Reserve Bank of New Zealand's Monetary Policy Statement, June 2013

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Paul Goldsmith, 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, June 2013, and recommends that the House take note of its report.

Introduction

This report summarises the contents of the Reserve Bank of New Zealand's Monetary Policy Statement, June 2013, and the central issues we discussed with the bank in our examination. Our approach to considering the statement, our membership, and the transcript of the hearing of evidence are set out in the appendices to this report.

The June 2013 Monetary Policy Statement announced the decision of the Governor of the Reserve Bank to maintain the Official Cash Rate (OCR) at 2.5 percent. As at the last review in March, the governor indicated that he expects the OCR to remain at this level throughout 2013.

Reserve Bank's reasoning

The decision to keep the OCR unchanged reflects the Reserve Bank's judgement about the balance between the various forces shaping New Zealand's economy at present. Particular features are the gathering pace of post-earthquake rebuilding, and rapidly rising house prices in Auckland and Christchurch—both of which are exerting upward pressure on inflation—and the sustained strength of the New Zealand dollar, together with the Government's programme of fiscal consolidation, which are moderating the effect of these forces on prices and economic activity. The result is that inflation remains subdued, at 0.9 percent, but the Reserve Bank expects it to rise to about 2 percent by 2016.

GDP growth is picking up, but unevenly. The Reserve Bank expects it to rise from its current 2.5 percent to about 3.5 percent by the second half of 2014. The main driver is the Canterbury rebuilding. The drought is estimated to have reduced growth by 0.5–0.75 percent of GDP. The unemployment rate is forecast to fall below 5 percent over the next few years.

The New Zealand dollar is expected to remain elevated, acting as a headwind against the economy's recovery. The Reserve Bank projects that it will moderate gradually in the medium term as the outlook for the major Western economies improves and they return to more orthodox policy settings. The current account deficit is projected to increase to about 6 percent of GDP in 2014/15.

Alternative scenarios

The Reserve Bank's central projection assumes that both house price inflation and the exchange rate will moderate from early 2014. However, the monetary policy statement explores two alternative scenarios: one where domestic demand, including house price inflation, turns out to be stronger than assumed, and one where the exchange rate remains

higher than assumed, for reasons other than an improvement in the New Zealand economy. In the first scenario interest rates would rise more quickly than in the central projection, which would cause the exchange rate to appreciate further, and the current account deficit to increase. The second scenario would see interest rates reduced; this would stimulate household consumption, including imports, and would boost momentum in the housing market. The current account deficit would also deteriorate in this scenario.

Policy tools

We note that recently elements of both of the scenarios described above have been occurring simultaneously, with overvaluation of both house prices and the exchange rate. The opposing pressures on interest rates have been cancelling each other out, avoiding the need for an OCR adjustment, but nevertheless causing deterioration in the economy's underlying balance. In particular, they make it difficult to counter the inevitable increase in the current account deficit that will result from post-earthquake rebuilding.

We believe this situation increases the importance of other policy measures by both the Government and the Reserve Bank, as monetary policy poses a dilemma for the Reserve Bank at present: increasing interest rates to dampen the housing market would risk further currency appreciation, while lowering the OCR could fuel consumption.

The Reserve Bank has been continuing to develop macro-prudential policy measures, including possible restrictions on high loan-to-value ratio (LVR) lending, for addressing risks to financial stability stemming from the housing market. We understand it will decide about the possible use of these measures after it finishes consultation with banks in July.

We asked the Reserve Bank whether such macro-prudential measures are still considered unorthodox. The governor said thinking has changed considerably since the global financial crisis. The view that central banks should not intervene to prevent housing bubbles, but should simply stand by to pick up the pieces when they burst, has largely been discredited. Macro-prudential tools are being used in at least five countries—Norway, Sweden, Korea, Israel, and Canada—generally in the form of restrictions on loan-to-value ratios. In the Reserve Bank's view, they are now seen as important complementary tools that should be available to monetary authorities.

