Supplementary stabilisation instruments

Initial Report to: Governor, Reserve Bank of New Zealand, Secretary to the Treasury, 10 February 2006

Executive summary[1]

1. The large and prolonged housing market cycle of recent years, and the associated pressure this appears to have placed on domestic resources, the inflation outlook, and the exchange rate, prompted you to commission this review. The review has looked at whether there might be useful tools, with a direct bearing on the housing market and/or the market for residential mortgage credit, which could supplement the central role of interest rates in managing inflation, either in this cycle or in future cycles in which housing-related pressures played a particularly important role. If such measures, targeted more closely to the housing or housing finance sectors, were available they might alleviate some of the pressures on the exchange rate, and on the tradables sector of the economy. A joint Treasury and Reserve Bank team has explored a range of options in this paper.

2. There are a number of areas where further work and policy development could be appropriate. However, it should come as no surprise that there are no simple, or readily implemented, options that would provide large payoffs.

3. Tailoring bank capital requirements better to the risk characteristics of loan portfolios and to the wider economic environment is an important element in refining the regulatory regime for New Zealand banks. Consideration of these issues will be a part of the implementation of the new Basel II framework over the next couple of years. Earlier, more limited, modifications to the existing capital adequacy regime could probably be made quite quickly. As the capital requirements for banks are refined, the banking system should be better placed to cope with periods of financial stress. It is less clear, however, what contribution modifications of this sort would make (as an ancillary benefit) to dampening this, or future, housing cycles, and hence how much pressure they might relieve from the Official Cash Rate (OCR) and the exchange rate. We would not expect these effects to be large, particularly for modifications to the existing regime, and hence we would be hesitant about promoting any early modification of the existing regime ahead of the Basel II schedule, except as a means of focusing banks on the emphasis the Reserve Bank will be putting on these risks in implementing the new Basel II framework.

4. Of the housing taxation instruments reviewed, 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. This would be a departure from the current practice and, as such, would raise a number of issues which would require further work, including determining the legislative basis for such a change in focus. At the margin, greater awareness of the existing tax law, and more stringent enforcement, might offer some incremental gains in dampening housing inflation in periods of particular stress. Given the growing number of investment properties reporting losses for income tax purposes, there may also be merit in some further work assessing whether the tax treatment of losses on investment property has played an important role in the cyclical behaviour of the housing market in recent years. We would note, however, that there is no clear evidence that ring-fencing such losses is associated with less pronounced housing cycles in other countries.

5. We also consider 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.

1 Only the executive summary is reprinted here. The rest of the report is available at rbnz.govt.nz/news/2006/2504934.html

The American literature, for example, highlights the differences in housing cycles between markets where supply is able to respond quickly and those where that supply responds only slowly.

6. Direct discretionary stabilisation instruments, such as a comprehensive limit on loan to value ratios or a mortgage interest levy, could be used to supplement the OCR at periods of particular pressure on the housing market. Of the two options examined here, a mortgage interest levy has the merit of being an explicitly price-based instrument. Instruments of this sort, which go well beyond the mainstream of international thinking about managing cycles, might appear to offer an effective technical means of influencing the housing cycle. But they also pose a variety of quite substantial problems, including issues around the extent to which such new statutory powers could appropriately be delegated (especially tax-based provisions), consistency with New Zealand's international commitments, and the difficulty of maintaining a strong and ongoing enforcement regime. Some implementation options could also risk eroding the operational autonomy of the Reserve Bank in the conduct of monetary policy. If you wished to consider this option further some quite extensive work would need to be done to address a number of the issues raised in this report. It would, then, also be desirable to consider this option against other possible measures for easing demand pressures, including discretionary tax ones, which were outside the scope of this particular report.

7. The tables on the following two pages outline in summary form the key considerations relating to each of the options that we examined in greater detail.

