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Forces Affecting the New Zealand Economy and Policy Challenges Around the Exchange Rate and the Housing Market

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Thank you for the invitation to meet with you today. I would like to discuss some of the key forces shaping our economy and the challenges they present for businesses and for the Reserve Bank. I will focus mainly on two highly topical areas: the exchange rate and the housing market, but first let me frame them in a broader context.

i) Forces affecting the New Zealand economy

Our economy is buffeted by a range of domestic and international factors. Some are driven by natural events, like the $40 billion rebuild activity in Canterbury, and the decline in agricultural production and spending associated with the drought. Some result from international conditions, like the 20 percent decline and subsequent recovery seen in our export commodity prices over the past 18 months, or the monetary and liquidity policies of major central banks that increase the upward pressure on our exchange rate. Other pressures, such as house price inflation, are driven by supply shortages, pent up demand, and the lowest mortgage rates in 50 years. And others, such as the government's fiscal consolidation, represent major adjustments in domestic economic policy.

At the same time, businesses also face challenges in adjusting to powerful long-term structural changes that are global in nature. These include: the growing importance of China and the East Asia Region as a major pole for global growth and international trade; the global transfer of skill enhancing technologies; the relative decline in the international price of information technologies and manufactured goods; and the rising international demand for highly skilled labour.

Producers therefore have many global and domestic forces to respond to. The success with which they adjust to global structural changes is also influenced by current economic conditions. For example, the challenges faced by producers competing against foreign low-cost producers, or multinationals with global supply chains, increase when our exchange rate overshoots. On the other hand, the high exchange rate makes imports of capital goods cheaper and may encourage the take up of capital intensive technologies.

The interaction of multiple forces can pose difficult policy challenges for the Reserve Bank, although taken in isolation, the direction of their short-term impact on output, employment, and inflation is reasonably clear. For example, the high exchange rate and fiscal consolidation generally exert downward pressure on demand, output growth, and inflation. In contrast, the massive programme of reconstruction in Canterbury, and the increase in house prices and residential construction in Auckland, are boosting demand and output, and tending to exert upward pressure on inflation.

One of the more complex analytical challenges for example, is whether New Zealand can achieve the resource allocation needed for the rebuilding activity in Canterbury and Auckland without seriously damaging its tradables sector. This damage could occur if the relative price changes needed to induce the supply response spilled over into broad inflationary pressures, necessitating tighter monetary policy and creating further upward pressure on the exchange rate. This is one reason why reducing the Government's demand for resources through fiscal consolidation is so important.

I will now turn to the issue of exchange rate pressures and the housing market.

ii) Exchange Rate Pressures

The high exchange rate continues to be a significant headwind for the tradables sector, restricting export earnings and encouraging imports over domestic tradables production.

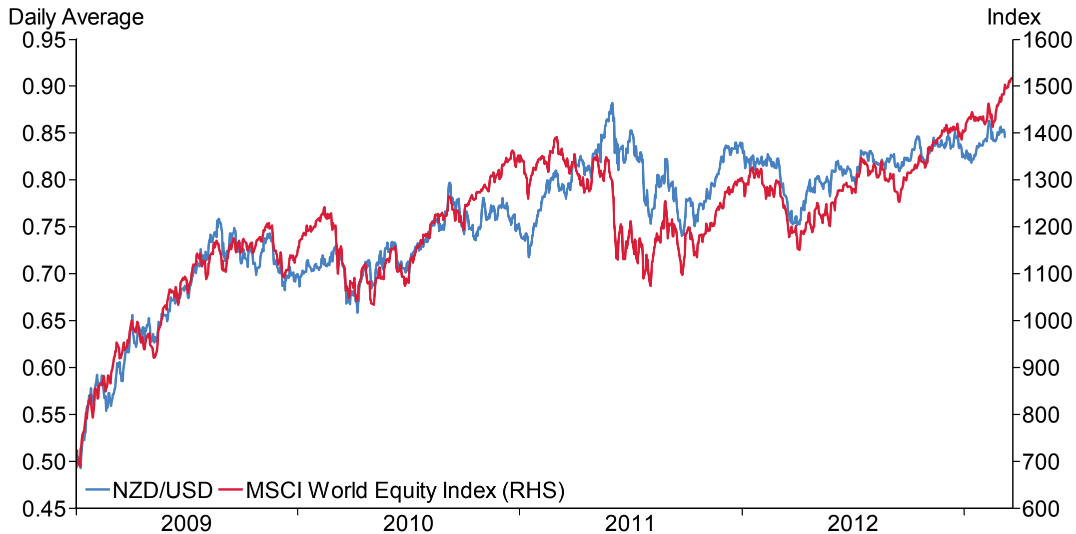
Our real effective exchange rate is about 18 percent above its 15 year average[1]. There are several reasons for this exchange rate appreciation. Foreign investors are attracted by our higher growth, commodity linkages into Asia, and positive interest rate differentials in a low yield world. Our economy is growing more strongly than most advanced economies, our terms of trade are 17 percent higher than their average level during the 1990s, and central banks in countries representing around two thirds of world output currently have official interest rates between 0 and 1 percent. In addition, various types of quantitative easing have added USD5 trillion of assets to central bank balance sheets over the past four years. These policies, which seek to stimulate growth by 'printing money', have negative currency spillovers for attractive investment destinations such as New Zealand that experience foreign portfolio inflows and upward exchange rate pressure.

