

## House prices and the role of the Reserve Bank

---

### Purpose and background

1. On 24 November 2020 you wrote to the Reserve Bank inviting our views on how we can “work together to address the issue of rising house prices”.<sup>1</sup> Your letter included a proposal for consideration, which is to amend the Monetary Policy Committee (MPC) Remit by requiring the MPC to seek to avoid unnecessary instability in house prices.
2. This briefing follows on from our interim letter sent to you on 24 November 2020. We outline the influence of the Reserve Bank on the housing market, including house prices. We consider the efficacy of your specific proposal aimed at your stated goal of moderating house price inflation.
3. We recommend, amongst other things, that the Government’s specific housing objective be issued as a factor for the Reserve Bank to take into account when setting financial policy under section 68B of the Reserve Bank of New Zealand Act (1989) (“the Act”) and articulated in the Reserve Bank’s forthcoming *Financial Policy Remit*.

### Government’s Policy Objectives

4. The effectiveness of government policy depends on the clarity of the objective and the choice of instruments. Your letter of 24 November 2020 acknowledges the objectives of the Government and the objectives for the Reserve Bank’s Monetary Policy Committee (MPC) set by the Government. These are summarised in Table 1 and highlight the ‘nested’ nature of the objectives i.e. the Reserve Bank’s policy objectives are a means to an end, and not the end in themselves.

**Table 1: Objectives - Labour Party, Government, and the Monetary Policy Committee**

	Objectives
<b>Labour Party Housing policy (2020 Manifesto)</b>	That every New Zealander has a safe, dry, warm place to call their own whether they rent or own.
<b>Reserve Bank Act (1989)</b>	<p>Purpose: To promote the prosperity and wellbeing of New Zealanders, and contribute to a sustainable and productive economy.</p> <p>Economic objectives: Achieve and maintain stability in the general level of prices over the medium term and support maximum sustainable employment.</p> <p>Promote the maintenance of a sound and efficient financial system.</p>

<sup>1</sup> Available at <https://www.beehive.govt.nz/sites/default/files/2020-11/Letter%20to%20RBNZ%20Governor.pdf>.

<p><b>Government’s economic objective:</b> <i>(Preamble to the Monetary Policy Committee Remit (2018))</i></p>	<p>Improve the well-being and living standards of New Zealanders through a sustainable, productive and inclusive economy.</p> <p>The priority is to move towards a low carbon economy, with a strong diversified export base, that delivers decent jobs with higher wages and reduces inequality and poverty.</p>
<p><b>Monetary Policy Committee primary operational objectives</b> <i>(Section 2a of the Remit)</i></p>	<p>Future annual CPI inflation between 1-3 percent over the medium term, with a focus on 2 percent.</p> <p>Support maximum sustainable employment.</p>
<p><b>Monetary Policy Committee’s other considerations</b> <i>(Section 2b of the Remit)</i></p>	<p>In pursuing the operational objectives, the MPC shall:</p> <ol style="list-style-type: none"> <li>i. have regard to the efficiency and soundness of the financial system;</li> <li>ii. seek to avoid unnecessary instability in output, interest rates, and the exchange rate; and</li> <li>iii. discount events that have only transitory effects on inflation, setting policy with a medium-term orientation.</li> </ol>

5. We noted in our response to you on 24 November that the Monetary Policy Committee (MPC) currently gives consideration to house prices when setting policy. We also noted that the Consumer Price Index (CPI) includes housing ‘consumption’ costs, such as rents, rates, construction costs, and housing transaction costs.
6. The distinction between house prices and housing consumption costs is important when considering the Government’s economic objectives, and the role of the Reserve Bank.
  - House prices are an asset price and are driven by many factors, including monetary and financial policy settings. House prices also have a variety of competing influences on the Government’s wider goals of housing provision, and reducing poverty and inequality.
  - Housing costs, as captured in the Consumer Price Index (CPI), relate to the cost of consuming (using) the asset i.e., being housed. The Reserve Bank’s monetary and financial objectives have a direct link to the cost of being housed, and hence an unambiguous link to the Government’s goals on housing, and poverty and inequality.
7. The many dimensions of government housing policy are show in figure 1 (adapted from the 2017 Briefing to the Incoming Minister of Housing and Urban Development). Housing policies span government housing provision, subsidies and rent-to-buy options, and private market decisions regarding owning versus renting.