	Tax on property purchased for resale	Ring-fencing	Improve responsiveness of housing supply
Description	Increased publicity and increased enforcement of current law (making gains on non owner-occupied properties purchased with the intention of resale liable for income tax). Other options: require reporting of all sales of property held for less than two years, or remove the exemption for owner-occupied property held for less than two years.	Prevent operating losses on investment properties being offset against other income.	Measures to increase the speed at which new land and houses are able to be brought onto the market in response to evidence of rising demand
Effects on cycle	Limited positive effects are possible (the more so, the more far-reaching the measures).	Likely to be quite limited (little evidence that cycles are more muted in countries that ring-fence).	Favourable, but hard to predict reliably how strong the effects would be. Any impact in dampening house price cycles would be offset, to some extent, by intensified pressure in the construction sector.
Other impacts (efficiency, stability, distribution)	Increased publicity and increased enforcement of existing law would have low efficiency costs. More far-reaching measures would involve greater administrative, compliance, and avoidance costs. Unlikely to be material adverse distributional impacts.	Immediate impact likely to be greatest on smaller and highly-leveraged participants in (and often new entrants to) the investment property market. Ongoing enforcement challenges and costs, and perhaps at the margin a reduction in the supply of rental properties. Represents a departure from the principle of treating similar investment activities similarly.	Should be generally favourable and, by improving affordability, should also have positive distributional impacts.
Implementation (enforcement, timing, legislation)	Heightening awareness of existing rules could be done quickly, although the legislative basis for any increased enforcement would need to be determined. A more extensive reporting framework would require legislation. Long-term effectiveness would be a challenge, with strong incentives to avoid any two year reporting threshold .	Would require new legislation. Longer-term enforcement challenges, especially for more sophisticated and diversified investors.	Significant lags, because many constraints are likely to involve a wide variety of local authority rules. Understanding these and securing changes would take considerable further time and effort.

	Linking bank capital to cyclical risk	Discretionary loan to value ratio limit	Discretionary mortgage interest levy
Description	Ensuring that bank capital requirements, under Basel II are better tailored to cyclical risks. Possible earlier modifications to Basel I, to link capital to loan to value ratios.	Comprehensive limit on loan to value ratio, imposed on all lenders and all loans secured by residential property. Able to be triggered at the discretion of the Reserve Bank, in response to periods of particular stress in the housing market.	Levy imposed on all loans, by all lenders, secured by residential property. Able to be triggered in response to periods of particular pressure in the housing market and when the gap between NZ and foreign interest rates is unusually large.
Effects on cycle	Likely to be quite limited. Main aim of the framework would be to ensure that banks have sufficient capital to cope with downturns rather than to dampen lending cycles.	Could be material, although would depend on correctly calibrating the scheme.	Could be material, by establishing a wedge between domestic mortgage borrowing costs and returns available to depositors.
Other impacts (efficiency, stability, distribution)	Limited adverse effects, as any changes would be designed to better align capital requirements with risk.	Poorly targeted and would impinge most directly on lower income and first home buyers. Could also constrain small and medium enterprise borrowing. Ongoing efficiency costs, heightened because it is a direct control.	Real resource costs devoted to implementing and maintaining the regime. Raises price of residential mortgage credit relative to other forms of credit, irrespective of relative risk considerations. Lowers returns to savers. Any increases in mortgage rates would fall most heavily on lower income borrowers and highly-geared new entrants to the housing market.
Implementation (enforcement, timing, legislation)	Basel II regime will not be in force for some time. Modifications to the existing requirements could be implemented quite quickly. If such measures had much effect on bank housing lending, disintermediation would be a concern because the existing powers affect registered banks only.	Would require new legislation. Long-term enforcement would rest with the Reserve Bank and would be a major challenge (especially for an instrument used infrequently). Particular difficulties may arise in avoiding offshore disintermediation.	Would require new legislation (with significant issues around ability to delegate authority to trigger the levy). Longer-term enforcement by IRD would face considerable ongoing challenges.
Initial assessment	Shift to Basel II should ensure that over time capital requirements are better tailored to risk. Limited ancillary counter-cyclical benefits are also possible. Weaker case for changes to Basel I, although might have positive signalling benefits.	A direct control instrument and one which is relatively poorly targeted. This, together with the likely ongoing enforcement problems, suggests this instrument should not be developed further.	Better-targeted and with the advantage of being explicitly price-based. Enforcement would be a continuing challenge. Further work would be needed in a number of areas. In any overall assessment other discretionary demand management tools (including tax ones) beyond the scope of this review would desirably be considered.