

RESERVE BANK ANNUAL REPORT

The following are extracts from the Reserve Bank Annual Report for the year ended 31 March 1986.

The statistical information included in this Report was finalised on 25 June 1986, and any subsequent revisions have not been incorporated. All amounts are in New Zealand dollars unless otherwise specified.

Introduction

Many of the major policy changes intended to stabilise the economy and subject it to the influence of market forces were either in place or under active consideration prior to the 1985/86 financial year. Perhaps inevitably, in introducing a revised approach to economic management the new Government had made more rapid progress in some areas than in others. Accordingly, many policy developments in the latest financial year either represented refinements to existing policies or extensions of the new policy framework to sectors of the economy that have proven less amenable to rapid adjustment.

In addition to the fundamental change in economic strategy there have been a number of other unusual factors affecting economic performance. The recovery from the trough of the recession in 1982 was uncharacteristically strong, especially through 1984, and it persisted well into 1985 despite a marked downturn in households' disposable incomes. The associated output and employment gains can no doubt be attributed in part to confidence factors resulting from the change to the more orthodox market-orientated economic policy strategy now applying. Yet it would be inappropriate to ignore a number of other special factors contributing to the relatively buoyant economy.

For example, New Zealand's geographical position has had an important bearing on the strength of the 1983 and 1984 domestic economy, and is also of some significance in relation to the subsequent slowdown in manufactured exports. The international recovery beginning in late 1982 was not initially well balanced in the sense that it was concentrated within countries bordering the Pacific Basin, most notably the United States of America and Japan. There were also strong spill-over effects on the Australian economy, and in this buoyant environment New Zealand achieved the fastest output and employment gains for more than a decade. More recently, the recovery in the major industrial nations weakened, but became more broadly based.

This was a reflection of a marked slowdown in the United States and a more moderate easing in Japanese growth, while European growth rates remained at lower and more stable levels.

The pattern of domestic expenditure associated with the large energy-related projects tended to reinforce the cyclical pressures on the economy generated by foreign demand movements. Much of the large project expenditure was concentrated in 1983 and 1984, just when activity growth in the United States and Japan was at its peak. The subsequent slowing in large project investment from the second half of 1985 occurred at a time when a cyclical slowdown in export demand had already commenced.

Domestic Activity and Policy

The Domestic Economy¹

After nearly two years of rapid growth economic activity was close to its cyclical peak by the end of 1984. Economic indicators in early 1985 pointed to a downturn, but this was delayed until later in the year as activity underwent a short-lived resurgence in the June quarter. Activity indicators were providing somewhat ambiguous signals in the September quarter, but by the December 1985 and March 1986 quarters it was clear that the economy had moved into a downward phase.

Given that real disposable incomes had fallen sharply over the 1984/85 year and that monetary conditions had tightened, a downturn in early 1985 had been widely expected. But household consumption expenditure did not fall in line with expectations, and savings fell, even though the year started with the ratio of savings to household disposable income at a level well beneath those typical of the last few years. Inflationary expectations, buoyed by the 1984 devaluation and the impending introduction of the Goods and Services Tax

¹ All quarterly data are presented on a seasonally adjusted basis.

which was initially expected to occur in April 1985, may have encouraged a 'spend now, save later' approach to household budgeting. Expenditures may also have adjusted in association with the buoyant real estate and share markets.

Eventually however, the effect of a 1.1 per cent fall in household real disposable incomes over the year to September, coupled with the high real interest rates, began to impact on consumption expenditure. Retail sales eased over the six months to December and stabilised at reduced levels in the March quarter.

Buoyant investment expenditures were an important further factor in the persistent strength of activity through to mid-1985. In particular, investment in dwellings was surprisingly strong, due in part to the rapid expansion in relatively cheap mortgage advances from the Housing Corporation and the Post Office Savings Bank following the announcement of the Government's Housing Package in March 1985. No doubt the impending introduction of the Goods and Services Tax also had the effect of bringing forward housing investment. Nevertheless, in the latter months of the year the number of permits issued fell sharply, signalling an imminent slowdown in housing construction.

Business investment in buildings, particularly for warehouses and offices, was generally firm throughout 1985, with construction volumes running over 20 per cent ahead of the level recorded a year earlier. Moreover, given that the value of building permits issued was still at a buoyant level in the March 1986 quarter, the normal time delays between the approval of permits and actual construction imply that industrial and commercial construction activity is likely to be sustained well into 1986.

