

FINANCIAL SECTOR POLICY REFORM

This article, written by Dr R.S. Deane, Deputy Governor of the Reserve Bank of New Zealand, is an extended and updated (to May, 1985) version of an address given originally to a conference on 'Financial Reform in the Pacific Basin Countries' held at the Federal Reserve Bank of San Francisco, 2-5 December 1984.

The transformation which has occurred in monetary policy in New Zealand over the past year, 1984/85, and indeed the changed nature of economic policy in general, represents a shift in stance which in terms of its scope and rapidity must be unequalled in the OECD region. After an extended freeze on wages, dividends, rents, prices, interest rates, and the exchange rate — a freeze superimposed on an economy already subject to extensive import protection, exchange controls, export subsidies and incentives, compulsory ratio requirements for all financial institutions, qualitative and quantitative credit guidelines, and an array of other regulatory interventions by the Government — the process of decontrol through 1984 and into early 1985 has been a dramatic one.

This process commenced with a number of important changes in 1983/84, and especially the termination of the price freeze in February 1984, but was greatly accelerated after the change of Government in July 1984. Since that time, all interest rate regulations, exchange controls, ratio requirements, credit ceilings, and numerous other interventions have been abolished. Moreover, the exchange rate has been floated, the fiscal deficit has been substantially reduced, and the effectiveness of monetary policy has been enhanced by the commitment to a public debt borrowing programme approximately equivalent to the net fiscal injections from the Government sector.

This paper sketches the background to this process of financial reform in New Zealand, discusses the nature of and the justification for the range of measures undertaken, comments on the nature of the new policy environment, and endeavours to draw together some of the major implications of the variety of moves undertaken.

Background

In the decade prior to 1984, the New Zealand economy had been characterised by one of the slowest average rates of real economic growth in the OECD region, serious and persistent balance of payments current account deficits which had been financed mainly by accumulating a substantial official overseas debt, a

large rise in unemployment, and for most of the period a relatively high albeit variable rate of inflation. Although some of the difficulties were externally induced, in the form of prolonged periods of international recession, unfavourable terms of trade, and restricted market access for some of New Zealand's agricultural exports, there can now be little doubt that the country's economic difficulties were aggravated by the slow pace of domestic adjustment.

For many years, the economy had been partly insulated from external realities by a high level of import protection, both by way of licensing, tariffs, and a diverse range of market interventions which distorted price signals and inhibited adaptation to changing circumstances. These interventions were illustrated most graphically by the comprehensive wage/price/interest rate freeze imposed from 1982 to 1984.

On the macroeconomic policy front, although the fiscal deficit varied to some extent in relation to the electoral cycle, its long term trend was strongly upwards during the 1970s and early 1980s. Throughout the period the exchange rate was pegged and despite occasional adjustments in the rate, adjustments which were more regular under the crawling peg regime of 1979 to 1982, balance of payments deficits became endemic. In part, of course, these were a reflection of inadequate monetary policies which in turn arose from extensive interest rate and other controls during much of the period, as well as from a reluctance on the part of the Government either to moderate its own deficit or to accept market related interest rates on its debt high enough to sell sufficient volumes of securities to ensure adequate monetary control. Money supply and credit aggregate growth rates were thus high and variable for most of the decade.

Although the freeze had the effect of inducing a sharp fall in the rate of inflation by mid-1984, the concentration of economic policy on one major objective tended for a time to divert attention from the seriousness of the remaining imbalances in the economy. However, when an election was announced in June 1984, the combination of an unsatisfactory fiscal and monetary situation, a pegged exchange rate, expectations of a possible devaluation, and frozen interest rates culminated in the foreign exchange crisis

which the new Government faced on its election in July 1984. In just four weeks prior to this, the Reserve Bank sold as much foreign exchange as it would normally have expected to sell in a full year, and despite extensive borrowing abroad and the official writing of a large volume of forward exchange contracts to help absorb some of the pressures at that time, external reserves dropped to an uncomfortably low level. Firm and decisive action was clearly called for.

A New Approach

The new Government immediately devalued the exchange rate by 20 per cent, removed all interest rate controls, and imposed a temporary price freeze to facilitate the development of a more satisfactory package of economic policies.

The principal features underlying the new approach were a concentration on medium term rather than short term objectives; an acknowledgement that a range of economic problems had to be addressed and that it would be unwise to place undue weight on any one particular objective; a recognition of the need to review the extent and nature of Government interventions in the economy in order to reduce market rigidities and encourage flexibility; and an emphasis on the philosophy that improved economic and social equity could be promoted most satisfactorily against the background of improved economic efficiency since this was seen as a prerequisite for sustainable economic growth. The approach embodies a rejection of short term fine tuning of stabilisation policies, an acknowledgement that the process of structural adjustment is a time consuming one involving lengthy lags and a medium term perspective with respect to the conventional macroeconomic policy instruments, and an emphasis on the need to give appropriate and clear signals to producers and consumers. There has been as much concentration on the appropriate microeconomic framework as there has been on the macroeconomic aspects. The policy adjustments have been rapid and extensive, encompassing the full range of policy instruments.

