



**Reserve Bank of New Zealand's
monetary policy statement,
June 2009**

Report of the Finance and Expenditure
Committee

Forty-ninth Parliament
(Craig Foss, Chairperson)
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Presented to the House of Representatives

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Recommendation

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand's monetary policy statement released on 11 June 2009, and recommends that the House take note of its report.

Introduction

This report outlines the contents of the Reserve Bank of New Zealand's monetary policy statement of June 2009, and details the main issues in relation to the statement that we have considered. Our approach to considering the statement, our membership, and a transcript of the hearing of evidence are included in the appendices to this report.

The 11 June monetary policy statement announced the decision of the Governor of the Reserve Bank of New Zealand to leave the official cash rate (OCR) unchanged at 2.5 percent. The Reserve Bank expects to keep the OCR at or below the current level until the latter part of 2010.

Reserve Bank's rationale

The Governor of the Reserve Bank decided to leave the OCR unchanged at 2.5 percent because he considered the current interest rate provided a degree of stimulus appropriate for the economy at this stage.

The governor considered that the economic outlook remained weak in New Zealand, although there were signs that international economic activity was stabilising, and international financial conditions were improving. The New Zealand economy is expected to begin growing again toward the end of this year, but the recovery is likely to be slow and fragile. The Reserve Bank warned that, if the New Zealand dollar were to remain strong for a sustained period, the projected recovery could be stifled. Many key economic indicators, such as unemployment, are projected to keep deteriorating well into 2010.

The Reserve Bank has noted some clear upside opportunities for activity for the first time in months. For example, there is a potential rebound in household spending and residential investment as a result of net immigration rising and the housing market picking up. However, the Reserve Bank did not believe such a rebound would prove sustainable, given high household debt and the soft outlook for employment, wages, and farm incomes. The bank notes that, on balance, the risks to activity remain weighted to the downside.

Given the weak outlook for the New Zealand economy, the Reserve Bank projects that the annual Consumer Price Index (CPI) inflation will trough at about 0.7 percent in the September 2009 quarter, before rising gradually to about 2 percent by the end of 2010.

Short-term wholesale interest rates and floating mortgage rates

We noted that pressures in the short-term money markets have eased in the past two months. Compared with late 2008 following the collapse of Lehman Brothers, short-term wholesale funding has been much more readily accessible and less costly in both domestic and offshore markets.

However, the Reserve Bank informed us of a growing spread between floating mortgage rates and the OCR. While the OCR has been reduced by 575 basis points from its peak last year, floating mortgage rates have fallen by only about 430 basis points over the same period. There was a notable lack of reaction from the major banks to the most recent 50-basis-point reduction in the OCR announced in April. This was despite the fact that the market had not expected the size of the OCR reduction, and wholesale interest rates fell accordingly following the announcement.

We noted with concern that margins on some lending, particularly floating-rate mortgages, appear to be significantly above historical level, and some partial indicators of business lending rates point to some widening of spreads relative to funding costs.

We are therefore of the view that there is room for banks to reduce their short-term lending rates further. The governor agreed, and stressed that the effectiveness of monetary policy depends on the banks' passing on OCR cuts. However, he noted that banks have to fund from higher term deposit rates in New Zealand, and rising long-term interest rates in the international money markets, which partly reflect the markets' concern about the fiscal deficits in the United States and other major economies.

We asked the governor to estimate how far the short-term interest rates set by the banks were above the reasonable level. Without being prescriptive, the governor noted that margins had gone quite a lot higher than normal and higher than conservative interest-rate settings required. Nevertheless, he suggested that the banks have set their interest rates higher than conservative interest-rate settings would require.

In the light of the governor's comments, we urge the banks to reduce their short-term lending rates further, as a low-interest-rate environment is critical to New Zealand's economic recovery and better reflects the current recessionary conditions.

Drivers for medium-term interest rates

We asked what had driven medium-term interest rates higher, even though swap rates have decreased and central banks have loosened their monetary policies. The Reserve Bank said that the main cause was increased bond yields in key offshore markets, as Governments around the world had embarked on expansionary fiscal policies. For example, fears in the US about the market's ability to absorb increased issuance of bonds exerted significant upward pressure on longer-term bond yields.

However, the Reserve Bank said that the upward pressure on medium-term interest rates had been eased to an extent by the narrowing gap between longer-term interest rates in New Zealand and those in key offshore markets. This narrowing gap arguably reflects the expectation that monetary policy will remain relatively loose in New Zealand for an extended period.

Interest burden on the productive and household sectors

We are very concerned that farmers at present face three major challenges to their financial security—a strong New Zealand dollar, falling commodity prices, and, most importantly, interest costs associated with banks' failure to pass on OCR cuts. We are particularly concerned that the implications of these challenges could affect the rest of the economy. The Reserve Bank considers, however, that these challenges are unlikely to create a sudden shock to the economy.

The Reserve Bank assured us that it is monitoring interest costs for the farming sector closely. However, the Reserve Bank commented that banks and farmers had both willingly increased their lending and borrowing significantly in the past two years, despite the Reserve Bank's warnings.

We encourage the banks to recognise the national importance of lowering interest rates because unduly high interest costs could lead to the closure of businesses that may be fundamentally sound but may be experiencing short-term liquidity problems due to the current economic environment.

Trading banks' profit margins

We asked whether the banks' profit margins reflect a willingness by the banks to share the burden of the recession. The Reserve Bank considered that, as a measure of the banks' willingness to share the burden, the margins between lending and borrowing would be more relevant than banks' profits. Profits depend not only on the margins between lending and borrowing, but also on other elements, such as provisioning against bad debts, which is expected to increase in the next year.

