Supporting Paper A6
Supplementary Stabilisation Instruments Project and the Macroeconomic Policy Forum

Introduction

Over the course of this economic cycle, the Reserve Bank has been very conscious that when global interest rates are relatively low, actual and expected increases in New Zealand's official interest rates could result in substantial upward pressure on the exchange rate. Large swings in the exchange rate have not been uncommon in New Zealand, and unease about those swings played a part in the addition of clause 4b to the Policy Targets Agreement in 1999.

Monetary policy has been conducted with this provision firmly in mind. At times, a desire to avoid undue variability in the exchange rate has meant that the OCR has been adjusted less aggressively than it might otherwise have been. However, ultimately the focus of monetary policy has to be on maintaining medium-term price stability, which means that there is often only limited scope to adjust monetary policy because of exchange rate concerns without jeopardising the medium-term outlook for inflation.

By 2005 the scale of the current house price cycle and the associated pressure on domestic resources and the inflation outlook had become increasingly apparent. Two projects were commissioned to examine whether additional measures or instruments could be used to assist monetary policy and to ease the extent to which pressures of tight domestic monetary policy in a relatively low interest rate world fell on the tradables sector. Both were designed to ensure that the net was cast widely, to be open to fresh or alternative thinking.

Supplementary Stabilisation Instruments

In November 2005, the Minister of Finance invited the Treasury and the Reserve Bank to review whether there were additional structural or cyclical policy measures that could be implemented in the short term and which would have a direct bearing on the housing market or the market for housing finance. In particular, the review team was asked to look at measures that might influence housing credit growth independently of changes to the OCR. Officials were asked to look at two classes of instrument:

One-off measures, such as:

- the removal or restriction of structures that facilitate tax reduction through property investment, such as Loss Attributing Qualifying Companies (LAQCs); and
- factors that may be incorporated into the banking supervision framework which could reduce the amplitude of housing credit cycles.

Discretionary stabilisation measures, such as:

- a limit on loan-to-value ratios for mortgages, that could be managed by the Reserve Bank as a macro-stabilisation instrument; and
- other direct interventions that might be used by the Reserve Bank to influence the quantity and/or price of mortgage lending.

A report ("the SSI Report") was provided to the Minister of Finance in February 2006, and was publicly released shortly afterwards.[1] It concluded that the house price cycle was largely being driven by macroeconomic factors, but that there were nonetheless a number of areas where further research and policy development could be appropriate. Officials noted that there appeared to be no simple, or readily implemented, options that would provide large payoffs.

Tailoring capital requirements better to the actual risk characteristics of bank loan portfolios and to the wider economic environment is an important part of refining the regulatory regime for New Zealand banks. Doing this job well is a challenge for supervisory agencies in all countries. The SSI Report noted that consideration of these issues would be a part of implementing the new Basel II framework, due to come into effect next year, with the aim of minimising any risk that regulatory provisions could exacerbate cycles in bank lending. Work is still underway on this project. A better system for determining bank capital requirements should improve the resilience of the financial system although we would not expect substantial gains in terms of managing the business cycle. Further material on work in this area is contained in supporting paper A8.

Of the housing taxation instruments reviewed, officials believed that there could be merit in encouraging Inland Revenue to have regard to broader cyclical stabilisation considerations when assessing the priority given to the enforcement of the existing income tax provisions that make liable for income tax any capital gains on properties (other than those occupied by the owner) purchased with the intention of resale. In the 2007 Budget, material additional funding has been provided to Inland Revenue to support the enforcement of the existing provisions on the taxation of gains on properties held for resale. We welcome this additional funding.

The growing number of owners of investment properties reporting losses for income tax purposes was one area focused on in preparing the report. It was noted that there was no clear evidence that ring-fencing such losses is associated with less pronounced housing cycles in other countries, and that introducing ring-fencing would be inconsistent with the comprehensive approach to income tax taken in New Zealand. However, officials nonetheless considered that there might be merit in some further work to assess whether the tax treatment of losses on investment property has played an important role in the cyclical behaviour of the New Zealand housing market in recent years.

