. Controls on bank lending were retained after the war in the belief that they represented:

"an important part of credit policy, particularly in countries which depend substantially upon overseas trade where the availability of bank credit to produce, process and finance exports must always be of the highest priority, even during periods of general restriction". (Reserve Bank of New Zealand 1963:110)

In 1947 the restrictions were broadened to apply to loans for capital expenditure and investment, including the purchase of farm properties, but were liberalised in 1950 and 1953, with much more discretion being placed in the hands of the trading banks in the latter year. In 1960 and 1961, and in response to general pressure in the credit market, the controls were again tightened, providing less discretion and more precise requirements for trading banks aimed particularly at limiting advances to finance imports and personal loans. Pressure eased again in late 1962.

The Report of the Royal Commission on Monetary, Banking and Credit Systems (1956) criticised the practice of monetary policy in New Zealand for the lack of co-ordination between different policy stances and regulations, the implementation of reserve ratios and voluntary co-operation from competitive trading banks (which was not always forthcoming) in regulating the amount of credit, and the failure of policies to adjust sufficiently to meet changing conditions. It recommended changes in the use of existing policies, including that minimum reserve requirements be adjusted "quickly and resolutely to make them effective and no limit should be placed on the power to raise these requirements to the appropriate level". It also recommended that the banks should be permitted to invest in government securities "if an effective system of control of total bank credit is adopted". In addition, it recommended the introduction of a new policy instrument: credit growth guidelines.

"In consultation with the trading banks, the monetary authorities should assess appropriate levels of bank credit for the months ahead. They should inform the trading banks of the policy decided upon and provide direct financial incentives for co-operation."

This policy was adopted, but, as the Monetary and Economic Council observed in 1961, the system was not operating to full advantage because of the failure of the authorities to provide sufficiently rigorous guidelines and enforce penalties when these were not observed.

In the 1960s officials attempted to control the growth of lending by setting advance ceilings for the trading banks and by mechanical adjustment of the banks' cash reserve requirements to the extent that they stayed within or exceeded their limits. Banks could be forced to borrow from the Reserve Bank at penal rates (and thus sanctioned for exceeding the credit growth limits) by increasing the requirement for cash reserves above their current holdings. But under this system competition between banks was inhibited because changes in market share were difficult to accommodate in the calculations of the limits which should be imposed on each bank.

By the end of the 1960s officials at the Reserve Bank were considering alternative means of credit growth control. In 1971 and 1972 a guideline growth policy was adopted as a temporary expedient which was initially intended to limit the amount by which the ceiling for low priority advances could be adjusted as a result of an increase in long-term deposits, but in 1972 it was actually used to encourage the banks to lend more.

By 1973 it had been replaced by a variable reserve assets requirement (RAR) which set on a monthly basis minimum levels of trading bank holdings of government securities, Reserve Bank notes and deposits, designed to provide for a desired level of monetary and credit expansion. Under this system, which operated with some modification⁶ throughout the period to 1984, any bank facing a shortfall of reserve assets because of an expansion of its lending could acquire assets by interbank borrowing, competing away other banks' deposits, exchanging deposit liabilities for reserve assets held by the non-bank private sector, and acquiring foreign exchange that could be used to obtain deposits at the Reserve Bank. This system had the advantage of allowing competition between the banks while still constraining the growth of credit overall, though during the periods of strict controls on interest rates the ability of the banks to compete was severely constrained in any event.

Public Sector Securities Requirements on Non-Bank Institutions

During the 1960s it became clear that the instruments of monetary control being employed were increasingly less effective. This was in part because of the impact of the policies on the ability of banks to compete with other financial institutions, which in turn meant that monetary policy controls were increasingly being applied to a smaller fraction of the financial system. The response of the Government was to attempt to constrain the credit multiplier, and thus the rate of credit growth, by extending public sector securities requirements to all of the major institutions operating in New Zealand.

The precedents for the application of this policy to the non-bank financial institutions were the trustee savings banks who operated with a public sector securities requirement under the terms of their Act (1948), and the Post Office Savings Bank which had invested all funds in government securities up to that time. A government securities requirement was imposed on the private savings banks from their establishment in 1964, and on building societies in 1966. In this period finance companies, hire purchase companies, stock and station agents and life insurance companies all agreed to 'voluntary' public securities ratios which were made more formal in subsequent years, and in 1970 a ratio requirement was established for private superannuation schemes.

With the benefit of hindsight it seems clear that the most important advantages associated with public sector securities requirements were the provision of a captive market for government securities. It meant that the fiscal deficit could be financed at rates of interest below the market level and appeared to be particularly advantageous for a government that wished to adopt both an expansionary fiscal policy and keep interest rates low.

In other respects the use of public sector securities requirements raised many difficulties. First, they could not be changed very often without causing considerable difficulties for the individual financial institutions and for the financial system as a whole. This problem was particularly acute so long as interest rates on government securities were held below the market rate, because it meant that changes in reserve asset requirements affected the

profitability as well as the portfolio structure of institutions. As a result, reserve asset ratios were changed infrequently, with consequent loss in their precision and usefulness as a tool of monetary policy.