Major Policy Changes

The country's economic problems have been addressed on a range of policy fronts.

1. In order to encourage a higher degree of international competitiveness for the economy in general, the Government is moving towards a lower and more uniform protective regime. A firm programme for expanding import licence allocations has been established, which is likely to mean that most licensing controls should be phased out within the next few years. The Government has also indicated that it proposes to commence reducing high tariffs from 1 January 1986.
2. Again to facilitate adaptation to international market conditions, and to avoid inappropriate official price signals, tax incentives and other

subsidies for exporters are being phased out. Export tax incentives are scheduled to be abolished over a three year period, supplementary minimum price arrangements for the pastoral sector have been abolished, various central bank export credit schemes for the trading banks have been cancelled, and central bank concessional advances to the major primary produce marketing organisations have been frozen with the intention of gradually phasing them out.

3. In the labour market, wage controls have been removed, the general wage order system is no longer in use, and the annual wage rounds are preceded by tripartite talks between the employers, the unions and the Government in an attempt to involve all parties in a more satisfactory wage determination system.
4. The fiscal deficit is being reduced sharply both in value and as a proportion of GDP, by such means as appropriate pricing of Government services, the introduction of a new operating framework for Government owned enterprises, constraints on Government expenditure, and various tax changes.
5. Moreover, discussions are now proceeding towards the reform of the income tax and welfare benefit systems, which will involve in particular a change in emphasis from direct to indirect taxation as the result of the scheduled introduction of a goods and services (value added) tax in 1986. The objective is to rationalise the present complicated array of welfare benefits, to reduce the high marginal personal income tax rates, and to provide a more satisfactory system of incentives to work, save and invest.
6. In the balance of payments area, the exchange rate was devalued by 20 per cent in July 1984, various moves were undertaken to strengthen and extend the foreign exchange market, exchange controls were abolished, and the exchange rate was floated in March 1985.
7. These moves, together with a range of other deregulatory measures, were designed to remove market rigidities and encourage additional competition, both domestically and internationally. The deregulatory moves are most sharply illustrated by the changes in the financial sector which are discussed in more detail below.
8. Monetary policy has been reformed not only by the process of deregulation, but also by the commitment to a public debt programme based on virtually fully funding the net public account injections to the private sector, thus facilitating an improved degree of control over the monetary base and, ultimately, the money supply. This framework is also discussed further below.

Financial Sector Reform

Although fuller descriptions of the range of policy measures are available elsewhere, particularly in various issues of the Reserve Bank's Bulletin, the following sections summarise some of the major changes and comment on the rationale underlying them. Within the financial sector, the changes have been designed to introduce more competition into both the domestic money market and the foreign exchange market, to broaden and strengthen these markets not only by freeing them of distortionary regulations but also by facilitating ready entry to the various markets for new participants, and generally enhancing the efficiency and efficacy of monetary policy. The full list of deregulatory moves adopted within the financial system is a lengthy one, and only the more important of them are discussed below.

Interest Rates

The controls which were abolished in July 1984 encompassed regulations over all rates of interest on institutional deposits, all forms of lending, and particular restrictions with respect to mortgage loans. Subsequent moves have permitted the payment of interest on cheque accounts, the abolition of the three per cent limitation on interest payable on savings passbook accounts, and the removal of the 30 day rule which had prohibited trading and savings banks from paying interest on term deposits for less than 30 days. The Government has also made it clear that interest rates on its own Treasury bills and Government securities will be market determined and these are now all sold through regular tenders or via central bank open market operations. Tap issues have been discontinued.

At the time interest rates were decontrolled, the most compelling immediate justification was the preservation of international solvency. By holding interest rates to levels well below those which would have prevailed in normal market circumstances, official controls had contributed to the foreign exchange crisis by encouraging traders to retain funds offshore rather than remit them to New Zealand, to pay for imports earlier than otherwise since relatively cheap domestic funds could be utilised to gain protection against an overvalued exchange rate, and to discourage private overseas borrowing generally when domestic credit was cheaply and readily available. Devaluation had become essential, and so too had interest rate flexibility if the devaluation was to be effective.

