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Dear Sirs,

Submission on Serviceability Restrictions as a Potential Macroprudential Tool in New Zealand

Thank you for the opportunity to comment on the above document.

I am associated with several high tech businesses that are highly weighted to export markets, offshore sales around 10 times greater than domestic sales in these companies. These businesses are highly sensitive to exchange rates, fortunately they operate at high margins that can buffer the impact. Nevertheless, fluctuating returns impact investment and recruitment decisions.

I often see comment that currency fluctuations are small, several percentage points. The problem is for highly weighted export business that the few percent operates on the sales line, and so has a major impact. A change of several percent could completely wipe out any profitability. It is worth noting that high tech business generally operates with low debt and so interest rates are of little concern, however predictable top line returns are vital to support business development decisions.

It is well recognised that more high tech, high margin, high export businesses are needed to give a better balance the New Zealand economy. The RBNZ paper seems to ignores the impact of policy via the currency feedback channel. If the RBNZ is continually caught in the: the economy needs a lower policy but asset prices are out of control dilemma the currency will tend to be overvalued – this is exactly what has happened. Look to past Monetary Policy Statements, they are like a broken record around an overvalued NZ dollar. More and better targeted tools need to be in place to take the pressure off the currency channel and in so doing help better balance our economy.

The right tools for the job.

A full suite of macroprudential tools are required to better target problems in our economy. These problems might naturally occur or be an artefact of broader government policy. The

RBNZ needs the ability to push back on asset prices beyond interest rates and thereby avoid upwards pressure on the exchange rate resulting in a higher OCR than would otherwise be needed in the presence of effective macroprudential intervention. Experience has demonstrated that interest rates alone are not effective in reducing demand for housing debt and that supply side reactions to property shortages seem to take decades.

In the messy real world, inflation and financial stability are not independent domains, each has influence the other. Debt to Income (DTI), Loan to Value (LVR) and policy rate (OCR) used together offers the RBNZ a targeted and nuanced response to problems in the economy, minimising the collateral damage in the tradeable economy.

It is clear that the RBNZ will come under pressure with targetted policies – interest rates, at first blush, help or hurt everyone equally. Effective macroprudential tools have specific targets and so impact some sectors more than others, leading to the inevitable political pressure. The RBNZ has to deal this pressure; other jurisdictions (Ireland lead the way) have successful adopted a targetted approach with a full range of macroprudential interventions.

Judging by the complaints the inroduction of LVRs has been effective, the addition of the DTI speed limit will go a step further by reintroducing the **vital** link between earnings and borrowing. Furthermore, the ernings in question could be the earnings from the asset, thereby limiting ponzi invetsment in the house rental sector.

It is worth noting from the perspective of the exchange rate feedback channel, even the latent ability to access a DTI tool will have an impact, as markets recognise the RBNZ has options beyond talking the currency down. That said, the use, in the end, makes the tool.

The fluctuations in currency over the past year exceed 10%, more than enough to influence investment and business development decisions. Another tool to take the pressure off the OCR, provides policy options to the RBNZ. A lower OCR to better balance the exchange rate and consequently the economy pushing back on asset prices via the macroprudential settings. This needs to happen.

Specific Questions

Q1: Do you have any comments on the evidence that high DTI borrowers are more susceptible to mortgage default and consumption stress? Are there other relevant studies, or other relevant channels through which a DTI policy would influence finacial stability?

DTI restores the linkage between asset debt and earnings. The approach can be applied to asset earnings to limit ponzi property investments. Given borrowing is linked to earnings unless earnings grow borrowing growth is limited providing intrinsic stability.

Q2: Do you agree that the current levels of debt (relative to income) that some borrowers are able to borrow risk putting them under pressure, especially if interest rates rise? Why are the DTIs achievable in New Zealand apparently higher than in other markets like the UK?

Prior to the 1980s in the UK borrowing for property was largely the domain of the Building Societies and they had strict DTI policies, equally duties on sale reduce the return to property investments, I am not sure on negative gearing rules in the UK but they would also have an effect. Here, absent capital gain, negative gearing, offshore money flows, poor supply side performance all contribute to high DTI. These characteristics that support Ponzi investment which in turn erode financial stability.

As mentioned above the RBNZ paper has the one major omission in that it does not consider the impact of higher interest rates - than would be the case given effective macroprudential tools were in play - on the exchange rate and what that implies for the development of our economy. If, over time, the exchange is biased only 10% above where it would otherwise be the loss of competitiveness on exports, the lower price of imports, the games played in the exchange markets all hurt the tradeable sector and consequently the balance of our economy. The impact is insidious and subtle but devastating in the long run.

Q3: Do you agree with our assessment of other possible policies that are under the Reserve Bank's control, or do you think one or more of them could be preferable to DTI limits? Are there other policy options under the Reserve Bank's control that we haven't listed that could be relevant?

Reconnecting debt and income via DTI ratios at the macro level is critical for financial stability. The loss of that connection has enabled the banks to grow their balance sheets, chasing ever higher profits, to the point where a down turn threatens us all. Together: DTI, LVR, and OCR can enable a subtle and targeted response to issues in the economy without collateral damage.

DTI should be introduced and used immediately, the OCR lowered to lower the exchange rate and give the real economy a break.

Q4: If a DTI policy was used, what would be the challenges and issues that could arise in the detailed rules and (for lenders and the Reserve Bank) monitoring compliance with the policy?

There are political pressures that come with targeting, the better the targeting the clearer the target and that will provoke a response via the political channel. Debts are clear, income associated with that debt might be less clear. Single property owner occupation is a simple case, investment property less clear (I would suggest ringfencing income from the rental property as the income element). Property used as security for business borrowing – very common in small business needs more care, debt to free cashflow in the entity that received the investment could be income factor.

Q5: Do you agree that a DTI policy (if implemented) should be broadly as described above (a speed limit, with similar exemptions to the LVR policy)? Are there other design options or additional exemptions (besides the suggestion described above for relatively inexpensive owner occupied homes) that would be worth considering?

The use of the term speed limit is fine. Exemptions should be limited, problems for first time buyers right now have arisen as price rises have out striped earnings growth – restoring a link between debt and incomes will tend to realign ratios.

Final Comments

The restoration of a linkage between debt and income, thereby limiting asset price rises is a **vital** policy step. Banks make money from debt, people want to have somewhere to live, property is an attractive investment (due to wider policy settings) - a system full of moral hazard crying out for impartial moderation.

The real world is messy, in combination DTI + LVR + OCR offer a subtle and nuanced response to events in the economy and the world. They come with political exposure but the RBNZ is best placed to explain and promote a better approach and what that approach means for the future economic development of New Zealand.

I have seen and the submission from the New Zealand Exporters and Manufacturing Association.

Yours sincerely,

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