

## REFLECTIONS ON THE NEW ZEALAND FINANCIAL SECTOR

*This article is based on an address by the Deputy Governor, Dr R.S. Deane, to a seminar on Future Directions in the Financial Services Industry, held in Wellington, 12 July 1985, under the auspices of the New Zealand Finance Houses Association.*

### Introduction

At a recent conference on 'Financial Stability', organised by the Federal Reserve System, and attended by a diverse range of economists, financiers and central bankers, much of the discussion centred on the prudential and monetary policy implications of what was widely perceived to be the now deregulated United States financial system.

Two dominant issues emerged. First, the problems associated with deregulation seemed no more severe than those which had been associated with the periods of extensive regulation and, moreover, many of the problems encountered during the deregulatory period appeared to have their origins in the earlier sets of official controls and the problems induced by these. Secondly, the apparently widely held assumption that the United States financial system is now largely deregulated seemed curious given the continued existence of mandatory reserve requirements for most banks, compulsory deposit insurance, severe geographical operating constraints, a variety of tax distortions with respect to the financial sector, and a burgeoning non-bank financial market characterised by the operation of such firms as Sears Roebuck.

Comparisons of this sort make one realise just how dramatic and extensive have been the changes in the New Zealand financial scene over the past year. We have not only abolished interest rate controls, which is the issue which has received most attention in the United States, but we have also seen the demise of the ratio system, the elimination of exchange controls, the move to a floating exchange rate, the removal of credit ceilings, the withdrawal of numerous Reserve Bank directives to the financial institutions, as well as a variety of analogous deregulatory moves in other sectors of the economy. The scope and pace of these changes has probably been unequalled in any other country in the OECD region.

The nature of these changes and the rationale underlying them have now become common knowledge. These matters have also been addressed in recent *Bulletin* articles. For this reason, this article concentrates on some of the principles underlying the changes; the nature of the new monetary policy

arrangements; some of the complications in interpreting this policy; and those institutional issues which still remain to be addressed. In this respect, the article comments on some of the microeconomic ideas embodied in the changes and then moves on to discuss briefly the remaining distinctions between banks and non-banks, and some of the issues related to prudential supervision.

### Some Monetary Policy Principles

At the macroeconomic level, the essential thrust of monetary policy is to contribute to a reduction in the rate of inflation and a return to a more sustainable path of economic growth by achieving more moderate and less volatile rates of change in the major monetary aggregates. This objective gives monetary policy its medium to longer term perspective, in contrast to the shorter term 'fine tuning' adjustments which have frequently characterised past periods. Because the monetary changes have been accompanied by a substantial reduction in the fiscal deficit and a move to a floating exchange rate, the new approach acknowledges the need for an integrated approach to the use of the various instruments of economic policy and the need to attend to a variety of economic problems rather than concentrating undue attention on any one particular objective of economic policy. Again, this approach is a departure from some of the practices of the past.

Reservations about the usefulness of frequent, short term modifications to monetary and fiscal policies do not imply that adjustments will not be required to the policy settings from time to time. Instead, such reservations acknowledge the length and variability of the lags in the process between taking a policy decision and that decision having an impact on the economy. We now know that these lags are long enough to render frequent short term adjustments unhelpful, and frequently counter productive, thus emphasising the need for consistency of policy making over time.

Adjustments to the numerical framework, such as the recent reduction in the Government's domestic debt programme from \$2.7 billion to \$2.0 billion in response to the reduction in the 1985/86 fiscal deficit and other

changes, are quite consistent with this view of the way in which monetary policy should be developed. This is because the underlying principle, that of virtually fully funding the net public account injections by domestic borrowing, has been maintained by this alteration to the debt programme.

Moreover, publication of the debt programme for the full year ahead, together with the announcement in more detail of the programme on a quarter by quarter basis, provides a clear signal to the private sector of the intentions of the Government in both a conceptual and an empirical sense. Matching the need to address a variety of economic problems has been a return to the use of the full range of macroeconomic policy instruments. Both monetary and fiscal policy can now operate in an effective manner, since they are freed of the shackles of both interest rate controls and a pegged exchange rate. Economic theory and practice confirms the impossibility of controlling directly and simultaneously interest rates, the exchange rate and the money supply.

