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## THE ABOLITION OF EXCHANGE CONTROLS

*Exchange controls restricted transactions in foreign currency by New Zealand residents between 1938 and 1984. The controls created an environment which assisted New Zealand Governments in pursuing demand management and other regulatory policies that tended to insulate the economy from external shocks. Over a prolonged period, the controls also gave rise to significant distortions in the allocation of economic resources. As part of a medium-term economic strategy to improve the efficiency of the New Zealand economy, exchange controls were abolished in December 1984. It is envisaged that, with the removal of exchange controls and the other measures that have been implemented to liberalise the New Zealand economy, New Zealand residents will be able to secure for themselves higher sustainable living standards than would otherwise have been the case.*

### Introduction

It is now almost a year since the effective abolition of exchange controls on 21 December 1984. Although the key factors underlying the removal of exchange controls were documented in the Economic Notes Section of the January 1985 *Bulletin*, a fuller discussion of the issues surrounding this decision is presented in this article. The article outlines the history of exchange controls, their economic effects and the rationale behind the ultimate relaxation of the controls.

### History

Exchange control regulations were introduced in New Zealand in December 1938. Their introduction followed a protracted period which began in 1935 of rapid depletion of the overseas assets of the New Zealand banking system. The imposition of exchange controls, import controls and export licensing regulations at that time was primarily aimed at containing the outflow of foreign exchange and thereby conserving scarce overseas reserves.

A lengthy debate preceded the introduction of exchange controls. The Reserve Bank opposed them, arguing that they would ultimately be detrimental to the standard of living of the people of New Zealand, that the cause of the foreign exchange shortage was an excess of national expenditure relative to income and that the real solution was for the country to resist excessive government expenditures.

The Government adopted the view that exchange control regulations were needed to protect the nation's foreign exchange reserves. Moreover, with leakages to the external sector constrained by the regulations, the Government expected to be able to maintain an expansionary monetary policy without incurring an unsustainable external account position.

Since their introduction, exchange controls have been applied in varying degrees of intensity depending on the state of the balance of payments and the level of overseas reserves. The controls were at their most stringent in 1940 when they were reinforced by the Finance Emergency Regulations. These regulations prohibited any form of free market in foreign currency by:

1. Requiring New Zealand residents holding any foreign currency to offer it for sale to the Reserve Bank.
2. Requiring New Zealand residents owning bank and other balances outside New Zealand to offer them to the Reserve Bank.
3. Requiring holders of any overseas securities to furnish a return of them to the Reserve Bank and not to sell, transfer, or create a charge on them without the Bank's authority.
4. Placing all transactions in foreign exchange under control.
5. Forbidding the use of any exchange rates other than those officially posted.

Prior to the introduction of the Finance Emergency Regulations there had been no controls over privately held foreign currency and securities or over the export of New Zealand bank notes.

The essential features of the exchange control system which operated from 1940 to the early 1950s can be summarised as follows:

1. Overseas currency receipts on account of exports had to be sold to the Reserve Bank or its agents, the trading banks.
2. All remittances from New Zealand were subject to the control of the Reserve Bank, with the trading banks acting as its agents.
3. There was a statutory control over private holdings of foreign securities and currencies, whether held at the time control was introduced or acquired later.

Exchange controls over this period were supported by an extensive system of import controls and export licensing. Early in the 1950s the Government began to relax exchange and import controls. However, this trend was interrupted temporarily in 1952 when the balance of payments situation deteriorated and overseas reserves fell rapidly. An improvement in the balance of payments situation in 1954 allowed a return to the policy of liberalising controls, but again the trend was halted in 1958 when there was a rapid and serious rundown in the country's overseas reserves.

The period 1960 to 1970 was primarily one of consolidation and clarification of the established exchange control regulations. In 1967 the controls were again tightened in some areas in response to a sharp deterioration in New Zealand's balance of payments position but by 1969 it was once more considered appropriate to relax some exchange controls. During this period, the policy on the remittance of capital and profits was clarified, and the treatment of New Zealand residents' holdings of non sterling currencies and securities was relaxed. The export and import of New Zealand bank notes was tightened but a limited market in certain types of overseas securities was permitted. In addition, limits on travel funds, emigrant transfers and remittances of legacies were increased.

Further impetus was given to the trend of liberalising exchange control regulations in 1973 when New Zealand joined the Organisation for Economic Co-operation and Development (OECD). Membership of the OECD required New Zealand to subscribe to the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible transactions. These codes oblige members to go as far as they deem possible to remove constraints over external current and capital transactions.