Fluctuations in investor risk appetite are also an important factor influencing our exchange rate. The surge in global liquidity, and especially that associated with quantitative easing, has led to rising equity markets in several countries. We see this most recently in Japan and the US, where the Nikkei and S&P indexes have increased by 40 percent and 16 percent respectively since the end of 2012.

[1] The real effective exchange rate provides a more accurate picture of competitiveness than the nominal effective exchange rate as it corrects for differences in relative inflation rates (or relative unit labour cost movements) between New Zealand and its major trading partners.

A close relationship exists between the New Zealand dollar and international risk assets such as equities. A rise in the S&P 500 often reflects a broader 'risk on' trading environment that leads to higher exchange rates in the currencies of better performing advanced economies such as New Zealand, Australia, Norway, Sweden, and some emerging market economies. Among the developed market currencies, the Kiwi has been the third strongest performing currency against the US dollar (after the Mexican peso and Swedish krona) over the past 12 months.

Figure 1: NZ dollar and global equities

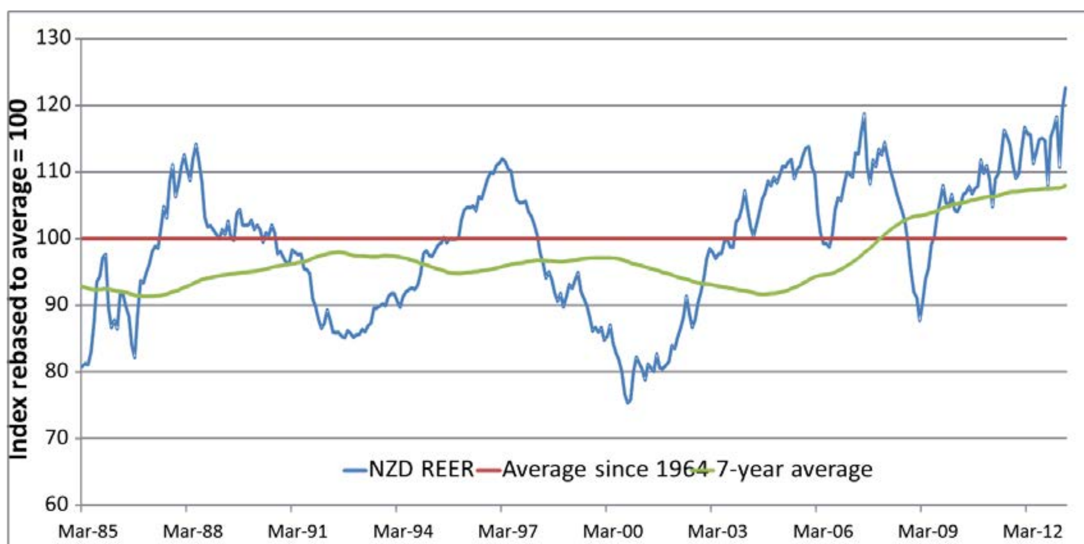


Source: RBNZ, Haver

On 11 April 2013, our exchange rate, on a trade weighted basis, reached a post float high of 79.7. Fortunately it has retreated a little in recent weeks as a result of a stronger US dollar. Investors, however, remain keen to hold New Zealand dollar assets even though, in our view, the exchange rate remains significantly over-valued. For the current exchange rate to be sustainable in the long term, sizeable increases in the terms of trade and/or productivity would be needed.