Rebalancing savings and investment

The current account deficit—in effect, a measure of the shortfall between New Zealand's savings and investment—is projected to rise from 4.7 percent of GDP at present to about 6 percent of GDP in 2014/15. The monetary policy statement notes that the need for capital from overseas to fund this shortfall underpins the high value of the New Zealand dollar. We asked the Reserve Bank whether this leaves New Zealand in a vicious cycle, as the dollar's strength reduces export earnings, making it harder to clear the deficit.

The Reserve Bank said that current account deficits of 5 percent of GDP or more, and a relatively overvalued dollar, have been a worry for New Zealand for some 40 years. While it believes the financial markets will continue to be prepared to finance the deficits needed for Canterbury's reconstruction, the problem will need to be addressed for the longer term. In its view, monetary policy is not well suited to addressing such issues, as they are structural rather than cyclical. Resolving the problem will require changing people's incentives to save and consume, relative to New Zealand's investment needs.

We asked whether the projected widening of the current account deficit, combined with inflating house prices, is repeating earlier patterns or whether the current situation is different, as the Minister of Finance maintains. The Reserve Bank said a key difference is that the previous cycle entailed a massive consumption boom: for every $1 a household earned, it spent $1.09. The balance between consumption and savings has been improving; at present, the savings rate is just slightly negative, and the bank is projecting that it will stay at about zero over the next three years.

The bank observed that a difficulty in reducing the current account deficit is that much of the investment required to rebuild Christchurch will be in buildings, both residential and commercial, and in infrastructure, that will not deliver a financial return.

The housing market

House prices have increased 9 percent nationally in the year to April 2013. This average is based on rapid rises of 14 percent in Auckland and 11 percent in Christchurch, with increases averaging 4 percent in other regions. At our hearing with the governor we heard that Auckland prices are currently growing at 15 percent.

In its central projection, the Reserve Bank expects the rate of increase to peak soon at 10 percent nationwide, assuming no use of macro-prudential policy tools. However, it describes the possibility of stronger house price inflation as a key risk in its forecasts.

High loan-to-value lending

The bank has expressed concern for some months about the property market heating up, and particularly about the willingness of banks to lend against low equity. It has been talking with banks in the hope that they will voluntarily limit the amount in new mortgages they lend at high loan-to-value ratios. We are concerned by reports that in the March quarter, 71 percent of new mortgage lending by one of the major banks, with significant exposure to the Auckland market, was at high LVRs. We asked the Reserve Bank if this suggests its efforts at persuasion are not working.

The Reserve Bank told us it does not discuss the behaviour of individual banks, as it concerns itself with risks to the banking system as a whole. In its view, it is not unusual for intense competition among the four major banks to mean that in any given month one or two of them will adopt more aggressive tactics to gain market share. Taking the industry as a whole, however, it said the average remains fairly constant among the major banks—30 percent of new lending tends to be at LVRs of 80 percent or more—although they differ in the stock of high-LVR loans on their books. What is of concern is how this low-equity lending has increased from an average of about 23 percent 18 months ago. The Reserve Bank says it does not keep regional data, but it appears that most recent high-LVR new mortgage lending is in Auckland.

We asked the governor to explain why such lending is of concern, if borrowers have the capacity to service and repay their debt. He said both debt-servicing capacity and the loan-to-value ratio are important; the former affects the likelihood of a borrower defaulting on a loan, while the latter determines how much a bank would get back in the event of default. While banks take both into account in assessing the level of risk in their portfolios, the Reserve Bank looks at the market in aggregate, to see how such lending is affecting the level of risk in the financial system as a whole, and therefore its stability. The governor said the Reserve Bank's aim is to avoid the type of situation the US found itself in after the

crash of the late 2000s, when fully a quarter of the country's 50 million mortgages had negative equity.

Policy measures to ease housing pressures

As in our last meeting with the governor in May, we explored the likely effectiveness of various policy measures to cool house price inflation and bridge the gap between supply and demand.[1]

The governor said analysis by the IMF indicates that restrictions on high-LVR lending can help to slow the rate of house price increases, but cannot prevent or cure a bubble in the housing market. He recalled that OCR increases amounting to 325 basis points had been required to cool the last housing bubble in the mid-2000s. He noted that the gap between supply and demand is large: the Auckland Housing Accord estimates that roughly 13,000 houses are needed annually over the next three years. With construction running at about 4,500 a year, he noted, any other measures to bridge the gap, such as proposals by the Productivity Commission to improve productivity in the building sector, would be helpful. He also supports proposals in the Auckland Unitary Plan to free up more land outside the city limits and allow infill housing.