We were interested in the reasons for the banks' decisions to increase their margins between lending and borrowing. The Reserve Bank commented that the banks had increased their equity capital to a level significantly exceeding the regulatory requirements and were trying to maintain high profitability in order to keep strong credit ratings in the presence of economic uncertainty. Nevertheless, the Reserve Bank acknowledged that the interest margins were high.

We recognise the need for the banking sector to remain profitable in the current economic environment, but we also believe that it should not be unduly so, particularly given the current recessionary environment. We are concerned that this may be the case at present. The Reserve Bank assured us that it would try to ensure that profit margins do not increase because of lack of competition. We believe the Reserve Bank should also continue to pressure the banks not to widen the margins between lending and borrowing unjustifiably.

Reserve Bank's tools

Given that some banks have not passed on the most recent OCR cuts to borrowers, we asked how the Reserve Bank has been applying pressure to banks to reduce their interest-rate margin. The governor said he had talked to chief executives of banks about the wide gap between the OCR and their interest rates, and was considering discussing it with the banks' boards of directors. He asked banks to weigh the interests of the shareholders against those of the New Zealand economy. However, he noted that banks ultimately determine their own interest rates.

We noted that, under sections 36 and 93 of the Reserve Bank of New Zealand Act 1989, the Reserve Bank has the power to require financial institutions or registered banks to supply information under certain circumstances. Under section 94 of the same Act, the Reserve Bank may require that the information supplied by a registered bank under section 93 be audited. The governor told us that it has not invoked the powers under these sections because banks have been co-operative in supplying information. He further commented that the power under section 93 should be invoked only for the purposes of prudential supervision and maintaining financial stability.

We noted that, under section 95 of the Reserve Bank of New Zealand Act, the Reserve Bank may require a registered bank to produce a report on its corporate, financial, prudential, and operational matters. The Reserve Bank told us that it has invoked this section in the past for the purposes of prudential supervision and maintaining financial stability, but not for other purposes.

We were also told that the Reserve Bank had not approached the Minister of Finance in relation to the powers under sections 101 and 113 of the Reserve Bank of New Zealand Act. Under section 113, the Reserve Bank, with the consent of the Minister responsible for the administration of the Act, may give a registered bank a direction under certain circumstances. Under section 101, the Reserve Bank may instigate an investigation of the affairs of a registered bank for the purpose of determining whether or not to exercise the power conferred under section 113.

We asked the governor whether he has considered using his powers to set capital adequacy requirements in order to influence banks' behaviour. The governor responded that he had considered doing so in the past, but not in the context of attempting to encourage banks to reduce their interest rates.

We asked whether the Reserve Bank should be given more power to ensure that banks reduce their interest rates in response to OCR cuts. The Reserve Bank suggested that the powers under the Reserve Bank of New Zealand Act are large enough to have unexpected, distortionary effects if used unwisely. The Reserve Bank cautioned against regulating interest rates.

Strong New Zealand dollar

We were interested in the reasons for the recent appreciation of the New Zealand dollar. The Reserve Bank considered that it could be explained partly by downward pressure on the US dollar. Also, currencies of commodity-based economies, such as New Zealand, Australia, and South Africa, appear to be relatively attractive to investors because of the perception that commodity-exporting countries are more sensitive to stronger global growth and commodity price gains.

We are concerned that New Zealand's economic recovery may be jeopardised if the New Zealand dollar remains strong. The Reserve Bank suggested that a relatively strong New Zealand dollar could lead to a premature recovery in the non-traded sector, and would not be conducive to improving New Zealand's export performance and current account balance. The New Zealand economy needs a weaker New Zealand dollar to achieve export-driven growth.

We considered whether the strength of the New Zealand dollar was partly due to the fact that the OCR and short-term interest rates in New Zealand are relatively high compared with other developed economies. We therefore asked the Reserve Bank's view on whether the OCR should have been cut further to stop the resurgence of the New Zealand dollar. The Reserve Bank was of the view that reducing the OCR by a further 25 basis points would not have had a significant effect on the exchange rate. Some other OECD countries, such as Canada, continued to have strong currencies, even though their official interest rates were near zero.

We would be concerned if carry trades, which draw "hot" money from overseas to New Zealand in pursuit of relatively high short-term interest rates, could place undue upward pressure on the New Zealand dollar. However, the Reserve Bank did not regard carry trades as a driver of the present currency movements because the current market environment, which is highly volatile, is not ideal for carry trades.

We understand that an unduly strong or excessively volatile New Zealand dollar would not be conducive to New Zealand's economic recovery. We are confident that, when the Reserve Bank makes decisions on monetary policy, it will take into account the possible interactions between interest and exchange rates.

We note that there is a current debate regarding the importance of domestic interest rate influences on the exchange rate, relative to other international factors such as investor risk preferences. We believe that this is an issue that deserves further careful consideration. If banks are not fully passing on OCR changes in a timely manner, this could reduce the effectiveness of the OCR as a monetary policy instrument, and potentially feed into interest rate and exchange rate interactions.

Risks to economic growth

We noted that the Reserve Bank expects the New Zealand economy to have an export-led growth in the year ending March 2011. The Reserve Bank was confident that commodity markets had "bottomed out", as they looked stronger now than they did six months ago. It also noted that commodity-based economies were performing better than economies that focused on manufacturing or financial activities.

We found it interesting that the Treasury's economic forecasts were more pessimistic than the Reserve Bank's. The Reserve Bank explained that it assumed exports were likely to resume growth sooner than did the Treasury. The Reserve Bank also pointed out that there was a gap of more than one month between its forecasts and the Treasury's. Because of the uncertainties in the current environment, economic forecasts can be highly variable.

We asked the Reserve Bank to specify the major risks to the New Zealand economy in the next six months, and explain how they could be mitigated. The Reserve Bank considered that the New Zealand economy could be at risk if the New Zealand dollar remained relatively high or banks did not pass on OCR cuts. While the Reserve Bank admitted that its ability to influence the exchange rate was limited, it believed that banks would eventually pass on OCR cuts if the Reserve Bank continued to pressure them to do so.