The most important element in the case in favour of market determined interest rates is the need for an effective monetary policy. This argument had two aspects: first, the need to maintain a sound public debt programme in order to finance the fiscal deficit in an appropriate manner, i.e. by selling that debt at competitive interest rates; and, secondly, the need to prevent financial sector disintermediation whereby the major institutions subject to either interest rate or ratio controls lose market share relative to those institutions or those parts of the market less subject to regulations. Disintermediation of this form renders monetary policy ineffective since financial flows increasingly escape the regulatory net, a process at which New Zealand firms became adept over a lengthy period of time.

Interest rates are of course the mechanism by which financial markets clear the demand for and supply of

funds. If interest rates are controlled at below market levels, savings are discouraged and spending encouraged relative to a situation free of controls. To put it another way, the accumulation of financial assets is discouraged and borrowing is encouraged to an artificial extent. This not only makes it difficult to achieve adequate control over the growth of the money supply and credit aggregates, but also encourages distortions in financial flows which will in turn be reflected in a misallocation of real resources. It is thus not surprising that if the money supply expands rapidly, this facilitates higher rates of inflation, and speculation in real assets such as land and commercial buildings is not only encouraged but also validated as profitable. With a pegged exchange rate in these circumstances, balance of payments current account deficits inadequately matched by private capital inflows become a persistent problem.

Interest rate controls may also impair the soundness of particular financial institutions and often fail to serve the broader equity aims which are sometimes claimed for them. On the first point, such controls normally bear most heavily upon the major institutions and thus encourage an increased flow of funds through other forms of less accessible, more expensive intermediation. Efficient financial institutions may suffer from the controls while the inefficient prosper. As far as equity is concerned, controls imply that markets are not free to clear themselves, and thus queues develop for loans. Although large, well established clients may not find this process as burdensome as others, at least in the initial stages of any control regime, smaller or lower income borrowers will invariably find themselves at the end of the queues. They will thus either be unable to obtain the funds or be forced to borrow on less favourable terms from more expensive sources. In New Zealand, the point has been well illustrated in the past by the housing finance market where some of the major groups of house lending institutions have also been amongst the most heavily regulated institutions.

In summary, market determined interest rates help protect a country's international position, are essential to a stable monetary policy and a sound financial system, facilitate an efficient allocation of both funds and real resources, and are also ultimately more equitable than an arbitrary system of interest rate controls. It was for these sorts of reasons that the Government decided to abolish interest rate controls.

Ratio Requirements

Up until January 1985, the financial system was subject to a maze of ratio requirements over all major financial institutions. The trading banks had a reserve asset ratio system while the non-bank deposit accepting institutions as well as the insurance companies and pension funds were subject to a wide variety of Government stock and other ratio requirements. Some of these requirements covered cash holdings while others covered investments in other sectors, such as housing and farming. In percentage terms, the requirements varied enormously but ranged to a high of 54 per cent for the private savings banks. At the time of abolition, the reserve asset ratio over the trading banks was 28.5 per cent.

Although the detailed reasons for the wide disparity in ratio treatment across different institutions are now lost in history, there appeared to be a number of

justifications in principle for their original introduction. These included the perceived need to augment the funding of the Government's fiscal deficit, presumably at apparently below market interest rates, the wish to direct funds to specified sectors, the thought that the ratios might enhance the prudential soundness of certain institutions, and the argument that the ratio system was a useful monetary policy device. Long experience has suggested that each of these justifications is invalid.

It is clear that compulsory ratio requirements which force financial institutions to hold public sector securities effectively impose penalties, or an implicit tax, on those institutions, forcing them to increase margins between deposit and lending interest rates, eroding their competitive positions, and thus encouraging funds to move to less controlled areas. Institutions with a low level of ratios, and a minimum of other controls, and particular financial markets free of all controls, usually grew considerably faster than those institutions or those markets subject to extensive ratios or other controls. Two markets which suffered most severely from controls or other distortionary interventions were those for housing and farming finance, which then ironically appeared to require more official assistance than other financial markets. Since the adverse impact of ratios appeared to be greater in retail than wholesale markets, their effect was probably more severe on smaller savers and borrowers rather than on the larger participants in the market place who generally have open to them a wider range of alternative sources of finance.

Since the imposition of ratios tends to result in funds being redirected towards uncontrolled areas, they have not proved an effective form of overall monetary control. Moreover, while it may appear possible to keep interest rates low on public sector securities because of ratios, the interest rate consequences of a budget deficit and its financing are not avoided since these consequences are still reflected in the interest rates charged by financial institutions. If it is thus accepted that adequate monetary control can only be obtained in an environment of flexible interest rates, including competitive rates on Government securities, then compulsory ratios became redundant since Government securities are held voluntarily in adequate volumes.