We also considered that further work would be warranted to examine issues around land use and the ability of housing supply to respond promptly to rising prices and other indications of rising demand for housing. American literature, in particular, had highlighted the differences in housing cycles between markets where supply is able to respond quickly and those where that supply responds only slowly. The Reserve Bank has addressed these issues a little further in our submission to the Commerce Select Committee's inquiry into housing affordability.[2] and we welcome the increasing attention being paid to these issues by other government agencies.

Further, more recent, analysis on structural issues relating to the tax treatment of housing and building supply issues is contained in supporting paper A7 which summarises our position on the possible measures which could assist in easing the pressures on monetary policy.

The report also looked at possible direct discretionary stabilisation instruments, such as a comprehensive limit on loan-to-value ratios or a mortgage interest levy. The report concluded that administrative tools such as loan-to-value limits posed major compliance and distributional challenges, but considered that further work might be warranted on a mortgage interest levy, which had the merit of relying on price mechanisms rather than administrative ceilings. It was recognised that an instrument of this sort went beyond the mainstream of international thinking about managing cycles, but that it might, nonetheless, offer an effective technical means of mitigating exchange rate pressures, by driving a wedge between domestic borrowing costs and the returns available to foreign savers. However, it was noted that such an instrument would also pose a variety of quite substantial problems, including issues around the extent to which such new statutory powers could appropriately be delegated by Parliament (especially tax-based provisions), consistency with New Zealand's international commitments, the difficulty of maintaining a strong and ongoing enforcement regime, and

1 Available at: http://www.rbnz.govt.nz/news/2006/2504934.html

2 Available at http://www.rbnz.govt.nz/monpol/about/2989594.html

the risks that feasible governance models might impinge on the operational autonomy of the Reserve Bank in the conduct of monetary policy.

Later last year, the Minister of Finance requested further work to be undertaken to develop more fully the Mortgage Interest Levy option. This work, in turn, was brought to a halt in February and at that time a more advanced report on the possible features of a Mortgage Interest Levy, and implementation and governance challenges an instrument of that sort would pose, was provided to the Minister of Finance, and published.[3]

Macroeconomic Policy Forum

New Zealand has been one of the faster-growing OECD economies since the early 1990s. During the last decade, however, this growth was accompanied by the emergence of macroeconomic imbalances: the balance of payments' current account deficit increased to over 9 percent of GDP (one of the largest among developed economies); asset prices (notably house prices) increased rapidly; household debt levels rose to historic highs, and the real exchange rate has risen well beyond levels regarded as justified by medium-term fundamentals.

The Treasury and the Reserve Bank commissioned a series of international experts, from a range of countries and with a practical policy focus to their work, to prepare papers on a variety of the sorts of issues identified above, and in particular to provide a comparative international perspective on the challenges New Zealand was facing. The papers were presented and discussed at the Macroeconomic Policy Forum held in June 2006 which brought together international and local participants to examine the policy issues relating to these recent New Zealand macroeconomic developments.

The overall assessment of the speakers at the Forum was that the essential elements of New Zealand's macroeconomic policy institutions are sound and remain appropriate. They also emphasised that changes in real exchange rates and fluctuations in current account balances are often an essential part of the processes of adjusting to domestic and international shocks. Further, some suggested that recent international developments and the way they have affected New Zealand may have been unique and hence unlikely to be repeated. The general tone was that New Zealand policy makers had no reason to panic, but equally many cautioned against any sense of complacency.

The Forum process was not intended to generate specific concrete policy recommendations. However, the papers and the discussion have proved very useful to the Reserve Bank in its ongoing work in this area, and several of the options discussed in other supporting papers were among those canvassed by speakers at the Forum. We have commissioned a variety of follow-up research papers and are planning to hold a smaller workshop-style forum towards the end of the year, to help ensure that we continue to explore the ways in which policy choices may affect various dimensions of New Zealand's economic cycles.

3 Available at http://www.rbnz.govt.nz/monpol/about/2950448.html.