Despite the economic uncertainties affecting the reliability of economic forecasts, we note that a weaker New Zealand dollar could be conducive to export-led economic growth.

Although the Reserve Bank is limited in its power to influence the exchange rate, we believe that the macroeconomic environment will be more favourable if banks pass through OCR changes in a timely manner.

Savings

We asked the governor what would happen to the interest rates for deposits and to savers' behaviour if the banks decreased their mortgage interest rates. The governor suggested that interest rates for deposits might decrease as a result, but noted that they are still relatively high by international standards. The governor thought there would not be a reduction in saving behaviour as a result of a decrease in interest rates, because many people tend to save as a matter of precaution.

We noted that competition between banks for savings has pushed up interest rates for deposits. The Reserve Bank was not concerned at this phenomenon, as it believes interest rates should be determined by the market.

Housing bubble and capital gains tax

We are concerned that a housing bubble may develop, since the housing sector has shown signs of recovery recently. The Reserve Bank shared our concern, and commented that the re-emergence of a housing bubble would not be conducive to improving the New Zealand economy.

The Reserve Bank told us that, in relation to the exclusion of any consideration of a capital gains tax, it had expressed its view that it would be useful to consider the neutrality of tax treatment for property investments vis-à-vis other forms of investment.

Fiscal policy

We asked the governor's view on the Government's fiscal policy. He commented that the Government's fiscal policy had good timing over the past year, as an increase in government spending coincided with the international downturn. He also expects the latest Budget to be considered to be sound by OECD standards.

Appendix A

Committee procedure

We met on 11 and 24 June, and 1 July 2009 to consider the Reserve Bank of New Zealand's monetary policy statement released on 11 June 2009. We heard evidence from the Governor of the Reserve Bank, and received advice from our independent specialist adviser, Ulf Schoefisch.

Committee members

Craig Foss (Chairperson)
Amy Adams
David Bennett
John Boscawen
Brendon Burns
Hon David Cunliffe
Aaron Gilmore (from 24 June 2009)
Raymond Huo
Rahui Katene
Peseta Sam Lotu-Iiga
Stuart Nash
Dr Russel Norman
Chris Tremain (until 24 June 2009)

Evidence and advice received

Reserve Bank of New Zealand, *Monetary Policy Statement*, June 2009.

Briefing paper, prepared by specialist adviser, dated 11 June 2009.

Supplementary information on New Zealand banks' interest rate margins, prepared by the Reserve Bank of New Zealand, dated 17 June 2009.

Summary of past 12 quarterly Monetary Policy Statement examinations, prepared by committee staff.

Appendix B

Corrected transcript of hearing of evidence 11 June 2009

Members

Chris Tremain (Acting Chairperson)

Amy Adams

David Bennett

Brendon Burns

Charles Chauvel

David Cunliffe

Stuart Nash

Hekia Parata

Allan Peachey

Paul Quinn

Staff

Meipara Poata (Clerk of Committee)

Bertrand Ngai (Report Writer)

Simon Poole (Committee Support)

Witnesses

Dr Alan Bollard, Governor, Reserve Bank

David Drage, Manager, Financial Markets (Research)

Tim Hampton, Head of Forecasting

Tremain Welcome, Dr Bollard. It's a pleasure to have you here. The floor is yours; you know the drill. I think you've met most of the members around the table; I won't waste your time by introducing us all again. The floor is yours. I'll get you to give an intro to the current statement, and we'll hand it over to members. Thank you.

Bollard Thanks, chairman. As you will know, this morning we released our monetary policy statement, and it was a story that had a forecast around it that shows that for the first time we're not continuing to get these nasty downward surprises in our international trading partners. That's the big change this time. We have had more certainty from northern hemisphere, Europe, and American forecasters. We broadly see a picture where they're pulling out of recession early next year. The balance of risk overseas is still to the downside, but we have had increasingly positive news out of countries like China, and, of course, out of Australia, although the recent Australian data about: "Did they avoid a recession or not?"—we do need to remember they're actually measuring something a little bit differently, and

on production GDP figures I'm not sure that they're different from our numbers.

We consequently see our price for exports picking up a little bit. We do have a story of commodity prices that look like they've bottomed out and are picking up a little bit. There is still a little bit of uncertainty around some of the more recent dairy price auctions. We have a short-term recovery coming off that. It's actually helped by the fact that imports are much weaker in this forecast than they were before. That leads to a current account improvement from around negative 8 percent to around negative 6 percent this year. There's a bit of a risk that that could be short-lived, and the main reason for that would be what would be determined by what happens around the exchange rate. The exchange rate is not doing quite what we might like in terms of wanting to see an external rebalancing of the New Zealand economy, and there is a risk that it stays higher and longer. In fact, as you'll see in our forecast, we put in a scenario where that happens so that we can track through what it looks like having an impact on recovery.

The financial markets internationally have been recovering in a way that we didn't quite expect, and that has been a picture whereby equity prices have been pushing up quite a lot. Bond prices have been pushing up, so long-term interest rates are pushing up, and the US dollar is looking a lot weaker, and that has been the dominant thing that has been feeding through on to the New Zealand—and a lot of other OECD country—accounts.

Funding for banks looks significantly eased and improved. We are very pleased about that, and that is a real improvement from the last few months that we've observed. Partly as a result of that we would say that we think, despite the fact that we kept rates on hold this week, that we still believe there is room for banks to cut their short-term rates, bearing in mind that they haven't moved since our last 50 basis point cuts in the April OCR review.

