

Reserve Bank Bulletin

THE OPEN ECONOMY AND COMPETITIVE MARKETS

This article is taken from an address by the Governor, Mr Spencer Russell, to the New Zealand Society of Accountants on 6 March 1985.

The Governor reviews the changes that have occurred in the financial sector since mid-1984 and provides an explanation of the reasons for the changes and an outline of their likely impact on the financial institutions.

"The aim underlying all the reforms made in the financial sector is a commitment to the removal of barriers to competition. The purpose is a more efficient financial sector and a more efficient allocation of resources to those sectors which use financial services."

"The months since mid 1984 have seen a period of considerable change in the direction of government policy. Although this has been broadly based, affecting virtually all sectors within the economy, most of the major initiatives have been those that affect the financial sector.

The first of these were the removal of blanket regulations controlling lending and deposit rates and the abolition of the penal marginal ratios applicable to finance companies. They were soon followed by the revocation of the 30 Day Rule and the 3 per cent interest rate restriction on the ordinary accounts of savings banks.

Although these steps were taken primarily to free up the financial sector, they have also effectively changed the emphasis in monetary policy from control to a market-determined level of interest rates. As a consequence, a number of the regulations previously used to control money and lending have also been removed. In particular, we have seen the abolition of the one per cent per month credit growth guideline, and the removal of compulsory government security ratios.

There have also been a number of steps to free up the ability of financial institutions to borrow or lend offshore. The liberalisation of overseas borrowing constraints is an example of one of these, as was the decision in December 1984 basically to remove the Exchange Control regulations. Similarly, recent changes to the system of liquidity management, in particular the tendering of Treasury bills, have been designed to

complement the changes that have occurred in the financial sector.

These policy changes represent a dramatic alteration to the environment in which financial institutions are now operating. Of more interest now is in what the likely implications will be for the business community. To answer that, it is necessary to first explain the reasons for the changes. Put simply, the deregulation of the financial sector reflects the Government's desire to create a more competitive environment by removing artificial impediments to competition.

Although the controls that have been removed were undoubtedly introduced with the best of intentions, with the benefit of hindsight it must be said that they did not achieve their prime objective — that of helping the 'ordinary' borrower.

Indeed, it could be argued that the regulations and controls made the plight of the borrower worse, by reducing the incentives to competition between institutions, by introducing an arbitrary system of funds rationing, and by channelling funds into fringe institutions. This made the financial sector less efficient in meeting consumer needs and resulted in a less effective distribution of resources within the wider economy.

Probably the most significant effect of the removal of controls will therefore be the reduction of barriers to competition. There have been two distinct steps taken towards that objective.

The first was the removal of blanket controls on interest rates. This removed fixed interest margins, and in the process forced financial institutions to compete against each other to retain or expand market share. Whereas controls effectively weakened the role of interest rates in the allocation of funds, their removal has placed emphasis on interest rates, and therefore necessitates a greater degree of competition for funds and for lending.

The second step towards removing obstacles to competition was of a more structural nature — it involved the removal of controls or regulations that had long been in place. Here, I am thinking in particular of three measures: the abolition of the 30 Day Rule, the removal of the 3 per cent interest rate restriction, and the revocation of mandatory government security ratios.

Each had served to restrict free competition. The 30 Day Rule and 3 per cent rule limited trading and savings banks in competing for funds at the short end of the market. The system of mandatory ratios placed differential ratios on different institutions and did not cover a wide range of fringe institutions.

The removal of all three forms of regulation could best be described as a form of competitive neutrality. It has effectively put financial institutions on a more or less equal footing and therefore reduced the obstacles to competition.

One of the main effects of this increased emphasis placed on competition should be an acceleration in the pace of change within the financial sector. There is likely to be a further reduction in the distinctions between financial institutions and segments of the financial market. This was already occurring, but the changes should speed the blurring of distinctions between financial institutions.

As a result, institutions will now have to compete more actively for market share. They will no longer be able to rely on established roles and historical differences to retain a secure niche in the market place. Having a market niche will still be important, but it now must be developed and defended, possibly by innovation and certainly by paying close attention to the needs of customers.

There is already some evidence of this.

On the deposit side, for example, a wider range of deposit facilities are being offered with the level of interest rate and other terms being given greater emphasis than before.

On the lending side a number of developments indicate the stronger degree of competition. This is particularly the case in the area of consumer finance, which has seen a fall in the level of interest rates relative to the average level elsewhere in the financial market.

Greater competition is also beginning to emerge in the market for mortgage funds, with a number of new institutions entering the market.

The conclusion, therefore, is that financial institutions will no longer obtain an unintended benefit from regulations. Those that thrive, will be those that conduct their business in a way that justifies the confidence and support of their customers.