**Figure 1: Aspects of government housing provision**

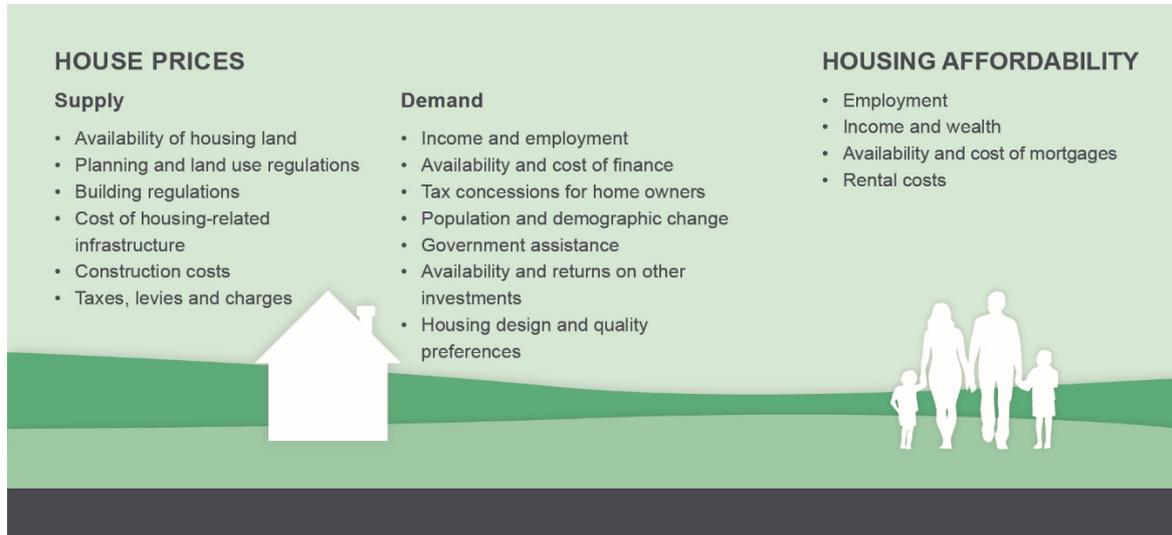


Source: 2017 Briefing for the Incoming Minister of Housing

**Many factors affect house prices and housing affordability**

8. Many factors are affecting house prices and housing affordability in New Zealand, as summarised in figure 2.

**Figure 2: Factors affecting house prices and housing costs (or affordability)**



Source: Adapted from the Productivity Commission’s Inquiry into Housing Affordability (2012).

9. Previous government studies have identified housing supply as the most significant determinant of house prices in New Zealand, with responsive housing supply essential for ensuring positive and sustainable housing outcomes.<sup>2</sup> Suppressing housing demand factors can reduce house prices, but will only prove to be a temporary intervention until supply responsiveness is re-established.<sup>3</sup>

10. Some factors that affect housing demand also affect housing costs or affordability, for example employment, mortgage costs, and rents. As such, there are important policy trade-offs to be acknowledged with house price inflation, and reducing poverty and inequality. These trade-offs are summarised at the end of this report in Table 4.

