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Deregulation in New Zealand

Just five years ago, New Zealand was one of the most heavily regulated Western economies. Today, its financial sector is one of the least regulated. The effects of New Zealand's rapid financial deregulation may provide lessons for the U.S. as it changes the regulatory landscape of its financial sector.

In this and a subsequent *Letter*, the changes occurring in New Zealand's financial sector are discussed. This *Letter* reviews the changes in regulation and financial structure that have occurred since 1984. Deregulation has had particularly important effects on the conduct of monetary policy, and these will be the chief focus of the subsequent *Letter*.

Regulation in New Zealand

Prior to 1984, the financial sector in New Zealand operated in a highly regulated environment designed to affect both the total volume of credit in the economy and its sectoral allocation. Regulations imposed direct controls on financial institutions, segmented domestic financial markets, and limited entry into the financial industry. Regulations affected the microeconomic structure of the financial sector and provided the tools for macroeconomic control over aggregate credit.

Direct controls on both interest rates and lending activity played a major role in the regulatory regime prior to 1984. These direct controls included interest rate ceilings on a variety of loans and deposits, restrictions on the composition of the assets and liabilities of financial institutions, restrictions on the volume of lending, and controls on the foreign exchange activities of financial institutions. For example, all major financial institutions were required to hold government or local authority debt to meet required ratios of public sector securities to total assets. These ratios generated a captive demand for government debt, particularly since the ratios in effect in April 1984 ranged from 30 percent for finance companies to 60 percent of assets for official money market dealers.

In addition to such requirements, the regulatory framework governing financial institutions in New Zealand also conferred specific cost advantages on the regulated institutions. These restrictions and advantages varied by type of institution. For example, trading banks were the most heavily regulated members of the financial services industry. They were prohibited from paying interest on deposits of less than 30 days maturity, and the composition of their assets was constrained by reserve asset-to-total deposit ratios. On the other hand, only trading banks had the authority to issue checking accounts and to make use of the lender-of-last-resort facility of the Reserve Bank of New Zealand (New Zealand's central bank). Likewise, lending by building societies was limited to long-term, fixed-rate mortgages. But they were also allowed to issue savings deposits that paid higher interest rates than deposits at trading banks.

The difference in the regulations governing various types of financial institutions in New Zealand served to segment the financial sector. This segmentation, it was argued, provided the government with leverage over the flow of credit to certain key sectors of the economy. These included agriculture, manufacturing exports, and housing. Through regulation, the government was able to create specialized institutions that would, in theory at least, insure the provision of credit to these key activities.

A second objective of financial regulation was to keep interest rates low. Prior to 1984, ceilings on many deposit and lending rates and rates on government securities were kept artificially low. The government stimulated demand for these government securities by including them in the assets trading banks could hold to satisfy reserve asset ratios. Likewise, the government forced nonbank financial institutions to hold such securities by applying public sector security ratios to these nonbank institutions.

Inefficiencies

Because assets satisfying the reserve asset and

public sector security ratios paid below-market rates of interest, the regulatory system imposed a discriminatory tax on the activities of regulated financial institutions. This tax adversely affected their ability to compete with institutions not subject to reserve requirements or subject to lower ratios. The regulatory framework therefore contributed to the development and growth of institutions subject to the lightest regulatory burden. It also reduced the level of intermediation services provided by the financial sector. To the extent that financial intermediaries reduce information costs in financing economic activity in New Zealand, diminished intermediation probably reduced real income in the economy.

Deregulation

While some moves towards financial deregulation were undertaken in New Zealand beginning in 1976, controls were generally reimposed in 1981. Wholesale deregulation did not begin until after the election of a Labour government in July 1984. The new government brought to office a new economic philosophy that views private markets as best able to manage the allocation of resources within an economy.

Within nine months of taking office, the new government had instituted a sweeping program of financial deregulation. While some aspects of prudential regulation remained, all lending and deposit rates were decontroled, controls on overseas borrowing were relaxed, interest payments on bank reserves were instituted, government debt was sold on an auction basis, all reserve ratio requirements on financial institutions were abolished, and the exchange value of the New Zealand dollar was floated.

These reforms eliminated both the direct control of interest rates that had previously characterized much of New Zealand's recent history, and the barriers that segmented the financial services industry. Regulatory barriers to entry into the industry were also abolished.