Since compulsory ratios imply a lack of flexibility and adaptability by the institutions which are subject to them, they may not serve a useful prudential role. If ratios are associated with artificially low interest rates on the compulsorily held stock, then prudential management is hindered rather than aided because of the low income and high capital risk. Securities held for ratio purposes are essentially illiquid and thus impair the ability of institutions to adjust their portfolios or compete for funds in response to a change in market conditions. Any exemption granted from a ratio on prudential grounds simply advertises the existence of a prudential problem. It is for this reason that the Reserve Bank favours a system of prudential oversight involving improved monitoring of financial institutions but one which does not attempt to distort balance sheets or dilute normal market disciplines on management.

Ratios which are imposed in an endeavour to influence the flow of funds to particular sectors of the economy, such as local authorities, housing or farming, tend to address symptoms rather than causes of particular problems and are generally an inefficient

means of assisting these groups. This is because over time the competitive position of the institution subject to ratios is eroded and those groups seeking funds eventually need to turn either to other, usually higher cost, sources or to the Government for assistance. The analytical point is analogous to that with respect to Government stock ratios.

At one stage there was concern that the abolition of ratios could result in institutions deciding to quit existing holdings, thus placing upward pressure on Government stock secondary market yields and thus on new issue yields in the tender system. However, as Government stock interest rates became more competitive over the latter months of 1984, it became apparent that securities were being sold on their own merits rather than for ratio reasons. Once this situation develops, and there is a large pool of voluntary holdings of Government securities, the ratio system becomes redundant. This was the situation reached by January 1985 when it was decided to abolish the system in total.

Floating and the Foreign Exchange Market

After the experience of the June/July 1984 foreign exchange crisis, it was obvious that whichever exchange rate regime was decided upon for the longer term, the foreign exchange market needed to become stronger and more competitive. Over the months following that period, the Reserve Bank moved to encourage the creation of further foreign exchange dealerships, indicated that applications for 100 per cent foreign ownership of foreign exchange dealers would be viewed not unfavourably, encouraged dealers to apply for reviews of their overseas reserves and foreign borrowing limits, removed the limitations with respect to overseas owned companies borrowing in New Zealand and New Zealand companies borrowing abroad, and in December 1984 abolished exchange controls. By that time, the remnants of the exchange control system related primarily to a prohibition on New Zealanders investing funds abroad for portfolio reasons, since all current account transactions were effectively free of any restriction and both inward and outward direct investment were treated in a liberal manner. As far as direct overseas inward investment was concerned, the Overseas Investment Commission moved to eliminate most of the discrimination between different types of industries.

Amongst these moves, the abolition of exchange control was undoubtedly the major change since this system had been in existence for almost 50 years. It had been greatly liberalised over that period, and particularly after 1969. As was shown during the foreign exchange difficulties in mid-1984, the freedom with respect to current account remittances which had existed for many years rendered the system ineffectual in regulating any short term shift in remittance and payment timing patterns. For example, even though the outflow of foreign exchange was apparently so large, it represented no more than an adjustment of several weeks in timing patterns for both export receipts and import payments. The possibility of such large adjustments occurring quite legitimately within the context of the exchange control system raised serious questions about its usefulness. Moreover, the system generated an enormous amount of administrative work for both the private sector and the Reserve Bank.

Against the background of a stronger overseas reserves position, a more realistic exchange rate, and market determined interest rates the Government decided that the exchange control system had become redundant.

Renewed pressure by way of foreign exchange outflows in January and February, allied with the various market strengthening measures which had been taken in the preceding months, facilitated a floating of the New Zealand dollar on 4 March 1985. Although the prior outflows had suggested the possibility of some downward pressure on the dollar if it were to be floated, it was interesting to note that in the months immediately after the float there was little net change in the trade weighted value of the currency although day to day movements were at times significant. An important contributing factor to this early stability was no doubt the firm monetary policy which underpinned the situation, and the relatively high nominal interest rates prevailing at that time.

Since a move to a floating exchange rate regime is unusual for such a small economy as the New Zealand one, it may be of some interest to document the principal reasons underlying the decision. They were as follows:

1. Given that the exchange rate is simply the price of foreign exchange, its most basic and important function must be to provide appropriate price signals for international traders and for international capital movements. Extensive experience with pegged exchange rate regimes in New Zealand has demonstrated the difficulty of determining the exchange rate by official means, a point confirmed by continuous foreign exchange current account deficits and a rapidly rising overseas debt. Although a market determined exchange rate will fluctuate from time to time, both analytical arguments and empirical evidence suggest that over the longer term a floating exchange rate should give price signals better suited to efficient resource allocation than an administratively determined exchange rate.
2. After exchange controls and ratio requirements had been removed, it was apparent under a fixed exchange rate that there remained only limited scope for insulating the domestic economy from external shocks through offsetting domestic financial policies. To put the matter another way, the move to a floating exchange rate not only facilitated the removal of exchange controls and compulsory financial sector ratio requirements but could indeed be seen as essential to the success of these latter moves. The greatly increased flexibility for financial institutions and others to engage in international capital movements obviously needed to be complemented by flexibility in the exchange rate to ensure a balancing mechanism between the demand for and the supply of foreign exchange.
3. Under a pegged exchange rate, private sector speculative pressures result in either an inflow or outflow of foreign exchange being matched by an increase or decrease in the money supply and an increase or decrease in official overseas reserves, since the central bank stands ready to purchase or sell foreign exchange at the pegged rate. This not only complicates the management of domestic monetary policy, but also exposes the taxpayer, via the medium of the central bank, to the risk of having to bear the cost of private sector speculation. Under a floating exchange rate, private sector speculators can only gain (or lose) at a cost (or a gain) to other private sector participants, assuming the central bank does not actively intervene to defend the floating rate.
4. Reverting to the resource allocation arguments in point 1 above, under a fixed exchange rate relative price adjustments in the economy are accommodated by means of changes in interest rates and aggregate demand. This suggests that any adjustment costs in terms of unemployment and output disruptions may well be higher than would be the case under a floating exchange rate, particularly if nominal wage rates tend to be inflexible in a downwards direction. Under a float, these adjustments should tend to work more directly through relative price changes (including the exchange rate) rather than via aggregate demand. This suggests two implications: first, that in the longer term a floating exchange rate should provide a less costly adjustment process in terms of unemployment and output disruptions than a fixed rate regime and, secondly, that the inflationary effects of exchange rate changes may be more quickly apparent under a float than under a fixed rate.
5. Under either regime, any permanent change in the real exchange rate as compared with the nominal exchange rate is importantly dependent upon the accompanying stance of fiscal and monetary policies, a point which is given even greater emphasis in the case of the floating exchange rate because any domestic policy deficiencies are likely to be more quickly apparent, as the preceding point 4 implies. The floating exchange rate thus becomes an important indicator of the stance of monetary policy.
6. The substantial practical difficulties involved in administering a fixed or crawling peg exchange rate arrangement, which inevitably involve long run forecasts of the balance of payments position, are likely to result in sustained departures of the real exchange rate from its appropriate equilibrium level. New Zealand experience, especially in mid-1984, suggests that the speculative pressures associated with such departures may be substantial, as indeed also would be the cost of any discrete exchange rate adjustment which may become inevitable.
7. A wide concern about freely floating exchange rates is their possible volatility and the fact that at times they may exhibit short to medium term fluctuations which could be interpreted as giving inappropriate relative price signals to the real economy. Because the real sector of the economy tends to adjust to changes at a rate different from that of financial markets, and indeed because the two sectors may treat the same information in different ways over different time horizons, the capacity of the exchange rate to 'overshoot' must be

acknowledged. However, the relevant point is that even under a fixed exchange rate information is fed into and utilised by the various markets, thus affecting a range of variables other than the exchange rate. The fundamental forces which make for any volatility of a floating rate will still be present under a fixed rate, but their effects will be shared by a smaller number of variables. If the exchange rate is not free to adjust, then any volatility in markets would be borne by variables such as interest rates, the money supply, and overseas reserves. It is an illusion to think that a fixed exchange rate either eliminates or by-passes such volatility.

8. Given an absence of interest rate and exchange controls, under an administered exchange rate regime a change in the level of world interest rates will feed through into domestic interest rates. If domestic monetary policies are lax relative to the rest of the world, then in time a discrete adjustment would be forced on the fixed exchange rate regime. Under a float, the domestic authorities have a degree of policy independence to the extent that any adjustment may be absorbed through either interest rates or the exchange rate, assuming both are market determined, thus ensuring the possibility of adequate domestic monetary control. The wish to run a firm and independent monetary policy was a prime consideration underlying New Zealand's move to a floating exchange rate. The problems resulting from a fixed rate were well illustrated by the large capital inflows in the closing months of 1984 and the foreign exchange outflows in early 1985.
9. With a fixed exchange rate, any balance of payments deficit after current and private capital account transactions must be financed by the use of official reserves or official borrowing. On the other hand, with a floating rate, it is possible for the monetary authorities to control more closely the composition of the official debt as between the foreign and domestic components. By allowing the exchange rate to be market determined, the Government can more precisely determine the level of official overseas debt it is prepared to tolerate.