Second, the ratio requirements varied between different institutions, reflecting historical factors such as the time of first introduction, the split between government and private ownership in different sectors, and perceptions of the 'normal' level of holdings of government securities among different types of institutions. But this meant that competition within sectors was inhibited by mandatory reserve requirements and consequent limits on the range of choices of total portfolio composition.⁷ Moreover, it meant that different types of institutions, and thus their customers, were taxed to different degrees by the requirement to hold low-yielding government securities.

Third, the often claimed benefits of ratio requirements with respect to liquidity, solvency and stability were over-rated. The flexibility of institutions in adjusting liquidity to different conditions was inhibited, and the liquidity of the securities (at book value) was in doubt both because of their low yield and the fact that institutions were not able to sell them if they were required to meet mandated reserve ratios. Stability was adversely affected by the fact that reserve ratios reduced both profitability and flexibility in portfolio management.

Finally, the direction of funds into government securities distorted flows into other types of securities. In the 1970s and early 1980s this led to government attempts to include in the ratio requirements loans to sectors with high political priority, such as housing and farming, and hence to further distortions in the overall pattern of intermediation in New Zealand. By 1984 private superannuation schemes and life insurance companies were forced to allocate more than 40 per cent of their portfolios within the framework of public sector securities requirements.

III. MONETARY POLICY

PRICES AND THE FRAMEWORK FOR MONETARY POLICY

Changes in the stock of monetary instruments in an economy in excess of the change in the real output of goods and services will generally lead to a rise in the price level in subsequent years - or, in other words, inflation. Empirical validation of this relationship is made difficult since, over time, financial markets have provided a range of instruments which have the characteristics of money, and the makeup of the money supply has evolved with the emergence of new institutions and instruments. Nevertheless, using a broad definition of the money supply (M3), it is clear that periods of rapid growth of the money supply have often been linked with high levels of price inflation, particularly during and after World War One and from 1960 to 1984 (Figure 1).

Up to 1914 the legal requirement that the notes issued by the trading banks be convertible into gold on demand linked New Zealand to the international gold standard and established a fixed exchange rate. The New Zealand banks maintained the credibility of the link with gold by holding relatively large reserves of gold coin in New Zealand and sterling balances in London.

By the interwar period economists in New Zealand had noticed that the balances held by the trading banks in London were the primary determinant of the expansion and contraction of credit in New Zealand. This was because in a small open economy trading primarily with the UK, sterling exchange was required to pay for imports and debt servicing, while export receipts and capital came primarily from the UK. It was crucial to the operation of this system that the UK was also on the gold standard; this meant that so far as the New Zealand trading banks were concerned, sterling balances were equivalent to holdings of gold for purposes of maintaining gold convertibility at the fixed exchange rate. For purposes of

making international settlements, sterling balances had superior convenience to actual holdings of gold coin.

The international gold standard had particular significance for macroeconomic trends in New Zealand because it focused adjustment to balance of payments disequilibria on the internal price level. Thus in New Zealand in the decades before 1914 there were frequent and sharp variations in the price level and the money supply, and periods of price inflation were offset by deflationary episodes which restored purchasing power parity and the equilibrium real exchange rate.

At the outbreak of war in 1914 the operation of the gold standard was suspended: the legal convertibility of bank notes into gold was abrogated, with bank notes being declared legal tender, exports of gold were prohibited without the permission of the Minister of Finance and, subsequently, the liquid asset requirements imposed on the banks were altered to provide for greater holdings of securities as reserves. But New Zealand did not follow Britain in returning to the gold standard in 1925; the barriers to the export and import of gold coin were never removed and the legal convertibility of bank notes into gold was not restored. In 1924, Professor A.H. Tocker argued that even under these conditions the essence of the gold standard could be retained by adopting a 'sterling exchange system' defined as:

"the maintenance of an approximately fixed exchange rate, and the automatic increase or decrease of monetary media within the exchange standard country to the extent of the net balance of payments through the exchanges ... [purchasing power parity is maintained] by providing that the money of the exchange country shall expand or contract automatically with similar changes in central reserves held overseas, variations in both being governed by the net balance of international payments".

This argument implied that so long as there was a fixed exchange rate and the banks provided for convertibility of New Zealand pounds into sterling on demand, sterling was a direct link with gold and so a formal commitment to the gold standard was redundant. But Tocker failed to note that without the discipline provided by legal convertibility of bank notes into gold the exchange rate was free to float outside the gold points whenever the policies of the banks or the government required an adjustment in the value of New Zealand funds to maintain purchasing power parity. This was the case prior to 1931. Although the banks attempted to manage the exchange rate at values near the traditional gold parity, the exchange rate was floating from August 1914 until 1931. The sterling exchange system described by Tocker existed only from January 1931 when the government fixed the exchange rate by agreement with the banks, until December 1938, when exchange control was introduced.

In response to the problems created by the onset of the Great Depression in the early 1930s, the New Zealand government introduced legislation regulating interest rates, fixing the exchange rate, and providing the power to use exchange control, as well as attempting to influence institutional lending policy. After World War Two these policies became entrenched in New Zealand. Monetary policy was built upon the implicit view that governments should have the maximum flexibility in fiscal and debt policy, that mandated low interest rates would ameliorate the effects of fiscal policy on domestic financial markets, and that inflation, foreign exchange crises and any other serious consequences of these policies could be alleviated by the application of additional controls.

