Opening comments to the third meeting of the Asia-Pacific Central Securities Depositories Group

Don Brash, Governor, Reserve Bank of New Zealand, Wellington on 4 November 1999

Introduction

Good morning, and welcome to New Zealand. I understand that this is the third occasion on which the Asia-Pacific Central Securities Depositories Group has met, and I am delighted that you have chosen Wellington as the venue for your meeting.

At this time, you will find, from watching our television and reading our newspapers, that most New Zealanders are lamenting New Zealand's shock defeat by France in the World Cup rugby contest in the United Kingdom; or possibly watching the Louis Vuitton yachting contest, leading up to the America's Cup yachting contest, in Auckland; or even, for those more seriously inclined, following the great political contest which reaches its climax later this month.

You will not find most New Zealanders focused on issues related to payment systems, or systemic stability, or central securities depositories. And I strongly suspect that the same is true in your countries also.

And yet you know, and I know, that long after the results of this year's World Cup rugby have been decided, long after the results of the Louis Vuitton and America's Cups have been decided, and long after the result of this year's election has been decided, issues relating to how best to strengthen the payments systems of all our countries will remain vital.

You know, and I know, that the peace and tranquillity of our countries and of our region depend in no small measure on improving the living standards of our people, and that is especially true in those countries where a great many people continue to live in conditions which nobody in this room has to endure.

And you know, and I know, that robust payment systems can make a vital contribution to improving living standards.

There are a great many factors which go together to make it possible for countries to improve their living standards, but robust payment systems can make a vital contribution. And robust payment systems which enable debt and equity markets to work efficiently, with minimal risk of settlement failure, are what you and your colleagues, and I and my colleagues, are all about.

So the contribution which you make to the prosperity of the countries in which you operate is very important, and I welcome you to Wellington.

It has been suggested that this morning I might give a brief over-view of some of the recent events in the global economy, and give a New Zealand perspective on some of the "solutions" which are being offered. And I am certainly happy to do that, while recognising of course that no single country's experience will be relevant to all other countries.

The global trend to liberalisation

As you are all aware, the last 20 years or so have seen a rapid trend towards the freeing up of capital movements. Flows of foreign direct investment have increased substantially. Flows of foreign portfolio investment have increased substantially. International bond issues, both by governments and by corporates, have increased substantially. The volume of bank lending across international borders has increased substantially.

The volume of funds under management has increased substantially, and most fund managers today regard it as appropriate and prudent to invest at least a part of their funds in countries other than their own.

And most countries have either recognised the benefits to be gained from allowing this increased international investment of funds or have been willing to accept it, perhaps as the price of admission into some international organisation, such as the OECD.

You are all familiar with this trend, so I don't intend to quote any numbers. Clearly, a very large number of private individuals, companies, financial institutions, and indeed central banks and governments, have very large cross-border assets and are managing those assets actively.

I think it is probably fair to say that, until two or three years ago, there was a near-unanimous view that the increasing liberalisation of international capital movements was desirable – for the countries which were doing the investing and for the countries which were receiving the investment. Freeing up capital movements allowed capital to move to where it could be most productive. Freeing up capital movements allowed companies and individuals to diversify the risk in their portfolios. Freeing up capital movements restricted the ability of governments to expropriate the savings of their citizens, perhaps through inflation. Freeing up capital movements seemed to be in everybody's interests, whether the country exporting capital or the country importing capital.

Those who opposed this trend to liberalised capital movements were regarded as nationalistic, xenophobic, Marxist, or just plain ignorant.

Questions raised by the Asian crisis

What a lot has changed in the last two or three years! As we all know, in July 1997 the Thai authorities were forced to devalue and float the baht, and over the next year several of the countries of Asia saw their currencies depreciate sharply, their banking sectors severely damaged, and their economies shrink substantially. In recent months, the most severely affected economies have begun to grow again, but many of their corporates remain under considerable financial strain, and banking sectors continue to grapple with massive levels of non-performing loans. It will be a miracle if we manage to escape further bouts of economic weakness in the region as countries strive to deal with these on-going problems.

