Submission On Serviceability Loan Restrictions as a Potential Macroprudential Tool in New Zealand

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My submission is that no Serviceability Loan Restrictions should be used in NZ. The key contention is that it is the Reserve Bank that is the problem and that this regulation is not the solution.

As part of this submission I resubmit my submission on the Asset Class Treatment of Residential Loans, which is even more relevant today than when submitted to the Bank in March 2015.

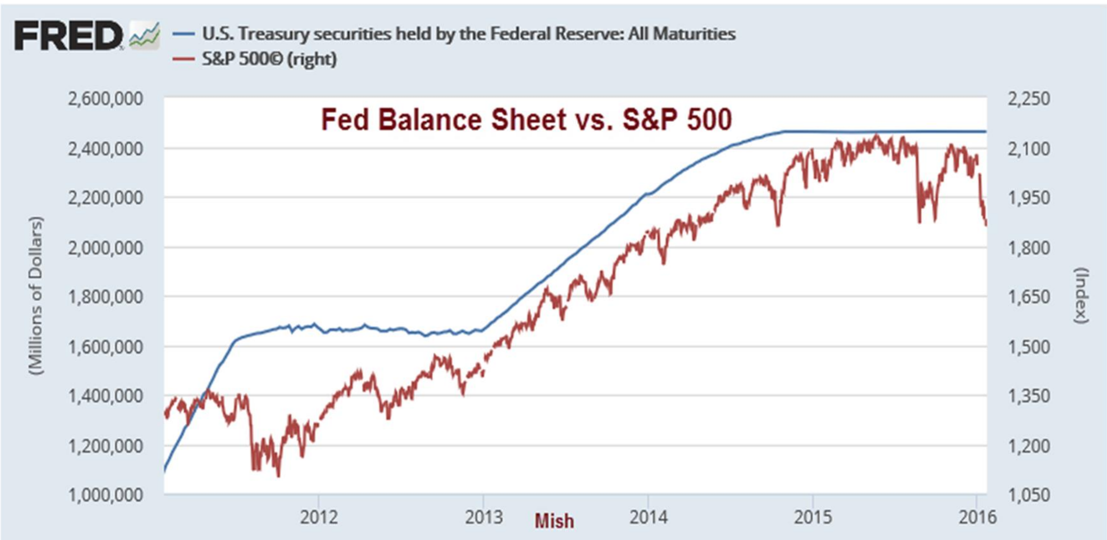
The Reserve Bank claims that the SLR macroprudential tool will -

(a) reduce household financial distress in adverse economic circumstances, including those involving a sharp fall in house prices;

(b) reduce the magnitude of the economic downturn, which would otherwise serve to weaken bank loan portfolios (including in sectors broader than just housing); and

(c) help to constrain the credit-asset price cycle in a manner that most other macroprudential tools would not, thereby assisting in alleviating the build-up in risk accompanying such cycles.

These claims like those made in the LVR policy introduced in October 2013 "that it would remove household inflation by 1-4%" cannot be substantiated for the same reasons as I set out in my previous submission that it is simply not possible to determine. We do know however that Central Banks by continually intervening are causing distortion in the bond, equity, property and forex markets, preventing true price discovery with the resultant boom and busts. In case there is any doubt the below chart says it all.



The solution therefore is for the Reserve Bank to stop what it is doing including adding marcoprudential regulations. It should instead be concentrating on its Liquidity Policy as this is where protection is assumed.

Looking at the Reserve Bank Policy Targets Agreement which drives monetary policy it states –

a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices, including asset prices, as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.

b) For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term, with a focus on keeping future average inflation near the 2 per cent target midpoint.

The key problem is that the inflation target of 2% is defining “a stable general level of prices” This target of 2% halves the value of your money every 36 years. How can this possibly be described as stable and why would anyone want that to happen to their money? Added to this is the question does the CPI even accurately measure inflation?

The 2% inflation target is commonplace in the G20 countries and as it hasn’t been met in recent years it has driven a lax Central Bank monetary policy including close to zero interest rates and QE and as a result fuelled the asset bubbles via debt that we now see. Where did the Central Banks think the money was going to go?

This grand experiment has failed and has caused a massive increase in debt, lower growth, rising wealth inequality and no doubt soon to repeated on a grander scale in the next bust where the central bankers will inevitably try to ease the shock, further encouraging moral-hazard speculation. The pattern repeats over and over creating bubbles of ever-increasing magnitude. It is time to reject this Keynesian & Monetarist group think and not target inflation and also realise deflation is not an issue.