Over the period from 1945 to 1984 the main features of monetary policy were:

- (a) the use of reserve or public sector security requirements and guidelines for growth in lending as a basis for limiting the expansion of credit;

- (b) administratively determined interest rates on government debt and controls over other interest rates prevailing in the domestic financial market;
- (c) a discount policy under which the Reserve Bank would buy and sell government securities of any maturity on demand and at a price changed at relatively infrequent intervals; and
- (d) a comprehensive system of exchange controls combined with a fixed or pegged exchange rate.

These policies appeared to be successful in the 1950s, when New Zealand benefited from favourable world prices for its exports and high rates of economic growth, but from 1960 onwards rates of inflation and credit growth increased substantially and the problems associated with this type of macroeconomic management became increasingly apparent.

In the 1970s and early 1980s the fundamental incompatibility of the different elements of monetary and fiscal policy followed by New Zealand governments in the previous two decades was highlighted by the disruption to the international economy resulting from the collapse of the Bretton Woods system of fixed exchange rates and the inflation and balance of payments difficulties resulting from large increases in oil prices. These conditions increased the size and volatility of new additions to the reserve assets of the financial system through the issue of securities to finance the Government's fiscal deficit. The resulting inflationary pressure placed more emphasis on the use of monetary policy to limit the growth in monetary and credit aggregates.

Within the framework for monetary policy in place during this period, monetary control could only be achieved by limitations on the extent to which financial institutions could expand their balance sheets, but this in turn implied strong upward pressure on nominal interest rates. Unwilling to accept this consequence, the Government found that interest rate controls were a necessary accompaniment of controls on institutional balance sheets.

This was most clearly illustrated from 1976 to 1981, when an attempt was made to reduce the severity and extent of interest rate controls. It became clear that with expansionary government fiscal policy and in the absence of more broad ranging liberalisation of the financial markets, removal of interest rate controls would simply focus the intense pressure building up within the New Zealand economy on the cost of credit. In response to continued high levels of inflation and credit growth, uncontrolled nominal interest rates increased sharply in the late 1970s and early 1980s, prompting the Government to reintroduce controls on interest rates in November 1981 with further controls added as part of the comprehensive wage/price control package in June 1982. These controls had the temporary effect of reducing inflation, but did not address the underlying causes of high inflation and high interest rates.

INTEREST RATES

In countries such as New Zealand that have relied on high levels of borrowing to finance development, interest rates have often provided a focus for popular discontent. New Zealand is particularly notable for its long history of experimentation, first with the provision of cheap credit to particular groups of debtors, and subsequently with mandated low interest rates across most of the financial system. Government policies on interest rates have often been based on erroneous concerns about 'market failure' and a poor appreciation of the costs of such policies: cheap loans represent a subsidy to the particular borrowers concerned, and the resulting diversion of funds has implications for the efficient operation of the financial system as a whole. Even more serious ramifications flow from the tendency for governments in New Zealand, from the early 1930s onwards, to legislate the interest rates that private intermediaries could charge.

Deane (1975; 1980) provides an overview of the costs of mandated low interest rates, focusing on the resulting allocative inefficiencies and restrictions on monetary policy. The influence of mandated low interest rates over the level and form of saving in New Zealand is perhaps demonstrated most starkly by the tendency for regulations to require institutions to offer depositors and borrowers rates of interest which were negative in real terms (after adjusting for the inflation expected over the term of the loan). As a result, saving in controlled institutions was discouraged, and because loans at controlled interest rates provided the borrower with a subsidy provided by depositors, the demand for credit often exceeded the available funds.

At the same time, controlled interest rates severely constrained the operation of monetary policy by allowing government debt to be floated at a cost below the market rate, and the public were encouraged to transfer their business to institutions outside the net of official controls. The latter effect also implied that the competitiveness of different institutions was influenced more by the dictates of government regulation than by the efficiency with which the institution was operated.

Regulated interest rates also meant that the capital account could not act as an equilibrating factor in the balance of payments and the economy more generally. Mandated low interest rates encouraged borrowing and spending, which in a small open economy created a demand for imports, while at the same time inhibiting the flow of funds on private account to accommodate the resulting current account deficit. Thus, interest rate controls were a fundamental cause of the series of foreign exchange crises that led to government intervention in the foreign exchange market in the period from the early 1930s to 1984.

In the period of falling prices from 1880-1895 borrowers faced high ex-post real rates of interest, and there was particularly widespread popular agitation about the cost and perceived shortage of credit for farmers. A government asset tax on mortgage loans, which became a heavy burden as interest rates fell and which was particularly onerous for foreign investors, drove lenders from the mortgage market and reduced the extent to which interest rates could fall (Quigley, 1989). But rather than address these anomalies in the taxation system, the Government Advances to Settlers Act 1894, was introduced to provide a framework within which the Government could make mortgage loans to farmers at below market rates of interest. These facilities were subsequently extended to urban properties. Through this institution the Government was able to exercise some influence over the average rates of interest being paid in the mortgage market, and forced private lenders who wished to hold high quality mortgage securities to match the terms which it offered to borrowers. However, government lending at below market rates of interest served primarily to drive private lenders from the mortgage market to higher returns on other types of assets.