In mid-2012 the IMF suggested that New Zealand's exchange rate was over-valued by 10-20 percent. The current account deficit is sizeable, and private sector external indebtedness is high. Foreigners already hold 69 percent of outstanding New Zealand government bonds. Investors also appear to downplay the liquidity risks inherent in a small market like New Zealand. Our past exchange rate cycles have exhibited substantial overshooting followed by a sharp and rapid exchange rate depreciation. Such rapid exchange rate corrections reflect the drain in market liquidity that can occur when a small market like New Zealand begins to turn down.

Figure 2: NZ's real effective exchange rate



Source: Bank for International Settlements

Note: BIS real effective exchange rate for New Zealand, broad measure incorporating bilateral rates with 61 economies.

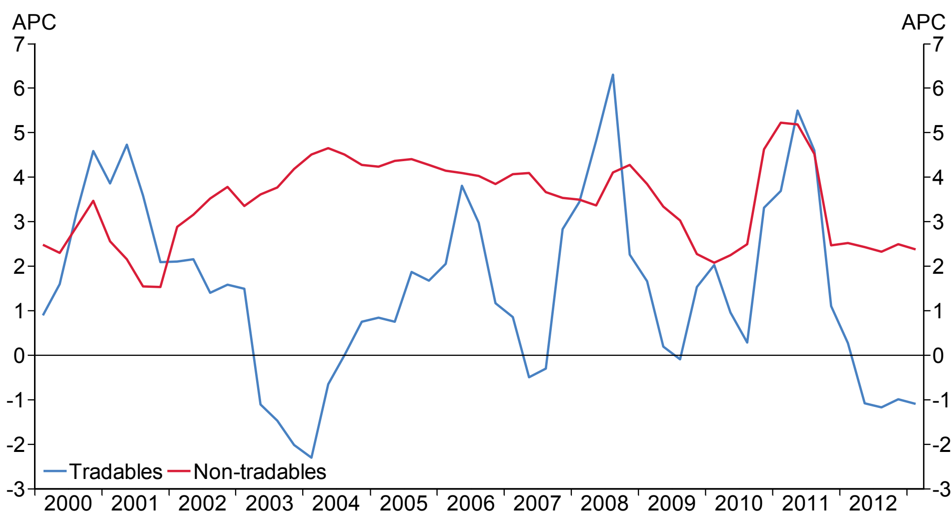
It is, nevertheless, possible that the exchange rate could remain strong for some time. Recent output, demand, and confidence indicators in New Zealand have been favourable whereas key economic indicators in the Eurozone remain grim and there is some uncertainty about the strength of growth in the US. A further surge in global liquidity is expected as Japan endeavours to double its base money supply within two years. And

while the Federal Reserve could begin to cut back its bond purchase programme later in the year, quantitative easing could well increase in the UK and the euro area. In addition, central banks and sovereign wealth funds, which tend to be more long-term investors, have been increasing their presence in the New Zealand market.

The Reserve Bank has been responding to the rising exchange rate through two avenues: in maintaining the Official Cash Rate (OCR) at an historically low level; and through a degree of currency intervention.

The high exchange rate is reflected in the current low level of the OCR. The appreciating exchange rate exerts downwards pressure on inflation in the tradables sector by lowering the cost of imported goods and reducing activity and resource pressure in the tradables sector (tradables inflation has been negative since the second quarter of 2012). This means that the OCR can be set at a lower level than would be the case if the exchange rate had not appreciated as strongly.