The business sector is still very weak in New Zealand, and so investment looks weak. Employment is now declining: we are seeing unemployment growing, and we expect to see it going up around the low 7s by later next year. We've been a bit surprised by the strength of migration, which will also feature into housing markets. As a consequence of those things we are seeing a pick-up in housing market turnover at the minute. We do question whether we might be seeing a bit of a pick-up in the housing market more generally. Certainly, we haven't seen business consents grow, and we're not really seeing residential investment growing yet, but there is a bit of a picture of the possibility of a short-term—but probably not sustainable—housing recovery coming through.

The overall effects of all of this: we think that we'll get growth in New Zealand in the latter half of this year, but it won't feel like a particularly strong growth story to a lot of people, because it will be a period when

unemployment is still picking up. As I have said, we've held the interest rate at 2.5 percent.

Chairman, I am very happy to answer any questions. To assist I have David Drage, who is head of our financial markets (intelligence), and Tim Hampton, who is head of our forecasting.

Tremain Thank you, Dr Bollard. I'll just kick it off before I hand it over to the Opposition. There has obviously been a lot of interest in this committee's report out on the financial stability exercise that we conducted recently. Just taking your point that you made that the funding for banks seems to have eased quite significantly, and you still see quite a lot of room in the short-term rates or movement downwards, despite the fact that you haven't lowered the OCR. I would just be interested in your comments, then, around what the banks have come back with in terms of their arguments against the ability to drop those short-term rates; they talk about that the rates are higher than their overseas borrowing costs, rising deposit rates, and the fact that they are reflecting higher lending risks.

Bollard As the committee clearly knows, the story for the banks has been a complicated one. It has been a difficult time in the banks over the last 6 months. They really saw what they thought were pretty stable sources of funding closing up on them late last year, and that was quite a shock. As a consequence, they turned quite conservative, as you might expect, as a result of that. However, we have now seen three of the four big banks going out into the overseas term markets and successfully raising funds at high-risk premiums, but reducing on what they were a couple of months ago. That is very pleasing to see; it means those markets are starting to open up.

They have had to deal with the fact that long-term rates internationally are rising. That is partly a reflection of the fact that the markets are concerned about how they fund the US deficits, and all around the world financial institutions are having to deal with those higher longer-term rates. In addition, they are getting a big pick-up in domestic savings. We think that's a very good, desirable feature, and they're paying quite a lot for that. So they're paying unusually high rates for term deposits in New Zealand.

Despite that fact, however, our short-term rates have gone down a long way, and we feel, when we take into account the weighted average cost of raising funds, that their margins are going up, and that they do have the opportunity to cut rates at the short end—floating and short term. We appreciate it's a complicated equation; I don't think we're looking at it too simplistically. I do think it's time when the banks have to look, as they ride through this recession, just how much pain will be borne by their shareholders and how much will be borne by the New Zealand economy. In our view it is very important that we continue to see orthodox monetary policy working. That does rely on the banks passing on the OCR cuts. They've been doing that very satisfactorily up until recently, but, as I say, it didn't happen in April. They really need to examine that themselves.

- Cunliffe Thanks, Governor. Just following on that line for the moment, you said in April that the banks passing through OCR cuts was—I think the quote was: “out of line with your expectations”, and you’ve said, more recently, that the movement in costs and rates doesn’t fully explain the relative lack of movements in interest rates at the short end, and I think you’ve repeated those conclusions today. What is the latest data telling us about the banks’ sources of funding? We were advised back in March that the proportion of offshore funding was actually falling, and that there was therefore no reason to offset holding up domestic rates for those increased offshore. Any comment?
- Bollard Well, they have been able to access some term funding overseas; they’ve got some way to go yet. They’ve also been accessing parent funding via the Australian banks. We’ve seen, however, the average tenor of funding go shorter. We want them to push that out, and they want to push it out themselves. So we’ve still got a long way to go to see them getting their average funding back to the sort of terms that we’d all feel more comfortable with, but things have definitely moved better in that direction.
- Drage Well, probably the other thing specifically within that is that we’ve seen one of the key features of the last 2 to 3 months has been increased investor appetite globally for corporate bonds again, and that’s been particularly evident.
- Cunliffe I think we can see that from your report, and we’ll come on, I think, in a minute to the external impacts. But just looking at those short-term rates at the moment, on the basis of your analysis, roughly how much too high, on average, are short-term interest rates—say, as a percentage?
- Bollard We’ve avoided trying to calculate that in simple terms, because it isn’t really a simple equation, but we do notice that margins have gone quite a lot higher than normal and, we even feel, higher than conservative interest rate setting would require.
- Cunliffe Are you aware that Federated Farmers have surveyed some several hundred of its members and have imputed an unnecessary loan cost of around \$450 million per annum to the farming sector, and on the same basis estimates placed the households’ mortgage cost at around \$2 billion per annum of unnecessary mortgage cost?
- Bollard Yes, we’ve seen those numbers; we haven’t tried to corroborate them. Of course, New Zealand farmers have been very willing to access that funding, and they did it at higher rates—
- Cunliffe Some of them are quite—
- Bollard —for the last couple of years.