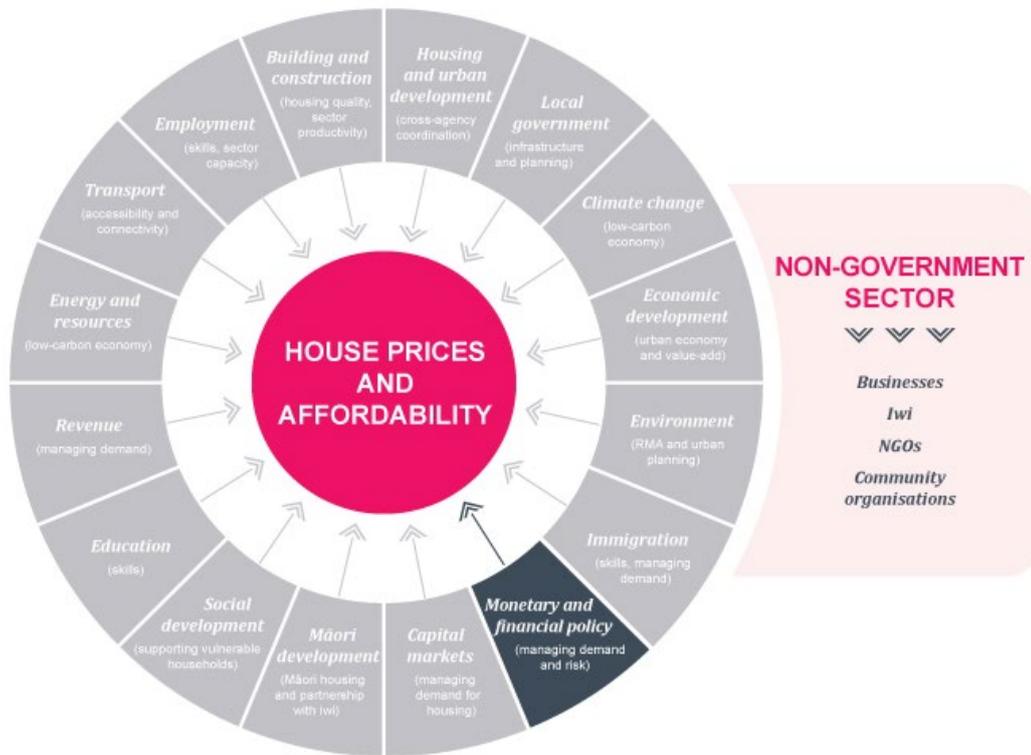
**Housing-related factors are affected by many parties**

11. Solutions to any identified problem of high house prices or housing affordability require the involvement of many government portfolios and agencies, as well as non-government participants (see Figure 3 for example).

<sup>2</sup> See, for example, the Productivity Commission’s 2012 Inquiry into housing affordability in New Zealand, and Eaqub, Howden-Chapman and Johnson (2018), *A Stocktake of New Zealand’s Housing*.

<sup>3</sup> Briefing for the Incoming Minister of Housing and Urban Development (2017).

**Figure 3: Government ‘portfolios’ and other sectors related to the housing market**



Source: Adapted from the 2017 Briefing for the Incoming Minister of Housing. The influence of various groups is not evenly weighted.

12. Government agencies already have a wide range of levers that could be used to address housing issues (see table 2). The key challenge is to clarify the policy ‘end-goals’, and to select and coordinate the most effective policy levers.
13. Given the wide range and number of parties involved, and the complexity of underlying issues, **there is a need for a single agency or ‘clearing house’ to co-ordinate the Government’s response across agencies.** The Reserve Bank welcomes the opportunity to participate within the Government’s wider response.

**Table 2: Examples of existing government levers**

Supply	Demand
Tax policy	Tax policy
Fiscal transfers	Fiscal transfers
Social housing	Overseas investment restrictions
Land availability / housing plans	Rental standards
Building standards (including materials)	Immigration
Infrastructure building	Capital market development
Māori Development	Kiwisaver policy
Immigration (for example, hiring foreign builders)	Monetary policy
Education (for example, training programmes)	Financial policy

**The Reserve Bank’s current role in relation to house prices**

14. As you identified in your letter, the Reserve Bank’s monetary and prudential policies can affect house prices and housing affordability. In turn, the housing market can affect the Bank’s monetary and financial policy objectives. This is summarised in Table 3, and discussed in more detail below.