Output changes closely followed the consumption and investment trends. In the June quarter total real Gross Domestic Product (GDP) rose by 2 per cent, but in the September quarter it declined slightly. Despite the significant boost to household disposable incomes implicit in the wage round, which was in the vicinity of 20 per cent if the unusually large adjustment in the public sector is included, output did not recover in the December quarter and real GDP fell by 0.6 per cent. Producers may have been reluctant to increase output in response to what they considered would be merely a transitory increase in demand. In the more competitive economic environment their ability to pass additional wage costs on into prices was restricted, and they may have taken the view that the higher than expected wage round carried negative longer-term consequences for both profits and future investment levels.

In line with the output turnaround, employment growth slowed markedly in the latter half of 1985. In the first half of the year employment had been growing at an annualised rate of around 4 per cent but this growth came to a halt in the three months to November. As a consequence, the number of persons registered as unemployed or in assisted employment rose over the December 1985 quarter by 7.2 per cent. This rise ended a period, lasting eighteen months or so, during which there was a reduction of 35,000 in the number of persons registered as unemployed or in assisted employment. Employment data for the three month period to February 1986 were distorted by the late start in the freezing works, but the available evidence suggests that the level of underlying employment declined over the period. This was reflected in a further 1.7 per cent rise in unemployment over the 1986 March

quarter. For the year to March 1986 unemployment rose by 3,300 persons to 54,200.

Balance of Payments

After displaying steady improvement over much of the 1985 calendar year, New Zealand's balance of payments on current account deteriorated sharply in the March 1986 quarter, resulting in an overall increase in the deficit over the year to March. Measured on a balance of payments basis², the current account deficit increased slightly from \$2,818 million in 1984/85 to \$2,870 million in 1985/86. Expressed as a proportion of Gross Domestic Product, however, the current account deficit displayed a small improvement, falling from 6.9 per cent in 1984/85 to an estimated 6.2 per cent in 1985/86.

In general the balance of payments developments over the year imply a satisfactory performance with respect to the new policy environment. Although the current account balance deteriorated in the March quarter, this was largely due to timing factors. The underlying trend over most of the year was one of improvement — despite a further decline in the terms of trade associated with difficult and unusual international trading conditions. On the capital account, the Government has confined official net borrowing abroad to a level which has been fully matched by increased foreign exchange reserves. On the other hand, there has been a rapid increase in net private borrowing abroad which reflects an imbalance in domestic savings and investment. Until such time as this imbalance is redressed, private sector borrowing is much to be preferred to borrowing by the official sector. Such borrowing is more closely linked to productive investment and it also puts the foreign exchange risk in the hands of private investors rather than the taxpayer.

Nevertheless, an increasing trend in external debt as a proportion of GDP, whether this be public or private, cannot be sustained indefinitely. The need to reverse the situation in due course suggests that further progress in reducing the fiscal deficit will be needed. The high level of private borrowing over the past year can be associated with relatively high domestic interest rates compared with those prevailing abroad, which in part relates to the Government's borrowing requirement. In this sense the Government, as a net spender, is contributing to the overall national borrowing requirement. The consequent capital account inflow, and the current account deficit which goes with it, are thus only likely to be reduced on a long-term basis when further progress is made in reducing the fiscal deficit.

Domestic Policy Developments

The overall objective of the Government's current economic strategy is to create conditions likely to facilitate the maximum possible rate of sustained non-inflationary growth. There are essentially two main strands to the approach. On the one hand the Government intends to liberalise markets previously constrained by direct controls and restrictive practices, and so expose the domestic economy to prices generated by competitive market forces. The intention has been to

2 The Balance of Payments basis for compiling external accounts data is the official information series of the balance of payments produced by the Department of Statistics. Under this system, transactions are recorded when a legal change in ownership of assets and services is deemed to have taken place between residents and non-residents.

reduce, and where possible remove, undue and unnecessary market rigidities and pricing distortions so that consumers' and producers' decisions reflect actual costs and benefits to the community as a whole. The essence of the policy is to make the economy more flexible and responsive so that resources may be free to move from areas of low productivity and low profitability to more successful areas with beneficial effects on overall efficiency and hence living standards.

The second part of the strategy involves the Government's commitment to a generally more stable economic environment. This includes a trend reduction in the fiscal deficit over time, together with a firm monetary policy orientated towards control over domestic inflation in the medium-term. In this context a firm monetary policy is defined as one which will constrain growth in aggregate domestic expenditure over time to a level which is broadly consistent with the potential growth in real economic activity. The new policy approach also involves a move away from the previous tendency to operate fiscal and monetary policies actively, where the stance of policy was 'fine-tuned' in response to short-run developments in general economic conditions.

An activist approach to macro financial policies has been rejected on the grounds that the lags between changes in policy and its impact on real activity can be long and variable. This means that attempts to use fiscal and monetary policy for short-term demand management purposes are likely to be ineffective and, at worst, may actually add to instability in the economy and delay the achievement of the ultimate objective of a return to low inflationary economic growth. For this reason, a major theme underlying the Government's new strategy has been that policy is directed at medium-term goals, and that the policy stance should not be adjusted frequently.