Although the new operating environment may cause some adjustment difficulties, it will also be one within which institutions can more flexibly plan their portfolios. In this respect, the removal of ratios and the

abolition of exchange control should give financial institutions much greater freedom in deploying their assets. Similarly, the new liquidity management package will give greater freedom to institutions to manage their own liquidity positions.

Of course, with greater freedom comes greater responsibility. In particular, the new liquidity management package places the onus on financial institutions to ensure their own liquidity is maintained at a satisfactory level. The removal after March 1985 of the compensatory deposit scheme for the trading banks is a reflection of this, as were the decisions to narrow the automatic discounting facility at the Reserve Bank and to increase the discount margin.

Hopefully, these developments will encourage a greater degree of responsibility within the financial sector and make them more cognisant of the need to maintain a balanced portfolio of securities. The move to market related interest rates on Treasury bills and Government stock should further encourage this by removing the implicit tax that the previously low-yielding government securities imposed on them.

The Reserve Bank's decision to upgrade its formal system of prudential supervision is another example of the need to ensure that increased responsibility accompanies increased freedom. This system should provide a general framework within which the Reserve Bank can monitor the prudential soundness of financial institutions, in order to ensure the stability of the New Zealand financial system.

However, while the Bank will be increasing its prudential supervision, this will not absolve any institution from following good prudent policies. It would be most unwise for anyone to assume that the Bank will provide a safety net for those who do not.

In addition to these direct effects on financial institutions there are also a number of indirect effects of the policy changes which have been made in the financial sector.

Probably the most important are the effects on financial institutions of a more effective monetary policy. The deregulation of interest rates, together with a more active debt policy should lead to greater stability in money supply growth, and therefore help to ensure that the economy enjoys more sustainable growth with lower inflation.

Furthermore, the changing structure of the economy will require the financial sector to become more attuned to user needs, and to channel funds to new growth areas — in particular, to those areas of the economy previously constrained by protection.

Another benefit of a stronger economy and more stable macroeconomic environment, will be the increased degree of certainty about future events. In particular, if we can achieve a lower rate of inflation and there are less volatile swings in the growth of money supply, this should make the job of forward planning by institutions that much easier.

The precise effects of financial sector decontrol are difficult to gauge at this relatively early stage, but it is not difficult to predict the benefits that are being sought. Firstly, of course, there will be the benefits as a result of a greater degree of competitiveness between financial institutions. Beyond the short-term that should lead to a lower structure of interest rates, and a wider array of financial services.

The deregulatory initiatives should also accelerate the trend towards increasingly sophisticated corporate financial packages.

Corporate borrowers which previously enjoyed only limited access to overseas sources of finance now have virtually uncontrolled access. Hopefully, they will now derive benefits not only from this new source of funds, but also from the increased competition that will bring within the domestic financial sector.

Similarly, the broadening of foreign exchange dealers' licences and the removal of various barriers to competition should ensure that corporate borrowers obtain overseas exchange at lower administrative costs.

The new environment is clearly intended to confer benefits on the users of financial services. But, any change in direction will bring with it a variety of adjustment pains which are currently occurring in a number of ways.

In particular the very high level of nominal interest rates is undoubtedly causing considerable discomfort for a lot of people, including the farming sector. However, it is a transitional phase which should be of a relatively short duration.

The major cause is the large fiscal deficit which, for the current March year is forecast to be not far short of \$3 billion. If the Government is to prevent these large fiscal injections leading to excessive growth in the money supply, and therefore eroding the benefits of the devaluation, the deficit must be offset by an appropriately higher level of domestic sale of government securities.

Although this is having the effect of bidding up interest rates in the short-term, it will have a stabilising influence in the medium and long-terms, by reducing inflationary expectations. This in turn will lead to a gradual easing in interest rates.

For monetary policy to be truly effective, however, and if there is to be more rapid progress in the lowering of interest rates, attention must be given to reducing the size of the deficit. Clearly the Government recognises this. It has already made substantive progress towards it, by implementing a wide range of expenditure appraisals and by moving to widen the revenue base.

As a result of the 1984 Budget and associated measures, Government expects to save about \$1.1 billion in the 1986 fiscal year and about \$1.8 billion in the year to March 1987. The steps already taken, coupled with tax reform and other moves planned for later in 1985, will hopefully see a substantial reduction in the size of the fiscal deficit.

Should this prove to be correct, good progress would have been made towards easing pressure on interest rates and reducing structural imbalances in the economy.

One group which has been largely overlooked in the current discussion on interest rates is the small savers of this country. For many years these people saved through institutions which were limited by regulation in the interest rates they could pay, and these rates were well below the rate of inflation. In effect, savers were being forced to subsidise those who borrowed their money. There seems scant justice in this and I hope that, whatever the final level of interest rates, recognition is given to the importance of this large, but largely silent, group.