**Table 3: Summary of the relationship between housing and the Reserve Bank**

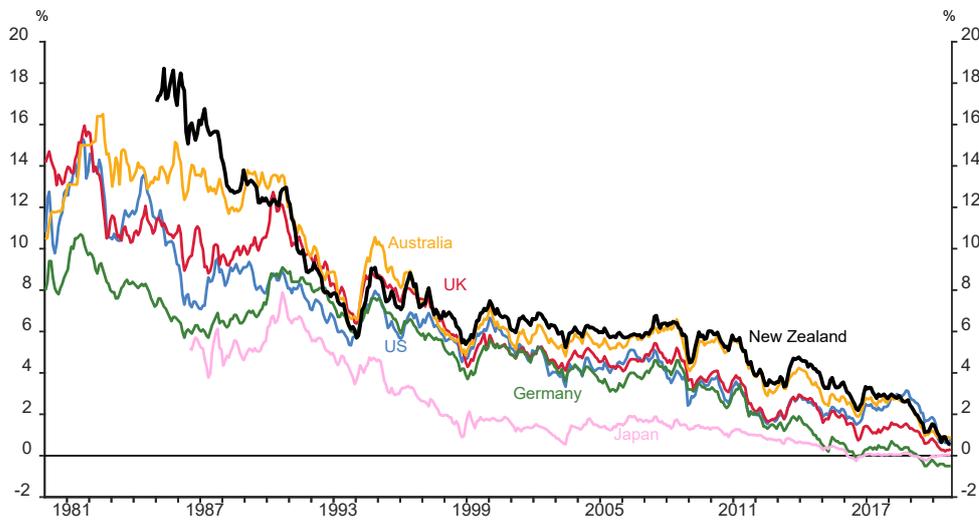
	Monetary policy	Financial policy
<b>Objectives</b>		
<b>Primary objective</b>	Price stability  Support maximum sustainable employment	Promoting the maintenance of a sound and efficient financial system  Avoiding significant damage to the financial system that could result from the failure of a registered bank
<b>Other objectives</b>	Have regard to the efficiency and soundness of the financial system  Seek to avoid unnecessary instability in output, interest rates and the exchange rate  Discount events that have only transitory effects on inflation	Reduce the risk that the financial system amplifies a severe downturn  Have regard to the impact of prudential policy on economic growth
<b>Impact of housing on objectives</b>	<i>MPC takes housing market dynamics into account when forming monetary policy, as housing market-related prices are included in the Consumer Price Index.</i>	<i>The Bank takes housing market dynamics into account when assessing financial stability risks and forming prudential policies, as mortgages are the NZ banking system’s largest exposure and houses are the largest household asset.</i>
<b>Policy tools</b>		
<b>Tools</b>	The level of retail interest rates relative to a ‘neutral rate’ as influenced by: Official Cash Rate; Large Scale Asset Purchases; Funding for Lending Programme; and Purchase of Foreign Assets	Capital and liquidity requirements Macro-prudential requirements Supervision of banks and other deposit-taking lenders
<b>Impact of tools on housing</b>	<i>Monetary policy affects house prices and housing affordability by influencing borrowing and renting costs, economic growth and employment.</i>	<i>Prudential regulation affects the availability and cost of mortgages by placing requirements and restrictions on mortgage lenders.</i>

**Current relationship between monetary policy and house prices**

15. The Reserve Bank has a number of means by which to influence the level of interest rates faced by households and businesses, and indirectly also the New Zealand dollar exchange rate. The recent monetary policy-led decline in interest rates has contributed to a rise in house prices. However, the lower interest rates have also supported housing affordability, by lifting employment and household incomes, and by lowering the debt-servicing costs of mortgage borrowers.

16. Under the Reserve Bank’s current monetary policy framework, the MPC formulates policy to achieve the primary economic objectives of achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment. In doing so, the MPC has regard to the factors set out in section 2b of the Remit.
17. Monetary policy is a cyclical tool that adjusts interest rates relative to their underlying structural level (known as the neutral interest rate). The neutral interest rate is determined by factors outside of the influence of the Reserve Bank, such as demographics and productivity. A long-term decline in neutral interest rates in many countries around the world, including New Zealand (figure 4), has resulted in lower interest rates on average faced by households and businesses.