Over the last decade there has been a further easing of exchange control regulations. This period of liberalisation led to the removal of restrictions on emigrant transfers and remittances of legacies to overseas residents and the freeing up of funds available to New Zealanders travelling overseas. These changes meant that both receipts and remittances of foreign exchange for current transaction purposes were practically free from restriction. Virtually all current payments for imports were freely approved by the Reserve Bank (or the Bank's agents) provided relevant shipping documents were sighted and, although export

receipts still had to be returned to New Zealand through the banking system, exporters were given six months to fulfil this condition.

### Economic Aspects of Exchange Controls

Exchange controls were an important element of the activist approach to economic management that prevailed in New Zealand from the late 1930s until mid-1984. This approach to economic policy was founded upon the concept that extensive Government intervention in the economy was required to ensure living standards were maintained at satisfactory levels. Controls on foreign exchange outflows assisted the Government in pursuing economic policies aimed at insulating the domestic economy from adverse external economic developments. When an adverse external development occurred, such as a decline in the terms of trade, the presence of exchange controls gave the Government scope to embark on expansionary financial policies to offset the resultant foreign exchange outflows through the current account. The liquidity these policies injected into the domestic economy assisted in maintaining domestic expenditure close to its former level without there being a large outflow of funds through the capital account.

If a downturn in national income, resulting from adverse developments in the external sector, was perceived to be of a short-term or cyclical nature then it was thought appropriate for the Government to boost domestic demand through expansionary financial policies whilst borrowing externally to finance the growing balance of payments deficit. If, on the other hand, the change in external conditions was of a more permanent nature then, in principle, it would be necessary to allow the economy to undergo a period of structural adjustment. Thus, in contrast to insulating the economy from the effects of adverse external events, these effects would be permitted to feed through into the domestic economy and bring about the necessary adjustment by influencing relative prices. For example, a deterioration in external conditions would reduce domestic expenditure and lower demand for both traded and non-traded goods. This reduction in demand would tend to weaken the prices for non-traded goods, or at least moderate their rate of increase, while the prices of traded goods and services would remain unaffected, being determined in international markets. Consequently, the price of non-traded relative to traded goods and services would tend to decline (i.e. the real exchange rate would tend to depreciate), providing an incentive for resources to transfer from non-traded to traded goods production. Together with the direct reduction in domestic demand for traded goods (especially imports) associated with lower aggregate demand, this transfer of resources from non-traded to traded goods production (i.e. exports and import-substitutes) would tend to correct the initial (and unsustainable) current account deficit.

Structural adjustment is, however, likely to entail short run costs for resource owners faced with adjustments in relative asset prices between the non-traded and traded goods sectors. Some capital equipment will become redundant and some workers may need to acquire new skills and/or change their physical location. Because structural adjustment is

likely to be costly, there is unlikely to be a transfer of resources to traded goods production unless the downturn in non-traded good demand is regarded as permanent.

If it is considered that Government is more adept than private market participants at distinguishing short-term cyclical disruptions from more fundamental adverse external sector developments, then there might be a case for the use of short-term stabilisation policies, of which exchange controls could be an integral part, in order to insulate the domestic economy from cyclical external sector developments. Such a policy would avoid the unnecessary adjustment costs that could otherwise be associated with short-term disruptions in the economy.

The experience of the past decade or so, however, would suggest that Government has either not been successful at distinguishing short-term external sector developments from long-term trends, or has been unwilling to allow the economy to undergo the necessary adjustments following fundamental changes in the external environment. When New Zealand's terms of trade fell sharply in 1974, the Government's initial reaction was to borrow overseas to sustain aggregate demand until external conditions improved again. The terms of trade did not, however, recover to their former level and in fact declined further in 1979/80. Long after it had become evident that New Zealand had experienced a long-term fall in its terms of trade (implying a permanent fall in national income), the Government was still borrowing overseas to support aggregate demand. In the decade to 1984, \$13 billion of official overseas debt was accumulated in order to insulate the domestic economy from the decline in New Zealand's terms of trade. As a result of this borrowing, the cost of interest payments on official overseas debt increased from 1.8 per cent of total taxation in the year ended March 1975 to 7.4 per cent of total taxation in the year to March 1985. Exchange controls had, in these circumstances, been used not to enhance short-term stabilisation policies but rather to support an overvalued exchange rate and prevent domestic expenditure from adjusting downwards in line with the nation's lower income.