- Cunliffe Let's move briefly to: so what are you doing about it? You were quoted this morning as saying that you could "talk to banks but can't do anything much more." One commentator, Brian Fallow, said that rather than cut the OCR again, you've had another go at moral suasion or jawboning. What tools have you been using in terms of putting pressure on the banks to make good on sharing the burden with the rest of the economy?
- Bollard Well, first of all we have reasserted that we think there is room for them to move and that we are keeping the OCR low. That's not a cast-iron commitment from us but it's a pretty strong view from us that the OCR is going to stay where it is, not just temporarily but well into late next year. That should give them a lot of room. On the banks themselves—we've been discussing this with the banks. I've been talking to the chief executives. I may go further and talk to the boards. It is still their decision to make on these things. I'm asking them to weigh up the two sides to this equation: their shareholders versus what the New Zealand economy needs to get through this. We do have other powers in the Reserve Bank of New Zealand Act, but they're quite heavy ones.
- Cunliffe Let's come on to some of those. Section 36 of the Act gives you the power to require financial institutions to supply information—for example, assets and liabilities, income and expenditure, interest rates charged and payable on their wholesale finance. Have you used any of those powers in your conversations with the banks or indicated that you might consider using them to get the quantitative detail you need to get a precise fix on the amount of gouging that's going on?
- Bollard We have not used those powers. We haven't had to use them. We are getting the cooperation we need in terms of supplying information at the moment around margins.
- Cunliffe Well, clearly, Governor, we are not getting the kind of cooperation that we need, because you've just told us that banks are unduly keeping short-term interest rates up and—
- Bollard I said we're getting cooperation around the information we need.
- Cunliffe Have you used or indicated that you might consider using the powers under section 93 of the Reserve Bank Act, which allows you to obtain information for the purposes of prudential supervision—corporate, financial, prudential, or other?
- Bollard Well, under that section and a couple of other sections, including section 101, I think, of the Act, we can obtain information. We're not restricted on obtaining information at the minute, but you do need to be cautious about that part of the Act, because it is there for prudential supervision / financial stability purposes. So to properly use those powers we would have to think there is a financial stability issue.

- Cunliffe Governor, the briefing I've got indicates that section 101 and section 113 have different provisos on them than section 36 and section 93 that I've mentioned. Also section 94, the power to require a bank to be audited, can be used without a threat to the financial stability of the system as a whole. Have you indicated any willingness to use the audit power to chase down the level of gouging that's going on on short-term interest rates?
- Bollard Well, not at this stage. We're not actually calling it gouging, either.
- Cunliffe No, sorry; those are my words, not yours—reluctance to lower short-term interest rates resulting in unnecessary cost to farms, businesses, and households.
- Bollard No, we haven't, because we are getting the information that we require from the banks.
- Cunliffe Governor, have you considered using section 95 powers in the Reserve Bank Act to require the banks to produce a report for you on this matter?
- Bollard Section 95s have been used with the banks, but for financial stability reasons, for prudential reasons.
- Cunliffe But the Act doesn't prohibit you from using section 95 on a matter such as interest rate management?
- Bollard Well, I'd need to consult section 95 subclause details to answer that.
- Cunliffe OK. My briefing may be incorrect, but my understanding is that section 101, which is the power to investigate the affairs of a bank, and section 113, the power to give directions—let us come on to that. Under section 113, if you were to direct the banks in any way to comply with what you consider reasonable interest rate management, you would need the consent of the Minister of Finance to use that power. Have you approached or signalled to anyone that you might consider approaching the Minister in respect of that power, and what response have you had from the Minister, if any?
- Bollard No, I haven't approached the Minister on that or section 101 powers.
- Cunliffe Have you considered using the powers on capital adequacy requirements, including capital ratios, as a means of incentivising proper behaviour from the banks?
- Bollard We have considered that, but not particularly with regard to cutting interest rates. We have considered that more broadly in the sense of when banks we felt were lending very liberally and whether we would use that to help slow them down, in addition to monetary policy. We went so far as doing a simulation on banks as they were 2 years ago, to see what that would involve. The fact is that isn't at all a sensitive tool, partly because banks, quite reasonably, hold enough capital to meet changing market conditions,

and they are holding capital at the moment a lot in excess of regulatory minima.

- Cunliffe I want to venture slightly to an opinion question here. The policy targets agreement between yourself and the Minister of Finance, successive Ministers of Finance, at 1b requires you to promote a growing, open, and competitive economy, and 4b requires you to implement monetary policy in a sustainable, consistent, transparent manner—and here is the key line—avoiding “unnecessary instability” in other things, including “interest rates and the exchange rate.” Do you feel that, potentially at least, banks’ reluctance to pass through appropriately short-term interest rate cuts might go to the stability of interest rates or exchange rates?
- Bollard No, I don’t think so. That says: don’t allow unnecessary volatility in those variables. That isn’t really what we’re talking about here. We are talking about mainstream monetary policy, getting through, and having stimulus.
- Cunliffe That was really just to get that on the record. Do you therefore ever wonder whether there was a case for broadening the policy targets agreement to make more explicit your prudential powers over the banks in the case where ordinary New Zealanders who are struggling to pay their mortgages are, in my words, potentially being gouged by extremely profitable financial institutions; where our farmers, who are suffering volatile commodity prices and exchange rates and high interest costs are paying hundreds of millions of dollars—potentially—too much? Do you think you’ve got all the powers you need to play the role that New Zealanders expect of you, to crack down on that behaviour?
- Bollard Well, I think New Zealanders have to be realistic about this. I don’t think changing the policy targets agreement is going to do much about that. Are the powers in the Act? Well, there are powers there; they’re not exactly atom bomb powers but they’re very big powers that could have unexpected, unforeseen, and distortionary effects. We do need to remember that the last time that regulators or the Government tried to tell banks where to set interest rates was back in the days of Robert Muldoon, and I don’t think any of us wants to go back to that sort of thing.
- Cunliffe Could it therefore be said, Governor, that if the powers in the Reserve Bank Act are currently too broad, you need finer instruments in that Act which would allow you to take more incremental steps in turning up the heat on the frog in the jar before it boils?
- Bollard We have surveyed what sort of powers might be there. I mean, the fact is I don’t think central bankers have really invented the sort of powers or instruments around the world that would do much better than what we’ve got there at the minute. But that’s not to say that banks shouldn’t be exposed to the full light of inquiry as to how they’re setting these.