The move to a float is not seen as any panacea for New Zealand's balance of payments difficulties. If anything, the need for firm accompanying domestic policies is even more apparent than under a fixed exchange rate, where this need can be disguised at least for a time by official overseas borrowing. Instead, the move was seen as part of a package of measures designed to facilitate medium to longer term adjustment in the domestic economy and to ensure that meaningful monetary restraint is an integral part of this approach. The exchange rate is now an important indicator of the stance of fiscal and monetary policies, and the Reserve Bank's normal policy is to intervene in the foreign exchange market only for small scale market testing purposes and to acquire sufficient foreign exchange to meet the current account needs of the Government. These needs relate to the interest outlays on the official overseas debt, the cost of Government imports, maintaining overseas posts, and so on. In the meantime, official borrowing abroad is being undertaken only to refinance debt falling due and to rebuild the overseas reserves to a more satisfactory level.

Further Issues

In view of the extensive and rapid process of deregulation, the Government has indicated that it sees a need for the Reserve Bank to undertake a somewhat broadened role in the field of prudential supervision. To this end, the Bank is moving to collect further information from financial institutions, to encourage uniform disclosure of information to the public by all financial institutions where such disclosure is mandatory, to discuss with particular groups of institutions the adoption of appropriate prudential standards (such as in the areas of capital ratios, liquidity ratios, exposure limits, etc.), and to amend the Reserve Bank Act to provide for last resort intervention powers should a financial institution encounter extreme difficulties such as a run. It is not intended that the intervention powers will provide for the injection of funds by the Reserve Bank but rather to allow for an orderly transition process, such as a merger or a winding down, should circumstances warrant this. The emphasis of the Bank's oversight will be on promoting satisfactory standards of financial management by all financial institutions and ensuring that the responsibility for this rests with shareholders, directors and management.

The other major area where further developments are contemplated is with respect to the remaining distinctions between banks and non-banks. These now cover such matters as the power to issue cheques, participation in the clearing system, preferred access for banks to certain classes of deposits, and the right to use the name 'bank'. At present a bank in New Zealand is defined by name in a schedule to the Reserve Bank Act. The intention is to remove as far as possible these remaining distinctions, which should then make the trading bank market a more readily contestable one with the only remaining issue of principle being the extent to which institutions which currently engage in business very much akin to that of banking are able to call themselves banks. This is a matter which the Government will be addressing in the near future.

The Monetary Policy Framework

Amongst the most important implications of the array of policy changes described above are those relating to the framework for and operation of monetary policy. For many of the changes which have been adopted, an important component in the rationale has been the desire to enhance the effectiveness of monetary policy which had previously been greatly frustrated by the vast plethora of controls and regulations.

The principal objective of monetary policy, as now embodied primarily in the public debt sales programme, is to achieve suitably moderate and steady rates of growth in the major monetary aggregates. Underlying this aim, of course, is the wish to influence the ultimate economic objectives and, in particular, over the longer term to reduce the rate of inflation and to maximise the rate of increase in real national income.

Given that it is well known that the lags in the adjustment process may be lengthy and variable and bearing in mind the scope of the recent series of deregulations, it is clear that historical experience can only provide limited guidance for the future operation

of monetary policy in such a dramatically altered environment. For this reason, it has been decided at this stage not to publish any particular targets for the usual money supply indicators but instead to concentrate analysis on a range of medium and short term indicators of monetary conditions. The medium term intermediate targets which the Bank monitors include the narrow money supply M1, the broader money supply M3, private sector credit, and 'primary liquidity'.

Primary liquidity is a broadly defined monetary base concept in that it comprises trading bank balances with the Reserve Bank plus Treasury bills and Government securities with less than six months to maturity which the Reserve Bank has undertaken to discount at pre-announced but market related interest rates. The discount penalty is currently one percentage point above market rates.

The Bank has always maintained an eclectic view about the usefulness of a range of indicators of monetary conditions and has avoided undue concentration upon any single indicator or any fixed 'desirable' growth rate for it. In view of the shifts in institutional arrangements and deposit shares which can be expected following such extensive deregulation as that experienced by the New Zealand financial sector, this rather pragmatic attitude towards the assessment of monetary conditions is probably unavoidable until such time as a more stable and durable set of relationships becomes re-established. In any event, the use of several intermediate indicators has now become more widespread in other countries as a result of the experience over the past decade with monetary targeting.

The main instrument of monetary policy is now the regular Government stock tender programme, comprising about 10 tenders per annum, supplemented by the instruments used for liquidity management purposes including the weekly Treasury bill tenders, day by day open market operations, central bank discount policy, and the interest rate paid on trading bank cash balances held with the Reserve Bank. Although there are inevitably transitional problems as financial institutions adjust their portfolios to the new operating regime, and as all market participants become familiar with the new rules of the game, the basic criterion the monetary authorities are using for monetary policy at present is to fund almost fully the net public account injections over the course of a year. This means that net injections from the Treasury and the Reserve Bank combined are funded by sales of longer term government stock. These injections comprise mainly the fiscal deficit and maturing government stock (or, to be more precise, given the definition of primary liquidity, government securities coming within six months of maturity).