The failure of domestic expenditure to adjust downwards in line with the nation's lower income necessarily resulted in ongoing current account deficits (by definition, a current account deficit is an excess of domestic expenditure over domestic income<sup>1</sup>). Rather than address the fundamental cause of these current account deficits (i.e. the Government's expansionary financial policies), Government economic management during this period instead had a tendency to focus on the symptoms of these deficits. In particular, economic policy was directed at enhancing the profitability of traded good production at the expense of non-traded good production by means of industry assistance. Export subsidies and incentives were introduced and measures to reduce the high average level of protection for import-competing industries were implemented slowly.

$$1. \begin{aligned} E &= C + I + G \\ Y &= C + I + G + X - M \\ E - Y &= -(X - M) \end{aligned}$$

where

- E = aggregate expenditure
- C = consumption expenditure
- I = investment expenditure
- G = net Government expenditure
- Y = national income
- X = exports
- M = imports

Because domestic demand remained high, however, the export subsidies and protective barriers provided only temporary incentives to transfer resources from non-traded to traded good production. High demand for non-traded goods enabled producers of these goods to increase their prices and continue to compete successfully with the traded goods sector for resources. As with periodic discrete devaluations of the exchange rate, which were implemented as a last resort to address the current account deficits, the various assistance/protective measures were not accompanied by firm financial policies. Consequently, these measures failed to produce a lasting increase in the price of traded goods relative to non-traded goods (i.e. a depreciation of the real exchange rate) and therefore did not induce the structural adjustment in the economy that would have been necessary to correct the ongoing current account deficits.

The maintenance of aggregate demand at a higher level than national income also necessarily meant that investment expenditure in New Zealand remained higher than domestic savings<sup>2</sup>. The Government largely had to finance this excess (i.e. current account deficit) by borrowing foreigners' savings at world interest rates. Because exchange controls allowed rates of return on savings and investment in New Zealand to be maintained below foreign exchange rate risk adjusted levels, at least some of the funds borrowed by Government would have been used to finance private investment expenditure in New Zealand that was expected to be less profitable than the cost of official overseas borrowing. In these circumstances, the Government's macroeconomic policy would have reduced New Zealand's medium-term national income by facilitating investment projects in New Zealand with lower returns than the cost of the official overseas borrowing effectively used to finance them.

The maintenance of interest rates in New Zealand below world foreign exchange rate risk adjusted levels imposed further charges on the sustainable welfare of New Zealand residents. Low domestic interest rates discouraged New Zealand residents from saving and necessitated the investment of those savings in New Zealand when more profitable investment opportunities may have been available overseas. This situation made New Zealand residents worse off by encouraging them to save less of their incomes than they would otherwise have chosen to save and by reducing the return that they could obtain on their financial investments.

Exchange controls also created an environment in which further regulatory measures to reduce rates of return on domestic savings and investment became feasible. Because exchange controls denied domestic residents the freedom to invest their savings wherever the rate of return was expected to be highest, it was possible to introduce interest rate controls in New Zealand without inducing a major foreign exchange outflow through the private capital account. From late 1981, the Government increasingly took the view that domestic interest rates were not low enough, despite the fact that expansionary financial policies in a guaranteed capital market had already reduced domestic interest rates well below foreign (exchange risk adjusted) levels.

$$2. \text{ Aggregate demand can be defined as:}$$

$$E = C + I$$

where, for convenience, I includes net Government expenditure

National income can be either consumed or saved:  $Y = C + S$

Hence

$$E - Y = I - S$$

Interest rate controls were progressively introduced from November 1981 until February 1984, by which time most deposit and lending interest rates were regulated.

In practice, exchange controls had further costly effects on investment decisions in New Zealand. The controls did not impact on all potential capital flows in a neutral fashion, with the result that some productive activities were favoured relative to others. Economic agents whose activities generated foreign exchange were in a position to acquire foreign assets earning higher effective yields than alternative domestic investments. This situation placed these economic agents at an advantage over others.

Exchange controls might also have discouraged foreign investors from investing in New Zealand. Even though, technically, there were no impediments for foreigners to repatriate funds, foreign investors may nevertheless have been discouraged by the effect of the controls on the New Zealand investment environment. Moreover, the controls tended to depress investment returns in New Zealand, made those returns highly dependent on the political factors governing demand management policies and entailed at least the risk that the controls could have been extended to cover foreigners wishing to repatriate capital, had sufficiently adverse foreign exchange market circumstances developed.

Finally, comprehensive exchange controls could not be maintained once it was decided to establish the pre-conditions necessary to float the exchange rate. Exchange controls would have prevented New Zealand residents from buying foreign exchange to adopt positions against future currency developments and to arbitrage between domestic and foreign capital and foreign exchange markets. This restriction would have disadvantaged New Zealand based financial institutions (especially foreign exchange dealers) relative to their foreign competitors and would have severely inhibited the development of an efficient foreign exchange market. Thus, while exchange controls could conceivably dampen the volatility of domestic financial markets under a fixed nominal exchange rate regime with a passive monetary policy, they would almost certainly have worsened any foreign exchange market volatility under the float.