The history of direct controls over interest rates in New Zealand goes back to World War One, when the Government's domestic borrowing requirements for war purposes prompted the introduction of controls on the interest rates of their competitors, the local bodies. During the late 1920s the trading banks were under considerable pressure from the Government to reduce interest rates, and in the early 1930s the first systematic controls on interest rates were introduced as a response to the Great Depression.

The Local Authorities Interest Reduction and Loans Conversion Act 1932/33 and amendment in 1934 provided for the conversion of local body debt obligations to lower interest rates and set the maximum rate of interest at which new borrowing could be undertaken at 3.5 per cent from 1934 (4.5 per cent from May 1939). The National Expenditure Adjustment Act 1932 reduced the interest rate on existing mortgages by 20 per cent (with a minimum of 6.5 per cent for chattel mortgages and 5 per cent for other mortgages), and these controls were made permanent in the Mortgages and Lessees Rehabilitation Act, 1936. Interest rates on bank loans were reduced by agreement between the Associated Banks and the government under threat of legislation, with the result that from 1930 to 1933 minimum overdraft rates fell from 6.5 per cent to 5 per cent.

Even then, there was a widespread popular consensus that interest rates continued to be too high, and academic economists in New Zealand generally supported this position. The Monetary Committee of 1934 heard evidence from three academic economists, all of whom were in favour of further legislated reductions in interest rates charged by both the banks and other financial institutions. The report compiled by this Committee expressed the view that a legislated adjustment of interest rates would increase economic activity by stimulating borrowing for productive purposes, reducing business costs and (because it implied a reduction in deposit rates), encouraging people to place funds 'in more active use' than in bank deposits. The Committee recommended that "the overdraft rate for first-class accounts should be reduced (from 5 per cent) to a minimum of 3.5 per cent with a maximum of 5 per cent". The report also considered that the Associated Banks had forced the Government to pay 'exorbitant' interest rates before the internal debt conversion scheme was legislated in 1933.

From the perspective of the 1990s the extraordinary feature of this debate is the treatment of the interest rate as a variable of only domestic significance. Only one of the three academic economists providing evidence to the Monetary Committee (D. Williams from Massey College) mentioned international interest rates when asked explicitly about the factors determining New Zealand interest rates, and he subsequently ignored this factor in making recommendations about the control of lending rates. Nowhere else in the evidence of economists or Treasury officials who appeared before the Committee is there any explicit cognizance of the fact that interest rates linked capital flows and the exchange rate directly to domestic monetary policy, or that mandated low loan and deposit rates would have indirect implications for the current account. Their position was put most explicitly by Professor H. Belshaw of Auckland who took the view that there was a considerable arbitrary element in the setting of interest rates in New Zealand, and that there was "no reason why interest rates could not have varied about a substantially lower level, provided the Government, the banks and other financial institutions co-operated".

After World War Two interest rate controls became imbedded in the structure of New Zealand economic policy. This was because of the view of policy makers that it was "socially and economically desirable for interest rates to be low at all times and that, if necessary, they should be controlled to prevent increases" (Reserve Bank of New Zealand, 1963, p. 113). This view rested on the argument that it was unclear whether a change in the rate of interest had "any worthwhile effect on decisions to save or to spend", as well as on the number of perceived advantages of lower borrowing costs for Government and businesses.

But so long as economic decisions in New Zealand were made based on interest rates set at below world levels, borrowers received credit at subsidised levels. The subsidy was provided by the taxpayer (who had to meet the cost of government borrowing at world interest rates to finance the resulting current account deficit) and by savers who received low or negative real returns. Businesses were financed which would not have been viable at market rates, and borrowers to whom the banks would have provided credit in a market system were denied funds from the banking system (though they increasingly obtained credit at higher interest rates from other sources outside the controlled sector).

Throughout this period there were calls to make greater use of changes in interest rates as a policy instrument. The Royal Commission on Monetary, Banking and Credit Systems recommended that more use be made of changes in overdraft rates to reinforce credit policy and selective advance control, but resistance continued. In 1961 the Monetary and Economic Council suggested that a rise in interest rates should be permitted.

In 1962 the Interest on Deposits Order was revoked, capital issues control was virtually abolished, and finance companies were freed from the net of restrictions. However, this is best interpreted as a relaxation of policy rather than a change in direction, because Government continued to exercise substantial control over interest rates and retained the power to reimpose tight restrictions. The rates of interest on local authority loans, Post

Office and trustee savings bank deposits, and average trading bank advances continued to be controlled, while the State Advances Corporation had a significant influence over mortgage loan rates and the trading banks agreed to consult the authorities before altering fixed deposit rates.

While interest rate controls inhibited the operation of some institutions, they provided a basis for the rapid growth of institutions outside the net of controls such as finance companies. By March 1972 the rapid growth of finance companies and increases in their interest rates prompted the Government to introduce the Interest on Deposits Regulations. These regulations provided for comprehensive control of deposit interest rates in non-bank financial institutions (setting the maximum interest rate on deposits at 7.25 per cent), and were accompanied by the introduction of similar controls on trading bank deposit rates. However, these regulations stimulated a liquidity drain from the finance companies, and as a result were amended in 1974 to provide that trading banks should pay interest rates 0.5 per cent below those offered by the controlled non-bank institutions.

