RECENT DEVELOPMENTS IN THE NEW ZEALAND FOREIGN EXCHANGE MARKET[1]

The Minister of Finance announced on 2 April 1983 that the Government was prepared to allow further suitably qualified institutions to act as foreign exchange dealers.[2] At the time, the Reserve Bank and the trading banks were the only institutions authorised to undertake the full range of foreign exchange dealing activities, although the Post Office and two travel agencies had some limited authority. These have since been joined by two trustee savings banks. On 5 August, the Minister of Finance followed up his earlier statement with the names of institutions that had by then been successful in their applications for authorisation. The Minister also outlined a number of technical and procedural changes that were to be introduced into the Reserve Bank's relationship with the local foreign exchange market in order to pursue further the freeing-up of that market.

This article discusses the nature of, and rationale for, these institutional changes rather than offering an analysis of the broader economic problems which have beset New Zealand's balance of payments in recent years.[3] Nevertheless, it is relevant to observe that the institutional changes are taking place against the background of an economy which over a lengthy period of time has faced persistent current account deficits financed largely by official overseas borrowing and, more recently, by a significant private capital inflow. The macroeconomic policy response to the external deficit has been a mixture of domestic expenditure restraint, at least in the majority of years since the mid – 1970s, and various expenditure-switching policies including changes in the exchange rate, fiscal support for exporters, and the encouragement of a number of large industrial projects oriented towards an eventual saving of foreign exchange.

BACKGROUND[4]

Turning to the institutional characteristics of the New Zealand foreign exchange market, and looking back to the situation which prevailed several years ago, the major features of the market can be summarised along the following lines:

1. Up until June 1979 the spot exchange rate was pegged to a basket of currencies and adjusted on an occasional discretionary basis.
2. There was a limited forward exchange facility available to cover New Zealand residents' exchange risks arising from export and import transactions, with such cover having to be arranged within ten days of the exchange risk arising. Forward cover for invisible and capital transactions, generally speaking, was not available and non-residents were excluded from the scheme. The Reserve Bank underpinned the forward market by offering a back-up facility to the trading banks.
3. The Reserve Bank and the trading banks were the only institutions authorised to undertake the full range of foreign exchange dealings. Several other institutions had limited rights to deal in foreign exchange but only for travel purposes and small personal remittances.
4. Under the Exchange Control Regulations, current account transactions were effectively free of control but surveillance was maintained with respect to private capital inflows and there was a prohibition on personal portfolio investment abroad. These rules still apply.
5. Prior to June 1979, the merchant banks (including the Government-owned Development Finance Corporation) operated as brokers in the unofficial forward exchange market (or hedging market) which had emerged to cater for forward exchange risks not eligible for protection under the official scheme. The merchant banks were not permitted to operate as official dealers in foreign exchange, although they could act as agents for their New Zealand resident clients in arranging foreign exchange transactions with both local trading banks and banks overseas. However, in doing so, they were not able either to acquire or to contract to supply foreign exchange as principals.

In June 1979, as part of that year's Budget, two major changes were made with respect to the foreign exchange arrangements.

First, the spot exchange rate system moved to one which could be loosely described as akin to a crawling peg. The rate continued to be linked to a basket of currencies but changes were made by small amounts at frequent intervals in a way not dissimilar to that which prevails in Australia. When the system was introduced, it was announced that changes in the rate would be made on the basis of two major criteria. On the one hand, changes would be made to the extent that New Zealand's rate of inflation, and particularly changes in exporters' costs, diverged from the average rate of inflation being experienced by the country's major trading partners. On the other hand, while it was made clear that the trend of relative prices would be the main criterion on which exchange rate changes would be based, it was also stated that account would be taken of other factors such as long-term changes in the terms of trade and other structural considerations, although any changes made on these grounds would also be accommodated within the framework of small frequent changes in order to minimise the short run dislocation to traders. This system operated satisfactorily until June 1982, when the regular adjustment of the exchange rate ceased as part of an overall freeze on incomes, prices, interest rates and the exchange rate.