Some of us drew attention to the OECD's recommendation of a capital gains tax, and asked the Reserve Bank to provide an estimate of the amount of change in the OCR that would be needed to equate to the effect of a hypothetical 15 percent capital gains tax on properties other than the first home. The Reserve Bank responded after our hearing that countries with formal capital gains taxes do not seem to have been any more immune to large cycles in house prices than those without, such as New Zealand. If such a tax were introduced, it believes that in the transition period there would be some dampening impact on house price inflation, and on short-term inflation expectations; this effect would be larger if the upward pressure on house prices was led by investors, and smaller if it reflected underlying population and supply pressures.

Foreign ownership of housing

We followed up our previous discussion with the bank about data indicating the extent to which purchases by non-residents are influencing the housing market. We were told that the available data comes from surveys of real estate agents; its usefulness and reliability are very limited, as it includes purchases by New Zealanders currently living overseas, and foreigners coming to live in New Zealand, as well as more speculative purchases by non-residents. The proportion of non-resident ownership of housing appears to be about 2.5 percent nationwide, and 5 to 10 percent in Auckland. We understand there is no firm evidence to support reports of a significant element of Chinese investment. The Reserve Bank said it appears that Europeans account for a fairly high proportion.

Some of us consider that, rather than relying on data from real estate agents, a land register should be established to record more accurately the extent of foreign ownership. The governor told us he has no strong view on the issue.

Canterbury reconstruction

Consistent with the Treasury's projections in the *Budget Economic and Fiscal Update 2013*, the monetary policy statement now expects $40 billion to be spent on repairs and reconstruction in Canterbury, up from $30 billion in the March statement. This would be

[1] See our report dated June 2013 on the *Reserve Bank of New Zealand's Financial Stability Report, May 2013*.

equivalent to 20 percent of GDP, spread over a decade, with activity rising to a peak in about 2015/16, when it would contribute about 2 percent to the GDP growth rate. The bank notes that the extent to which the rebuilding will increase inflation is uncertain at this stage; it will depend on the efficiency and flexibility of the construction industry, and how well the work is coordinated. While its central projection assumes that construction will proceed in an orderly way, it notes that the inflationary impact could be much larger if demand pressures are allowed to accumulate.

Construction costs

The monetary policy statement shows that construction costs in Canterbury increased by about 12 percent in the year to March 2013, compared with less than 2 percent in Auckland and about 3 percent nationwide.[2] We were told that the bank is not concerned about such relative cost increases, as shifts in relative prices are a normal way the market signals incentives for labour and resources to move to where they are most needed. As well as Christchurch, Auckland will also see major construction activity over the next decade. The bank would, however, be concerned if price increases spilled over into other regions as more generalised inflation.

Some of us remain concerned that the decision to use Fletcher Construction as sole project manager for the Earthquake Commission's rebuilding programme will inevitably contribute to cost increases as it is, in effect, a legalised monopoly. The Reserve Bank said the Ministry of Business, Innovation and Employment is the more appropriate agency to comment on such matters. It understands that the ministry is examining costs of construction materials and the potential for more providers. Some of us believe the ministry should seek a Commerce Commission inquiry into the lack of competition in building supplies.

Lending to smaller businesses

We are interested in access to credit for small and medium-sized businesses. The monetary policy statement notes that banks' funding costs have been reduced, and their profitability has been improving. We recall that in the wake of the global financial crisis banks introduced a "term liquidity premium" on their business lending. We asked the Reserve Bank whether banks have been passing on the reduction in their costs by lowering this premium, or whether this is one reason for their improving profitability.