By the mid 1970s the evidence that interest rate controls were creating serious impediments to the effective and efficient functioning of financial markets and limiting the operation of monetary policy while delivering few economic advantages was more clearly articulated (for example, Deane 1975) and more widely accepted. Consequently, from March 1976 interest rate controls were reduced substantially: the Interest on Deposits Regulations and controls on interest rates paid by trading banks on large deposits were abolished; maximum interest rates on trading bank deposits (below \$12,000), savings bank deposits and government securities were increased; and the long standing control over the maximum average overdraft rates that could be charged by trading banks was removed. Further reductions in controls applying to private savings banks, trustee savings banks and the Post Office Savings Bank were introduced in the 1977 Budget (but the long standing prohibitions on the payment of interest on cheque accounts and the payment of interest on trading bank term deposits of less than thirty days, together with the limitation of 3 per cent interest payable on savings passbook accounts, remained in force).

The stated objectives of the reduction in controls were to improve the efficiency of the financial system by giving greater rewards to savers, allowing competition between institutions, and applying rates closer to market levels to public sector securities while at the same time making monetary policy a more effective instrument of overall economic policy.

By 1980/81 it was clear that in the absence of a broader programme of liberalisation of the financial markets, and so long as government fiscal policy and other factors continued to provide an inflationary impetus for the economy, interest rates would rise to high levels. In November 1981 concern about rising interest rates led to the reintroduction of measures to allow the authorities to exert some direct control over interest rates charged by all financial institutions employing funds of \$2 million or more. In June, July and August 1982 interest rate controls were increased by an extension of these regulations and the reintroduction of Interest on Deposits Regulations. In late 1983 and 1984 controls on lending rates were extended further, so that by 1984 even interest rates in the market for solicitors' mortgage loans were effectively fixed. Thus, by July 1984 the New Zealand financial system was enveloped in regulations covering rates of interest on institutional deposits and all forms of lending, with particular restrictions applying to mortgage lending. Interest rates on issues of ordinary government stock were so far below the market level that there was little demand for these instruments outside of the captive market provided by ratio controls.

THE EXCHANGE RATE AND EXCHANGE CONTROL

The exchange rate is the price of New Zealand currency in terms of foreign currency. In discussing its economic significance it is best to distinguish the nominal exchange rate from the real exchange rate, defined as the nominal exchange rate adjusted for relative changes in the New Zealand and foreign price levels. The nominal exchange rate is important in the sense that it affects the cost of imported goods and the amounts received for exports in domestic currency. Adjustment of the New Zealand economy to changes in its international competitiveness or to external shocks occurs through changes in the real exchange rate. These may occur as a result of changes in the nominal exchange rate and/or changes in domestic prices and costs (including wages).

The choice of exchange rate regime will depend on views about the appropriate balance between these different types of adjustment as well as by the inflation and monetary policy objectives of the Government. Fixed exchange rates provide fewer policy options: adjustment must occur through changes in the domestic money supply, prices (including interest rates) and wages (in which case there may be significant unemployment and other subsidiary effects). A permanent downward adjustment in the real exchange rate may be achieved at lower cost under a floating exchange rate, but the flexible exchange rate also introduces higher risk in fuelling domestic inflation if adjustments in the real exchange rate are less than those in the nominal rate.

New Zealand history provides examples of a number of different types of fixed and floating exchange rate regimes. Until 1914 New Zealand utilised a fixed exchange rate regime in which the value of the currency was set at one New Zealand pound to one pound sterling via legal convertibility of the currency into gold at the same parity as established in the UK. From the outbreak of World War One until 1931 the trading banks managed an exchange rate which floated around the traditional parity of the New Zealand pound and sterling. From January 1931 until June 1979, and from June 1982 until March 1985 New Zealand maintained a fixed exchange rate regime with occasional discrete adjustments in the parity determined by the Government (in consultation with the Reserve Bank after 1934). During the interval from June 1979 until June 1982 a type of managed floating regime known as the 'crawling peg' was in operation.

Before 1914 the notes issued by the trading banks were legally convertible into gold on demand at the legally established gold parity, and circulated together with British gold sovereigns, which were widely used for day-to-day transactions. The gold convertibility of the notes of the New Zealand banks at the same parity as that established in the UK, together with the freedom to import or export sovereigns⁸ served to fix the New Zealand-UK exchange rate at par (NZ£1 = £1 sterling).⁹ A fixed exchange rate was crucial to the operation of the sterling exchange system described earlier in this essay because without it the direct link between the balance of payments, London funds and the monetary policy of the trading banks in New Zealand would have been broken.

When the legal requirement for convertibility of bank notes into gold was ended in August 1914, arbitrage in gold could no longer serve as the basis for a fixed exchange rate, and this meant that in technical terms the value of the pound in New Zealand was free to float against sterling. But from 1914 until early in 1930 the banks managed the exchange rate in a range plus or minus 3 percent from the traditional parity. This reflected a commitment on the part of the banks to the continued operation of a sterling exchange system even in the absence of a legal basis for a fixed exchange rate. This commitment resulted from the fact that the commercial community had become accustomed to working with a fixed exchange rate and harboured a deep suspicion of flexible exchange rates. Any deviation in the exchange rate from the traditional parity generated a barrage of criticism of the banks from groups within society who would have benefited from the maintenance of the exchange rate at par.