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1 This article is based largely on an address given in Sydney on 7 July 1983 by Dr R.S Deane, Deputy Governor of the Reserve Bank of New Zealand, and sponsored by the Australian Business Economists and the Centre for Money, Banking and Finance at Macquarie University.

2 See *Bulletin*, April 1983, pp 120-121

3 Chapters 1 and 4 of Deane, R S., Nicholl, P W.E and Walsh, M.J. (eds.) *External Economic Structure and Policy*, RBNZ, December 1981 analyse these issues.

4 See ibid., Chapters 2, 6, 7, for further background.

Secondly, a liberalised forward exchange scheme was introduced in June 1979 which enabled both local and non-residents to enter into forward exchange contracts with a trading bank. Both current and capital account transactions could be covered and there was no limitation on the period between the emergence of the risk and the writing of the cover. In cases where a customer was unable to deliver his forward contract with his bank for any reason, the trading bank was authorised to effect the spot sale/purchase of foreign exchange to the customer against an immediate repurchase/resale of the funds by the bank to enable delivery of the forward contract to be made. The availability of this facility effectively removed the need for the unofficial hedging market. As with the former scheme, the Reserve Bank underpinned the market by offering what amounted to a reinsurance facility for the trading banks.

In order to give more flexibility to traders, and to encourage competition within the market, a further change was made in December 1980. This allowed the settlement of 'undeliverable' forward exchange contracts to be effected through any trading bank, whereas previously only the originating bank could settle the deal. The intention of this extended authority was to provide trading bank customers with the opportunity to seek the most competitive available spot exchange rate for the 'closing out' transaction necessary to complete the forward exchange contract.

While this liberalisation did engender a rather more competitive market without increasing the number of dealers, it was soon found that it led to major accounting and exchange control supervision problems. As a consequence, in July 1981, special arrangements for reporting the 'closing out' transactions were introduced. Although this helped to ease the supervision problem, the new system itself became an avenue for greatly expanded dealing by merchant banks which used it to conduct a much wider range of transactions than was intended. Using their broking role, merchant banks found customers with a variety of offsetting foreign exchange requirements and met them on a competitive basis by negotiating quotes from trading banks in New Zealand and overseas. The ability to purchase spot exchange to close out an 'undeliverable' forward contract provided merchant banks with an opportunity to handle a host of other foreign exchange deals while maintaining a balanced foreign exchange book.

The Reserve Bank was thus faced with something of a dilemma. Although the system promoted improved competitive conditions within the market, it also led to concern within the Reserve Bank about the number of unauthorised transactions which were occurring. As a result, in January 1983 the Bank withdrew the arrangement. Although no remittance was identified for which a trading bank would not have received approval in the normal course of events, or could not have used its discretion in terms of the delegated authority given to it, the judgment about exchange control requirements had clearly to some extent moved away from the trading banks.

In effect, the merchant banks involved had become foreign exchange dealers without the specific approval of the monetary authorities. Moreover, the unofficial nature of their activities meant they were not subject to the reporting and supervisory requirements of the authorised foreign exchange dealers (the trading banks) as prescribed by the Reserve Bank. A matter of major concern was the potential that this unsupervised situation gave for unauthorised capital outflows. The withdrawal of these arrangements was associated with a reminder to the de facto dealers of the limited range of transactions involving foreign exchange which they were permitted to process.

This sequence of events has been described in some detail because it highlights the essential problem of the foreign exchange arrangements which have existed in New Zealand up until the present time. This is simply that the limited level of competition in this area between the authorised dealers (the trading banks), left opportunities for other institutions to offer an improved, more innovative, service to foreign exchange customers when the market was partially liberalised. It was in response to these opportunities that the merchant banks became involved and apparently found even this rather limited access to be profitable. The Reserve Bank's awareness of the benefits to traders induced it to allow the market to expand to a greater extent than could perhaps be justified on exchange control grounds alone, in the hope that it would be possible to find a workable solution that would allow the continuation of this enhanced competition in the marketplace. In the event, this did not prove to be possible.