The Reserve Bank said it is not unusual for SMEs to pay a risk premium on top of banks' base rates. While the risk spreads charged by banks widened after the financial crisis, they have returned to more normal levels. It considers that small business lending is growing at a reasonable rate. We sought more information, as we have heard that some SMEs have been finding it very difficult to access credit, even with prepaid export contracts. The Reserve Bank agreed that it can be difficult to secure a loan against cash flows; most SME borrowing is secured against property. Following our hearing, the Reserve Bank informed us that recent data suggests that system-wide SME lending growth has been low, with average monthly growth of 0.2 percent over the last six months, compared with 0.6 percent for the previous six months. It told us this reflects the fact that some businesses are continuing to de-leverage, which is at least partially offsetting the growth in lending to business borrowers seeking new or additional funding.

[2] *Monetary Policy Statement, June 2013*, p. 21, figure 4.20.

Deposit insurance and open bank resolution

We asked whether the Reserve Bank has revised its views on deposit insurance, noting that the OECD's recent country report recommended that New Zealand should adopt an insurance scheme to limit depositors' losses in the event of a bank failure. It described the Reserve Bank's open bank resolution policy as a novel approach, but did not consider it a complete alternative, suggesting that deposit insurance was important as an additional safety valve. The Reserve Bank said it has always acknowledged that there is a case for deposit insurance, but it is not clear-cut. There are also arguments against deposit insurance from the point of view of moral hazard. The Reserve Bank's policy is that open bank resolution will help to reduce such risks, and that deposit insurance is not appropriate at this point.

Appendix A

Committee procedure

We met on 13 and 26 June 2013 to consider the Reserve Bank of New Zealand's Monetary Policy Statement, June 2013. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O'Donovan.

Committee members

Paul Goldsmith (Chairperson from 26 June 2013)
Maggie Barry
David Bennett
Hon Clayton Cosgrove
Hon David Cunliffe
John Hayes
Hon Todd McClay (Chairperson until 25 June 2013)
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Jami-Lee Ross (from 26 June 2013)
Hon Kate Wilkinson

Appendix B

Corrected transcript of hearing of evidence 13 June 2013

Members

Paul Goldsmith (Deputy Chairperson)
Maggie Barry
David Bennett
Hon Clayton Cosgrove
Hon David Cunliffe
Paul Foster-Bell
Claudette Hauiti
John Hayes
Dr Russel Norman
Phil Twyford
Andrew Williams

Witnesses

Graeme Wheeler, Governor
Grant Spencer, Deputy Governor
Dr John McDermott, Head of Economics

Goldsmith Welcome, Governor, and your team to the committee, and we are very keen to hear your summary of the situation and then to have an opportunity for members to question you. So, welcome.

Wheeler Thanks very much indeed, Chair. I will be brief, but first let me introduce John McDermott, who's the Assistant Governor and Chief Economist at the bank, and on my left is Grant Spencer, who's the Deputy Governor and the Head of Financial Stability.

There are multiple forces shaping the New Zealand economy. The major ones are the changing global economic outlook, the scale of the Canterbury rebuild, the impact of the drought, the programme of fiscal consolidation that the Government has under way, the high exchange rate, and the buoyancy of the housing market in Auckland and Christchurch. We think the New Zealand economy is currently growing at about an annual rate of around 2.5 percent, but activity is very uneven across sectors. A key driver behind the growth is the Canterbury rebuild and the expectation that we will see more residential construction in Auckland.

Despite having fallen in recent weeks, the New Zealand dollar remains overvalued and is creating headwinds in the tradable sector. We're seeing rapid house price inflation in Auckland and Christchurch, and we don't want to see financial or price stability compromised as a result. Our

forecasts suggest that the economy will be growing at around 3 to 3.5 percent annual rate by the end of 2014, the unemployment rate would be around 5 percent, and inflation around the midpoint of the 1 to 3 percent target range.

So, given this outlook, we expect to keep the OCR unchanged through the end of the year. Thanks very much.

Cosgrove GDP figures appear to be relatively flat going forward. Do you have any comment on that?

Wheeler They appear to be—

Cosgrove Relatively flat or stable going forward. Do you have any comment on that?

Wheeler GDP growth—well, you know, we think the economy, as I say, is growing at around 2.5 percent at an annual rate. It was growing at around 3.5 percent in the second half of last year. We think that it's slowed down primarily because of the drought, which we think is probably around a 0.5 to 0.75 percent impact on GDP, but we anticipate that a number of factors will cause the economy to grow more rapidly towards the second half of next year.