In the absence of a legally defined parity between the circulating currency in New Zealand and either gold or sterling, the responsibility for economic adjustment which would allow the maintenance of purchasing power parity at a fixed exchange rate was transferred from the Government to the banks. In practice, there were two reasons why the banks could not effectively perform this role. First, if the Government chose to follow a course of fiscal policy or to place pressure on the banks to pursue policies which were incompatible with this regime, the banks had limited power to enforce their view of more appropriate policy on the politicians.

Second, in the absence of a legally defined gold or exchange parity, the banks provided the primary but not the only market for foreign exchange operating in New Zealand, so that any attempt by the banks to manage the exchange rate could be undermined by the transfer of exchange dealings to this outside market. Whenever the outside market price of New Zealand funds was further from the traditional parity than the exchange rates set by the banks, large companies such as stock and station agents and insurance companies found it profitable to create an outside market in foreign exchange. As a result, a sharp fall in the value of the New Zealand currency would result in an outside market price for sterling exchange which made it unattractive for exporters to place the sterling funds they earned with the trading banks in New Zealand.¹⁰ This would in turn result in a sharp fall in the foreign exchange reserves held by the banking system at the same time that the importers' demands for London funds increased because they could obtain sterling exchange at a more favourable price through the banking system.

During 1931 the pressure on the foreign exchange holdings of the trading banks increased as export receipts fell faster than payments for imports and as pressure on the London capital market made it appear likely that the public debt falling due in London during 1932 would have to be repaid in full rather than funded. The result was that the price of New Zealand funds on the market outside the banking system fell, and the banks found it extremely difficult to persuade their customers to place funds earned in London with the banking system.

The response of the New Zealand Government to this crisis addressed its symptoms rather than its underlying causes. By an Order in Council of 24 December 1931, the New Zealand Government established a system of compulsory licenses for exports which effectively applied exchange control to the proceeds of all export trade. This curtailed the flow of export receipts into the foreign exchange market outside the banking system, enhancing the ability of the banks to provide the funds required by the Government in London (Tocker, 1932). However, early in 1932 a sharp improvement in the New Zealand current account balance, an easing of conditions on the London capital market and a fall in the interest rate differential between New Zealand and the UK served to ameliorate the perceived shortage of foreign exchange and the exchange control regulations were revoked.

In 1936 the Minister of Finance in the first Labour Government, Walter Nash, explicitly considered exchange controls as part of the general platform of policies providing for large scale economic planning. Officials in the Reserve Bank were strongly opposed to the introduction of exchange controls as a planning measure, and argued that as a monetary policy measure they were inefficient because they were difficult to administer and addressed only the symptom of excess demand for foreign exchange rather than its cause.

But after a severe depletion of the foreign exchange reserves held by the New Zealand banking system during 1938, and with a major sterling loan conversion due in January 1940, the Government moved to introduce exchange controls. Regulations introduced on 5 December 1938 were designed to give the Government complete control over foreign exchange and imports into New Zealand, but focused on control of imports, leaving most avenues of capital transfers unregulated. Only in 1940, as a result of the war, was the comprehensive system of exchange and import controls that characterised post-World War Two New Zealand economic policy introduced.

The cause of the exchange crisis was a combination of current and capital account deficits, together with the Government commitment to interest rate controls and a fixed exchange rate. The isolationist and expansionist policies of the Labour Government fuelled an import boom that depleted foreign exchange reserves despite the increase in export receipts that occurred in 1937. In addition, there was significant capital outflow from 1936-1938. This was caused by the repatriation of funds placed in New Zealand in 1935 in anticipation of a revaluation of the New Zealand pound to parity with sterling, and unease about the extent to which the Labour Government would implement the more extreme policies advocated by some of its members. However, this capital outflow was also very largely influenced by the interest rate differential between New Zealand and both Australia and the UK. One contemporary commentator argued that it was "probable that investment conditions in Australia in 1936 and 1937 were sufficiently attractive to encourage a transfer, whatever the political situation" (Belshaw, 1939: 177). The combination of these factors drove the price of sterling on the 'free' market outside the banking system above the official price, so that persons earning sterling funds did not place them with the New Zealand banking system at the quoted prices.

The key question is why this policy response was adopted and, in particular, why the banks were unable to protect their foreign exchange reserves by rationing as they had in earlier decades. Two answers seem important. First, two of the traditional weapons were not open to the banks in 1938: interest rates were controlled and could not be increased to encourage capital inflow, while the exchange rate was fixed by the Reserve Bank which did not have a mandate to allow short-term fluctuations in the cost of foreign exchange to assist adjustment in such a crisis. This left the trading banks powerless to respond to the fall in the value of the NZ pound on the market outside the banking system in the way that they had in 1939. Second, much of the demand came from the Government itself, and it utilised its power through the Reserve Bank to isolate it from the discipline that the private banking system had instilled in earlier decades. Though few contemporary economists recognised it, the interest rate and exchange rate policies of New Zealand governments from the early 1930s made the use of exchange and import controls inevitable in any balance of payments crisis - the policies of the Labour Government simply precipitated the crisis.

