

MONETARY POLICY SINCE THE CHANGE OF GOVERNMENT

This article is taken from an address by the Governor, Mr Spencer Russell to the New Zealand Institute of *Credit and Financial Management* on 23 October 1984.

'The period since the election' has been most eventful. The Government has probably moved faster and further in the monetary policy area than in any other. Not only has there been a wide range of individual policy actions initiated, but we have also seen a fundamental shift in the direction of monetary policy itself.

In a comparatively short time we have seen many examples of policy measures based on an underlying confidence in the allocative power of markets. I am not sure that the general public has appreciated yet just how wide the range of deregulatory initiatives introduced by the new Government has been. They include:

- The removal of the Interest on Deposit Regulations 1984, the various economic stabilisation regulations, and most aspects of the financial institutions and services regulations;
- The removal of the penal marginal ratios that had been applied to curb finance company lending;
- The abolition of the 30 day rule, which had prevented the trading and savings banks from entering the short end of the money market;
- The removal of the 3 per cent restriction on the interest payable on savings banks' ordinary savings accounts;
- The abolition of the 1 per cent per month credit growth guideline; and
- The termination of the special status that had hitherto been accorded to the four official short term money market dealers.

Rather than these steps reflecting deregulation for its own sake, they have arisen from a careful assessment of the regulatory framework. Each element has been considered in turn according to its costs and benefits, and discarded if it failed to measure up. Needless to say, a great many regulations have been found to have costs far in excess of their benefits.

These moves to free up the financial sector have, I believe, been based on the principle that the role of the Government is not to try to determine in minute detail the direction of the various sectors of the economy. It is to create a climate in which investment in productive assets is encouraged, but the choice of where that investment occurs is left to the private sector.

It is certainly too early to assess the long term implications of these initiatives, but in the Bank's advice to the Government, we have argued that finance sector deregulation, and what the Government has indicated are its social policy objectives, are not incompatible. The resulting increase in operational efficiency should make a direct contribution toward economic growth and thus allow the Government more scope to adopt measures aimed at social equity. We also have had serious doubts that many of the finance sector

regulations which were introduced on social equity grounds, actually helped achieve it.

Interest rate controls perhaps provide the most significant example of what I mean. These have frequently been advocated and introduced on equity grounds. That is, the controls are intended to protect the less well-off members of the community from the costs of high interest rates on personal and mortgage lending. Our experience with such measures is that they have tended to work in the opposite way. One of the most serious distortions such controls create is non-price forms of rationing. Some form of rationing funds available for lending is required because, with lending rates controlled, the demand for credit almost always exceeds the amount available for lending. The rationing techniques that are used inevitably favour the well-established, creditworthy borrowers and thereby directly penalise the less affluent.

In the jargon of my economists, interest rate controls involve an implicit subsidy to those who are able to obtain borrowed funds at the cheaper rates, and an implicit tax on those who are forced to hold financial assets at the low rate of return. This means that such controls ensure that savers subsidise borrowers. That is seldom, if ever, a very sensible thing.

There is another major way in which interest rate controls disadvantage the personal sector. It is possibly not widely realised that the household sector in New Zealand is a net saver. It is the only major sector that is: the Government, the business sector and the farm sector are all net borrowers. Interest rate controls that hold down deposit rates therefore have the perverse effect of hurting those they were intended to protect.

From the borrower's viewpoint, artificially constrained lending rates can also have undesirable consequences. A prime example of these is the upward pressure low rates of interest can create as they are capitalised into land prices. Frequently, under the misconception of being able to service a debt greater than would otherwise have been the case, farmers in particular can easily over commit themselves. This fact becomes only too apparent at times like these when an inevitable degree of interest rate volatility returns as steps are taken to rekindle competition in the financial markets.

These, then, are the arguments which motivated the abolition of the Interest on Deposit Regulations, and also the removal of both the 30 day rule, and the restriction which prevented more than 3 per cent interest being paid on ordinary savings accounts offered by savings banks.