The crux of the matter thus became an administrative choice between imposing restrictions on the extent of the market in order to ensure compliance with the legal requirements of the Exchange Control Regulations, or granting additional foreign exchange dealerships in order to guarantee appropriate oversight by the authorities.

The issue was thus not one of whether or not there should be additional commercial banks permitted to operate on the basis of the usual range of banking services, but rather the more particular point of whether it was feasible to promote competition in those areas where the traditional banks still retained monopoly rights. Given the wide ranging nature of the services provided these days by non-banks in New Zealand, it was clear that the foreign exchange market remained an important area of continuing protected activity for the trading banks.

The prospective move to free up this market should help in time to clarify the issue of whether additional banks, in the present sense of the term, would be likely to contribute to the further development of the financial system or, indeed, whether additional banks would have any particular wish to become established. This is an unresolved issue in New Zealand, and one which cannot be readily addressed during the freeze in view of the extensive controls which currently prevail with respect to financial institutions' charges and interest rates. The same point could of course be made about introducing new foreign exchange dealers, although it is less compelling in this case given the extent of the earlier hedging market.

It was the Reserve Bank's view that the shortcomings in the New Zealand foreign exchange market led to a number of undesirable costs for the users of that market.

First, it appeared that margins charged in the foreign exchange market were wider than would normally be observed in a fully competitive situation. This is a direct cost, hampering the development of trade and adding to the prices of goods and services. The basis of the banks' arguments against reducing these margins significantly was usually that this would mean increases in other charges and particularly higher interest rates for exporters. On the other hand, in more recent years there has been no doubt that the banks have responded to the unofficial but effective external competition from the non-bank institutions, and this has not gone unnoticed by either the Government or the marketplace.

Secondly, a less visible cost of the restricted access to foreign exchange dealing is a weakening in the efficiency of the financial system. If banks are able to enhance their profits by their exclusive access to foreign exchange business, this places them in an advantageous position vis-a-vis non-bank intermediaries since banks are then able to subsidise the cost of their other banking services which may otherwise be provided in many cases at least as efficiently by the non-banks. The ability to charge more than a competitive market would allow also leads to the over-provision of relatively inefficient and costly services. While the costs of this fall most immediately on domestic traders, which have had to contract with the trading banks as principals in all foreign exchange deals in New Zealand in the past, the whole financial system ultimately shares the burden.

A third cost was the possible weakening of the incentive to develop the wide range of instruments and services which are offered in overseas foreign exchange markets. This is illustrated by the success which merchant banks encountered even within the confines of the limited market in which they were able to operate. It was also thought that access to appropriately priced, comprehensive and otherwise efficient foreign exchange services might result in reduced pressure for export assistance in more direct ways. The position of the trading banks as the only fully authorised dealers in the market was seen by some as unnecessarily restrictive from the point of view of overall export development, especially given the wide ranging networks of international contacts also available to a number of merchant banks which were anxious to compete with the trading banks.

Another disadvantage of the previous foreign exchange arrangements was that companies with substantial involvement in the foreign exchange area were encouraged at times to direct their foreign exchange business through overseas intermediaries related to the non-banks in New Zealand in order to secure the best possible deal in terms of cost and quality. While such a diversion of business may have clear advantages for the trader, it implies a prospective loss of taxation revenue for New Zealand.

