
The business cycle, housing and the role of policy: summary of a recent conference held by The Treasury and the Reserve Bank of New Zealand

Robert A Buckle and Aaron Drew¹

The Treasury and the Reserve Bank of New Zealand hosted a conference during December 10-11, 2007 on the business cycle, housing and the role of policy. Research presented included investigations of recent shocks to the New Zealand business cycle, including the role of housing and the influence of fiscal policies. Research considering the monetary policy transmission mechanism and the roles that fiscal and prudential policies might play in macroeconomic stabilisation was also discussed. In this article, we summarise the themes and insights from this workshop and suggest areas for future work that will aid policy advice.

Background

Since the mild recession in 1997, New Zealand has experienced the strongest and longest economic expansion on record. This lengthy growth phase and the very high rates of employment in the economy is an excellent outcome. The growth pattern has, however, been associated with a number of economic ‘imbalances’ and strong inflationary pressure, requiring a tight monetary policy stance. Over this decade, the exchange rate has also appreciated from record lows against the US dollar to record highs.

The appreciation of the exchange rate and the associated imbalances have been a concern for many and, in particular, have led to questions over whether an alternative mix of policy and the use of additional policy instruments might result in smaller swings in the exchange rate, whilst still maintaining low and stable inflation and good growth outcomes.

The Reserve Bank of New Zealand, The Treasury and other agencies have over the past few years sought to better understand the key forces influencing this business cycle, including the roles of monetary, fiscal and other policies. In 2006, international macroeconomic policy experts

were invited to New Zealand to share their views on New Zealand’s macroeconomic situation and its macroeconomic policy framework and practice (Buckle and Drew, 2006). Although the broad macroeconomic policy frameworks were generally regarded as sound, several areas of research were suggested for follow-up, including investigating the monetary policy transmission mechanism, the influence of fiscal policies, the roles that fiscal and prudential policies might play in macroeconomic stabilisation, and investigating the influences of recent large swings in the New Zealand housing market. In December 2007, the Reserve Bank and The Treasury hosted a follow-up workshop where research in these areas was presented. In this article we summarise the themes and insights from this workshop and suggest areas for future work. Access to most of the papers from the workshop is available from the Reserve Bank’s website at www.rbnz.govt.nz.

Themes and insights

The business cycle and the roles of policies

Over the first day of the workshop, the focus was on ‘shocks’ that have shaped the recent business cycle and the role of macroeconomic and prudential policies.

The day began with a paper by Drew *et al.* (2008) that investigates the mechanism by which monetary policy is transmitted to the economy. The paper gives particular attention to how this mechanism has changed over the past decade. This has been a topic of some public debate

¹ Professor Bob Buckle is Pro Vice-Chancellor and Dean of Commerce, Victoria University of Wellington, Wellington, New Zealand, and was previously a Principal Advisor at The Treasury. Aaron Drew is a Senior Investment Strategist at the New Zealand Superannuation Fund, and was previously Manager, Research in the Economics Department of the Reserve Bank. The authors are grateful for comments from John Carran and Tim Ng on an earlier draft of this paper.

in New Zealand, with some arguing that monetary policy transmission has either weakened or the lags are longer (see, for example, Grenville, 2006 and Allsopp, 2006). The key finding of Drew *et al.* (2008) is that monetary policy transmission has not obviously weakened, and in some areas has strengthened, over the past decade. This implies that the scope for the Reserve Bank of New Zealand to run an independent monetary policy remains as strong as ever. Evidence is also presented that suggests the exchange rate has become more responsive to interest rate changes over recent years. However, the impact of exchange rate changes on inflation and domestic activity has weakened somewhat.

A paper by Dungey and Fry (2008) estimates the contributions of monetary policy, fiscal policy, and other domestic and international 'shocks' to the New Zealand business cycle. Building on previous New Zealand business cycle modelling research, several interesting findings emerge from this work. First, output and inflation are found to be much more affected by demand and supply shocks, such as swings in the terms of trade, than by monetary and fiscal policies. Second, estimates suggest that fiscal policy (including both the so-called automatic stabilisers and discretionary fiscal policy shifts) tend to have significantly larger impacts on the economy than monetary policy.

The third interesting finding is that monetary policy has dampened output fluctuations and inflation over the past five years or so. Fiscal policy settings, however, are estimated to have become significantly expansionary from around early 2005, in line with Reserve Bank estimates (Reserve Bank of New Zealand, 2007a). This last finding prompted some debate at the workshop on alternative measures of fiscal policy settings and whether fiscal policy should give a larger (implicit) weight to macroeconomic stabilisation, or even have a formal explicit cyclical stabilisation role.

