NEW ZEALAND COUNCIL OF TRADE UNIONS
Te Kauae Kaimahi

# Submission of the New Zealand Council of Trade Unions Te Kauae Kaimahi

**to the**

# Reserve Bank of New Zealand

**on the**

## Macro-prudential policy instruments and framework for New Zealand


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## 1. Introduction

1.1. This submission is made on behalf of the 37 unions affiliated to the New Zealand Council of Trade Unions Te Kauae Kaimahi (CTU). With 340,000 members, the CTU is one of the largest democratic organisations in New Zealand.

1.2. The CTU acknowledges Te Tiriti o Waitangi as the founding document of Aotearoa New Zealand and formally acknowledges this through Te Rūnanga o Ngā Kaimahi Māori o Aotearoa (Te Rūnanga) the Māori arm of Te Kauae Kaimahi (CTU) which represents approximately 60,000 Māori workers.

1.3. The submission is in response to the March 2013 Consultation Paper, “Macro-prudential policy instruments and framework for New Zealand” (“the Consultation Paper”). We thank the Reserve Bank (“the Bank”) for the opportunity to comment on these matters.

1.4. Our interest in monetary and financial stability policies stems from a concern not only with price and financial stability but also with the effects of actions taken in the pursuit of these objectives on the real economy in terms of full employment, good incomes, and a well-balanced society and economy. Some elements of this balance include the exchange rate, the current account balance and international investment position, and diversification of the economy in order to provide for a range of thriving and productive industries which provide good jobs, and economic resilience. We are

therefore also interested in the potential use of policy instruments to directly assist these real economy objectives.

1.5. In general we welcome the thinking that has led to consideration of a wider range of policy instruments and support the proposals in the consultation paper, but with some reservations set out below. We urge the Bank to broaden both their purpose and the range of measures it considers.

## 2. Objectives of using the policy instruments

2.1. We note that at the outset it is stated (paragraph 10 of the Consultation Paper) that "The objectives of macro-prudential policy are to promote greater financial system stability through: building additional resilience in the financial system during periods of rapid credit growth and rising leverage or abundant liquidity; and dampening excessive growth in credit and asset prices." This does not include the objective of price stability.

2.2. While it is acknowledged (paragraph 13) that "It is expected that, in most circumstances, measures undertaken to meet macro-prudential objectives will provide support for monetary policy in its role of maintaining price stability", these instruments should also be considered to be part of the price stability toolbox and used directly for that purpose. If this is considered inconsistent with current legislation, the legislation should be changed, though it is difficult to see why that should be needed.

2.3. For example, if there is concern that another house price bubble could stimulate general price inflation, the use of these instruments may be useful even if financial stability is not necessarily threatened. The alternative may be, as we saw in the 2000s, a perceived need to raise interest rates to a level that does significant damage to the rest of the economy in order to constrain housing-related credit growth. The damage occurs through both strangling many desirable forms of investment and an over-valued exchange rate stimulated by the high interest rates. If instead, more weight could be placed on instruments like those proposed, over-exuberance in the housing market could be targeted with less or minimal damage to the rest of the economy.

Clearly the appropriateness of their use would depend on the circumstances, but that should not rule out their use in this way.

2.4. Further, the Core Funding Ratio and other instruments not canvassed in this consultation could be used to manage international financial flows into and out of the country, and/or address the risks they present. For example the offshore funding which is part of the Core Funding Ratio could be specifically targeted to progressively lower bank reliance on such sources of funding. Short term changes could also be used as a tool to manage the exchange rate. In general, the objective would be both financial stability and management of the exchange rate. Chetwin and Munro (2013), in their contribution to the recent Reserve Bank and Treasury Exchange Rate Policy Forum (26 March 2013), observe that macroprudential measures have been used by countries including Singapore and South Korea for such purposes, and list many such tools in use by the countries they survey.

2.5. The potentially destabilising effect of capital flows has been well known but has been highlighted by recent financial crises (see for example Stiglitz & Ocampo, 2008).