**Figure 4: 10-year Government Bond yields in selected countries**



18. When formulating policy, the MPC takes account of the impact of house prices on its objectives in a number of ways. For example, housing demand affects the demand for housing-related goods and services, such as property construction, rents, and property maintenance. Together these components account for around one quarter of the CPI weights.
19. Low interest rates can also influence asset values, including house prices, and the decision to own or rent a house. Equity ownership in housing represents more than two-thirds of New Zealand households’ total wealth. House price variation thus influences perceived wealth, and hence households’ spending decisions. In addition, wealth gains from house price inflation affects households’ ability to borrow against their homes to finance consumption. These factors – increased wealth and leverage – eventually impact on economic growth, inflation, and employment, amongst other factors.
20. Higher house prices, relative to the costs of house building, will also encourage increased building activity, as it becomes cheaper to build new than buy existing. Increased house price inflation can therefore encourage increased supply.

21. The MPC is also required in the Act (and it is reiterated in section 2a of the Remit) to have regard to the soundness and efficiency of the financial system when formulating monetary policy.
22. Significant house price instability poses risks to financial system soundness, and can cause instability in output and the exchange rate. For example, retail banks could create overly concentrated mortgage lending portfolios, making their stability vulnerable to variations in house prices and households' ability to service their mortgages. The MPC receives advice from both monetary and financial stability areas of the Bank when formalising its policy decision.

#### Current relationship between financial policy and house prices

23. The Bank uses its financial policy to promote the maintenance of a sound and efficient financial system, and to avoid significant damage to the financial system that could result from the failure of a registered bank. The Reserve Bank has a number of financial (prudential) tools to help address the risks that confront the financial system, including instability in house prices. These tools include:
  - Publicly highlighting the risks (e.g. in twice-yearly *Financial Stability Reports*);
  - Imposing capital (including risk-weights) and liquidity requirements on banks;
  - Restrictions on high 'loan-to-value ratio' (LVR) lending;
  - Requiring banks to undertake stress tests with scenarios, including sharp house price falls and unemployment increases; and
  - Supervising banks to ensure they manage their own exposures to the housing market.
24. House price instability can threaten the resilience of banks at the system and individual level. Sharp declines in house prices during a recession can cause significant mortgage defaults and large losses for banks. This risk is particularly acute when many mortgage borrowers are highly indebted, relative to their incomes and home values. As interest rates have structurally fallen over the last decades, debt serviceability has become more affordable, while the amount of debt relative to income for new mortgagors has steadily increased.
25. These trends have been outlined in numerous *Financial Stability Reports*. Banks and households remain vulnerable to risks that may impair peoples' ability to service their mortgages, especially higher unemployment rates. If banks provide a large amount of credit to higher-risk borrowers this can amplify the impact of a housing downturn on the financial system. It is worth noting that restrictions on high-LVR loans over the past seven years have improved the resilience of household and bank balance sheets.
26. The Bank has used LVR restrictions to cap banks' mortgage lending to borrowers that are highly leveraged (i.e. have low deposits). LVR restrictions were removed in May 2020 to help maintain credit flows and to support the *mortgage deferral scheme*. However, since that time, the housing market has proved resilient and high-LVR lending has been increasing, particularly to investors.
27. As commenced on December 8 2020, the Bank is consulting registered banks and the public about re-instating LVR restrictions from 1 March 2021. This is to reduce the risk of this higher-risk lending amplifying the impacts of a housing downturn on the financial system.

28. We have also previously consulted on introducing debt serviceability restrictions, such as debt-to-income (DTI) limits, on mortgage lending. Although we consider that restrictions on high-DTI lending could complement the current LVR policy, we note that this tool is not currently part of the Reserve Bank's Memorandum of Understanding with the Minister of Finance. **We request that the Government gives consideration to adding restrictions on debt serviceability (that would include DTI limits) to the permitted tools in 2021.**
29. Other prudential tools can also affect housing market dynamics. Increasing capital risk weights on mortgage lending would be expected to marginally increase the cost to banks of providing that lending.
30. While studies by the Bank have found that binding LVR restrictions can affect house prices,<sup>4</sup> our prudential tools mainly enhance the resilience of the financial system to shocks.
31. It is ambiguous as to whether increased LVR restrictions or the imposition of DTI restrictions and higher capital requirements would assist the Government's goal of housing New Zealanders, and reducing inequality and poverty. Higher prudential requirements generally imply higher deposit requirements, lower credit ceilings, and higher interest costs for the mortgage borrower. All of these factors disadvantage lower income and lower wealth households.
32. Finally, when implementing our financial stability policies, we must have regard for the efficiency and soundness of the financial system under current law. Efficiency considerations include aspects such as financial inclusion and the efficient allocation of financial resources.<sup>5</sup> Under current law the Bank could not tighten prudential policies for the primary purpose of dampening house prices, if that is not justified on financial stability grounds.