The Government has implemented a wide-ranging programme for change in many of these areas, although so far the medium-term macro stabilisation package is the more advanced, in part because these changes involved adjustments to administrative procedures rather than legislation. Thus the major changes needed to create a generally more stable economic environment were already in place before the start of the 1985/86 financial year: the upward trend in the fiscal deficit had been reversed; the exchange rate had been floated; and the firm monetary policy stance had been adopted.

Accordingly, macroeconomic policy measures taken during 1985/86 were typically designed to consolidate, and improve on, initiatives taken in the preceding year. No changes were made to the substance of the policy arrangements.

For example, the 1985 Budget proposed a further reduction in the fiscal deficit for 1985/86 to around \$1,300 million, an amount equivalent to less than 3 per cent of GDP, or less than half the average over the past 10 years (6 per cent of GDP). But as the year unfolded it became increasingly apparent that progress was both slower than intended and slower than desirable. Accordingly, towards the end of the year an expenditure review committee comprising four senior Cabinet Ministers with appropriate access to administrative resources was established. By the year's end the Cabinet had approved a set of 12 principles designed to improve public sector efficiency, and so permanently lower government expenditure growth. Included were a group of proposals to bring about improvements in the

efficiency of government departments, a review of a wide range of grants and subsidies to ensure their value to the community, and several measures intended to put departments' revenue collections on a commercial footing.

The process of removing government imposed or sanctioned distortions at the microeconomic level continued. Given that there are numerous problems in need of attention and that legislation is required on a case-by-case basis to give effect to many of them, the programme is an on-going one which will take some time to complete. Several measures were adopted or announced in the 1984/85 year. For example, the intention to introduce the Goods and Services Tax as a means of broadening the tax base and of reducing direct taxation had been announced; most export subsidies and import controls had been placed on either progressive phasing-out or phasing-down schedules; the exchange rate had been initially devalued and subsequently allowed to float; the financial sector had been largely freed from control; and, although the twelve months rule proscribed wage earners' ability to renegotiate terms and conditions, the wage freeze itself had been ended.

During 1985/86 the timing of some of the intended changes was accelerated. In addition, the Government initiated study and discussion which should ultimately lead to other changes of some significance. The announcement that the Government intends to press ahead with the State-Owned Enterprise framework as a means of improving public sector efficiency falls into the latter category. Essentially this is an initiative designed to develop mechanisms to subject government departments and other official organisations to market forces where appropriate, and to provide them with both more autonomy and more accountability. Similarly the Green Paper 'Industrial Relations: A Framework for Review' is in the same category — insofar as it represents an important further step along the path of increased labour market flexibility.

In introducing the new economic strategy there was a recognition that the benefits in terms of improved efficiency and resource allocation would only accrue in the medium to long term, while the costs of structural adjustment would be more immediately obvious, albeit not lasting. This has been borne out by the experience to date, and several sectors of the economy are now keenly aware that the path to reform is neither smooth nor painless. The Bank is well aware of these difficulties, but nevertheless supports the overall thrust of the new economic direction in the belief that the ultimate benefits will far outweigh the temporary transition costs now being experienced. The Bank believes that, if anything, there is a need to broaden and accelerate the process of structural adjustment.

Some of the most difficult problems that have emerged are in large part due to the unevenness of the overall adjustment: some sectors of the economy have been insulated by the maintenance of various price rigidities and distortions which have been less amenable to change. In the Bank's view the most appropriate response to these difficulties in general is to press forward with the process of liberalisation in those areas of the economy where resistance to change has been most stubborn.

An obvious example of this is the outcome of the 1985/86 wage round. The average level of settlements achieved was not only unexpectedly high, but the

negotiations were dominated by historical relativities and the level of settlements in the early trend-setting awards. The tendency for businesses and unions simply to agree on the 'going rate' was strong. There were a number of special reasons peculiar to the 1985/86 year accounting for the high overall level of settlements, including the after-effects of the wage freeze, skilled labour shortages in some areas of the economy, buoyant corporate profits, and the effect of unusually large Higher Salaries Commission determinations just prior to the beginning of the wage round. Nevertheless, the wage bargaining process in New Zealand has a long history of seemingly inflexible relativities. When not constrained by wage controls, there has been a traditional disposition in many areas simply to compensate wage earners for inflation with a standardised additional margin to allow a uniform real growth irrespective of relative productivity performances. The 1985/86 wage round continued this process: 63 per cent of awards were settled within a 15.5 to 16.5 per cent range, and only 3 per cent were settled at a lower figure, while the remaining 34 per cent were settled at a higher figure.³

Moreover, the awards themselves are generally defined in terms of occupational groups, and apply on a national basis — irrespective of either regional considerations or the relative economic wellbeing of individual businesses. In the face of a more competitive, less regulated environment such inflexibility is not only out of place, it is also likely to be prejudicial to the success of the Government's overall economic strategy. Visible signs of this rigidity in the wage-setting process can be seen in youth and worst-case regional rates of unemployment that are more than twice as high as the comparable adult and best performing regions' unemployment rates.