The absurd underlying notion behind the battle cry for inflation is that if prices fall people will stop buying things and the economy will collapse. The fact is most people have to spend most of their income irrespective and the idea that falling consumer prices will lead to a downward spiral is absurd. Further to what is clearly common sense the BIS published in its March 2015 quarterly review “The Cost of Deflations: A historical perspective.” It found –

> “First, before accounting for the behaviour of asset prices, we find only a weak association between goods and services price deflations and growth; the Great Depression is the main exception. In some respects, this confirms previous work. Second, the link with asset price deflations is stronger and, once these are taken into account, it further weakens the association between goods and services price deflations and growth. Finally, we find some evidence that high private debt levels have amplified the impact of property price deflations but we detect no similar link with goods and services price deflations.”

Stability in prices will be achieved by not targeting inflation, allowing true price discovery to occur with prices being driven by supply and demand, not intervention.

In conclusion our monetary policy needs to be changed. Discussion with the Government to change the Policy Target Agreement deleting the inflation target is required. This will remove the need for intervention and is the solution to the boom/bust problem which has been created by the Central Banks in the first place.
This also means the proposed Loan Serviceability restrictions should not be implemented and current macroprudential policy should be disbanded. Also the OCR can then be tied to the 30 day BB rate and not used as a policy tool.

Previous submission follows

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Dated: 30 March 2015

Submission on the Reserve Bank Housing review stage two: asset class treatment of residential property investment loans.

This submission will deal solely with the principle as to whether the Reserve Bank should be intervening and regulating in this area.

The Fed Chairman Ben Bernanke in an address to the Boston College of Law in 2009 said:
"The Federal Reserve devotes substantial resources to economic forecasting. You will know that many very smart people have applied the most sophisticated statistical and modelling tools available to try and better divine the economic future. The results unfortunately have more often than not been underwhelming."

Translated, the Fed can't predict the outcome of their policies, they don't really know what they are doing and have been frequently wrong.

You can be sure the same situation exists for all Central Banks around the world, NZ included. If they really did understand what they are doing and understood the underlying cause of the 2007 Global Financial Crisis then why didn't they prevent it? Having got this so wrong, why now think what they are doing is so right.

There is a danger of the decisions from Central Banks, especially when more often wrong than right, to cause suffering. When decisions are made by a handful, large economic risks are likely and this is exactly the opposite of what is needed. We are in a “need to know they don’t know situation.”

It is the function of the Reserve Bank in NZ to manage the monetary policy to maintain overall price stability and a sound and efficient financial system. This is an impossible ask. Economies are about people, and humans have many unpredictable biases. These biases keep us from feeling like idiots as we look back but don’t stop us acting like idiots as we go forward. The rationalisation of our past choices influences our present ones so the chances of getting all of the above right apart from pure luck are near zero. The problem is humans hate randomness and want to predict the unpredictable.

In other words rational expectation and efficient market hypothesis is just a dream. The Reserve Bank, no matter how smart, is not going to achieve the above outcomes. Millions of decisions by consumers can’t be distilled into anything of value as the data set is too vast to be useful. The econometric models will repeatedly fail and we are down to guesswork and luck. Mostly luck.

Nasim Taleb in his books *Black Swan* and *Fooled by Randomness* has addressed this issue brilliantly. He tackles the question of “how do we know what we know”. He shows that there are behavioural and statistical reasons why we all make the same mistakes. That is, the nature of the human mind and personality makes us prone to make the same mistakes over and over.
His basic premise is that financial experts underestimate risk. As such they are caught by surprise when some significant unforeseen event occurs. Such events can be good or bad, but it is the bad ones that can kill you. The surprise is that these kinds of events, he refers to them as Black Swans, occur unpredictably, but regularly.

A research paper written by Carmen Reinhart and Kenneth Rogoff in 2011, *This Time is Different: A Panoramic View of Eight Centuries of Financial Crises*, reveals that credit and business cycles have several things in common, mainly the debasement of money via the process of inflation. The point of the article is that, there is no difference from any other time when analysing the cycles. In its initial stages it is seen as “the easy money.” They show that during these cycles, easy money is pumped into the system via the actions of the Central Banks or Sovereigns, distorting financial decisions, encouraging the malinvestment of capital, and causing prices to rise. Prices rise faster than their productively useful value, a crisis results, eventually money is deflated, and prices go back to a price value equilibrium.

Credit cycles in modern times are created by the Central Banks. These cycles tend to behave the same way, but the asset class differs from cycle to cycle.

In 2001, it was dot com tech stocks; in 2007 it was the subprime crisis as too much money chased residential property, this time the prolonged easy money from the Central Banks is seeing a number of bubbles forming in various share, property and debt markets around the world the latter of which will most likely lead to Sovereign defaults.