Cosgrove Those factors being?

Wheeler Well, we're anticipating that by the middle of next year the economy will be growing at around 3.5 percent in real terms.

Cosgrove And those factors being?

Wheeler Well, the factors that are pushing it are the Canterbury rebuild, which is very significant—it's 20 percent of GDP, $40 billion in real terms, spread over, perhaps, a decade. But by 2015-2016, we're probably at a peak level of activity there, so we're building up towards that peak and that will be contributing, we believe, something like 2 percent of the growth that we will see.

The other thing is, you know, we've got low interest rates, the lowest mortgage rates in 50 years. We're seeing some expenditure effects coming from the rising house prices that are starting to come through into consumption. So there are several factors, and, more recently—and it is recent, but nevertheless welcome—we've seen some reduction in the exchange rate.

Cosgrove Could I ask you a couple of questions around bank lending rates—the LVR. You expressed a pretty vigorous view last time that you were talking with banks to ensure their LVR levels were heading to an appropriate level—heading south. The advice we have is that ASB is somewhere in the 71 percent range, while others are moving south. Can you give us a view on that? Is the jawboning not working—no disrespect? Why are they different from the pack?

Wheeler Well, I think if you look at it overall in terms of, say, the four major banks, the high loan-to-value ratio lending above 80 percent represents about 30 percent of total lending. Now that's increased from around 22 to 23 percent

of total lending 18 months ago, and we think that very intense competition for high loan-to-value lending is really putting some upward pressure on the house prices. I mean, you've got Auckland house prices currently growing at 15 percent.

Cosgrove No, but specifically I'm talking about ASB, because they seem to be the outlier. Others are moving south; ASB appears to be moving north—

Wheeler Let me check with Grant on individual—

Spencer We prefer not to talk about individual banks, individual names. We've never done that in the past, and we prefer to stick to that. We talk about the banking system and what's happening in aggregate, but not individual banks.

Cosgrove I take your point, but it is out there. It is public knowledge, and you have been reasonably vigorous, you told us last time, in engaging with the banks to ensure those levels are appropriate. We're advised there's one outlier—one's heading north, that is the ASB; it's not a State secret—and the others are heading south. I'm just struggling as to—is the jawboning not working? Is ASB not listening?

Spencer I wouldn't say there are any particular outliers amongst the major banks.

Cosgrove So my hypothesis is wrong and I've been badly advised, because what I am advised is that the other majors are heading south and these guys are heading north and it's around the 71 percent—

Spencer If you go and look at the statistics over, say, the past year, you'll find that in any given month, one or two banks will be more aggressive than the others. So they'll tend to take market share for a couple of months and then back off a bit. So that mix of aggression, if you like, in the market between the banks varies from month to month.

Cosgrove Could you tell me if I'm correct—without naming the bank then, although it is all out there? What's the gap between that particular entity, if it's around 71 percent in outlier in terms of LVR?

Spencer In terms of LVRs, you know, they're all —

Cosgrove What's the average, then?

Spencer Well, the average is 30 percent. For the industry, as Graeme said, 30 percent of new lending is high LVR. In terms of differences between banks, the main difference is on the existing book—the LVR proportion in the existing book, as opposed to new lending. And there are some differences there between banks. But at the margin they all have around that 30 percent mark of new lending.

Hayes Could I ask you, please, could you please lay out what your concern is, because if you look at life from the point of view of a banker and you're loaning money, you're concerned about the borrower's ability to pay, and it doesn't matter a damn whether it's a high or a low LVR; the issue is, is the person going to honour the obligation of paying back the money? So why are you targeting high LVR, when, actually, surely, the borrowing is

dependent on the borrower's capacity to repay the money they've borrowed?

Spencer Well, the debt service capability, I agree, is certainly a significant factor in assessing the risk of a loan, but the loan-to-value ratio is also a significant factor. In particular, debt service will tend to influence the probability of default, but once a loan is in default, the amount of money you're going to get back, from the bank's perspective, is very much dependent on the LVR, because if there's been a downturn you may not get all your money back. So both are important risk factors.

Hayes So isn't that a commercial risk on the part of the bank, when they're going into the market?