In the Bank's view there should be a move towards a wage setting process that makes economic realities within individual businesses more explicit in terms of wage packets, and hence ensures that scarce labour resources are more likely to move to those areas where they can be most productively used. Moreover, a system of this nature would help take away the perception that there is a 'going rate' in the context of any particular wage round, and in doing so help to ensure that job opportunities can be maintained, or even increased, despite a fiscal and monetary policy strategy designed to bring sustained downward pressure on inflation.

Monetary Conditions and Policy⁴

Policy Framework

The new framework for monetary policy had largely been established by the beginning of the 1985/86 year. A series of policy changes implemented over the period July 1984 to March 1985 had left the authorities in a position to operate an effective monetary policy for the first time in several years.

The major purpose of the Government's monetary policy reflects the desire to obtain control over inflation, and to do this within a medium-term

³ These figures cover the period to 3 June 1986 and exclude a number of flat-rate award increases. They also ignore the flexibility implicit in the second tier bargaining process.

⁴ All quarterly and monthly percentage changes are based on seasonally adjusted data, unless otherwise indicated.

perspective, recognising that past attempts to fine-tune the economy have all too often proved to be counterproductive. At an operational level the main tool of monetary policy is the government stock tender programme. The sale of medium-term debt through regular stock tenders constrains the growth in the liquidity base of the financial sector which would otherwise result from the combined effect of the fiscal deficit, Reserve Bank activities and maturities of existing government debt.

This provides the authorities with the scope to influence financial institutions' behaviour, and in particular the scope to constrain credit growth to a rate consistent with the ultimate objective of sustained low inflationary growth. The 1985/86 policy of unchanged primary liquidity over the year as a whole meant that interest rate responses would have forestalled any sudden lift in the demand for borrowed funds. If larger credit demands had arisen institutions would have been forced to compete more vigorously for an unchanged volume of liquid assets, short-term interest rates would have risen, and these would have affected longer-term rates, particularly if the increased demand for credit had been sustained. Expenditure plans would then have been revised to reflect the increased cost of borrowing.

The stance of policy first adopted in late 1984 and carried over into 1985/86 was that the stock tenders would be aimed at fully funding expected public sector injections into primary liquidity⁵ over the year as a whole. Over time, the medium-term policy approach is likely to involve an allowance for modest growth in primary liquidity, in line with the desired rate of growth in nominal activity. The full funding stance adopted for 1985/86 was essentially an approximation of this, in recognition of the fact that there would be a need for considerable judgment regarding the appropriate level of the liquidity base in the early stages under the new policy framework. In making such judgments, the Government and the Bank look at all the available indicators of monetary conditions, including movements in the narrow and broad monetary aggregates, credit growth, interest rates and the exchange rate.

The public debt policy is supported by liquidity management operations which attempt to smooth short-term liquidity conditions while ensuring consistency with the broader stance of monetary policy. The need for liquidity management operations arises from both the seasonality and the random nature of Government financial flows. Although some allowance for this seasonality is incorporated in the stock tender programme, the impact on the banking system of a significant portion of the seasonal fluctuation in government flows is smoothed by liquidity management operations involving Treasury bill tenders and Reserve Bank open market operations.

Despite short-term smoothing by liquidity management operations primary liquidity may vary substantially at certain times of a year as a result of the seasonality in the Government accounts. In particular, a

⁵ Primary liquidity measures the level of liquid reserves readily available to the private sector for settlement of transactions with the Reserve Bank. The operating definition used by the authorities includes trading bank and Post Office Savings Bank deposits at the Reserve Bank and private sector holdings of Treasury bills and government stock discountable on demand at the Reserve Bank. For much of 1985/86, government securities up to six months to maturity were discountable on demand, but this policy was modified in December 1985 and access to the discount window was progressively narrowed to securities with up to 30 days to maturity.

build-up in liquidity is required prior to the tax flow periods in March and September.

Monetary Policy in Perspective

Debt Sales Programme

In an operational sense, the new monetary policy framework appeared to work well in 1985/86. The stock tender system proved to be an effective means of meeting the Government's quantitative debt sales targets in a flexible interest rate environment. A total of \$3,200 million⁶ of wholesale stock was sold during the year in 11 tenders, with all tenders being well covered by bids and the bulk of yields bid generally falling over quite a narrow range.