Figure 3: Tradables and non-tradables inflation



Source: Statistics NZ

In assessing whether to intervene in the exchange market, we apply four criteria. These are whether the exchange rate is at an exceptional level, whether its level is justifiable, whether intervention would be consistent with monetary policy, and whether market conditions are conducive to intervention having an impact. This last factor is especially important given the volume of trading in the Kiwi. (In the most recent survey – April 2010 – by the Bank for International Settlements, the Kiwi was the tenth most traded currency in the world with daily turnover of spot and forward exchange transactions totalling around USD $27 billion.)

In recent months we have undertaken some foreign exchange transactions to try and dampen some of the spikes in the exchange rate. But we are also realistic in respect of potential outcomes given the strength of the foreign demand for the New Zealand dollar relative to the scale of our intervention capacity. We can only hope to smooth the peaks off the exchange rate and diminish investor perceptions that the New Zealand dollar is a one-way bet, rather than attempt to influence the trend level of the Kiwi. But we are prepared to scale up our foreign exchange activities if we see opportunities to have greater influence.

iii) Housing pressures

Housing has a particularly important role in the New Zealand economy. It comprises almost three quarters of household assets and mortgage credit accounts for over half of total banking system lending. Consequently, housing is a major source of value and of risk to both our household sector and banking system.

In considering the sources of risk around housing, the Reserve Bank focuses on three broad dimensions. First, what are the inflation risks from rising construction costs, rents,

and other housing-related expenditures, and the additional spending from 'wealth effects' associated with rising house prices and households' willingness to borrow against housing capital gains? Second, how well are the banks capitalised in order to protect their balance sheets against a significant fall in house prices, and how serious might the risk be for individual banks and the domestic financial system as a whole? And third, what is the possible impact of a significant fall in house prices on the New Zealand economy? While these three risks relate to both our price stability and financial stability mandates, it is the financial stability risk that concerns us most in the current situation.

The IMF consider New Zealand house prices to be over-valued by around 25 percent[2]. House prices, relative to disposable incomes and rents, are high by international standards, and unlike in some other economies, our house prices did not decline significantly in the aftermath of the global financial crisis. Our median house price is 12 percent above the end 2007 level even though New Zealand experienced the biggest house price boom in its history over the 2003 to 2007 period (and the most rapid house price inflation in the OECD).

We are now into our second major house price cycle over the past decade and house prices, as measured by the Real Estate Institute of New Zealand, rose by 8 percent over the past year (March quarter 2013 over March quarter 2012), and 13 percent in Auckland and 10 percent in Christchurch. Outside these areas, prices rose by an average of around 4 percent, although there is considerable variation among districts.

House price increases are being driven by a combination of supply shortages (especially in Auckland and Christchurch), pent up demand, and the lowest mortgage rates since the mid-1960s. The rise in house prices in Auckland in particular has strong momentum.

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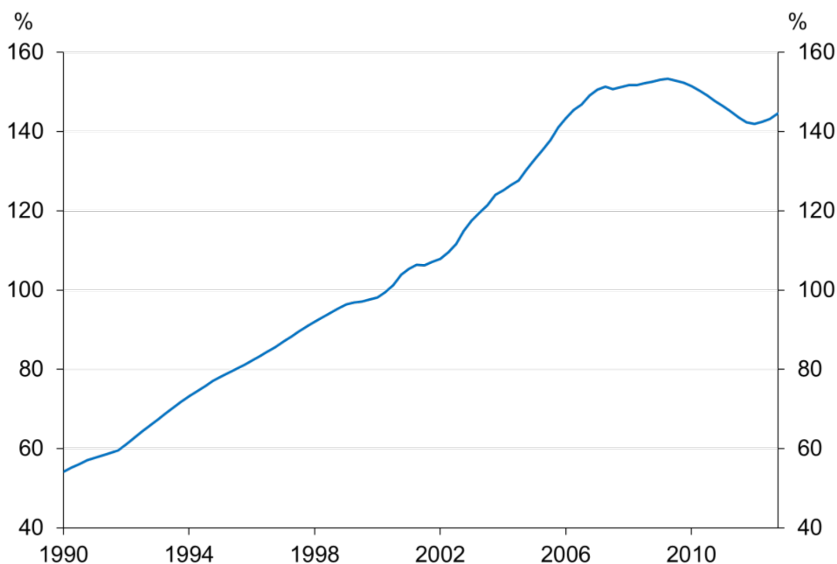
[2] IMF, April 2013, "New Zealand – Staff report for the 2013 Article IV Consultations".