And the cause of these problems? Surely, some argue, it was the unrestricted movement of foreign capital which triggered this crisis – the inflow of capital was excessive and, when the relatively trivial problems in Thailand triggered a rush to the exit, the outflow was excessive also. Speculators, typified by US-based hedge funds (or highly-leveraged institutions in the new jargon), turned what could have been a relatively mild adjustment into an enormous calamity, wiping out many billions of dollars in the process. Surely, it is suggested by some, the answer lies in measures to restrict the free flow of capital, to "throw sand in the wheels" in some way, to restrict the freedom in particular of the hedge funds.

And this view is being espoused not just by some of the political leaders in this region, but also by others, including some in the World Bank. Perhaps after all small economies are too vulnerable to allow the free movement of capital. Perhaps they should retain, or impose, controls on capital movements, of the Malaysian or the Chilean variety. Perhaps there should be restrictions placed on the activities of hedge funds or, if that is impossible, then at very least they should be obliged to disclose more about the nature of their activities. Some perfectly respectable people are joining this chorus.

New Zealand's experience

What was New Zealand's experience? New Zealand imposed capital controls in the 1930s – moderately severe controls on incoming investment and very severe controls on outwards investment – and maintained those controls, particularly on outwards investment, until 1984. In December that year, to almost everybody's surprise, those controls were abruptly ended, so that there were virtually no controls on inwards investment and no controls at all on outwards investment, whether by banks, companies, or private individuals.

And that situation continues to this day. Banks, companies, and private individuals are free to invest outside New Zealand without restriction, and indeed even without the need to report their activity to the Reserve Bank or other official body. Not surprisingly, after half a century of being denied this freedom, there has been a large increase in offshore investment – some of it direct foreign investment by New Zealand companies and much of it portfolio investment by private individuals, buying shares, bonds and property all over the world.

Equally, foreign residents are entitled to invest in New Zealand, with virtually no restriction on their right to do this.

There has been a huge increase in the amount of foreign direct investment in New Zealand – in banking, transport, telecommunications, forestry, tourism, food processing, commercial property, electricity generation and distribution, and manufacturing. (In practice, the only restriction on inward foreign direct investment relates to investment in the fishing industry and some kinds of rural land.)

There has also been a huge increase in the amount of foreign portfolio investment in New Zealand equities, with some estimates suggesting that more than 50 percent of all the shares listed on the New Zealand Stock Exchange are now held outside New Zealand.

By early 1997, foreign residents held more than 60 percent of all the New Zealand government New Zealand dollar bonds on issue, and about half the New Zealand dollar Treasury bills.

New Zealand-based banks have in recent years also been heavy borrowers in the international market, in the form of New Zealand dollar deposits taken through branches in places like Singapore and Hong Kong, in the form of US dollar issues in the capital market, and in the form of funding from foreign parent banks.

On a net basis, the inwards movement of capital has substantially exceeded the outwards movement, and this has been associated with a large and on-going current account balance of payments deficit. In other words, investment in New Zealand has substantially exceeded what New Zealanders were willing to finance from their own savings, and the difference was financed by using the savings of foreigners.

By the time the Asian crisis began in mid-1997, New Zealand's current account balance of payments deficit was getting close to 7 per cent of GDP, not much less than that in Thailand and above that in other Asian crisis economies.

Because we had been running a current account deficit in every year since 1973, the ratio of our net external liabilities to GDP was among the highest in the world – certainly higher than in any other OECD country and higher, I suspect, than in any other country in this region.

Because our banks had borrowed heavily overseas, and foreigners held large amounts of bonds and shares, there was ample scope for mayhem.

What actually happened? Well, the Asian crisis undoubtedly affected New Zealand adversely. Nearly 40 percent of our exports had been going to East Asia prior to the crisis, and Asian tourists were a significant part of tourist arrivals. Particular companies, such as those involved in the export of forest products and dairy products, were severely affected. Many of the exports which had been going to Asia had few alternative markets available – deer velvet was one small but striking example – and some of the alternative markets which were initially available, such as Russia, collapsed shortly afterwards. The New Zealand dollar fell from around 70 US cents in April 1997 to less than 50 US cents just 18 months later, a fall of some 30 percent.