In a less satisfactory development, significant volatility in longer-term government stock rates was a feature of the year. These movements tended to coincide quite closely with the fluctuations in short-term interest rates, possibly suggesting that the market was somewhat preoccupied with short-term considerations over this period. In addition to short-term funding costs and changing perceptions of the underlying stance of monetary policy, other major influences on long-term rates included inflation expectations, which appeared to change significantly over the course of the year, and expectations of future government demands on the supply of loanable funds, as represented by the size of the fiscal deficit.

On several occasions during the year, changes in the sizes of the estimated 1985/86 fiscal deficit and borrowing requirement had a significant effect on the structure of wholesale interest rates. Particular examples were the sharp fall in the interest rate structure following the downward revision to the debt programme in June, and the subsequent firming in interest rates in January associated with the announcement of the need for an increase in the borrowing programme.

Two lessons may be drawn from this. First, changes in the stance of fiscal policy and the size of the Government's borrowing programme now have a more immediate and obvious impact on financial markets than was the case in an environment of interest rate and exchange controls, when the effects tended to operate more gradually, particularly through imbalances in the external accounts. This highlights the need to coordinate closely fiscal and monetary policies in a deregulated environment. The current emphasis being placed by the Government on restraining public expenditures will therefore be an important element in the success of the overall economic strategy.

The second point to come out of the experience in 1985/86 is that financial markets again appear to have become overly preoccupied with short-term considerations, such as the absolute size of individual stock tenders and their immediate impact on short-term liquidity conditions. There has also been a tendency for the market to over-dramatise adjustments to the Government's estimated financial position for the current year which is always, of necessity, a very approximate figure. The full funding stance is very much a medium-term policy, and the success or failure of the debt programme to exactly match net public sector injections over any particular period is not crucial to its overall effectiveness. Indeed, given the wide

margin for error in forecasting fiscal deficit outcomes from year to year, it is most unlikely that full funding will be exactly achieved over any particular accounting period. What is important is that full funding is maintained over time, subject to an allowance for an appropriate level of growth in the liquidity base, so that 'errors' in one fiscal year are made up again in the subsequent year.

In this regard, the extent of movements in the interest rate structure which were associated with changes in the borrowing requirement during the year appeared excessive. It would be hoped that the volatility in the interest rate structure experienced in 1985/86 will decline over time, as the market becomes more familiar with the medium-term focus of policy in the new environment and less disturbed by temporary shocks to short-term liquidity conditions.

Liquidity Management Policy

While liquidity management policy was successful through the year in achieving its broad objectives, it was evident that a greater amount of uncertainty and hence variability in market conditions existed than was necessary or desirable. Changes to the structure of the liquidity management operation were announced in December and progressively implemented in the final months of the financial year. These amendments were refinements to the Bank's operations designed to produce less uncertainty and more stability.

The basic task of liquidity management policy is to smooth fluctuations in liquidity while retaining consistency with the medium-term policy stance as reflected in the public debt strategy. These fluctuations result from the seasonal nature of cash flows between the financial system and the official sector. In addition, an erratic pattern of daily flows is superimposed on the seasonal trends. The basic design of the liquidity management policy, in operation for all but the final few weeks in the year, involved Treasury bill sales to absorb cash balances originating from seasonal influences, with cash holdings of the financial system at the Reserve Bank acting to absorb the day-to-day fluctuations. At times, when daily cash flows were unusually volatile, Reserve Bank open market operations in government securities and sell-back transactions were also used as an additional buffer.

As a general rule, Treasury bill maturities were planned to coincide with subsequent liquidity withdrawals, especially those associated with the usual end-of-month tax flows to Government, as well as the two 'main' tax flow periods in September and March. In doing this, cash was maintained within a broad band over the full year. Primary liquidity on the other hand had been defined to include Treasury bills with maturities of up to six months, and consequently the seasonality associated with government transactions was reflected in a seasonal pattern in primary liquidity itself.

Following the September tax flow period it became apparent from market behaviour that the adopted approach to liquidity management was creating undue uncertainty in the money markets over both short-term liquidity conditions and the medium-term monetary policy stance. In part this appeared to reflect the market's unfamiliarity with the new policy environment, although the scope for large seasonal shifts in both the level and composition of primary liquidity was clearly contributing to these interpretive difficulties.

6 Nominal value as opposed to cash received.

Consequently, the definition of primary liquidity was revised to include cash balances at the Reserve Bank (as before) together with government securities with maturities of 30 days or less (rather than six months). This change in the definition of primary liquidity was given operational significance by a corresponding reduction in the on-demand discount facility at the Reserve Bank.