2.6. In addition, following the Global Financial Crisis, the International Monetary Fund has revised much of its thinking regarding the openness of the capital account and is now producing research and advice that acknowledges and explores the value of management of both capital flows and the exchange rate (for example Adler & Tovar, 2011; Bayoumi & Saborowski, 2012; Benes, Berg, Portillo, & Vavra, 2013; Brockmeijer, Marston, & Ostry, 2012; Ghosh, Kim, Qureshi, & Zalduendo, 2012; Ghosh, 2009; International Monetary Fund, 2012; Korinek, 2011; Magud, Reinhart, & Vesperoni, 2012; Malloy, 2013; Jonathan D. Ostry et al., 2010; Jonathan David Ostry, Ghosh, & Chamon, 2012).

2.7. As Chetwin and Munro describe, relatively advanced countries such as Chile, South Korea and Singapore have adopted such policies using various instruments, and a number of long-developed economies including Japan and Switzerland have policies of intervention in their exchange rates. In

addition, many emerging economies use such policies successfully. Given the persistent overvaluation of the New Zealand dollar, our economy's vulnerability to its high level of international liabilities, the persistent current account deficit which drives it, and the evident difficulties that firms have to thrive as exporters, such measures should be under active consideration.

2.8. It is not enough to say that we must only address the fundamentals and dismiss such instruments as treating symptoms. Firstly, what has been asserted as "the fundamentals" must be reconsidered given New Zealand's experience over the last three decades: as the OECD famously noted,

> "The mystery is why a country that seems close to best practice in most of the policies that are regarded as the key drivers of growth is nevertheless just an average performer" (OECD, 2004, p. 29)

2.9. Secondly it is neglectful not to treat "symptoms" where they present evident barriers and risks, as long as that does not become a substitute for whatever are the correct "fundamental" actions, should they exist. It may be necessary to treat side effects as well as underlying causes. Just as physicians must treat the side effects of needed medication, so must we be ready to treat the side effects of other policies. For example Merrouche and Nier (2010, p. 28), conclude from an empirical analysis of the drivers of financial imbalances ahead of the Global Financial Crisis that there is evidence that monetary policy, particularly in small open economies, contributed to the build-up of current account imbalances:

> "We find interest differentials between the domestic and U.S short-term rate to be a key driver of the current account over our sample period. Apart from the country's private savings rate, which also has a strong effect, monetary policy is the only variable that consistently enters significantly. High domestic rates relative to rates in the U.S. are associated with net capital inflows (a current account deficit) while low rates are associated with outflows.
>
> It is worth noting that this finding is unlikely to be driven by an endogenous monetary policy response to capital flows, where, if anything, we would expect capital inflows to be associated with an appreciation of the local

currency and hence lower inflationary pressures, potentially prompting domestic monetary easing. Causation therefore runs from monetary policy to capital flows rather than the other way around.

Further investigation reveals that the effect of the spread on capital flows is largely confined to the smaller open economies among OECD countries. Moreover, we find that the effect of the spread on capital inflows is more pronounced in the boom period, 2003-2007. This is plausible since for smaller advanced countries and in boom times capital flows might have been more strongly driven by "carry trade" strategies.

Overall, this evidence suggests that monetary policy across the OECD was not entirely neutral with respect to the build-up of imbalances. While we found little empirical support in the previous sections for the notion that *low* policy rates had contributed to the build-up of "home-grown" imbalances within the financial and household sectors, we find that the *tighter* was monetary policy relative to the U.S. the stronger the build-up of current account imbalances and hence the build-up of cross-border exposures in the aggregate. Monetary policy may therefore in this way—and likely unwittingly—have contributed to the global financial crisis.

2.10. Very pertinently to the current discussion, they conclude (p.29):

Our results on the importance of capital flows in fuelling the build-up underscore the need for a rethink of policy tools to address global imbalances and the associated capital flows. In surplus countries, structural policies to reduce excessive savings rates and policies to develop domestic and regional financial markets hold some promise. In deficit countries, monetary policy and capital controls are traditionally viewed as the main tools to address capital inflows. In addition, macroprudential tools may need to be developed that can be closely targeted at the build-up of vulnerabilities associated with capital flows."

2.11. The Reserve Bank currently intervenes in foreign exchange markets when it considers the New Zealand dollar is overvalued. Accompanying such interventions with management of capital movements could add to its effectiveness. However other instruments could also be used to manage the exchange rate more directly, including appropriately chosen macroprudential

measures (such as short term changes in the Core Funding Ratio), capital flow management measures and international financial transaction taxes. They would not necessarily be in place permanently but be available to use to prevent the build-up of potentially destabilising financial imbalances or to manage crises should they occur. It should not be assumed that capital controls are an “all or nothing” option that forces us to choose to either allow all financial transactions or to cut New Zealand off completely from international capital markets. Policy design should be selective, and be prepared for a number of possible scenarios.