- Cunliffe Just one final supplementary, Mr Chairman, if I can, because it relates to that sentence. In the full light of inquiry, how would you feel if Parliament were to seek to shine some sunlight on banks' accounts and take them up on the request, I think, that Westpac made to have an opportunity to testify to Parliament on its side of the story?
- Bollard I think it would be very helpful if the select committee were to hear from the banks on this.
- Tremain Just further to where David Cunliffe's been questioning you on in terms of the short-term rates. Obviously that goes to one of the statements you made about if the exchange rate stays where it is now, it will actually mean a recovery takes longer. Your words were: if it stays at these levels it will put the recovery at risk. There is a view out there that you should have cut the OCR again rather than just trying to jawbone the short-term rates down. I'd be interested in your comments around that because clearly our farmers need that exchange rate realigned.
- Bollard Yes, I have heard that view. We disagree with it. We don't actually think that it would have had very much effect on the exchange rate if we were to push down another 25 basis points. We've been pushing down and pushing down, and we achieved a lot of that through the OCR. In support of that, I'd point to other OECD countries that have pushed down their rates further and still are suffering the same sort of currency problem—Canada being one of those, with rates almost at zero. They are still getting pressure on the Canadian dollar, because what's happening is it's the US dollar weakness.
- Cunliffe We've still got time remaining. Supplementary to that exact point, how do you react to the argument that because there is a still a significant differential between Australian and New Zealand OCR rates—with ourselves at 2.5 percent and the European average at 1 percent, the UK and Sweden 0.5 percent—there is still hot money flushing into the New Zealand economy, chasing and rolling over on those short-term rates? It's not that we've got Belgian dentists here for 5 years, but we've got them often for 3 or 6 months. That's putting undue upward pressure on the exchange rate, and is potentially dampening the recovery that we all need at a time when our producers are also suffering unnecessarily high interest rates.
- Drage Probably the thing to bear in mind at present is that those so-called carry trades are much more problematic for traders in the current environment, with volatility in markets being very high. We've tended to find that that's not generally a driver of currency movements. It's tended to be more relevant growth costs.
- Cunliffe It has been a significant issue in the past, but not so at the moment?
- Drage Not so at the moment.

- Cunliffe I note from your document, page 9, you're showing about a 40 to 45 percent reduction in the 3-month LIBOR spreads on short-term rates, which presumably means that it is now perceived as less risky for inter-bank borrowing on short-term funds. Is that a correct interpretation? The swap rates have gone down?
- Drage Yes.
- Cunliffe If that is the case, and if equity indices have risen significantly—your figure 3.1—and if Governments around the world, perhaps apart from our current Government, are embarked on expansionary fiscal policy, and if central banks are embarked on relatively easy monetary terms, what exactly are the drivers for increased pressures on medium-term rates? Is it simply competition for funds? How do you measure the impact of that locally?
- Drage Well, there are two factors there. Probably the main factor driving these rates higher is increased bond yields in the key offshore markets, particularly the US, where, undoubtedly, fears about the ability of the market to absorb increased bond issuance is putting significant upward pressure on those longer-term bond yields. But partly offsetting that has been some narrowing in the spread between longer-term rates in New Zealand and those in the key offshore markets, which arguably reflects the expectation that policy will remain relatively easy in New Zealand for an extended period.
- Cunliffe My final supplementary on that question is have you quantified what the net impact of the interaction between the short-term spreads and those medium-term rates should be on medium-term domestic rates? Have you quantified what the impact should be, and if you have not, why not? If you have, how have you?
- Drage Well, the main way in which we assess the level of those longer-term spreads is looking at how they line up with relative monetary policy expectations in New Zealand and in key offshore markets. For the most part, those spreads have moved very much in line with those relative policy expectations. So from that perspective—
- Cunliffe I'm sorry to exhaust another supplementary, but the Government—
- Tremain That was the end of it.
- Bennett Supplementary to that, when we're talking about the impact of Government policy, you mentioned in your document that the movement away from tax to more infrastructural development is potentially going to have a bigger impact for our economy going forward. How do you relate that to your high growth figures that you're looking at, coming through in your document?
- Bollard There's bit of export growth, but there's actually more negative import growth—if you can imagine that. Imports falling away contributes to GDP, but also Government spending contributes, as well, and some of that is

current spending and some of that is infrastructural spending. So it's underpinning growth out there in the future.

- Bennett OK. And do you see that exchange rate height that we're at as being a big problem that will go into your growth figures going forward?
- Bollard Well, we're more concerned that it might lead to a premature recovery in the non-traded sector of the sort that we just saw before but really wanted to get away and get a rebalancing of. It makes it much harder to get an export-driven growth, which is clearly what the New Zealand economy needs. We need to get the current account down, and that is going to require a softer exchange rate.
- Bennett You mention that you're looking for that export-led growth and you expect that to come, say, next year. What basis do you have that on when you're looking at international markets, which are looking pretty tight at the moment, and you're not expecting a great demand in some of our big markets?
- Bollard We do have some confidence that those markets have bottomed out and they're showing a little bit of growth. The commodity markets, across a wide range of commodities, are looking a little bit stronger than 6 months ago, so that gives some confidence on that. It doesn't apply evenly across all products, but the commodity economies are doing better than the manufacturing economies and the financial economies, and that helps us.
- Burns Dr Bollard, I'd just like to pick up on the issue of concerns for the productive sectors. If banks do continue to fail to pass on cuts, as farmers have identified, there may be \$450 million that they see in costs attached by the failure to pass on those rates. There is a triple whammy going on though, because they have got that, they've got the dollar continuing to trade high into the sixties, and you've also got falling commodity prices—projections in the same story that referred to the bank rates of dairy returns perhaps dropping to \$3.80 a kilogram. I just wondered if you've got some concerns that if banks continue to take that hard-nosed attitude and we see farmers coming under real pressure, some who've geared it highly—in that environment where you talked about banks lending very liberally—and are unable to make their payments, and if banks continue to take this hard-nosed attitude, we will see real consequences for our productive sector, which will filter out across the whole of the economy.
- Bollard There is a risk there, and we are monitoring that quite closely. Of course, I think both banks and farmers have to come to terms with the fact that they were both willingly increasing borrowing and lending a lot over the last 2 years. At times we were making warnings about that. It took quite a while for that to come off, nevertheless. So they both did that knowingly; they should bear the consequences of that. We don't think the risks are so great that they're going to have a sudden stock effect through the economy. We are watching that quite closely.