Although there have been mixed reactions to the extent and pace of deregulation, it is important not to confuse the nature of the arguments in this area. On the one hand, although the process of removing controls has been a rapid one, the full effects of this will take some years to become evident. In particular, the costs are likely to be immediate and transparent in the short term, such as in the form of higher inflation, while the benefits are likely to accrue mainly in the longer term. On the other hand, the success of the deregulatory process will probably not be judged with respect to its speed but rather its completeness and thus its ultimate effectiveness. In this sense, the maximisation of the gains from the changes which have already taken place is dependent not only on the durability of those changes but also on complementary changes to make other product and factor markets more flexible and adaptable. The need for more flexibility in the labour market and for additional reductions in frontier protection would be the clearest examples of this problem.

## The Monetary Policy Framework

The principal instrument of monetary policy is now the public debt sales programme. The amount of this programme is based on an operating guideline geared to the need to finance virtually fully the net public account injections by domestic medium to long term borrowing. These public account injections comprise mainly the fiscal deficit and Government stock coming within six months of maturity.

Given a successful debt programme in the sense just defined, it should be possible over the course of a full year to control that aggregate we now describe as primary liquidity. This is a base money concept which comprises trading bank balances at the Reserve Bank plus Treasury bills and government securities with less than six months to maturity. This definition is in turn linked to the Reserve Bank's discount policy, under which the Bank stands ready to discount on demand any government paper with less than six months to run at a discount rate which is at present determined by market interest rates plus a penal margin of one percentage point.

As is becoming clear to all market participants, primary liquidity can show considerable short term

volatility. This is because of the normal seasonal patterns one would expect in such an aggregate, since it needs to build up in advance of periods such as the September and March tax flows, and also because of the mismatching in timing between the Government's regular debt programme and the injections/withdrawals as a result of variations in the pattern of Government revenue and expenditure. Stock maturities also tend to be irregular and do not match precisely with debt sales.

Seasonality is handled under the new arrangements in a three tier manner. First, the ordinary Government stock tenders are varied from quarter to quarter to some extent in line with expected seasonal liquidity developments. Secondly, the weekly Treasury bill tenders are used to absorb seasonal liquidity fluctuations. Thirdly, where there are significant divergences from the expected seasonal pattern, Reserve Bank open market operations can be utilised.

Given the significant short term variations which can be expected in primary liquidity, it will be clear why the monetary authorities can only claim to control this aggregate on average over a lengthy period of time. Short term variations will become of less concern once market participants become familiar with their nature and develop a clearer understanding of the usual seasonal patterns. This process could take a year or two.

However, at the end of the day, the essence of the matter is that the Reserve Bank should over time be able to maintain a reasonably firm grip on primary liquidity. Since this aggregate comprises the basic reserves of the financial system, appropriate control of it should exert an important influence over subsequent developments in the money supply and credit aggregates. The transmission channel for this influence is the interest rate mechanism. For example, if the debt programme is stepped up, primary liquidity will contract and interest rates are likely to rise (ignoring, for simplicity, exchange rate changes). This in turn will in time dampen the demand for credit and affect the money supply.

## Some Related Issues

While the analytical underpinnings of this approach are clear enough, its operation in practice will take time to become effective. There are in any event lengthy lags in the monetary policy process, and it needs to be borne in mind that the final elements of the policy package were only put in place with the move to a float in March and with the reduction in the fiscal deficit announced in the June 1985 Budget.

Furthermore, the change in the approach to monetary policy has been superimposed on a wide variety of other deregulatory moves in the financial system which will take time to permeate the system and will in the meantime impair our ability to interpret the conventional monetary indicators. The process which economists call 'reintermediation', whereby those financial flows which had previously escaped outside the net of the controlled institutions return to these institutions, will be a lengthy one. For example, bank lending is currently strongly up on the figures for a year ago whereas the commercial bill market, which had grown rapidly in the days of interest rate controls, is only a few percentage points up on an annual basis. While bank lending has an impact on the broad money supply, M3, it should be noted that much commercial bill activity is outside this aggregate.