The regulations introduced in December 1938 consisted of controls over export receipts, a requirement to obtain licences for imports, and a system of permits for remittance of funds overseas. They were effective in channelling the flow of export receipts through the banking system at the official exchange rate, but were completely ineffective in stemming the current account deficit: the number of licences issued for imports was far in excess of the overseas funds available to pay for them, and it was left to the trading banks to allocate overseas funds among these licences. Nonetheless, the 1938 regulations left a free market in sterling funds not acquired from export receipts, and in this market the exchange rate on UK funds was 12 per cent above the official price in 1939 and early 1940, so that few of these funds were placed with the banking system.

This gap was plugged in 1940, when wartime regulations introduced the first comprehensive system of exchange controls on overseas payments and receipts. From this time:

- (a) overseas currency receipts on account of exports had to be sold to the Reserve Bank or its agents (the trading banks);
- (b) all remittances from New Zealand were subject to the control of the Reserve Bank, with the trading banks acting as its agents; and
- (c) there was a statutory control over private holdings of foreign securities and currencies, whether held at the time control was introduced or acquired later.

At the conclusion of the war the New Zealand banking system had accumulated very large reserves of sterling funds, but the Minister of Finance decided to use these to appreciate the exchange rate and repay government debt rather than to remove exchange control regulations. In August 1948 the exchange rate with the UK that had been maintained since 1934 was altered when parity with sterling was restored by a revaluation of 25 per cent. This parity was maintained in September 1949, when sterling was depreciated by 30.5 per cent against the US dollar, resulting in a similar devaluation of the NZ pound.

From 1949 it was government policy to remove exchange control and import licensing 'wherever practicable', and controls within the sterling area were reduced. However, while controls on interest rates, fixed exchange rates and expansionary fiscal policies were maintained, the inevitable result of any general liberalisation of exchange control and import licensing was a sharp deterioration in the balance of payments. Thus, a series of crises in 1951/52, 1957/58, 1961/62 and 1967/68 severely curtailed attempts to remove these restrictions, and the regulations were actually made more restrictive by their extension to cover additional types of invisible earnings in 1964.

By the mid 1960s there was a clear consensus in the Treasury and the Monetary and Economic Council that sole reliance on import licensing was inefficient, and that because the pressure of demand continually caused more licences to be issued than the banks were able to provide sterling funds to finance, it was the banks rather than the system of licensing that kept the current account balance within reasonable bounds. But it was also clear that unless import licensing was replaced by some other form of disincentive to import, it could only be removed as part of a much more general liberalisation. Thus, from the 1960s increases in tariffs gradually reduced the reliance on import licences, and this became official policy after the National Development Conference in 1969. However, at this stage, there was no official suggestion that import licenses could be removed completely.

It was the balance of payments crisis of 1957/58 and ensuing foreign exchange difficulties that prompted New Zealand to join the International Monetary Fund (IMF) in 1961, a move which had been delayed since 1949 by popular fears about erosion of New Zealand policy independence. In the 1960s and 1970s short-term loans from the Fund became central to strategies for dealing with foreign exchange difficulties, and long-term loans were obtained from the World Bank. Membership of the IMF also implied a change in the denomination of the NZ pound, which had been officially defined solely in terms of sterling up to that time. Each member was required to establish a par value expressed in terms of gold and the US dollar, and to maintain the value of the currency within 1 per cent of this parity, but New Zealand retained a link with sterling by using it as its intervention currency. The New Zealand parity was NZ£1 = US\$2.7809, but following decimalisation and a devaluation in 1967 in which the New Zealand currency was depreciated 19.45 per cent against the US dollar to parity with the Australian dollar, the parity was NZ\$1 = US\$1.12.

By the late 1960s differences in monetary and fiscal policies as well as long-run changes in relative competitiveness among the major industrial countries created a series of crises in the fixed exchange rate regime of the Bretton Woods system, and these were exacerbated by the oil shocks of the 1970s. The Smithsonian Agreement, introduced in 1971, provided for a realignment of parities and wider bands within which the currencies should be maintained, but by 1973 most of the world's major currencies had abandoned this system and adopted floating exchange rates. In this period New Zealand elected to follow Australia in severing the link with sterling and pegging the value of its currency to the US dollar, but after the devaluation of the US dollar early in 1973 this system was replaced by one in which the value of the New Zealand dollar was fixed against a trade-weighted basket of currencies.

There was a series of discrete devaluations/revaluations of the exchange rate over the period to 1979, by which time it was clear that New Zealand required a fall in its exchange rate to maintain its competitiveness in international markets. From June 1979 a 'crawling

peg' approach to the determination of the exchange rate was adopted under which the value of the New Zealand dollar was subject to frequent small adjustments to offset inflation differentials between New Zealand and its major trading partners. In the following three years this system resulted in a depreciation of the New Zealand dollar by an average of 0.5 per cent per month, but it was ended in June 1982 when a fixed exchange rate was reintroduced as part of the wage and price freeze. As described elsewhere in this book, the fixed exchange rate system was subsequently replaced by a floating exchange rate system in March 1985, following the removal of all exchange controls.