The critical elements underpinning monetary policy are thus the scheduled reductions in the fiscal deficit, the commitment to market determined interest rates and exchange rate, and the 'fully funding' operating guideline for Government domestic borrowing.

This implies that over the course of any fiscal year, the monetary base concept which is being used, that of primary liquidity, will vary for a number of reasons. First, a moderate rate of growth will be permitted by the authorities; secondly, there will be substantial seasonal fluctuations to the extent that the seasonal ebbs and flows in Government revenue and expenditure are not matched precisely in terms of timing by the

Government's debt programme; and, thirdly, some random element may be present at least in the short run to the extent that the actual net public account injections or withdrawals differ from those forecast by the authorities.

Seasonal variations in primary liquidity will be handled by appropriate adjustments to the ordinary Government stock tenders, the weekly Treasury bill tenders (some of which will be zero), and by open market operations. Given the present taxation payment arrangements, some build up in primary liquidity can be expected prior to the September tax flow, and this will occur to an even larger extent prior to the March tax flow period.

Under the new regime, the authorities have a much greater degree of control over the monetary base than was previously the case. The foreign exchange window, which was continuously open at a pre-announced pegged exchange rate under the old arrangements, is now effectively closed other than when the Reserve Bank enters the market to finance the Government's current transactions or engages in testing or other discretionary operations. Moreover, the discount window for Government paper with more than six months to maturity was closed towards the end of 1984 and the Reserve Bank will now only discount automatically at pre-announced market related rates Treasury bills and ordinary Government stock with less than six months to run to maturity. This substantial tightening of the authorities discretionary control over the monetary base should be reinforced by the programme to reduce the fiscal deficit and to eliminate the central bank as a source of net injections via its lending operations with respect to bodies other than the central Government. Since primary liquidity is being used as the monetary base concept, and since this is defined as trading bank balances with the Reserve Bank plus Government paper with less than six months to run, it will be clear why the authorities now have a more precise degree of control over the monetary base, after allowing for seasonal and timing variations in it.

In view of the likelihood of considerable short run variations in primary liquidity for these reasons, and because of the uncertainty surrounding the short term path of the cash balances component of primary liquidity, there remains a case for a reasonably active role for liquidity management on both a within month and within quarter basis. In assessing the stance of such operations, the most important interest rate indicators are those emerging from the regular Government stock tenders at approximately monthly intervals. These medium to longer run interest rates are linked via the usual term structure relationships to a range of short term interest rates which are monitored regularly by the Bank. In the short run, the important indicators of monetary conditions are short term (30-90 day) interest rates, call rates, Government stock yields on the secondary market, day to day and week to week cash/liquidity forecasts, the margin between short term commercial paper and Government security rates, and exchange rate movements. Other significant elements in the policy package include the Reserve Bank's discount margin, at present one percentage point over market interest rates, and the interest rate the Reserve Bank pays on cash balances held with it. This is at present five per cent.

In conducting any short term liquidity management operations, the important underlying criteria are the

need for consistency with the achievement of medium to longer term monetary control, and thus the need for short term interest rates to vary in a manner which would be consistent with the longer term rates required to sell the desired amount of longer term debt. Although criteria have been developed with respect to open market operations, these will clearly need to be modified on the basis of experience.

Such a major change in the method of operating monetary policy involves a number of transitional difficulties. These include the need for financial institutions to adjust their portfolios to the new environment, and the need for the authorities to form a view about the appropriate base level of primary liquidity, to develop additional knowledge on the inter-relationships between the various indicators and the different instruments, and to acquire further understanding on the fundamental relationships between interest rates, primary liquidity, and the various monetary aggregates. Other relationships, such as those between the monetary aggregates and nominal income, and between interest rates and the demand for institutional credit, may also be subject to significant shifts as a result of the changed financial environment. There is unfortunately no simple answer to these transitional complications and for this reason the Reserve Bank has engaged in extensive consultations with the various groups of financial institutions in order to help explain the new arrangements and to maintain close contact with the pattern of institutional change.

Some Lessons and Some Myths

Although it is early days yet, some tentative lessons can be drawn from the New Zealand deregulatory experience.

For example, it was demonstrated by the period prior to mid-1984 that it is not possible to control simultaneously both the growth of the money supply and interest rates (including those on Government securities) at below market levels. Furthermore, matters are even more complicated if this is attempted with a fixed exchange rate and/or with large fiscal deficits. Direct controls over interest rates and asset/liability ratios tend to promote disintermediation, render monetary policy ineffectual, and create other distortions, inefficiencies and inequities.

The time it takes to adjust away from an extensive control regime is one of the lessons to be learnt. While regulations can in many cases be removed quickly, regaining monetary control takes time. On the other hand, the responsiveness and adaptability of the financial system has been reassuring and the fears that the changes were either too large or too sudden do not appear to have been justified.