But the astonishing thing is how resilient the economy was in the face of the Asian crisis. Real GDP in the December quarter of 1998 was almost identical to real GDP in the December quarter of 1997, whereas most of the Asian crisis economies experienced a sharp downturn in real GDP during 1998. Given the two successive droughts which also affected the New Zealand economy over 1997 and 1998, we could reasonably have expected a much worse outcome.

Yes, the exchange rate fell sharply and the proportion of government bonds and bills held offshore declined from 62 per cent of the total in April 1997 to just 40 percent in September this year. But on a trade-weighted basis, the exchange rate simply returned to its level of four or five years earlier: it certainly did not fall in any precipitate way, or in a way out of line with the underlying fundamentals of commodity prices and current account position.

Lessons from the New Zealand experience

I hesitate to draw too many lessons from New Zealand's experience. Or rather, I hesitate to draw lessons for other people from New Zealand's experience. Every country has its own unique circumstances. But for us at least, I think we can draw the following conclusions.

First, there have been huge benefits in allowing free capital movements. New Zealanders have been able to diversify their savings across a much wider range of investments than could ever have been feasible in a small economy of just 4 million people. On the other side, we have gained access not only to very large amounts of foreign savings – something which has made it possible for us to enjoy levels of investment which considerably exceed our willingness to save – but have gained access also to new technologies and new markets.

Secondly, by having a floating exchange rate regime, the impact of external shocks, including the recent Asian crisis, has been considerably softened. The depreciation of the currency which took place in 1997 and 1998, far from being a matter of official regret, was in fact an important part of the way in which the impact of the Asian crisis was spread across the whole community, to the considerable benefit of the export and import-competing sectors. While the international price of many of the commodities which New Zealand exports fell quite considerably over that period, the domestic New Zealand-dollar price of many of those exports either fell only slightly, or actually rose somewhat.

Thirdly, by having a floating exchange rate regime which long preceded the Asian crisis (we floated our currency in March 1985, and I think we are the only central bank in the world which can claim that we have not intervened in the foreign exchange market for more than 14 years), the sudden depreciation of the currency over 1997 and 1998 did virtually no balance sheet damage to the banks and corporates which had borrowed abroad so heavily in the preceding period.

And this was not because of any official policy. As indicated, we imposed no restriction on the right to borrow overseas, no restriction on the maturity structure of such borrowing, and no requirement on banks or corporates that they should hedge that overseas borrowing. But because the currency was freely floating, because it was widely understood that neither the government nor the central bank would intervene to stop the currency depreciating, and because most of the senior executives of the banks and corporates were old enough to recall times when the currency had gone down as well as up, the overwhelming amount of the foreign borrowing which had been undertaken had been hedged into New Zealand dollars.

This hedging had the advantage from a public policy point of view that it tended to push up the effective cost of borrowing overseas to something close to the cost of borrowing in New Zealand dollars, making New Zealand monetary policy more effective than might otherwise have been the case. From a private point of view, it meant that, when the currency depreciated, there were very few tears and indeed quite a few smiles (on the part of exporters).

Fourthly, we are convinced that, to get the benefits of free capital movements while minimising the risks, it is crucial that the financial system is sound. It is now rather painfully clear that the banking systems in several Asian economies were not in a sound condition, and were ill-prepared to handle the direct and indirect effects of a sharp currency depreciation, or the liquidity consequences of a sharp withdrawal of overseas credit lines. By contrast, our banking system has rarely been in better shape and, as we emerge from the impact of the Asian crisis and two successive droughts, is ready, willing, and able to extend credit to sound businesses.