- Burns But if we're having a difficulty in trying to get banks to acknowledge what we see as a national interest issue attached to lowering interest rates, what guarantee do we have that they will take cognisance of that when it comes to potential for closures in the productive sector?
- Bollard Well, you don't have any guarantees other than their own self interest, and it's not really in their interests to get to a foreclosure stage. The banks are being, I think, more intelligent about managing some incipient bad debts this time, and the corporate sector generally has much better balance sheets than the late 1980s and early 1990s, which was the previous period of banking stress. So we are not expecting that sort of impaired asset story that we saw back then.
- Burns It could be argued it is in their interest and the national interest for them to be playing a better game on the interest rates front. As recently as last night even the Prime Minister was saying the interest rates could be lower if banks tried a bit harder.
- Bollard Absolutely.
- Adams Dr Bollard, I just want to come back to the exchange rate. You've talked about the recent increase in the exchange rate being surprising, and, equally, a central plank of your projections going forward seemed to be based on the fact that you see that falling away quite quickly. I just want to explore that a little bit more, but also ask you where you see this as having come from, given that you've talked about other overseas countries having similar currency situations now, so you're discounting the OCR impact and what New Zealand's doing on that. But, equally, it seems to me in your report that you're linking some of that exchange rate growth in the net migration figures and things that are relatively specific to New Zealand. So where has it come from that it has taken you by surprise, and just explain to us a little more what you're basing your projection of that falling away again, because obviously that is so central to the export led recovery—commodity prices won't help us; it's being eaten up in the exchange rate.
- Bollard There were a lot of words in that question, but perhaps I could ask Tim Hampton if he could answer it.
- Hampton In terms of the second component, about what is it that's driving our assumption—and it is very much an assumption—about where the exchange rate is going, as the Governor has outlined we think a recovery in the New Zealand economy that is driven more by net exports is going to be a lot more sustainable than a recovery that's driven by the household sector. So that's the projection that we've worked around—so we've got a consistent one. It is quite conceivable that the exchange rate does remain high, and, yes, you do end up with the scenario that you outlined of a weaker economy down the track.

- Adams But you've made a projection in the report of the exchange rate falling away, so what would that be based on?
- Hampton That is an assumption.
- Adams Based on?
- Hampton That's an assumption based on the view that at some stage in the future the New Zealand economy is going to have to revert to being more net export driven rather than being household driven. This assumption works on the idea that that's going to happen over the next year or so. It's quite possible, as outlined in the scenario in the box, that that might be 2 or 3 years down the track before that happens.
- Adams The first part of that question was really just asking you: where has this come from? You talked about it taking you by surprise. Now, with the benefit of hindsight, is it just the net migration and that early recovery in the household spending that you think is driving it, and is that the case globally?
- Hampton No, I think really what's going on is the extent to which the US dollar, in particular, has come under pressure, where the international markets have taken a view that the US economy needs to adjust, and part of that adjustment is through a weaker US dollar. So that's part of the story. The other part of the story is, as financial markets internationally have stabilised to some extent, market participants are coming back and going: "OK, where do we want to invest our money?". Commodity countries such as New Zealand, Australia, South Africa: those look relatively attractive in a world where perhaps the world is going to start recovering. That's fine so long as the world does continue to recover.
- Nash Dr Bollard, I just note in your commentary around the rebound in the housing market, small though it may be at the moment, and whether you have any concerns about that being something of a false bubble? Goodness knows, we've seen enough of that in the past with housing. Allied to that, what were your views of the exclusion of any consideration of a capital gains tax measure by the current review of taxation as prescribed by the Government?
- Bollard In answer to your first question, yes, there is a risk that it's a false bubble or false dawn. That wouldn't be helpful from the New Zealand economy, and we hope that doesn't happen. On taxation, well, we've expressed our view that we do think it would be useful for the group under the auspices of Victoria University that's looking at tax reform at the moment to consider neutrality for investment in property vis-à-vis other forms of investment, and they've been very interested to hear from us on that. So I think that is well within their review, actually.

- Nash Thank you, Dr Bollard. I'll keep it reasonably simple. What do you see as the three major risks to the New Zealand economy in the next 6 months, and what can you do or are you doing to mitigate those risks?
- Bollard That's not simple! Well, number one, I guess, is the exchange rate delivering us an unhelpful international price. Number two would be seeing that the interest rates don't get passed on to keep monetary policy providing the stimulation. Number three would be some combination of numbers one and two; they're the big things that are out there for us. On the exchange rate we are frankly limited in what we can do. On interest rates we think that some pressure on the banks will show dividends.
- Peachey If the banks start taking a hint and dropping mortgage interest rates, what impact do you expect that to have on the rates that are being paid to savers, and is there a point where savers may start turning their back on banking?
- Bollard Well, I mean, it's absolutely right that there's a link between rates paid for deposits and rates charged for loans, so you could see some payback there. I think New Zealanders are saying at the minute that they want to save, and we're encouraged by that. The rates they're getting, actually, in international terms, are very good. They're a lot less than they were 2 years ago, but they're still very good compared to what they'd be getting in most countries. Is there going to be a shortage of people wanting to save? I don't think so. I think a lot of people want to do that from a precautionary basis. At the minute the feel for savings is a little bit distorted by the Government's deposit guarantee scheme as to where you put your money. That will need to resolve itself in the medium term.
- Peachey Are you concerned about the impact on it? There's a bit of competition out there in terms of interest rates and saving. I heard a figure of 4.5 for 120 days the other day. Are you concerned about that?
- Bollard No, we think that should be delivered by the market. There clearly is competition for savings at the moment.
- Chauvel Just two quick questions. You said in response to a question from David Cunliffe that you were getting the sort of information that you want from banks at the moment. Is that including the analysis of whether or not their profit margins at the moment are reflecting any willingness to perhaps share the pain, or the burden, right now?
- Bollard Well, as I know you understand, profits will depend not just on the margins between lending and borrowing—which is really, I think, the issue here—but they're depending on a number of other features, including their trading activities, and, of course, depending on what they see as provisioning necessary for bad debts. There's no doubt that bad debts are picking up at the minute from very, very low levels to medium sort of levels, and they're provisioning for that, and that's going to increase over the next year or so. So that is going to be a call on their profitability. We're not focused on their