The announcement on 2 March 1985 that New Zealand would adopt a floating exchange rate is another policy change that will impact on the financial sector.

The Government decision was taken against the background of the major policy changes which have been implemented over the past eight months, from the removal of interest rate controls in July 1984 to the dismantling of exchange controls and the removal of government reserve asset ratios on financial institutions.

The move to a floating exchange rate was a planned and carefully assessed decision taken for good economic reasons. It was not a reaction to the moderate foreign exchange outflows which occurred over the last week or so of February.

Those flows represented no lack of confidence in the New Zealand dollar in its own right. Rather, they were a reaction to the quite strong movements in two other currencies of importance to New Zealand traders, the Australian and United States dollars.

The Australian dollar devalued quite strongly against the US dollar over the first to the third weeks of February. Because of the method of fixing the New Zealand dollar rate against a basket of currencies under the pre-floating system, the New Zealand dollar appreciated against the Australian currency.

It is not surprising that traders with Australian obligations to meet decided to take advantage of a more favourable rate by paying then rather than later. Hence there was an outflow which was not in any way associated with a lack of confidence in the value of the New Zealand dollar.

There has been considerable talk of speculators gaining from the move to a floating rate regime. Speculation is difficult to define.

If one regards speculation in exchange rates as being the transfer of money from one currency to another in the expectation that one of those currencies will change in value, and give a profit when the transaction is reversed, then, in the transition from a fixed to a floating rate the possibility of that profit is reduced. Indeed, a loss may be incurred because the rate which will apply at the reversal of the transaction has become uncertain in a floating regime.

Once a floating rate is in place, for a speculator to make a profit other speculators must make losses because the exchange rate is fixed by the market. The Government, through the Reserve Bank, is no longer guaranteeing a fixed rate and thereby providing the means for speculative profit.

In the longer term the float will provide greater rather than less stability to those e.g. exporters and importers who, in the course of business, buy or sell foreign exchange.

During the transfer period there will be some volatility in the rate but this is expected to be shortlived. In the longer term the reduction being forecast for both the internal deficit and the balance of payments deficit augurs well for confidence in the strength of the currency.

One final point on the transition to a floating exchange rate. One of the factors which the Government had to consider in the advice from the Reserve Bank was the degree of expertise achieved by the banks and foreign exchange dealers and their ability to handle the new market situation. The smooth

introduction of the new system owes much to the skill, maturity and expertise of the foreign exchange dealers. Also acknowledgement needs to be given to the work done by the Reserve Bank's own staff who made a major contribution.

As indicated earlier, the aim underlying all the reforms made in the financial sector is a commitment to the removal of barriers to competition. The purpose is a more efficient financial sector and a more efficient allocation of resources to those sectors which use financial services.

Finally, it is worthwhile to give a personal assessment of the philosophical thrust of these substantial and significant changes.

First, the changes should not be seen in isolation. There have been a number of other policy decisions, all of which suggest that they are part of a pattern. These include the phasing out of a number of export incentives and concessional export credit incentives, the implementation of the motor industry plan and the liberalisation of the import licence tendering scheme. In addition, the Budget contained moves to remove or phase out subsidies, especially in the agricultural sector, and initiated a progressive increase in government charges and lending rates.

All these conform with a desire to create a more open and competitive economy in New Zealand, one which will be sufficiently flexible to react in a constantly changing economic environment. It involves change, for which the necessity for this was accepted at the Summit Conference. It was also accepted that the transitional period would not be easy and, indeed, could be painful.

Not surprisingly, now that the transitional period has come, there are suggestions that the changes should be made more gradual, to spread the impact and to allow time for adjustment.

This is understandable, but our national statistics show that gradualism in adjusting to changes in the external environment and to developments within the domestic economy have had their own costs: low growth, periods of sustained inflation, persistent balance of payments deficits and relatively high unemployment. These seem to make the case for more rapid change. Its burdens may not be borne equally but, as the unemployment figures show, that has also been true of gradualism.

However, while there may be debate on the nature and rapidity of change, it is clear that New Zealand will never return to those days of the 1950s and 1960s when it enjoyed stability and guaranteed markets. It must now earn its national living in the realities of the international market place. This means that it cannot adopt a fortress mentality and erect protective barriers behind which it can sit while it waits for the world to return to its senses.

This leads inescapably to the need to develop a competitive economy which can respond to external pressures. This is the need against which changes that are taking place today should be examined. New Zealand shall not move away from the rigidities of the past without some strain and some discomfort. But there is a chance now to begin a new and permanent pattern in the economy. New Zealanders owe it to the future to continue as they have now begun."