Easy credit conditions mean that the cost of credit is now only slightly above average rental yields of 4.5 percent and this, combined with the rise in house prices, increases the incentive for renters to become first home buyers and for existing house owners to upgrade.

Banks are competing aggressively to meet the demand for mortgage lending. Consequently, the share of mortgage lending to clients with deposits less than 20 percent of the value of the house now comprises around 30 percent of new lending across the five major banks – up from around 23 percent in October 2011. Households remain highly levered with household debt around 145 percent of household disposable income. The correction in the debt ratio after the global financial crisis was gradual relative to the build up over the 15 years prior to the global financial crisis, and the ratio has recently picked up.

Figure 4: Household debt as a percent of disposable income



Source: RBNZ

Despite being over-valued, house prices could continue rising for some time. In this respect, the recently agreed Auckland Accord reflects the growing need to improve the

responsiveness of housing supply. Other measures can help. The adoption of the full range of supply side measures in the Productivity Commission's recent report would lower costs, and the demand for housing could also be moderated by changing the tax treatment of housing to reduce its attractiveness as an investment relative to other assets. But the current supply/demand imbalance in Auckland is very large and it could take several years to address this through supply measures alone.

Adding to the challenge is the decline in capacity in the construction industry in the last five years. According to the latest Business Demographic Statistics, in February 2012 there were 5,000 fewer firms and 14,000 fewer employees in the construction sector than there were in February 2008. Despite this overall decline, construction sector employment in Canterbury had increased by 15 percent. Although the construction sector is a relatively fluid industry and attracts workers from other sectors, the level and pace of construction activity outside Canterbury will no doubt be constrained by the pull of resources into the Canterbury rebuild.

A strong run-up in housing markets can be a risk to future financial stability because it can increase both the risk of a sharp correction and the consequent financial sector disruption. The Reserve Bank is concerned that the current escalation of house prices is increasing the probability and potential effect of a significant downward house price adjustment that could result from a future economic or financial shock. These concerns are shared by the OECD and by the IMF in its recent review of the New Zealand economy, and housing risks have been noted recently by all three of the major international credit rating agencies.

We are responding to the financial stability risks around the housing market in several ways: by raising banks' capital requirements for housing lending; conveying our concerns

about risks to financial stability; and putting in place a framework for macro-prudential policy to address those risks and increase the financial system's resilience.

Earlier this month, following a review of the major banks' housing risk models, we raised the risk weights applying to all current and new high loan-to-value ratio (LVR) housing loans for the four major banks that use their own models to calculate minimum capital requirements. This represents a 12 percent average increase in housing capital (an increase of around $125 million on average) and it should further strengthen the capacity of banks to withstand a housing downturn and encourage banks to review the riskiness of the loans they are writing.

We have been expressing concerns about the financial stability risks associated with the scale of housing lending, and especially high LVR lending, in our published research and speeches, and in our conversations with bank boards, audit committees, chief executives, and risk management teams.

We recently completed a round of public consultation on a macro-prudential policy framework that is aimed at building additional resilience in the financial system during periods of rapid credit growth and rising leverage or abundant liquidity. The instruments can also help to dampen growth in credit and asset prices that might pose risks to financial stability. These measures would require banks to hold additional capital buffers, have higher proportions of stable sources of funding, or limit the share of high LVR lending. Instruments such as counter cyclical capital buffers and overlays on sectoral risk weights are aimed more at increasing banks' capital adequacy rather than increasing the cost of lending for borrowers. Quantitative restrictions on the share of high LVR lending are designed to more directly affect the supply and cost of this type of lending.

Two weeks ago the Minister of Finance and I signed a Memorandum of Understanding confirming the elements of the policy, including the range of policy instruments, and governance arrangements relating to their possible deployment. We are currently working on the operational details for each of the instruments and will soon be consulting with banks on these features.