This point is sometimes expressed by saying that, before a country allows free movements of capital, it should ensure that it has a good system of banking supervision. I certainly agree that it is important that before a country allows free movements of capital it should ensure that it has a sound financial system; but that is not quite the same thing as saying it must have a good system of banking supervision, at least as that is conventionally understood.

In New Zealand, we do not have a conventional system of banking supervision. We lay down only three quantitative rules or limits (two on minimum capital and one restricting credit exposure to the bank's controlling shareholder). We conduct no on-site inspections. We lay down no specifications on the nature of internal controls. As indicated, we lay down no rules about overseas borrowing. We lay down no rules about liquidity, and have no minimum reserve requirements.

But we do require banks to disclose a great deal of prudential information to the public on a quarterly basis, and we require that information to be audited twice a year by the banks' own auditors. We also require all bank directors to sign off on these quarterly disclosure statements, attesting to the reliability of the information in the statements and to the fact that the internal controls of the bank are appropriate to the nature of their banking business, and that those controls have been properly applied during the preceding quarter. We also make it clear at every opportunity that neither the government nor the central bank is guaranteeing any bank, or any bank deposit.

In this way, we seek to bring market discipline to bear on the banks, and provide a strong incentive for bank directors to ensure that their banks are sound.

Perhaps partly as a result, the New Zealand banking sector is now almost entirely foreign owned and controlled. Foreign banks have long owned a major part of the New Zealand banking sector, but since four government-owned banks were privatised in the early 1990s and a small number of privately-owned New Zealand banks were acquired by foreign-owned banks, only one of the 19 banks operating in New Zealand remains in domestic ownership – and that is a very small bank. What a disaster, some might say. On the contrary. From my point of view, I want the New Zealand banking sector to be sound, highly competitive, and technologically innovative. By having strong foreign representation in the banking sector, I have all three. In a relatively small country, it is actually difficult to see how the banking sector can be sound, highly competitive, and technologically innovative unless foreign banks do play a major role, and I am convinced that New Zealand has gained greatly from that foreign bank participation in the New Zealand economy.

Finally, we are convinced of the value of transparency, of the full and frank disclosure of all information relevant to financial markets. Sometimes, the information which we disclose does not make particularly attractive reading – at the moment, for example, the Treasury's official projection for the balance of payments deficit has it reaching 8.3 percent of GDP in the year to March 2000, and the last Reserve Bank projection was not very different. Sometimes, the information disclosed looks pretty encouraging, as in the case of official projections for public sector debt. But the key point is that by being open and transparent the likelihood of surprising markets is greatly diminished. Similarly, by being open and transparent the likelihood of being caught up in somebody else's difficulties is greatly reduced.

Conclusion

So those are our key conclusions:

- we gain much more than we lose by allowing capital to move freely;
- there are major advantages in having a freely floating exchange rate;
- in terms of the behaviour of banks and corporates, it is helpful to have a long track record of allowing the exchange rate to float freely;
- having a strong banking sector is crucial in getting the maximum gains from free capital movements; that does not necessarily imply doing the conventional thing with banking supervision but, for small countries at least, probably does mean being open to a high level of foreign participation in the banking sector; and
- transparency is vital in avoiding nasty surprises for markets.

Note that I have said nothing about reform of the international financial architecture. Like most other central banks, we are of course following this discussion with intense interest. But we attach relatively little importance to its outcome. This is partly because, like many others, we do not expect to see much actual change in that architecture but partly because we rather strongly suspect that the main need for reform lies not in the international financial architecture but in the domestic policies of many capital-importing countries. If those policies are sound, the international financial architecture is relatively less important.

Among those policies are measures designed to ensure that payment systems are sound and reliable. Indeed, ensuring that payment systems are sound and reliable may be one of the most crucial objectives for policy-makers keen to equip their economies to take part in the modern world. That is where you and your colleagues come in.

The underlying reality is that international capital mobility is in part a product of a technological revolution which often makes the movement of capital the result of a mere click of mouse. That situation is not going to change in any fundamental way. We must prepare our economies to take advantage of that new reality.

I wish you well for a very successful meeting here in Wellington.