RECENT DEVELOPMENTS

It was for these sorts of reasons that the Government agreed in April 1983 to extend new foreign exchange dealing authorities to suitably qualified applicants, in addition to those currently held by the trading banks and the more limited foreign exchange dealers. In announcing this, the Minister of Finance indicated that the Government wished to encourage the further development of competition and expertise in the field of foreign exchange operations to assist New Zealand's international traders.[5] Although there was no predetermined number of authorisations that would be granted initially, it was made clear that approval to operate would be conditional upon the compliance of the applicant with fairly tight criteria with regard to capital adequacy, financial standing, proven management and expertise, as well as otherwise substantiating a capability to provide the proposed service.

Since that time, the Reserve Bank has considered a range of applications, and on 5 August the Minister of Finance announced the names of those applicants which had been successful up to that date.

The new dealers to be authorised at this stage are:

Broadbank Corporation Limited
Citicorp Forex Limited
Development Finance Corporation of New Zealand
Indosuez New Zealand Limited
Lombank (New Zealand) Limited
Marac Corporation Limited
N.Z.I. Securities Limited
New Zealand United Corporation Limited
South Pacific Merchant Finance Limited

In announcing the names of the new dealers, the Minister of Finance explained that the listing of these dealers did not preclude the later entry of other prospective dealers which were able to meet the criteria applied by the Reserve Bank. The Government's aim was to improve the competitiveness and efficiency of the foreign exchange market and entry to it was to be kept open. Equally, all dealers were being made aware that their authority could be withdrawn if they failed to maintain satisfactory standards of performance.

Authority for the new dealers was given under the Exchange Control Regulations 1978, Amendment No.2, with effect from 25 August, 1983. However, it is important to note that this regulatory notification alone does not permit the companies to commence dealing. The authority becomes operationally effective only following a formal consent to be issued to each dealer by the Reserve Bank. These consents will generally permit dealers to commence business from 1 September 1983 provided the Bank's technical requirements are satisfied by the new dealer by that date. However, some of the named dealers will not be in operation until later in the year.

The consents will be couched in broad terms, allowing each dealer to offer those foreign exchange services that it chooses, provided these come within the Exchange Control Regulations 1978. Nevertheless, each consent will impose some operating constraints on the dealer, principally by way of crystallising internal prudential limits on the daylight, overnight, and mismatch exposed positions that the dealer may take. The Bank will be watching closely to see how the market develops with the new dealers, in addition to its existing prudential supervision of all foreign exchange dealings.

RESERVE BANK INVOLVEMENT

The introduction of additional dealers into the New Zealand foreign exchange market has also provided an opportune occasion for the Reserve Bank to review the nature of its own involvement with the market. On this score, a number of technical improvements have been implemented, although these are of interest primarily to local foreign exchange dealers.

From 8 August the Reserve Bank's former practice of fixing a firm exchange rate for the US dollar each day ceased. That rate now moves in reflection of

5 It is not the intention at this stage to move New Zealand towards becoming an offshore trading centre The principal immediate interest lies in promoting a more competitive environment for domestic traders

international currency movements throughout the trading day. The change does not indicate a new exchange rate policy — New Zealand rates will continue to be fixed on the basis of a trade-weighted basket of currencies.

The change to moving exchange rate quotations throughout the day is simply a recognition of the fact that international markets are now closely linked and continuously moving. In these circumstances it is no longer sensible or practical for the New Zealand market to ignore those movements. The changed situation will simply bring the New Zealand market into line with international foreign exchange practice. No problems for traders or exchange dealers are expected to arise from the change in procedure. In general, firm exchange rates for large deals will be available only from mid-day, when Asian markets open, but rates for small transactions will be available throughout the day as at present. The change in quotation practice is expected to have little or no impact on the foreign exchange requirements of most customers of the dealers.