- profitability; we don't really think that's the issue. We think borrowing and lending margins are much more to the point. But we want to have a profitable banking sector in New Zealand. An unprofitable banking sector is a worry. We don't see that worry. At the minute we think we do have a profitable one. We see one where we think there's room to work on those margins.
- Chauvel So you don't want an unprofitable sector.
- Bollard Absolutely.
- Chauvel You don't want an unduly profitable one either, where that has had its consequences—
- Bollard Well, we would look to try and ensure that wasn't coming about as a result of lack of competition, if you saw that sort of thing.
- Bennett Do you think it's a case that the banks are actually increasing their asset base as their capital through that margin, rather than their vulnerability so much, just so that they're in a position going forward? Do you think that that's what they're after? If so, you're saying that you can get money on the international market now which has freed up, which they didn't have that problem before. Have they got a reason for doing that?
- Bollard Well, they certainly increased their liquid funds, and that was through the difficult period—end of last year, early this year—when they were quite nervous about things. They've certainly increased their capital considerably beyond our regulatory requirements. That's because they're interpreting the market as saying that's what you need to keep that sort of credit rating in these quite fragile times. So, yes, they have been building those up. But what I'm saying abstracts from those. Nevertheless, the margins do look pretty high.
- Chauvel Just on one other issue. The Treasury forecasts or projections seem quite a bit more pessimistic than the New Zealand banks, just going by the Budget documentation. Do you know what the reason is for the difference in the two sets?
- Bollard I would say we're a little bit more optimistic than Treasury.
- Chauvel Quite a bit more.
- Bollard Well, some of that is real, some of it's nominal.
- Hampton In terms of the main difference, we do have exports coming back sooner than they do, and that's supporting business investment. The world that we're projecting is very uncertain, and it's very easy to change your assumptions and come up with a weaker outlook than the one we've got.

- Chauvel So obviously there's a risk that Treasury might be more right on this sort of stuff, and that the recovery might take longer?
- Bollard There's always that risk.
- Quinn Well, Charles has already answered it, but if you go to 11-12, there's a one point spread in terms of your GDP forecast, and in 10-11 there is, in fact, almost a 2 percent spread.
- Bollard Sorry, what are your references?
- Quinn Your GDP growth figures are significantly—I mean, in terms of 10-11 it's a plus 2 spread, which is significant. It's almost over-optimistic from Treasury's point of view, given that the forecasts have only been done a month apart, at most.
- Bollard Well, I think they might have been a little more than a month apart, given the time that Treasury needs for cut-off to get it to the Budget, so there is a bit of time between that. I am sure as an ex-central banker you will recall days when there's a lot of variability around these forecasts, and these confidence intervals are very wide.
- Quinn We used to resolve them.
- Cunliffe I just want to clear up a teeny-weeny bit of confusion that goes to Mr Chauvel's first question. I've heard that you're getting the information you need from the banks, so you haven't considered using any of the many powers under the Reserve Bank of New Zealand Act to require the provision of information, and I've also heard you say, I think, that you can't put an exact number on the profit margins or excess interest rates being charged—that it's a judgment question. I find it difficult to square those two, because it's basically a mathematical question. Can you help me with my confusion? Have you got all the information you need, or would you like more, and if you have got it, why can't you tell us?
- Bollard No, we've probably got the information we need, and we've achieved that without having to use those powers. The information about profit margins—well, we haven't been focused on corporate profits; we've been focused on margins. We've got a lot of information about margins. If the committee is interested, we can provide the sort of material that I think you might be interested in on those, provided only that I can assure myself that we have the legal powers to pass them on, I think. The stuff I have in mind, we probably can.
- Cunliffe That would be helpful for our report, to maintain the climate of sensitivity.
- Tremain Just in wrapping up, Dr Bollard, and thank you for being so frank with us this afternoon, can you comment on the Government debt track that we are currently projected out, in conjunction with the firming of our credit rating, and also the fiscal stimulus that's coming out of that, out of this Budget. I

understand 3.3 percent is about where we were at, at about this time last year. Are you comfortable we are in a relatively good position?

Bollard The fiscal story for us is one where we have seen quite a bit of increase in spending over the last year or so, and for whatever reason that was put in place, that's actually turned out to be quite good timing because it has coincided with the international downturn. We also would concern ourselves if we were to see that increase in spending just continuing in a big bow wave, because then it will actually exacerbate the recovery. We don't think that's happening. We think that the Budget delivered a fairly clean cut-off to that, and so from our point of view, for whatever reasons, we think we've got quite helpful fiscal policy through this period, and I suspect that will turn out to be pretty good by most OECD countries' standards—fiscal policy, of course, traditionally having a problem about being lagged through the cycle; we don't think that's happening, so it has been helpful.

Tremain Thank you very much for your comments. They are much appreciated.

conclusion of evidence