By shortening the primary liquidity definition the concept was made more homogeneous (and therefore less open to compositional problems), and the bulk of the seasonal variation was moved outside the primary liquidity definition leaving a more stable aggregate that will be less open to misinterpretation. In future, the month-to-month movements in primary liquidity should be more easily identified with the underlying trend determined by the overall debt programme. Seasonal variations in primary liquidity will now only be accentuated immediately prior to the main tax withdrawal periods in March and to a lesser degree in September, rather than throughout the year.

One difficulty with the original liquidity management package was that the rate of interest paid by the Reserve Bank on the cash balances of the settlement institutions was set at a somewhat low 5 per cent. At this interest rate the institutions preferred to hold Treasury bills rather than cash, which in turn caused more frequent discounting and contributed to volatility in short-term interest rates. Accordingly, the liquidity package announced in December included measures intended to both increase and stabilise the level of cash which financial institutions hold at the Reserve Bank.

In order to increase the demand for cash balances the interest rate paid on them was raised to a level equivalent to 65 per cent of the Reserve Bank's assessment of seven-day market interest rates. Also in order to limit the degree of variation in cash balances, more frequent use of open market operations by the Reserve Bank was proposed. While the first change appears to have had a negligible effect on the demand for cash, the second move has had a major effect on market conditions, with smoother and more predictable cash balances leading to a significant reduction in short-term interest rate volatility.

Conclusion

It is not possible to make any conclusive statements regarding the effectiveness of monetary policy during 1985/86, given the lags involved between policy changes and their effects on the ultimate objectives of policy. Interest rate and exchange rate indicators clearly indicated that the Government's monetary policy remained firm over the course of 1985/86. This had not been reflected in any substantial slowing in M3 growth by the end of the year, though M3 appears to have been significantly affected by the increasing market share of M3 institutions, notably the trading banks, in the deregulated environment. The firm policy stance did result in a slowing in credit growth over the latter part of the year and this would be expected to feed through into slower monetary growth over time.

Although the inflation rate also showed signs of slowing during 1985/86, a close relationship between the firm monetary policy stance and inflation cannot be expected in the short term. Monetary policy operates on inflation both directly, through its effect on inflationary expectations, and indirectly through its effect on the exchange rate and the level of spending in the economy.

While there were signs that the latter channels were operating in 1985/86, with a strong exchange rate contributing to import price reductions and increasing indications of a downturn in economic activity towards the end of the year, there was little evidence of the former more direct channel operating. In particular, wage settlements during the year appeared to be generally well above a level which would have been consistent with the medium-term stance of monetary policy. As a consequence, the effects of the Government's firm monetary policy may initially be seen less in lower inflation and more in reduced output and employment growth than would otherwise have been hoped for.

Institutional Reform and Prudential Supervision in the Financial Sector

Institutional Reform

From a position of rigid constraint and controls on the structure and operation of the New Zealand financial sector, a number of significant steps have been taken over the past few years towards the promotion of efficiency and competition in the financial sector. Although this is an area of special significance for the Bank, from an economy-wide perspective it is but one of a whole series of measures designed to improve resource allocation within the economy. Accordingly, this is an area where progressive improvement and new policy implementation is part of an ongoing process.

The most significant changes made by the new Government prior to the start of 1985/86 were the removal of controls on interest rates, the withdrawal of credit guidelines, the abolition of compulsory ratios, the removal of exchange controls and the eventual decision to float the New Zealand dollar. Already this has led to benefits in terms of the broader range of financial services now available to the public. Moreover, some easing of margins between costs of funds and income was evident from the annual accounts of many financial institutions reporting during 1985/86.

During the year under review, there were further developments designed to promote efficiency and competition in the financial sector. The most notable development was the decision to reduce entry barriers to the banking sector. This policy initiative was a natural progression on developments within the market itself, which in recent years have included a marked change in the nature of institutions and a blurring of traditional institutional boundaries.

At present, 'bank' status is restricted by law to the four trading banks, private savings banks, trustee banks, Post Office Savings Bank, and the Reserve Bank; each institution or group of institutions operates under its own legislation, and new banks are able to commence business only by special Act of Parliament. Given that much banking activity is now undertaken by other 'non-bank' institutions, an important aim of the new banks policy is gradually to alter perceptions about the word 'bank'. However, it has to be recognised that the adjustment of public perceptions both domestically and internationally will take time, and an explicit authorisation process is favoured at this stage.

Nonetheless, it is intended that the authorisation procedure will be consistent with the general policy objectives of encouraging a competitively efficient and 'contestable' banking sector. Consequently, a

qualitative rather than a quantitative approach to applications for new bank authorisation has been proposed. To encourage maximum market contestability the system is to be 'open-ended', with no limit on the number of new entrants nor any restricted period during which applications must be submitted.