## 3. Specific comments on the proposals

### Loan-to-Value Ratios

3.1. Regarding restrictions on high loan-to-value ratios (LVRs) in residential mortgages we would encourage the Bank to also consider high debt servicing ratios as another potential policy instrument.

3.2. However in both cases, we have significant concerns about the distributive and social effects of such instruments. They are likely to most affect (a) low income and first home buyers, since people “trading up” are likely to have accumulated significant equity in their previous properties which reduces the LVR required for subsequent housing purchases; and (b) property investors using high leverage in order to take maximum advantage of potential capital gains.

3.3. While we acknowledge this is a complex issue, there are major social consequences of even more difficulties being placed in the way of young families and people on low incomes trying to buy their first home. Care needs to be taken to as far as possible design these measures to recognise this social need and/or coordinate their use with government action to assist first home buyers (such as assisting them into new homes if the cause of property price inflation is a housing shortage). For example, similarly to Hong Kong there could be lower limits (with recognition of geographical differences) to the value of the owner-occupied properties the measures apply to in order to protect low income buyers.

3.4. The primary focus should be on property investors and others buying primarily for capital gain, though a price bubble once it begins does encourage many participants in the market to buy beyond their normal range of affordability in the expectation of capital gain.

**Capital requirements**

3.5. Regarding Countercyclical Capital Buffers, as is noted in paragraph 44 of the Consultation Paper, there may be problems of asymmetry in use of such measures, as was experienced in the US Government's response to the crash of financial institutions in the early stages of the financial crisis: that providing them with funding did not necessarily flow into lending and thus into stimulating the economy. It is important the Bank considers measures it could take in such circumstances.

3.6. Regarding the use of sectoral capital requirements, a further consideration is that it may be important to do two things at once. For example in the agricultural sector the Bank may wish to lean against increased lending that encourages unwarranted property price inflation, but continue or even encourage lending for farm and product development.

**Countermeasures and enforcement**

3.7. Gaming of these measures such as, for LVR controls, by use of secondary mortgages, financing from relatives and friends, and from non-bank lenders, is likely to be a growing phenomenon. It would be advisable to apply such measures to all commercial lenders including non-bank deposit takers at the outset. If the Bank lacks regulatory authority for this, it should be given it.

3.8. We are also concerned that, as noted in paragraph 49 of the Consultation Paper (and also in the accompanying paper, *Unpacking the toolkit: the transmission channels of macro-prudential policy in New Zealand – "Unpacking the toolkit"*) foreign bank branches could be exempt from the proposed measures and therefore undermine their effectiveness. Given the small size of foreign bank branches in New Zealand relative to the size of the parent banks, the reciprocity provisions of Basel III are hardly likely to be a

major constraint on their behaviour, and in any case, as *Unpacking the toolkit* acknowledges (p.16) these provisions do not apply to sectoral capital requirements. The measures should apply to foreign bank branches from the outset, and the Bank should also consider controls on sourcing funding directly from overseas given the use of this in the past and the increasing ease with which it can be undertaken.

3.9. We agree with the need for rigorous enforcement to ensure these measures are not brought into disrepute as a result of becoming seen as applying only to those without access to privileged financial advice and funding sources.

**Implementation**

3.10. Regarding the proposal in paragraph 45 as to the decision process before any implementation decisions are taken, involving a memorandum of understanding between the Minister of Finance (after consultation with Treasury) and the Bank, we express some concern that this could restrict the flexibility and speed at which the Bank can react to changing circumstances. It would clearly be desirable for such a memorandum to be sufficiently general to apply its conditions over a longer period in order to give the Bank some flexibility and the ability to respond quickly. *Unpacking the toolkit* observes (p.4) that the right timing of the use of these measures is critical. It could be counterproductive if a sudden spurt in demand to avoid credit tightening occurs because the use of these measures is anticipated as a result of a drawn out implementation process.

## 4. Conclusion

4.1. We support the Bank in considering new measures. However we urge it to broaden both their purpose and the range of measures it considers.

4.2. As acknowledged in the Consultation Paper, these measures must be designed to minimise inequitable and otherwise undesirable social effects and evasion.

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