Some commentators have expressed concern about the apparently rapid growth of M3 which is currently 16 per cent up on a year ago. On the other hand, the aggregate most favoured by monetarists, the narrow money supply M1, is only 2 per cent up on an annual basis. Both figures are probably distorted by the deregulatory changes: M3 by a return of funds to the major M3 institutions which had under the control regime lost funds to non-M3 markets; while M1 is probably artificially reduced by the shift of funds into interest earning accounts following the removal of interest rate controls.

It is for these sorts of reasons that care is needed in interpreting current monetary conditions. It is probably also why a number of commentators find it difficult to agree over the present state of monetary conditions. Short term indicators such as relatively high nominal interest rates and a reasonably sturdy exchange rate imply a firm monetary policy. This view is reinforced by the prospective reduction in the fiscal deficit and the commitment of the Government to fund this fully by domestic long term borrowing. On the other hand, some of the important monetary aggregate indicators, such as M3 and private sector credit, are still running at unduly strong rates of increase.

The interpretation one places on these figures seems to differ according to whether one concentrates analysis on the future or the past. Overseas experience, and our own previous efforts at regaining monetary control, confirm that the process can be a lengthy one. This is shown also by the data for the past six to twelve months. However, if it is accepted that the final elements of the policy package have only recently been put in place, and bearing in mind that the June quarter fiscal deficit was somewhat larger than had been anticipated, which suggests that the rest of the fiscal year could be somewhat tighter than might otherwise have been the case, then a study of the Budget and the details of the Government's debt programme should reinforce the view that monetary conditions will tighten over the coming months. This is likely to be associated with some slowing in the pace of real economic activity, which is needed to facilitate a reduction in the present rate of inflation.

These remarks illustrate the problems involved in interpreting the traditional monetary/real economy inter-relationships in an environment which has been subject to so many radical changes. It will take a considerable period of time for a new set of stable relationships to re-emerge and it will also take time for all market participants to appreciate fully the nature of the new monetary policy and liquidity management arrangements. Because of these uncertainties, no particular monetary targets have been announced by the Government. Whether we will be able to move to such targets in time, and whether it will indeed be helpful to do so, is a matter which will need to be resolved further down the track. In lieu of such a money supply target, the Government has of course made its own intentions clear with respect to its debt programme, which should ensure that all financial institutions have a full appreciation of the share of funds which the Government requires and the likely timing of its borrowing programme.

Apart from the uncertainties induced by the extent of the changes which have occurred, the new monetary policy arrangements will be subject to other problems not dissimilar to those which other countries have experienced from time to time. In particular, the income

velocity of money, that is the ratio of money to national income, will vary according to cyclical and other institutional changes. This means that the interpretation of monetary conditions is never an easy task, and reinforces the point that too much should not be expected of monetary policy alone. The policy cannot be described simply as a 'monetarist' one, as some commentators have liked to assert, since it is readily acknowledged that while adequate control of the money supply is a necessary condition to help moderate the rate of inflation, it is not by itself sufficient. Appropriate accompanying policies, such as with respect to the fiscal position, the labour market, and protection policies, are clearly also essential ingredients.

## Future Institutional Issues

Deregulation of the financial sector has of course been only one component in the Government's review of the nature of its own interventions in the economy. The philosophy underlying this review has not been related to the futile question of whether or not the Government should intervene, since clearly it must intervene in some form, but instead the analysis has concentrated on the form of that intervention. In the financial area, there has been a desire to move away from ad hoc, discriminatory and arbitrary direct controls, and to concentrate instead upon more generalised, market related forms of intervention.

For instance, the removal of interest rate controls will not only enhance the effectiveness of overall monetary policy, but it also will allow financial markets and institutions to operate more efficiently. The microeconomic analysis has been just as important as the macroeconomic rationale. There is no enthusiasm either to protect monopolistic positions or to restrict unduly particular institutions or particular activities.