IV. CONCLUSION

New Zealand has a long history of government intervention in the financial system. Before 1914 intervention was focused on the establishment and operation of financial institutions, and represented the pragmatic response of governments concerned about the operation of particular financial markets but generally committed to minimal levels of regulation and direction of markets. Without the discipline of the international gold standard after 1914, pressure was focused on the trading banks to maintain macroeconomic equilibrium in the New Zealand economy, but during the 1920s government fiscal and interest rate policies increasingly conflicted with those desired by the banks.

In the early 1930s, policymakers became convinced that the trading banks could not manage the New Zealand economy in the national interest. The legislative responses to individual symptoms of the Great Depression laid the groundwork for the controlled economy of the period after World War Two. The legislative control of interest rates introduced as part of depression policy effectively removed the capital account as an equilibrating mechanism in the New Zealand economy. At the same time the New Zealand Government remained committed to a fixed exchange rate regime, despite acceptance that occasional adjustment of the value of the currency against sterling might be appropriate. By the end of the 1930s these policies had resulted in an exchange crisis which was met by exchange controls and import licensing, and thus in the extension of government regulation to every aspect of New Zealand economic relations with the rest of the world.

In the period from 1945 until 1984, successive governments maintained a fundamental belief in the fact that they should have the maximum flexibility in fiscal and debt policy, that mandated low interest rates would ameliorate the effects of fiscal policy on domestic financial markets, and that inflation, foreign exchange crises and any other serious consequences of these policies could be alleviated by the application of additional controls. Despite some periods when controls were reduced, the normal policy response to crises in the New Zealand economy was the extension or reintroduction of controls on the financial system, together with attempts to broaden the impact of monetary policy regulations. Increasing inflationary pressure in the early 1980s led to the reintroduction of controls on the financial system, but this served to reinforce the perception of their ineffectiveness and finally provided a mandate for the comprehensive reform of the financial system that has occurred since 1984.

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FOOTNOTES

- 1 University of Western Ontario, Canada, and Victoria University of Wellington, New Zealand. Much of the research for this paper was completed while the author was Visiting Research Fellow, Economic Department, Reserve Bank of New Zealand.
- 2 By 1984 the New Zealand Government owned the State Advances Corporation (Rural Bank, Housing Corporation), Public Trust and Post Offices, the Bank of New Zealand, State Insurance, Government Life and the Development Finance Corporation.
- 3 There can be no question that this requirement represented a significant barrier to entry, since it was implicit in the notion of a charter that the authorities would undertake some scrutiny to ensure the soundness of prospective new entrants. Nonetheless, the barrier was not absolute, as is shown by the entry of the Commercial Bank of Australia just before World War One.
- 4 The last bank to remove the double liability clause from its charter was the Bank of New South Wales - in 1963.
- 5 For surveys of the debate about the role of government in the financial system and the lessons of the 'free banking' period, see Friedman and Schwartz (1986) and Gorton (1985).
- 6 The most important modifications related to the methods used to calculate the appropriate level of reserve asset holdings and the role of free or excess reserves in these calculations. For a detailed treatment see Reserve Bank of New Zealand (1982) ch 20.
- 7 Even where requirements were initially based on averages for groups of institutions, this might imply substantial distortion of the optimal portfolio structure for individual institutions. For an example from the superannuation industry, see Quigley (1988).
- 8 There was no mint in New Zealand, so all gold coins were imported.
- 9 Under this regime the exchange rate could vary within the gold export points determined by the cost of shipping gold between New Zealand and the UK (approximately 1.5 per cent).
- 10 This section is based on the analysis in Quigley (1991). For a description of the outside market in sterling exchange which arose in Australia in response to similar bank policies, see Schedvin (1970).

TABLE 1

THE INSTITUTIONAL STRUCTURE OF THE NEW ZEALAND FINANCIAL SYSTEM 1885-1980

(share of total assets - %)¹

Year	Banks					Insurance		State Advances	Stock & Station	Public Trust	Finance Companies	Other
	Reserve Bank	Trading Banks	Post Office	Trustee Savings	Other ²	Life	Other					
1885	--	55.0	4.7	1.6	4.3	NA	NA	--	32.5	0.7	1.2	--
1910	--	33.0	17.2	2.0	4.8	14.4	NA	11.6	9.6	5.2	1.5	0.7
1940	9.7	20.7	13.1	3.4	3.5	11.5	7.7	15.2	4.3	8.1	0.4	2.4
1960	10.1	17.5	17.7	4.1	3.2	13.3	7.9	16.7	4.2	1.2	0.2	3.9
1980	6.8	21.9	6.5	7.0	7.4	11.7	7.1	15.2	2.5	0.4	5.7	7.8

¹ Note that these calculations are made on the basis of the data available for individual institutions, and will therefore be biased by any gaps in the availability of data. Even in 1980 there is an important gap resulting from the unavailability of data on private superannuation schemes.

² Private savings banks, credit unions, friendly societies and building societies.

Source: Sheppard, et al 1990, Table 28.22.