A paper by Barker *et al.* (2008) proposes a framework for assessing the appropriate roles of fiscal policy. The paper argues that, in terms of economic policy objectives, fiscal policy should be viewed through three lenses: fiscal sustainability (the ability to finance government policies), fiscal structure (the structure of taxation and expenditures), and fiscal stabilisation (the automatic and discretionary

fiscal stabilisation effects on the economy). These roles all contribute in different ways to growth and stability. Moreover, they are not entirely independent and there can be trade-offs between them. Hence, in weighing up whether there is a case for a more active stabilisation role for fiscal policy, consideration should be given to how that role would impact on fiscal sustainability and structure.

The paper discusses the appropriate stabilisation role of fiscal policy when monetary policy targets inflation as part of an overall macroeconomic policy regime. The authors suggest that the instruments required for effective fiscal stabilisation exist, but that those instruments should be applied within an institutional framework designed to avoid compromising the sustainability and structural roles of fiscal policy. The paper also reviews current measures of the impact of fiscal policy, and concludes that the standard fiscal impulse measures are not sufficient to assess or guide the stabilisation role of fiscal policy and that more effort is needed to go into developing robust measures of the stance and economic impact of fiscal policy. Work in this regard by Claus *et al.* (2006) illustrated the importance of identifying the impact of components of the budget when trying to understand the impact of the budget on the business cycle. The paper by Dungey and Fry (2008), which additionally takes into account the impact of public debt, is another important step in this direction.

A paper by Barker and Philip (2008) reviews the weight that fiscal frameworks in other countries place on the stabilisation role of fiscal policy and the rules and institutions that have developed to support this role. They find that it is common for fiscal frameworks to be designed to reinforce the operation of automatic fiscal stabilisers, but beyond that there is no general agreement that it should have a more active stabilisation role. The type of rules designed to enhance the role of automatic fiscal stabilisers and to additionally support fiscal sustainability included (i) balancing the operating budget on average over the economic cycle, typically backed by a public debt rule; (ii) targeting a cyclically adjusted overall budget balance; (iii) multi-year expenditure rules; (iv) stabilisation funds; and (vi) independent fiscal institutions tasked with improving macroeconomic stabilisation.

Barker and Philip (2008) also consider how some of these approaches might have been applied in New Zealand during the recent cycle and whether they would have led to significantly different outcomes. A key challenge for fiscal policy over the recent cycle has been the identification of structural and cyclical components of budget balances in 'real time'. Given this challenge and the unexpectedly high taxation revenue growth, the authors doubt that alternatives to New Zealand's current fiscal framework would have been more stabilising. For example, targeting a structural balance may have in fact resulted in even larger operating allowances in recent years (and therefore an even stronger fiscal demand impulse), while fixed expenditure rules may have led to delayed but more abrupt increases in government expenditure. This review also illustrates the importance of the point made in the paper by Barker et al. (2008) that in designing fiscal frameworks there are trade-offs between the objectives of sustainability, structure and stability. In making these trade-offs it is important that best-practice indicators of the impact of fiscal policy are available.

In a similar vein to asking whether fiscal policy could play a greater stabilisation role, a paper by Ng (2008) asks whether the regulation of bank capital could be used for cyclical-stabilisation purposes. The main conclusion is that regulation of bank capital should not be relied upon to substantially dampen the cycle, at least in upswings, as the level of regulation required to have a meaningful impact would likely lead to disintermediation of lending away from locally incorporated banks to their offshore parents. However, a case could be made for requiring banks to accumulate larger 'war chests' of capital during cyclical upswings to reduce the likelihood of financial distress and credit crunches in a downturn. Moreover, as discussed in the paper, there may be scope for other forms of prudential policy to play a greater stabilisation role, and this is a lively area of international research currently.

The business cycle and role of housing

Over the remainder of the workshop, papers focused on various New Zealand housing market issues. This focus

reflects the fact that developments in housing markets have been a key concern of policy-makers in New Zealand and other countries over the recent years. The scale of the housing boom has been the largest in New Zealand's history, whilst affordability measures have reached all-time lows. A paper by de Veirman and Dunstan (2008) re-examines the linkage between housing (and other wealth) and consumption spending. In line with previous New Zealand research, the paper finds that increases in house prices have a relatively quick and large impact on household spending in New Zealand, implying housing market developments are an important driver of the business cycle in New Zealand and an appropriate concern of monetary policy.

On the 'supply side' Grimes (2008) draws upon a range of previous research by Motu dealing with the impacts of land availability, housing supply and associated planning infrastructure on New Zealand house prices. Evidence is presented that at the local authority level, some authorities seem much better able to respond to increases in housing demand than others, and consequently, have relatively small increases in house prices compared to regions where housing supply is less responsive to changes in demand conditions.