However, one move which may be of wider interest is the manner in which the Reserve Bank has been gradually withdrawing from the forward exchange market by widening the margins in its quoted buying and selling rates. When the liberalised forward exchange market arrangements were introduced in 1979 it was thought that it would be possible for the Bank to determine its forward rates primarily on the basis of interest rate differentials between New Zealand and abroad. This was seen to be the logical corollary of the move to a crawling peg spot rate determined largely by inflation differentials between New Zealand and overseas. In the event, of course, short term interest rate and other fluctuations were so severe as to render this approach inappropriate. The emergence of these fluctuations, combined with a general concern about pressures on the New Zealand spot rate, as reflected in movements in reserves and overseas borrowing, meant that the Reserve Bank's oversold position increased sharply during 1981. Concern about the rising external current account deficit compounded the problem. In other words, the speculative pressures on the exchange rate, which in earlier years had been absorbed primarily by changes in leads and lags, were being reflected in the Reserve Bank's forward position. Despite a policy of gradually increasing the cost of forward cover, significant fiscal losses were incurred.

In 1982, the Bank moved more decisively to resolve this problem by steadily but significantly widening the margin between its selling and buying rates for forward cover to points outside the normal trading range. As a consequence, the Bank's net oversold position declined rapidly and substantially.

The intention of these moves has been to facilitate a gradual withdrawal by the Reserve Bank from the forward exchange market. Given that the Reserve Bank has provided a forward facility only to the trading banks, the Reserve Bank's formal withdrawal from the forward market will not affect the existence or operation of that market for most traders, although the special concessional facility hitherto available to woolbuyers was withdrawn from 8 August 1983. That special facility had, in any case, been little used in recent months. The Reserve Bank will cease quoting in the forward market when satisfied that the new arrangements have settled down.

Our moves in this area should not only eliminate the previously substantial fiscal cost of this system as far as the taxpayer is concerned, but should also facilitate the development of an active and competitive forward exchange market based on a widened network of dealers. The market has shown itself able to function effectively without the support of the Reserve Bank, and it is anticipated that the introduction of new dealers will further strengthen the market (including that between dealers themselves).

In a sense, these moves can be seen as further steps in an evolutionary process. They reflect a philosophy similar to that which underlay the moves in New Zealand in March 1976 to eliminate interest rate controls and to ease some of the other regulatory constraints over financial institutions. The course of these changes was interrupted by the advent of the freeze in June 1982, although at that time the Minister of Finance made it clear that the Government hoped to return to a policy based on financial market flexibility once inflation was reduced to tolerable levels. It is now hoped that the introduction of additional foreign exchange dealers and the withdrawal of the Reserve Bank from the forward exchange market will encourage competition, efficiency and improved services for New Zealand traders. Given the experience of other countries, and given the quality of the new and existing dealers, the Reserve Bank is convinced that users of the foreign exchange market will not be disappointed by these moves.

EDITORIAL NOTE

Since this article was written the Reserve Bank has issued the press statement reproduced below.

FOREIGN EXCHANGE DEALING

The Governor of the Reserve Bank, Mr D. L. Wilks, on 26 August 1983 announced that formal consent under the Exchange Control Regulations 1978 had now been issued to seven of the nine new foreign exchange dealers named earlier by the Minister of Finance.

The seven dealers authorised to commence dealing from Thursday 1 September 1983 are:

Broadbank Corporation Limited
Development Finance Corporation of New Zealand
Indosuez New Zealand Limited
Marac Corporation Limited
N.Z.I. Securities Limited
New Zealand United Corporation Limited
South Pacific Merchant Finance Limited

Mr Wilks explained that the remaining two of the nine named dealers (Citicorp Forex Limited and Lombank (NZ) Limited) would be issued with formal consents when they had completed technical arrangements to commence dealing. This should occur within the next month or two.

Mr Wilks also noted that, as foreshadowed in the Minister's statement, the Reserve Bank would cease quoting in the forward exchange market from Monday 29 August. The Bank had effectively moved out of the market some time ago by widening its quotations to points outside the normal trading range. That withdrawal had not affected the operation of the forward market and it was expected that the introduction of new dealers from 1 September would, in fact, help to strengthen the market in the future.