The removal of interest rate controls, compulsory ratio requirements and exchange controls were each consistent with the wish to minimise contrived distinctions between different groups of institutions and to maximise the ease of entry by competitive elements into as wide a variety of financial activities as possible. This is not to suggest, as some commentators have endeavoured to do, that some sort of ideal 'perfect competition' model underlies this view of the world. That is not a useful way of looking at matters, and certainly does not reflect the view of any of the participants in the policy making process. On the other hand, there is a wish to move towards a situation where Government interventions are as competitively neutral as possible and to ensure that markets are genuinely contestable. The issue is not simply how many market participants there are, or how large or concentrated they are, but whether access to the market by other participants is reasonably feasible and, in particular, to ensure that such access is not inhibited in an unwarranted fashion by official constraints.

In relating these ideas to the difference between banks and non-bank financial institutions, it will be clear that many of the distinctions which existed a year ago have now been eliminated. Financial markets are becoming more highly integrated and there is considerable competition between institutions of different types.

The remaining distinctions appear to be primarily those relating to the ability to issue cheques, to participate in the clearing system, to gain preferred access to certain classes of deposits, such as provided

for under the Trustee Act, and to use the word 'bank' in an institutional name. In the area of special legislative privileges and particular institutional restrictions, there remain a series of questions to be resolved over time such as the role of the guarantee for trustee savings banks, where the Government has made it clear that any phase out of this guarantee would not be contemplated until appropriate alternative arrangements were made, and the nature of some legislation such as the Building Societies Act, where the Government has indicated a willingness to contemplate liberalisations which would place building societies eventually on a footing similar to other financial institutions.

As far as access to use of cheques and participation in the clearing system are concerned, it could be argued that there is no compelling reason for the continuation of official restrictions in this area. Non-bank financial institutions already have access to plastic cards and are moving into electronic funds transfer and point of sale (EFT/POS) arrangements. These developments are akin to the cheque system without the complication of so many pieces of paper. To maintain a special status for cheques, and to restrict the use of these to trading and savings banks, seems inconsistent with the present reality of the financial system. If the Government were to agree that other institutions should be able to participate in the cheque mechanism, then clearly there would also be a need for a corresponding participation in the clearing system. There are unlikely to be any technical difficulties in this area, other than the problem for non-banks of gaining access to Databank or alternatively of establishing their own clearing arrangements. In either event, the Reserve Bank would need to establish settlement accounts for institutions other than trading banks. These are matters which the Government is presently studying within the wider context of the issue of new banks.

It has already been agreed that a review of the Trustee Act should be considered, in order to study whether the present 'legal list' should be replaced by the 'prudent man' principle, or some appropriately more liberal arrangements. Also under study is the question of how to eliminate the special preferences for trading banks in terms of access to certain classes of deposits as provided for under a wide range of legislation. It could take some time to resolve this matter given the legal and administrative complexities involved.

If progress can be made on these issues, the only remaining bank/non-bank distinction of principle will be the use of the word 'bank'. This is a matter which is under study by the Government at the present time. The principles enunciated earlier in this article would suggest that there is no justification for continuing to maintain such a tight distinction as exists at the present time, where only a very limited number of institutions can use the word 'bank'. Liberalisation in this area would be consistent with the other moves which have already been taken, and indeed would be the logical conclusion to those moves.

Given the increased degree of competition and diversity within the financial sector, the Reserve Bank has decided to upgrade its system of prudential supervision. The principal elements of this are likely to be the collection of additional data from financial institutions, a move to more uniform disclosure requirements where these are mandatory, the encouragement to financial institutions to adopt appropriate prudential standards (such as in the area of capital and liquidity ratios), and amendments to the Reserve Bank Act to provide last resort intervention

powers for the Bank to use in cases where financial institutions encounter prudential difficulties of a severe kind.

It is important that all parties understand the principles which should underpin prudential supervision. It should be neither a form of deposit insurance nor carry explicit or implicit deposit guarantees. It is intended that the legislation should make it clear that the onus of responsibility for sound prudential management rests with the shareholders, directors and management of individual institutions. Moreover, any prudential losses which may be incurred should not be borne by either the Reserve Bank or the taxpayer, but instead should be borne by the depositors and the creditors of the institution which gets into difficulties. It is important that strong incentives remain with management to ensure good performance with high prudential standards, and the Reserve Bank has no intention of impairing these incentives by offering or implying to offer any financial underpinning for particular institutions.