Contestable markets

The concept of "contestability" has guided the New Zealand government's policy of financial reform. Economists Baumol and Willig have shown that when a market is contestable—that is, when it has no barriers to entry and exit—it will generate efficient outcomes. In other words, this theory suggests that even a monopolist will not be able to exploit monopoly power if potential competitors can enter the market and undercut the monopolist whenever the firm tries to earn above-normal profits by raising its price.

Traditionally, most industries in New Zealand have had only one or two dominant firms. Many argued that regulation was necessary to limit the adverse effects of such concentration. But the new view suggests that efficiency in the financial services industry (and other industries) is best served by ensuring that potential competitors to existing firms are allowed to freely enter the market even if the number of existing competitors is small. Consequently, the New Zealand government has sought to ensure that markets for financial services are contestable by eliminating artificial regulatory barriers that have segmented financial markets.

The effects of deregulation

To a large extent, the deregulation of New Zealand's financial sector has led to predictable changes. Financial firms, formerly restricted by the segmented market structure, have moved into new fields in order to capture the economies of scope that arise when two products can be produced jointly at a lower cost than when these goods are produced separately. Economies of scope are most likely to be achieved when a firm moves into activities closely related to its original line of business. Thus, it is not surprising that Economists Harper and Karacaoglu found diversification by New Zealand's existing financial firms since 1984 has been into closely related fields.

The removal of barriers to entry has also had a major impact on the number of competitors in the financial services industry. Entry by foreign financial firms, in particular, has increased dramatically. Many of the firms now applying for banking licenses already had some operations in New Zealand, but had previously been prevented by regulation from expanding into full retail banking.

Likewise, the removal of interest rate controls has increased competition for funds. Formerly-regulated institutions now compete by offering market-based rates. Consequently, deposits at these institutions grew rapidly after deregulation. Since

many of the liabilities of these institutions are components of the various monetary aggregates in New Zealand, deregulation led to very high growth rates in the aggregates. For example, real M3, a broad aggregate, declined two percent per year from 1981 to 1983, but grew nearly nine percent per year in the period from 1984 to 1986.

Lessons for the U.S.

Because of its previous policy of limiting entry into banking, deregulation in New Zealand is leading to an increase in the number of banks. In contrast, further deregulation in the U.S. may lead to increased merger activity and a decline in the number of independent financial institutions because U.S. regulations, such as unit-banking laws and restrictions on interstate branching, keep the number of banks artificially high. The theory of contestable markets suggests that regulators should attempt to remove artificial or regulatory barriers to entry and exit; whether the number of firms remaining in the market is large or small may be of little importance.

In the U.S., concern for financial sector stability has often tempered enthusiasm for more complete deregulation. The cost of regulation—a less efficient financial sector—is viewed as a fair price for ensuring financial stability. The New Zealand government, in contrast, is attempting to avoid such a tradeoff by separating policies designed to promote financial sector efficiency from policies designed to ensure financial sector stability. Efficiency is promoted by minimizing government interventions. Stability is promoted through monetary policy, with some role for prudential oversight.

Unlike the U.S., New Zealand does not have a system of deposit insurance. Instead, the Reserve Bank of New Zealand is responsible for monitoring individual institutions and ensuring that problems at one institution do not spread to others (via bank runs, for example) and cause a breakdown of the financial system. In this way, New Zealand may avoid the tendency for deposit insurance to create incentives for insured institutions to invest in risky assets. However, a potential conflict may still exist between the desire to minimize government intervention in financial markets and the need to obtain the detailed information necessary to monitor the riskiness of individual financial institutions.

Conclusions

The policy of financial deregulation in New Zealand has been guided by the principle that competitive private markets can generally be relied upon to ensure the efficient allocation of resources. The theory of contestability has helped to provide a consistent framework within which policymakers can approach the issue of deregulation. This theory requires the elimination of regulatory barriers to entry. It also implies that anti-trust policy should use ease of entry and not the number of active firms as a measure of the competitiveness of a given market.

Prior to 1984, New Zealand's economy paid a high price in lost efficiency to ensure stability. The recent reforms have emphasized efficiency considerations almost entirely. Whether New Zealand has adequately solved the problem of promoting financial efficiency while protecting financial stability remains to be seen.

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