In addition, non-bank institutions will not be discouraged from offering cheque account facilities, or taking part in the clearing system.

The criteria which it is expected institutions will be required to satisfy before they are permitted to use the word 'bank' in their name have been widely publicised and include:

1. A minimum capital amount — authorised capital of at least NZ\$30 million of which a minimum of \$15 million is fully paid up.
2. Demonstrable expertise in the conduct of banking business.
3. Evidence of good standing in the financial community.
4. A willingness to co-operate with the Reserve Bank in carrying out its functions.

Implementation of this policy will require changes to various Acts of Parliament, principally the Reserve Bank Act. These legislative amendments are currently being drafted.

During the past year a number of other legislative restrictions/privileges have been under review. A review of the Trustee Act investment provisions is currently underway, primarily to determine whether the present 'legal list' should be replaced by the 'prudent man' principle or some more appropriately flexible and neutral arrangements. There are also the many examples of statutory advantages given to a number of financial institutions; the official policy, in line with the principle of competitive neutrality, is to remove those advantages where possible.

For example, the Government has indicated its wish to phase out the government guarantee given to deposits with trustee banks, subject to appropriate alternative arrangements being put in place. In response, the trustee banks are now considering various restructuring options and have been holding discussions with officials. Similarly, the Government has indicated its willingness to consider changes to the building societies' legislation, which would eventually place building societies on a footing more similar to that of other financial institutions. In the case of Government-Owned Enterprises, these are being reviewed with the intention of both enhancing the efficiency of their operations, and of making them operate within a regulatory framework more in line with those applying to their private sector counterparts.

Prudential Supervision

In the longer term a deregulated and competitive financial system is likely to result in a more efficient group of market participants and a stronger financial system. However, potentially there remains scope for large economic costs to arise from the spread of failure from one financial institution to others, implying that special arrangements for the oversight of the financial system are warranted. Accordingly, work on a stronger supervisory framework is nearing completion. It is hoped that legislative amendments covering both the

'new banks' and the prudential supervision proposals will be passed in the second half of 1986. Arrangements to facilitate closer monitoring of financial conditions and of risk exposures are under discussion with institutions.

The fundamental objective of prudential policy is to create an economic and legal environment conducive to stability for the financial system. Thus supervision will have the primary objective of preserving confidence in the financial system as a whole, rather than being aimed at protecting depositors and individual institutions. Care will be taken to ensure that supervisory arrangements do not lessen the incentives for prudent management of financial institutions that are provided by normal market disciplines.

The role of the Reserve Bank will involve detailed and regular monitoring of the financial condition of institutions, and consultation with management. This oversight will concentrate on banks and the larger non-bank financial institutions of a sufficient size to justify the concern that their failure might lead to system-wide problems. The proposed legislative amendments include stronger information collection powers and strict requirements for the protection of that information. In addition, there are wider powers of inspection than in the existing Act, although these would not be used as a means of regular inspection as is the case in some countries.

An institutional collapse is more likely to have contagious effects to the extent that it is prolonged. The legislative proposals therefore provide the Bank with reserve powers to facilitate the orderly exit of failing institutions from the system.

The Foreign Exchange Market and Exchange Rate Developments

The Foreign Exchange Market

In marked contrast to 1984/85, the year to March 1986 saw no major changes in the structure or function of the local foreign exchange market. Rather, this was a year of consolidation and adaptation to the new policy framework. It was, however, a year of enormous turbulence in international currency markets and, taking that into account, the performance of the New Zealand foreign exchange market and the newly floated New Zealand dollar was generally very creditable.

The policy changes introduced in the foreign exchange market over 1984/85 were designed to enhance the depth and efficiency of the market. These changes included the removal of most controls on the foreign currency balance sheets of the authorised foreign exchange dealers (the major exception being the retention of net exposure limits for prudential purposes), and the removal of limits on the extent of foreign ownership of authorised foreign exchange dealing companies.

These initiatives permitted an increased number of foreign exchange dealers to assume a more effective role in the market and thereby better serve the foreign exchange needs of the public. They also allowed the development of sufficient depth and sophistication in the market to cope with a more flexible exchange rate regime and, as such, were a prerequisite to the decision of March 1985 to float the dollar.

While there were no new policy initiatives specific to the foreign exchange market over the year to March 1986, the process of development within the new policy framework continued. There was continued interest in gaining access to the market, and four new foreign exchange dealing authorities were granted by the Minister of Finance. All were for 100 per cent foreign-owned financial institutions, three of them Australian based. With one licensee withdrawing during the year this took the total number of licenced foreign exchange dealers at the end of March 1986 to 18.