Spencer Definitely, they're taking both of those factors into account. What we've said is that, you know, while the banks are managing their own risks from their own individual portfolio perspective, they don't actually see the effect on the whole system. They don't see the effect of their behaviour on the whole market, which is then coming back and affecting the risk of all of the banks. That's our job.

Wheeler Maybe if I could elaborate on that. We've got a situation here where house prices in New Zealand are overvalued. The IMF says it, the OECD says it, the central bank says it. You've got a challenge with house prices in Auckland growing at 15 percent and in Christchurch at 11 percent. This increases the financial stability risk for the banking system as a whole. I lived in America for 15 years and I watched house prices go up quite substantially over the period 2003 to 2007. The global financial crisis came along. America has roughly 50 million mortgages, right—50 million mortgages—and 25 percent of those had negative equity a year or two after that crash. That is what we need to avoid in this country—the risk that that could happen, depress household incomes, and put the economy into serious damage.

Hayes We had it here in 1987.

Cosgrove I won't labour the point, but I suppose I'm just seeking some factual checking here, and maybe you aren't at liberty to give us an explanation now and you could provide us with something in writing, but I'm still struggling with the 71 percent of one bank when others are heading south. I don't quite understand. What I'm trying to seek from you is a view as to, one, is that correct, and, if it is correct, where you see that, given the average is around 30 percent, why is there an outlier? Either I'm not correct—but that's the advice we've got—or, if I am, I am seeking an explanation about that.

Wheeler We'll come back to you in writing if we need to, but let me indicate what my understanding is. That is, for the system as a whole, amongst the four major banks, the average of high LVR lending is 30 percent of total mortgages. That tends not to vary a great deal between individual banks. What does vary is the stock of their portfolio of high-value lending. So they're at different levels in terms of the stock that they have currently on

the books, but the flow in terms of mortgages that they're writing is 30 percent currently in terms of annual mortgages that they're printing, and that tends not to vary much between the four banks, because they compete aggressively.

Bennett Perhaps just to help Clayton—

Goldsmith Is this a supplementary question?

Bennett Yes, to help Clayton. On a regional basis, do you do any differential there? Do you see the rates in the Auckland region quite different from, say, the Wellington region? Do you notice any of that change?

Spencer Well, we don't collect that data specifically on a regional basis, but, from talking to the banks, it's pretty clear that a high proportion of the high LVR lending is in Auckland.

Cosgrove Thanks for that, I'm always gratified. Just in respect of the term liquidity premium that SMEs pay, plus their margin, do you have a view as to whether that's being rolled out ad infinitum or is it supposed to be there as a stopgap, as it were? Are SMEs being dealt to in terms of the term liquidity premium?

Spencer To my knowledge of the pricing, it's not unusual that the SMEs are paying a risk premium over and above the base rates.

Cosgrove That's generally in times of difficulty. Do you have any evidence where this is being rolled out just because the banks can get an extra margin?

Spencer No, I don't see any unusual behaviour in this regard. I mean, post the GFC, I think there was a big increase in risk spreads and there were concerns that they were being pushed out too far, but now that lending is getting going on a more normal basis, and small business lending is growing at quite a reasonable rate, in fact—

Cosgrove Could I test you out on that, because the feedback—and others may have different feedback—I get from SMEs is that unless you've got bricks and mortar, as it were, it's extremely difficult for SMEs, and even those larger SMEs, to access capital from banks. They just don't want to know; it's too risky. I could give you a couple of examples of where exporting SMEs have got prepaid contracts, out of China, in one respect, and they wouldn't be looked at—they wanted a million bucks, which, you know, in the scheme of things wasn't huge money. They have a track record; they're a not a fly-by-night. They are not inventing some new invention. This is an established SME, as in one example, and they find it almost impossible to access capital.

So do you have any figures, if SME lending is going up—can you give us any figures, either now or later, as to the amounts, percentages, and the size, nature, and scale of the SMEs that are being lent to?

Spencer Well, I would only just say that you're right, that most of the SME lending and growth in lending now is collateralised, effectively, on property. And you're right; it is more difficult to secure a loan on a cash-flow basis.

Cosgrove Could you provide us with some data?

Spencer We don't have data.

Wheeler We'll get you what we've got.