A case study of the Auckland region suggests that housing supply responsiveness in large part reflects differences in local body regulations, such as zoning restrictions, that impact on the availability and price of residential land. As such, housing affordability may be improved if regulatory changes are made to reduce the cost of purchasing land and increase the responsiveness of housing supply. Discussion focused on the incentives that local body electives face with regard to the provision of housing supply and the 'land banking' issue, wherein developers hold back development of new housing supply. On the latter issue it was felt that authorities should be more expeditious in applying policy levers to encourage development.

On the 'demand side' Coleman and Landon-Lane (2007) examine the impact of net migration swings on housing turnover and housing prices in New Zealand. They find that swings in net migration historically and over recent years have had very large impacts on housing prices over the short-to-medium run, much larger than what is seen in the international literature. Two hypotheses are offered

to rationalise this finding. First, the bid-up in house prices might reflect an underlying third factor, such as surging income prospects and productivity growth, that tends to occur around the time of net migration increases. Second, immigrants might de-stabilise house price expectations by bidding up prices above what locals are prepared to pay. It is not possible for Coleman and Landon-Lane to distinguish between these hypotheses, but in any case, it seems clear from their work that more stable net migration flows would reduce one important source of cyclical volatility. Moreover, they find that monetary policy can affect house prices and housing demand by adjusting interest rates. To the extent that house prices are bid up unsustainably when net migration surges, this suggests policy-makers may need to be quite aggressive, even if overall CPI inflation is relatively contained, to reduce the likelihood of a housing boom-bust scenario.

Also on the demand side, Coleman (2007) uses an overlapping generations model to examine the impact of the relaxation in credit constraints and the trend declines in nominal and real interest rates that have been seen in New Zealand over the past two decades. The model focuses attention on the role of property investors in the property market, and suggests that changes in credit constraints (such as bank imposed loan-to-value ratios) mainly affect the tenure decisions of individual households, but not the aggregate level of house prices. Instead, the model suggests the secular decline in real interest rates is likely to be a more important influence on the trend rise in house prices and the decline in home ownership rates since 1990.

The final workshop paper by Hargreaves (2008) analyses the potential influence of the structure of the taxation system on the housing market, in particular its impact on the desire to hold residential property. The paper extends a simple discounted rent model to consider the impact of the present tax system on house prices and possible implications of alterations to the taxation system. The model suggests that the present tax system biases investors towards ownership of housing (and other 'real' assets) rather than debt-type instruments, and that this bias may be a significant factor behind the elevated level of house prices in New Zealand. Of the range of alternative tax treatments considered to

reduce the biases, making the inflation compensation component of nominal interest rates free from taxation is seen as the most attractive on both economic efficiency and practical implementation grounds. However, further work is seen as necessary to test the robustness of these conclusions and the wider implications for the tax system.

Priorities for macroeconomic policy research and policy

The workshop papers and discussion highlighted a number of areas for future work that warrant attention, as touched upon above. In terms of fiscal policy, there was considerable debate around the effectiveness and desirability of greater use of fiscal policy as a stabilisation instrument. However, given that judgement will always need to be made in determining the appropriate fiscal stance at any particular time, there is a limit to which rules-based approaches can be used for macroeconomic stabilisation. This underscores the importance of having best-practice indicators of the impacts of fiscal policy. Although there has been recent progress in developing alternative measures of the impact of fiscal policy, this work needs to be rapidly progressed to a point where it can be applied regularly and understood more widely, given the present pressures on fiscal policy settings.

Second, perhaps the key concern throughout the recent cycle has been the potential implications of a high and a volatile exchange rate on economic performance. The macroeconomic impact of this is mixed. In very broad terms, the tradables sector of the economy has underperformed over the past few years. However, exporters have managed the appreciation of the exchange rate better than many commentators expected, whilst there is little doubt that import-competing manufacturers have found the appreciation very difficult. To understand better the impact of the exchange rate on the economy, more work is needed on assessing impacts at the firm level, including the impacts on the propensity for firms to export, invest and improve productivity.

On the policy front, much of the basic research required to understand core influences on the housing market has been conducted. The policy challenge is to use insights from this

research to motivate changes in housing-related policies. In line with previous discussion by the Reserve Bank of New Zealand (2007a and 2007b) and Briggs (2007), policy changes on the housing supply and taxation fronts seem most likely to improve housing affordability over the longer term, and to mitigate the impact of the housing market on the New Zealand business cycle.

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