We expect that one of the longer term effects of these policy initiatives will be to accelerate the lessening in the historical differences between the various classes of financial institution which is already evident. The distinctions among trading banks, savings banks, merchant banks, and building societies that seemed fairly clear ten years ago are now much narrower. This in itself has increased the degree of competition in the New Zealand financial system quite considerably and is likely to result in a continued expansion in the range of services offered by the finance sector to both corporate

and personal customers. It should also result in a significant shaving of operating cost and profit margins. It is one of the ironies of interest rate regulations that the profits of financial institutions tend to be at the highest when all interest rates are controlled. Their margins are fixed and safe from any inroads from competition. I am well aware that increased competition carries with it increased risks that not all financial institutions will prosper. These risks have been increased in recent years by the international volatilities in interest and exchange rates, and by rapid technological and institutional changes in financial markets. In recognition of these developments the Reserve Bank now has a heightened awareness of the need to take positive steps to increase its role as supervisor of the prudential soundness of financial institutions, in order to ensure the stability of the New Zealand financial system. The Bank, with the full support of the Government, has commenced an upgrading of its system of prudential supervision and surveillance of the activities of major New Zealand financial institutions. The object of this upgrading exercise is to develop a system which reduces the risk of institutional failure, but the system will not eliminate such risk entirely. There remains no substitute for good, prudent, management and the shareholders and management of each financial institution must ultimately take responsibility for their business decisions. We expect substantive progress to have been made in this exercise by early next year.

I would like to conclude by discussing the way monetary policy is now operating. Some fairly dramatic changes in the approach to monetary policy have taken place recently — changes which I suspect have not yet been fully appreciated by decision makers in the finance sector. The major tool is public debt policy, which is being implemented mainly through the tender system. Government has already indicated by its actions its determination to carry out this policy. It has run five tenders in the fourteen weeks since the election, selling almost \$1.4 billion of stock in all.

The essence of the change is that the Government has made it clear that it really does mean what it says when it states that monetary policy will not allow an excessive rate of expansion in money and credit to offset the July devaluation and jeopardise the achievement of control over prices and the external accounts. The Government is aware, as are we, that while the fiscal deficit remains high, such a policy probably means high interest rates. But the Government is committed to reducing the fiscal deficit, and this, I suspect, will become apparent in the forthcoming Budget.

In previous years, unwillingness to accept high interest rates over the adjustment period has generally meant that tight monetary policies have not been maintained when it came to the crunch. We have had periods of tight monetary policy in the past. But by backing off at the eleventh hour, money and credit growth rates have been allowed to expand excessively again and the benefits from the temporary period of tightness have been lost. The Government has made it clear this will not be the case this time.

One result of the pattern of not sticking with firm policies in the past has been that financial institutions have become used to being able to obtain liquidity relatively cheaply from the Reserve Bank when the going gets tough. Rapid credit growth on the part of

financial institutions generally leads to reductions in their liquid reserves. In planning their strategies, therefore, institutions would be very wise to take heed of the fact that in the future such losses of liquidity will not be accommodated cheaply by the Reserve Bank.

Just recently, a newspaper column referred to the decision to proceed with the 13th government stock tender for \$200 million on 18 October as 'a juggernaut blundering along' in the face of the havoc being reaped in financial markets. The 13th tender amount is consistent with the Government's medium term strategy. The lesson to be taken from the tender announcement is that the Government intends to stick to a firm and consistent policy line. This does not suggest that there is no concern about variations in the degree of short term tightness in financial markets resulting from seasonal and other fluctuations. Reserve Bank open market operations are to be stepped up and they will take account of such fluctuations. This should enable the tender programme to keep on a relatively steady track. This should give the market clearer signals of where debt policy is heading.

To sum up then, the debt programme, supported by open market operations, will ensure that the growth in liquid reserves of financial institutions will be more tightly and consistently constrained than has previously been the case. This will continue until such time as the monetary policy stance can be eased. This means that unless institutions adapt, they will find recourse to liquidity, either from the market or the Reserve Bank, very expensive.

If there has been a theme in my remarks, it has been one of change and I would not under-estimate the effects of the changes of the last few months nor the purpose behind them. Moreover, Government has made it clear that it intends to achieve both structural and permanent changes. In my opinion, nimbleness in the market place will not be enough. We have a new environment and it will demand a much greater degree of financial skill and prudential management than in the past.

I believe that the sector as a whole welcomes this new freedom, the competition it will encourage and the efficiency it should produce but I believe that we should also remember that while competition can bring great rewards it can also impose harsh judgements on those institutions which do not meet an acceptable standard of managerial skill.

While, as I have mentioned, the Bank will be increasing its prudential supervision no one should assume that we shall provide a safety net for any individual institution which does not follow prudential business practices and policies. Individual institutions will need to ensure that they conduct their business in a manner which continues to justify the confidence of their customers.

The aim is to promote an efficient and competitive financial sector, not for its own sake, but for the simple reason that this is important in achieving efficiency in the economy at large. By using financial resources most effectively the prospect of economic growth is more certain and that is the only way of improving the living standards of our people. The financial sector is a service industry and it is being given a fresh opportunity to serve the best interests of the community at large."