The Bank's role should be to ensure reasonably uniform treatment for all institutions of a like kind and to monitor prudential data on a regular basis in order to be as well informed as possible about the prudential soundness of the financial system. The Bank will also hold regular discussions with financial institutions in order to encourage those institutions to adopt acceptable and reasonable prudential standards. However, there is no intention that we should return to a system of compulsory ratio requirements or any set of prudential regulations.

The Bank's concern will primarily be with respect to the financial system as a whole and the need to limit as far as possible the effects on the system of any prudential difficulties which may be encountered by an individual institution. To facilitate this, it will probably be necessary for the Bank to have last resort powers to ensure an orderly transition to a new set of arrangements for a financial institution which may find itself in irrecoverable financial difficulty. Such arrangements may include, for example, the power to appoint a statutory manager, or to arrange for a takeover or a merger of a failing institution. The powers would need to recognise the need for both speed and secrecy in cases of prudential failure. But they should not be designed to prevent a financial institution from leaving the industry or being absorbed by another institution. The essence of the matter should be an orderly transition process for a failed institution, to minimise the losses for depositors and to minimise the complications for the financial system as a whole.

## Some Implications

At the macroeconomic level, the new monetary policy arrangements, based on the principle of fully funding by domestic long term borrowing the net public account injections, should over a reasonable period of time yield a firm degree of influence over the monetary base of the financial system. After allowing for the perhaps lengthy and variable lags which are involved in any system of monetary control, and for the effects of the deregulatory process to work their way through the financial system, this control over primary liquidity should in turn lead to more moderate and less volatile rates of increase in the major monetary aggregates. The success of the policy will be dependent upon its

durability, in the sense of the commitment to the reduced fiscal deficit and the debt programme, as well as to continued interest rate flexibility and the floating exchange rate. Given that the final elements of the package were only recently put in place, it would be premature at this stage to look for meaningful results in terms of the most recent economic indicators.

Although the Bank will have control over primary liquidity in the medium term, substantial short term fluctuations in this variable should be treated as a normal part of the system. They will also be accompanied, from time to time, by some fluctuations in both interest rates and the exchange rate. The new liquidity management arrangements should assist in moderating any severe volatility in interest rates, although these arrangements will not be used to force a departure from the trend of medium to long term interest rates determined by the regular Government stock tenders. Instead, the liquidity management arrangements are designed to ensure a reasonably orderly transition from one tender to the next.

At the microeconomic level, the removal of superfluous controls and regulations should help promote both greater competition and efficiency within the financial system. While many of the old legal, administrative and technical distinctions between different groups of financial institutions have been or will be abolished or phased out, new arrangements are likely to facilitate easier entry into the bank industry and a more satisfactory set of arrangements for institutions which experience prudential difficulties.

Increased competition and the process of change generally are likely to appear in diverse ways:

1. Some narrowing of margins (which is already occurring).
2. Rationalisation by way of takeovers and mergers as the number and size of units in some segments of the industry alters.
3. The emergence of both financial conglomerates and highly specialised units competing within and across parts of the total market.
4. The removal of many of the remaining special privileges and unwarranted restrictions for some groups where these are no longer justified.
5. A greater degree of integration of New Zealand's financial market with the rest of the world and, one hopes, the emergence of a genuinely internationally competitive financial services industry.
6. Easier access to and, where necessary, an orderly process of departure from, the various segments of the financial sector.
7. Probably quite widely different rates of growth for different institutions, geared to their relative degrees of efficiency rather than to the nature of any legislative or regulatory regime.
8. Finally, changed perceptions of the connotations attached to some of the traditional institutional names and other forms of description.

One way or another, the remainder of the 1980s should be exciting and challenging years for the New Zealand financial sector. It should also be a rewarding period for the ultimate beneficiaries of this process: consumers of financial services.