### Rationale for Liberalisation

An implicit justification for the imposition and retention of exchange controls lay in the view that Government was better qualified than private market participants to identify and deal with short-term cyclical disruptions. However, in the decade to mid-1984, policies were pursued that had the effect of maintaining aggregate demand at an unsustainable level relative to the nation's income. In keeping with the high level of aggregate demand maintained, resources were not encouraged out of non-traded and into traded good production. Ad hoc assistance measures were implemented but these did not get to the root of the problem and the real exchange rate remained at a high level. At the high levels of aggregate demand experienced, the price of non-traded goods could not fall relative to traded goods because resources were required to produce the large quantities of non-traded

goods still demanded. There was thus a failure to adjust to the lower terms of trade and the resulting large and persistent current account deficits were financed by official overseas borrowing.

In view of both the unsustainable nature of the high official overseas borrowing that occurred over the decade to 1984, and the economic efficiency costs of the demand management and interest rate control policies over the same period, the present Government decided to open up the domestic economy to external influences. The exchange rate was devalued in July 1984, interest rate controls were removed, monetary policy was tightened and net official overseas borrowing (other than to raise the level of official foreign exchange reserves) terminated. With these policy measures in place, rates of return on investment in New Zealand became more attractive relative to returns available overseas.

As a result of the policy changes implemented between July and December 1984, interest rates in New Zealand rose to levels that were competitive in foreign capital markets. In response to the higher interest rates, substantial private capital inflows occurred over this period. During the December quarter 1984, there was an Overseas Exchange Transactions (OET) private capital inflow of \$1,642 million. Under these conditions it was clear that exchange controls were no longer required to support demand management policies. Indeed, insofar as the controls prevented any substantial offsetting capital outflows, they tended if anything to inhibit the successful operations of the new tighter demand management policy. Furthermore, the distortions in saving and investment patterns caused by exchange controls were clearly inconsistent with the Government's aim of improving microeconomic efficiency through a more responsive market system.

It thus became a natural extension of Government policy to effectively abolish exchange controls altogether. Exchange controls were relaxed in December 1984 so that receipts or remittances of foreign exchange for any purpose were free from controls. The sole exchange control provisions remaining are:

- that foreign exchange dealers must be authorised by the Reserve Bank under the regulations;
- that all transactions must be carried out through an authorised foreign exchange dealer;
- that information required for the production of official statistics must be furnished by the dealers concerned;
- that information required for purposes of prudential supervision of foreign exchange dealers and the foreign exchange market (e.g. dealer exposure returns and turnover data) must be provided to the Reserve Bank.

Overall, there appears to have been less public response to the easing of exchange controls than was originally anticipated. In January, there was an OET private capital outflow of \$266 million, this outflow followed the large inflow and build-up in domestic liquidity during the December 1984 quarter and would probably have still occurred had exchange controls remained in place. With the exception of February,

there have been private capital inflows in all subsequent months. In the medium to longer term, the removal of exchange controls is unlikely to significantly alter net foreign exchange outflows or the exchange rate provided that sound monetary and fiscal policies are adhered to.

The relaxation of exchange controls is, however, likely to increase the extent to which New Zealand residents own foreign assets and foreigners own New Zealand assets. In the absence of restrictions on foreign exchange outflows, New Zealand residents can now take the opportunity to diversify their investment portfolios to include foreign assets. Moreover, now that the returns on investment in New Zealand have increased to world levels (adjusted for exchange rate risk), foreigners are more likely to take the opportunity to diversify their investment portfolios to include New Zealand assets. So as to be able to approximate the extent of overseas investment by New Zealand residents following the relaxation of exchange controls, the Reserve Bank conducted a survey of New Zealand shareholdings in companies listed on the Australian Stock Exchange in early 1985 (see June 1985 *Bulletin*, pp 308 — 309). It is intended to repeat this survey in the future to monitor trends in overseas investment by New Zealand residents.

## Conclusion

Exchange controls existed in one form or another in New Zealand since 1938. The controls were central to the activist approach to economic management in New Zealand over this period. Restrictions on foreign exchange transactions enabled governments to pursue demand management and other policies that at times resulted in a significant misallocation of resources within the New Zealand economy.

In view of the relatively poor performance of the New Zealand economy during the past few decades and the unsustainable nature of demand management policies during the decade to mid-1984, this approach to economic management was shifted towards economic policies that reduce unnecessary Government intervention in the market place. With the removal of exchange controls and the other measures that have been implemented to liberalise the New Zealand economy it is envisaged that New Zealand residents will be able to secure for themselves higher sustainable living standards by making economic decisions that better utilise available resources and opportunities.