Macro-prudential instruments directed at the financial sector risks arising from the housing sector have been deployed in several countries (eg., Canada, Israel, Korea, Norway, and Sweden), with weight often put on restrictions around the level of high LVR lending. While there are important design issues to address in devising such measures, the empirical evidence to date suggests that during episodes of quickly rising real estate prices, LVR limits can help reduce the incidence of credit booms and decrease the probability of financial distress and sub-par growth following the boom[3].

One should be cautious in predicting the size of the impact of such measures when house prices are increasing rapidly, but we believe that macro-prudential instruments could have played a useful role in building up capital buffers and reducing credit demand and asset price pressures in the housing price boom of 2003-2007.

iv) The exchange rate and the housing market

The exchange rate and the housing market present difficult challenges for monetary policy when both the currency and asset prices appear to be overvalued and investor demand is expected to remain strong.

[3] Blanchard, Olivier, Giovanni Dell' Ariccia, and Paolo Mauro, April 2013, "Rethinking Macro Policy II; Getting Granular", IMF Staff Discussions Note.

Generally, housing demand can be constrained by raising official interest rates and letting them feed through into higher mortgage costs. However, while this would help constrain the demand for mortgage finance, increasing the OCR would carry significant risks in New Zealand in the current environment. It would increase the interest rate differential between New Zealand and most of the advanced countries, and could lead to a further strengthening in the exchange rate and further downward pressure on tradable goods prices. This would, in turn, be expected to push CPI inflation further below the 1 to 3 percent target range. The exchange rate impact could be pronounced if investors believed that the increase in the OCR was a precursor to further increases and saw New Zealand as leading other countries in the monetary policy tightening phase.

Viewing the issue from another perspective, if our exchange rate continues to strengthen on a trade weighted basis, in the absence of a corresponding improvement in New Zealand's economic outlook, inflation pressures would diminish and a reduction in the OCR might be warranted. However, with mortgage interest rates at a 50-year low, large housing shortages in Auckland and Christchurch, and surveys indicating that home buyers expect price rises to continue, a lower OCR would quickly feed into higher house prices and further increase the risks to financial stability.

This is where macro-prudential policies can play a useful role. Capital and liquidity overlays can help build up buffers in the banking system while adding to the cost of bank funding. And loan-to-value restrictions may help to reduce the actual supply of mortgage lending.

While these measures are aimed at financial stability objectives, their effects might also have the benefits of increasing the degrees of freedom available to the Reserve Bank in conducting monetary policy. For example, if house price pressures abate, all other things

unchanged, it would increase the possibility that the OCR could remain at its current level for longer than through this year, which is the time profile built into the forward projections contained in the March 2013 Monetary Policy Statement. Similarly, if housing pressures are much less of a concern and the exchange rate continues to appreciate and the inflation risk looks low, it may create opportunities to lower the OCR.

Macro-prudential measures can be useful in helping to restrain housing pressures, but they are no panacea. This reinforces the importance of progressing measures to enhance productivity in the construction sector, free up land supply, and examine related tax issues. If the house price and credit expansion begin to fuel excessive consumption spending and inflationary pressures, a monetary policy response would become more likely.

v) Concluding comments

As a small open economy, New Zealand can expect to be buffeted by an array of domestic and financial shocks that are sometimes temporary in nature or linked to longer-term global structural change. But these are extraordinary times. Not only does the economy need to absorb the impact of a significant drought, a major programme of fiscal reduction, and the resource allocation associated with rebuilding our second largest city, we also have to adjust to heavy portfolio inflows that cause our exchange rate to appreciate and reduce the profitability and competitiveness of our tradables sector. And we need to do so at a time when house price inflation is increasing risk in the New Zealand financial system.

Many of these challenges will be with us for some time. The Government's fiscal adjustment is expected to be spread over three years, the Canterbury rebuild is likely to

take a decade or longer, and the housing supply/demand imbalance in Auckland could take three to five years to close if left to supply measures alone. On the external side, New Zealand is likely to be an attractive investment destination for the foreseeable future and interest rate rises in the major economies may be two or more years away. The Reserve Bank needs to achieve its price and financial stability objectives in this environment. Doing so will require us to draw on the full array of policy instruments, including macro-prudential instruments, as appropriate.