### **Strengthening the Reserve Bank's role in relation to house prices**

33. Having considered your letter of 24 November 2020, we believe that there are two possible options for strengthening the Reserve Bank's role in relation to house prices:
  - a. Adding a house price consideration to the Monetary Policy Remit
  - b. Adding a house price consideration to the purpose of financial policy
34. The first option is not preferred by the Reserve Bank. Under this option the MPC would be required to have regard to the house price consideration provided when formulating monetary policy. This could be formalised by amending section 2b of the MPC's Remit, as suggested in your letter.
35. Under the second option, our preferred option, the Reserve Bank could be required to have regard to housing issues in its financial policy settings. This could be achieved using the Reserve Bank of New Zealand Bill (RBNZ Bill), which is due to have its first reading this week. The RBNZ Bill contains a provision for you to issue a *Financial Policy Remit*

---

<sup>4</sup> See Armstrong et al (2018), '[Loan to value ratio restrictions and house prices](#)', Reserve Bank of New Zealand Discussion Paper, DP2018/05.

<sup>5</sup> For example, the Capital Review decisions, published in 2019, were calibrated so as to balance the resilience benefits of higher capital with the cost anticipated from increasing interest rates.

to which the Reserve Bank must have regard in its pursuit of its financial stability mandate.

36. The RBNZ Bill is not expected to be enacted until the second half of 2021. However, a house price consideration could be added to the Reserve Bank’s financial policy remit more immediately using section 68B of the Act. This enables you to issue a direction to the Reserve Bank to have regard to a specific government policy when forming financial policy.
37. For both options, the house price consideration will have to be clearly articulated to ensure the Reserve Bank’s actions support the Government’s housing objectives and to ensure the Reserve Bank is properly accountable for its actions. Furthermore, if you chose to issue a direction under section 68B, you would need to specify a clear Government policy to which the Reserve Bank must have regard.

*Assessment of the options*

38. Our assessment of these options is summarised in table 4, below.

*Table 4: Options for strengthening the Reserve Bank’s role*

Option	Possible benefits	Limitations and challenges
<b>Add a house price consideration to the monetary policy Remit</b>	<p>It could justify MPC decisions that, at the margin, result in higher interest rates and lower house price inflation.</p> <p>Commits the MPC to communicate how house prices are accounted for in its decision making.</p> <p>Strengthens the Reserve Bank’s commitment to any broader Government work on housing issues.</p>	<p>The primacy of the MPC’s economic objectives of stable inflation and sustainable employment mean the impact on house price inflation is likely to be limited.</p> <p>In situations where MPC action on house price inflation would be justified, there are potential trade-offs:</p> <ul style="list-style-type: none"> <li>• Higher interest rates, leading to lower employment and below target inflation and inflation expectations.</li> <li>• Lower employment most impacts those at the margins of the labour market e.g. Māori, Pasifika, women, and youth.</li> <li>• A higher than otherwise New Zealand dollar exchange rate and a negative impact on export earnings.</li> <li>• Lower growth in housing supply due to higher borrowing costs.</li> <li>• Increased mortgage servicing costs and decreased housing affordability.</li> </ul> <p>Adding house prices to the monetary policy objective would be unique internationally, which could make monetary policy less effective and impact financial market efficiency, by reducing public understanding of the objective of monetary policy.</p>

