Economy Watch

bnz

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Lofty Virtuous Regulations – RBNZ Style

- Saving the banking sector can't be bad
- Global excesses front of mind for Wheeler
- LVRs just might help
- But not at the expense of orthodoxy
- Cash rate still the best tool to fight all inflation

Let's get things straight, from the beginning:

- We are fully supportive of the central bank doing what it can to ensure the integrity of the New Zealand banking system is protected;
- We are comfortable that the recently announced LVR restrictions will help, in this regard;
- We do believe that excessive house price inflation is unwelcome;
- We do think that house prices are "overvalued" relative to standard metrics;
- And we do think that the LVR restrictions will have a negative impact on house price inflation;
- Moreover, we do accept that an overvalued housing market will tend to go hand-in-hand with an "overvalued" exchange rate so reducing the pressure on housing inflation will, all other things being equal, result in a lower currency.

However:

- We still believe that monetary policy orthodoxy is being dismissed too quickly;
- The central bank is tending to use spurious analysis to support its stance
- There are many inconsistencies in the central bank's diatribe.

On Tuesday, all the focus was, understandably, on the specifics of the RBNZ's announcement on LVR restrictions. But in the process, the accompanying speech by Governor Wheeler was largely overlooked yet it contained some very interesting insights into the way the still-relatively-new Governor sees the world.

Before going into the specifics, this, and other missives by the Governor, shed an interesting light on the framework that the new man utilises. His career as a world banker shines through in that he seems to hold in high regard the research of the world's major institutions in that he constantly pays homage to the likes of the IMF and the OECD more so than his predecessors may have done. Wheeler has been "institutionalized" for some time prior to his current appointment so this should be no surprise.

This is neither a good thing nor a bad thing – just an observation. What these entities are prone to being, however, is interventionist. They are often prescriptive in nature and have a need to "do-something". In Governor Wheeler's case, he is probably more aware than most of the dangers of doing nothing (or the wrong thing) given his first hand international experiences during the Global Financial Crisis in his former World Bank role.

For these reasons, the Reserve Bank of New Zealand has moved into the realms of experimentation with its macro-prudential prescription. The Bank accepts that it is in broadly uncharted territory. Earlier this week it said "The macro-prudential policy approach is new for New Zealand, and experience in the use of these policy instruments and the data required to support them are currently limited. This makes the quantification of costs and benefits difficult".

Again, the clear message here is that the Bank is taking an educated guess that what it is proposing will work. In this case "work" is probably best defined by the statement that "The Bank's modeling also suggests that house price inflation could be 1- 4 percentage points lower over the first year. This reduction is expected to arise from reduced competition for houses, a direct lowering of the price that some purchasers are able to pay, and reduced house price expectations as a result of the restriction." In addition, "work" will mean that banks' exposures to high loan to value ratio loans are constrained.

The balance sheet implications will be easy to assess but the counterfactual on the price front will never be known so, we guess, the only reasonable marker would be to see lower house price inflation than we currently have.

What continues to worry us is the Reserve Bank's reluctance to utilise orthodox monetary policy to cure the "problems" that the economy faces. If the Bank really does believe that house price inflation is getting out of control the accepted wisdom is that rising interest rates will be most effective at limiting it.

Remember when all and sundry were arguing that the Reserve Bank should use quantitative easing to lower the currency and boost the domestic economy. The Reserve

Bank rightly responded that there was no reason to do so when orthodox tools remained. Namely, that there was ample opportunity to lower the cash rate if stimulus to the economy was required.

Accordingly, if lowering house price inflation is a priority, why not raise interest rates? Sure, we understand the reluctance to do so given the strength in the NZD and the currently low level of measured inflation but this is a tried and true way of attacking the problem. Is the housing market overheating because the banks are supplying too much credit or is it because the cost of money is simply too low. If it is the latter then 85% of home borrowers and nearly every other borrower in the economy will not be adversely affected by the LVR announcement. In fact, they will face lower interest rates than would otherwise have been the case.

This is important when you take into consideration the fact that the recovery is becoming more broad-based and that growth threatens to push above potential. Moreover, the nature of the expansion makes New Zealand look quite different, cyclically, to most developed economies so wouldn't you expect the NZD to be outperforming and relative interest rates to be higher?

In this regard it seemed rather ironic to us that the opening paragraph in the Governor's speech focused on these strengths, which were then mainly overlooked in the remainder of the text. For the record the opening paragraph read: "New Zealand's economy is now one of the most rapidly growing among the advanced economies. Growth is likely to remain strong and become more broadly based over the next two years, particularly as construction activity in Christchurch, Auckland and elsewhere gathers momentum and provides further stimulus to the manufacturing sector."

The Bank rightly says that "provided loan-to-value restrictions help to dampen house price inflation, they will also assist monetary policy" but only, of course, if monetary policy assists itself. To be fair, we are not yet privy to the Bank's latest interest rate track. It will be published in its 12 September Monetary Policy Statement. This statement will be watched very closely for detail of the RBNZ's estimates of the monetary policy impact of the prudential policy announcements though given there is huge uncertainty as to the likely impact of the recently announced policy measures it's hard to see any meaningful quantification provided. We do know that the RBNZ remains adamant that there will be no rate increase this year. We don't know whether it intends to formally move its first tightening from September 2014 (as indicated in its June MPS) to earlier in the year (as the markets now have it).

We should again make the point, though, that its fears that rate increases might push the NZD significantly higher are probably overdone given that the market is already pricing in 170 points of hikes over the next two years.

We remain bothered that the Reserve Bank continues to promulgate the view that New Zealand is vulnerable to a housing correction based on what happened in such places as the United States, the UK, Ireland and Spain. One would have to first correct for such things as the prevalence of low-doc loans to predominantly low-income people, the impact of adjustable rate mortgages, the fact that LVR's in some cases were well above 100%, the excessive growth of finance sectors, different refinancing obligations and, most importantly, the role of excess supply of housing before making such comparison.

You would be hard pressed to conclude that New Zealand house prices were currently under threat from excess supply. The Reserve Bank suggests that it is able to measure the supply/demand balance as it says that "LVR restrictions would be temporary and would be removed when the housing market had returned to a better balance of supply and demand". So maybe there is some argument to be less perturbed about house price inflation while there are supply constraints?

It does look like house prices are above sustainable values but it's unlikely that price pressure will diminish significantly until such time that there are sufficient new houses built to cope with (a) the stock destruction in Christchurch and (b) population growth.

The time to act on this front may be when supply looks like it is going to get out of hand not when relative prices shift to encourage more construction activity.

The Bank itself does acknowledge that "Rising house prices in Auckland and Christchurch are mainly a result of supply shortages" though it does go on to say "although demand-side pressures are also a factor due to pent up demand, the lowest mortgage rates in 50 years, and aggressive competition among banks for new borrowers, including borrowers with low deposits".

We'd be keen to understand the relativities here. "Most" of the pressure is due to supply shortages, and we believe that the ultra-low mortgage rates are a key factor, so how much impact is the "high" LVR really having? The Reserve Bank says "high LVR lending is a significant factor behind the buoyant housing demand in some regions" but, given the aforementioned, just how "significant" is it in the overall picture.

All things considered then, we restate our premise that we are not opposed to LVR restriction per se but we are worried lest an experimental macro prudential tool becomes seen as a replacement for orthodox monetary policy.

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