Frank Shostak well known economist of the Austrian school states that "regardless of expectations what ultimately matters for the long-term interest rate determination are individuals' time preferences, which are manifested through the interaction of the supply and the demand for money."

He goes on to say "the introduction of new regulations from The Basel 3 accord in July 2013 cannot make the current monetary system stable and prevent financial upheavals. The main factor of instability in the modern banking system is the present paper standard, supported by the existence of the Central Bank and fractional reserve lending. In a true free market economy without the existence of the Central Bank, banks will have difficulties practicing fractional reserve banking. Any attempt to do so will lead to bankruptcies, which will restrain any bank from attempting to lend out of "thin air." By means of monetary injections, the central bank makes sure that the banking system is "liquid enough" so that banks will not bankrupt each other. The consequences of the monetary management of the Central Banks are manifested in terms of boom-bust cycles. As long as the present monetary system stays intact it is not possible to prevent a financial crisis similar to the one we had in 2007-9. The introduction of new tighter capital requirements by banks cannot make them more solvent in the present monetary system. Given that since 2008 the Central Banks have been pursuing extremely loose monetary policy this raises the likelihood that we have had a large increase in bubble activities as a percentage of overall activity."

Shostak says "according to the mainstream way of thinking, one must differentiate between the activities of individuals and the economy as a whole (i.e., between micro- and macroeconomics). Within this framework of thinking "the economy" is assigned a paramount importance while individuals are barely mentioned.

In fact one gets the impression that it is "the economy" that produces goods and services. Once the output is produced by "the economy" what is then required is its distribution among individuals in the fairest way. Also, "the economy" is expected to follow the growth path outlined by Government and Central Bank planners. Thus whenever the rate of growth slips below the outlined growth path, they are expected to give "the economy" a suitable push.

In reality however, goods and services are not produced in totality and supervised by one supremo. Every individual is pre-occupied with his own production of goods and services.

In practice, the so-called macroeconomic indicators are fictitious devices that are used by Governments and Central Banks to justify intervention with businesses. These indicators can tell us very little about wealth formation in the economy or individuals' well-being."

What is clear from Shostak is the more Central Bank intervention, the more the distortion and the bigger the bust.

Currently we have Central Banks targeting 2% inflation whereby the value of your money will halve every 36 years so in one's lifetime a dollar will only be worth 25 cents. Why would we want this? The current obsession by Central Banks with Keynesian economics and fear of deflation as if everyone is going to stop spending confirms that a reassessment of the Central Banks policies is required.

David Stockman who was President Reagan's budget director has lambasted the Fed for leaving its federal funds rate target at zero to 0.25 percent since December 2008. The central bank has used low inflation as an excuse not to raise rates, Stockman explains.

"Interest rates impact all financial pricing in the world — tens of trillions of dollars of cash, stocks and bonds. The Fed has fundamentally distorted all those prices. The answer is to get the Fed out of the financial markets and let price discovery work."

Stockman maintains "interest rates should never have been on zero, now they have to get off zero to be credible. . . . Sooner or later we've got to get off the monetary heroin. Needless to say, six years of continuous monetary levitation by the Fed and its fellow traveling Central Banks around the world has generated a ticking time bomb. That's because after 80 months of drastic financial repression, financial markets have been reduced to a state of abject addiction to Central Bank monetary stimulus.

At the end of the day, therefore, our modern Keynesian Central Bank amounts too little more than a serial bubble machine. Its cheap money and severe financial repression campaigns inexorably fuel leveraged speculation in the financial markets which eventually cause asset prices and valuations to become unhinged from the real main street economy. Then the bubble bursts, as it has already twice this century——even as the Fed drives the financial markets to a third and even more spectacular meltdown in the not too distant future."

There is no doubt when we have the situation where the world financial markets become fixated on the speeches of Central Bank Chairs that there is something seriously wrong and it is of concern that the Reserve Bank of NZ by more and more regulation are thinking that they are the solution rather than realizing that they are the problem.

The conclusion to this submission is

- **The chances of the Reserve Bank policy decisions being correct are down to luck.**
- **Large economic risks are being taken by the Reserve Bank which should not be taken.**
- **The Reserve Bank by continually intervening is causing distortion in the bond, equity, property and exchange rate markets preventing true price discovery.**
- **It is clear that the law of unintended consequences applies and these have major impacts on the lives of many people.**

As a result the Reserve Bank of NZ should not proceed with the asset class for residential property investment loans and in fact should conduct an open review of all its policies in light of the above.