<p><b>Add a house price consideration to the financial policy remit</b></p>	<p>It would justify financial policy decisions that lower house price inflation, alongside strengthening the soundness and efficiency of the financial system.</p> <p>Policy decisions will be consistent and publically understandable, as few trade-offs between the financial system soundness and efficiency objective, and a house price consideration.</p> <p>Allows for a whole-of-Reserve Bank response to housing market issues, and provides a wide range of policy actions, including some that can targeted at specific drivers of the housing market.</p> <p>Strengthens the Reserve Bank's commitment to the whole-of-Government suite of work on housing issues.</p>	<p>Financial policy actions to address house price concerns could result in the potential trade-offs with monetary policy. This could increase the need for a resolution between the Reserve Bank's financial policy and monetary policy.</p> <p>Financial policy actions would need to be justified by achieving financial stability.</p> <p>Some financial policy actions could reduce the availability or increase the cost of finance for some borrowers.</p>
---	---	---

39. As summarised in Table 4, both options would strengthen the Reserve Bank's role in relation to house prices and support our ongoing participation in the whole-of-Government response to New Zealand's housing issues.
40. Adding a *housing consideration to the monetary policy remit* could lead to MPC decisions that moderate house prices. However, our assessment is that there are strong reasons why it would be unlikely to result in significant policy changes.
41. First, the MPC already takes account of house prices when formulating monetary policy, as previously outlined.
42. As an illustration, the 2012 Policy Targets Agreement (PTA) included a clause for the Reserve Bank to "monitor asset prices" in pursuit of its general price inflation objective. This inclusion was a specific reference to the role that asset prices played in the domestic and international financial cycle leading up to the global financial crisis.<sup>6</sup> This clause was removed from the 2018 PTA on the basis that it was redundant given the long-standing regard to financial stability contained in the Act.<sup>7</sup>
43. Second, if there were trade-offs between the house price consideration and the MPC's economic objectives of stable inflation and sustainable employment, the MPC would be obligated to formulate policy that supports its price stability and employment objectives.
44. This is illustrated by considering the factors influencing the MPC's design of the Funding for Lending Programme (FLP), launched this week. A key element of the FLP is the provision of a sufficient alternative source of funding for banks, which is necessary to reduce the marginal cost of bank funding and, hence, interest rates for bank customers. This is the same for central bank funding programmes implemented abroad. For example the central banks in Australia, the Eurozone and the UK each provide retail banks access to a large amount of funding without any sector specific lending conditions.

<sup>6</sup> Kendall and Ng (2013), 'The 2012 PTA: An evolution in flexible inflation targeting in New Zealand'.

<sup>7</sup> Treasury Report, available at <https://www.treasury.govt.nz/sites/default/files/2018-04/pta-tr18-176.pdf>

45. Restricting the FLP to only new business lending, for example, would limit its impact on broader retail interest rates significantly. The FLP's monetary policy effectiveness would be impaired, as would the MPC's ability to achieve their inflation and employment objectives.
46. Finally, the addition of a housing consideration to the monetary policy remit could also make the goal of monetary policy confusing and reduce financial market efficiency.
47. Adding a *housing consideration to the financial policy remit* could lead to policies that are more effective at supporting the Government's housing objectives, with lesser concern for policy trade-offs. There are considerably less trade-offs between the Reserve Bank's financial policy objective, of a sound and efficient financial system, and stable house prices. It would also enable the Reserve Bank to use financial policies that can be specifically targeted at key drivers of the housing market.
48. A challenge of this approach is that it could increase the need for resolution between the Reserve Bank's financial policy and monetary policy. This challenge already exists and is managed by the Reserve Bank, for example, by providing the MPC with advice from financial policy experts prior to finalising their decision.
49. Given this assessment, **if you wish to strengthen the Reserve Bank's role in relation to house prices, our recommendation is that this would be best achieved by amending our financial policy remit.** This could be achieved permanently by issuing the *Financial Policy Remit* provided by the RBNZ Bill, and temporarily by issuing a direction under section 68B of the Act.
50. We are keen to engage with you on the definition of the house price consideration. It is important that it accurately captures the Government's concerns about the housing market and the unique role of the Reserve Bank in relation to the complex and multifaceted drivers of housing market.



Hon Grant Robertson  
**Minister of Finance**  
Date:

Adrian Orr  
**Governor**  
**9/12/2020**