A major part of the rationale for moving to allow 100 per cent foreign ownership of foreign exchange dealing companies was the perceived desirability of gaining a stronger capital basis for local foreign exchange dealing operations. It is pleasing to note that the newly authorised companies will all start with capital of \$10 million or more. That, plus the support derived as wholly owned subsidiaries of major international financial institutions, gives those participants considerable capacity to operate effectively in the marketplace.

Despite the relative inexperience of some participants and the difficult conditions internationally in currency markets, the local foreign exchange market performed well during the year under review. The rapid growth of the previous year continued with most traders experiencing sharp increases in turnover and offering a broader range of currency and related services to their clients.

In particular, the forward market developed apace with the removal of domestic interest rate controls and exchange controls which created the requisite conditions for a soundly-based forward market. Spreads in the forward market narrowed appreciably during the period with strong forward buying and selling interest being evident within the corporate sector. A further indication of the strengthening of the forward market was seen in the increasing ability of market participants to transact substantial parcels of business, particularly for terms of up to one year, without unduly influencing either the exchange rate or the spreads being offered.

As with the spot market, the major impediment to further growth in the forward market is the limited capitalisation of many of the market participants which has restricted their capacity to accept more extensive exposures with other market participants.

Unlike the forward market, spreads in the spot market have not shown a tendency to narrow over the year. This is a clear reflection of the extra degree of risk being assumed by traders as a result of the exchange rate float together with the volatile conditions in the international capital markets. In essence, prior to the float, much of the risk of the foreign exchange market was being absorbed by the Reserve Bank, and dealers were able to offer quite narrow spreads as a result. Now that the risk has been transferred to the private sector, wider spreads have become necessary.

When announcing the change to a floating exchange rate regime in March 1985, it was stressed that the Reserve Bank would retain the right to intervene for the purpose of smoothing exchange rate volatility. In the event intervention of that kind did not take place, and the Bank was active in the market only to satisfy the Government's foreign exchange needs (mostly interest on foreign debt, embassy funding and direct government imports). During the course of 1985/86, the

transactions conducted to satisfy the Government's current account needs were close to \$2 billion. That business was conducted according to commercial criteria, and without causing the Bank to become unduly prominent in the marketplace. In itself, the ability to conduct such substantial business in a low key fashion is a good indicator of market depth. While the exchange rate has shown itself to be prone to an occasional sharp movement, the market has been able to cope with these movements, and the rate has stabilised quite quickly in the absence of official intervention.

Exchange Rate Developments

The first full year of the exchange rate float saw a generally strong New Zealand dollar reflecting the Government's commitment to a firm monetary policy. While the Reserve Bank's indicative exchange rate index finished the year only marginally above its pre-float level, there were periods, particularly through the latter part of 1985, when the strength of the dollar was placing considerable pressure on exporters' margins as well as substantially reducing the domestic cost of imported goods.

As mentioned earlier, the year was marked by considerable turbulence in international currency markets with resultant sharp shifts in the relationships between the major currencies. Those shifts were also reflected in the relationship between the New Zealand dollar and the currencies of our major trading partners. Over the course of the year to March 1986, the New Zealand dollar appreciated against both the United States dollar (15.5 per cent) and the Australian dollar (13.1 per cent), but depreciated against the yen (18 per cent), sterling (3.5 per cent), the Deutschmark (13.8 per cent) and the Swiss franc (14.7 per cent). These relative changes would have been little different had the New Zealand dollar continued to be fixed against the basket of currencies in the manner applied prior to March 1985.

If the level of the exchange rate has caused serious concern for exporters through the year, its volatility has also been seen by users of the market as a significant problem at times. To a substantial degree, the volatility apparent in bilateral rates was a consequence of sharp movements in other currencies, and would have occurred regardless of the exchange rate regime employed in New Zealand. A close analysis of the New Zealand dollar as compared with other currencies against the benchmark United States dollar shows that, on a day-to-day basis, the New Zealand dollar has moved, on average, through a range from low to high of about 1 per cent. That compares with 0.7 per cent for the Australian dollar, 0.4 per cent for both the Deutschmark and sterling, and 0.3 per cent for the yen.

Week-to-week, the corresponding average movements from low to high were: 3.2 per cent for the New Zealand dollar, 2.7 per cent for the Australian dollar, 2.7 per cent for sterling, 2.1 per cent for the Deutschmark, and 1.5 per cent for the yen. Over the full year period the New Zealand dollar moved through a range of around 39 per cent against the United States dollar, compared with ranges for the United States dollar against the Australian dollar, the Deutschmark, sterling, and the yen of 30 per cent, 63 per cent, 42 per cent and 47.3 per cent respectively. These movements are clearly quite extraordinary, and illustrate the importance of a robust and flexible exchange rate regime.