The process of decontrol is cumulative. Removal of some controls accentuates the problems with any remaining direct controls. It was for this reason, as well as for more fundamental reasons, that the Government moved to deregulate across a wide spectrum within a short space of time. Large scale institutional changes can occur after deregulation, and as one would expect, some institutions cope better than others with the adjustment period. Reintermediation is as real a phenomenon as disintermediation.

On a practical level, decontrol may make the monetary situation and the usual monetary aggregate

indicators more difficult to interpret in the short run. And it does not reduce the work load of the central bank bureaucrats, as some wishful thinkers amongst us have had the misfortune to discover.

Deregulation may also give rise to a new mythology surrounding those who advocate it.

For instance, in New Zealand the policies have been labelled by some observers, in a simplistic way, as monetarist. Although it is readily acknowledged that control of the money supply is an integral component in the overall package of policies being pursued, the 'necessary but not sufficient' nature of this condition has not been readily recognised by the opponents of deregulation. Moreover, the breadth of the policy changes takes them well beyond any single and simple label.

It has also been claimed that the policies are of a free market, non-interventionist kind. The point that seems to be missed is that the debate is not simply about whether or not Governments should intervene, but rather about the form of that intervention; and how to achieve a form which not only facilitates the exercise of consistent, stable Government policies but also allows markets to function as effectively as possible. Governments inevitably intervene; the issue is whether they do it in an efficient and equitable manner, or whether they do it in an arbitrary, ad hoc and discriminatory manner. The latter characteristics tend to be associated with direct control regimes.

It has also been argued that because some of the past historical relationships are unclear, such as that between primary liquidity and the money supply, this implies that the present thrust of policy is unsatisfactory. The problem is that the answer to this concern must be an analytical one rather than an empirical one. The regulatory and institutional changes have been such as to render past relationships unhelpful in determining the stance of future policy. The analytical basis of the new approach has been explained above and elsewhere. The issue then becomes one of whether the form of monetary control is sufficiently precise, and if it is not, what alternative approach to the instruments should be adopted. On this score, few of the critics within New Zealand have been explicit (other than those advocating a return to controls).

At the other extreme, there have been claims that the Reserve Bank can now hold primary liquidity constant and thus makes all the rules. The response to this point is, first, that financial markets are now as free of controls as in any period in New Zealand's recent history, and it will thus be markets themselves which will play a more important role than in the past in determining the allocation of funds between various activities. On the other hand, it is true that the monetary authorities now have much improved leverage over the growth rate of the monetary base aggregate, and thus in the longer term over the money supply, although the extent of seasonal and other short term fluctuations in these should not be under-estimated.

While the Government is a major participant in the market for funds, it is actively endeavouring to reduce its own borrowing needs by cutting the fiscal deficit, and its requirements are now met wholly by paying market determined interest rates on the basis of pre-announced debt sales targets for up to a year ahead. In this sense, the market should be reasonably well informed about the Government's intentions and the magnitude of its role.

Conclusion

The moves which have been taken to deregulate the financial and foreign exchange sectors of the New Zealand economy over the past year should be seen as part of a broader package of measures designed to promote more rapid economic adjustment. These include the measures to reduce the fiscal deficit, phase out or reduce protection, eliminate export incentives and subsidies, pursue a reform of the taxation system, and generally promote an economic environment conducive to flexibility and adaptability for both the private sector and the Government. The Government sees its role as encouraging the efficient operation of markets; providing a stable, more predictable macroeconomic policy environment; and thus promoting in the longer term more sustainable economic growth. This should in turn help it to meet the community's social and equity goals.

Within the financial sector, competition has been enhanced and the potential effectiveness of monetary policy transformed. The rapid rate of growth in the real economy and in employment during 1984/85, more rapid than in any other year in the past decade, has provided an appropriate backdrop for the process of change.

The importance of a sound underlying microeconomic policy base, and the close inter-relationships between fiscal, monetary and exchange rate policies, are now well recognised. A new analytical framework has been developed and the tools of policy are well in place. But change takes time, and there are still some important fundamental and transitional issues to be resolved.

Although the New Zealand experience has demonstrated that extensive deregulation can take place quickly, the process is clearly a necessary but not sufficient condition for a more effective monetary policy. It offers no guarantees or panaceas. The essence of the matter remains the durability of the commitment to soundly based policies once these are in place.

For New Zealand, the costs of the new policy approach are likely to be short run and transparent, such as in the form of a higher rate of inflation for a time, while the gains in terms of economic efficiency and more satisfactory macro policies are likely to be longer term in coming to pass. The greater the durability of the policies, the greater must be the opportunity of maximising those gains.