Norman Just briefly, on the housing stuff. I guess what you're trying to do is manage a soft landing, in a sense, for housing. You talk about in America, essentially they had a hard landing for the housing market, and you're trying to use the tools you've got to target the housing market so you get a soft landing there, without using the OCR to damage the broader economy. Is that a fair summation of what you're trying to achieve?

Wheeler Yes, that's, I think, fair comment.

Norman My question is about the relationship between the current account deficit and the dollar. You had some interesting comments in your report that I don't think I'd really thought through properly before. You said: "The demand for capital from offshore required to finance this saving shortfall"—with regard to the current account deficit—"underpins the high level of the New Zealand dollar."

So the fact that we're running large current account deficits, which need to be serviced, which mean there's all this money coming in, actually pushes up the dollar, but the higher dollar, in turn, makes it harder for us to deal with our current account deficit, because the tradable sector is undermined by the higher dollar. How do we not end up in a kind of very malign feedback around this, because it sounds like it when I read your paper?

McDermott It's a good observation, and it's been a longstanding issue for New Zealand—some 40 years' worry about our current account deficit. It means, as a country, we haven't saved enough for our own investment purposes. That means to finance that we have to attract foreign inflows. As that money comes across the border, it puts pressure on the exchange rate. So it's been a longstanding issue, where we've had what feels like an overvalued exchange rate. It's not just a current-day position, although it can go up and down. This is not something monetary policy is well suited to deal with, because this is a structural issue, not a cyclical issue. If we really wanted to change things, we would have to change the incentive for people to save and consume, relative to our investment needs.

Norman Would it also mean—we had Mr English in front us yesterday, wasn't it, in front of the FEC, comparing this current account deficit problem with the one in the mid-2000s. His argument, and I hope I don't misrepresent it, was this one is different because more of the incoming flow is going into investment in the productive sector, whereas in the mid-2000s it was going into housing, I guess. But looking at the housing bubble that clearly has emerged, do you have evidence that it is different in the sense that more of the inflow is going into productive investment versus just housing, or is it actually similar to the last one?

McDermott No, I think that's a reasonable description. Clearly, there was a massive consumption boom in the last cycle, so we had household savings rates of minus 9 percent. So for every $1 the household was earning, it was

spending $1.09. Right now we've got a household savings rate that's close to zero—slightly negative. For the next 3 years we think we'll be around about zero. That's the sort of different nature now relative to the previous cycle.

Norman But do you have evidence about where the inflows are going? I guess that's the question: if the inflows are ending up in the productive sector, then you can see that, OK, we're borrowing money from the rest of the world, but we're investing it so we can trade our way out of a hole. Do we actually know where that money is going and if it is going to help us trade our way out of this hole?

McDermott One of the challenges—it is investment, but it's often investment in residential activity. One of the big players here—one of the big factors—is Christchurch. The fact is that there's a lot of investment required to put in new buildings, both residential and commercial, and also infrastructure. Those are necessary to rebuild Christchurch after the earthquake, but, of course, a lot of those won't deliver a financial return.

Goldsmith Could I just ask a supplementary question on that. With this graph on page 16, related to the value of house sales and credit growth, I'm just wondering where this money is going. This gap has opened up between the value of sales and credit growth. How do you explain that? Is that related to where investment is going, or what?

Spencer The relationship you see there did change after 2008, after the GFC. It basically reflects what John was saying about the changed savings behaviour. Following the GFC, a lot of people were paying off loans and reducing their debt, so the net effect of new lending less the repayments gave you much lower rates of growth of overall credit, which is that blue line you're seeing in the graph. So that relationship between the overall house sales and net credit growth was altered.

Goldsmith So if we maintain that gap for longer, then there's an element of rebalancing going on.

Spencer That's right. It reflects improved savings behaviour.

Norman I guess what we're seeing in that graph is credit growth taking off again, and the gap starting to narrow again as the housing boom takes off again.

Just, if I may, just one other. My concern about what we're seeing currently in terms of GDP activity is that we've got GDP activity clearly picking up, but at the same time we're developing these huge external—well, huge is obviously a value judgment—large external liabilities associated with the growing current account deficit. Is it really a sustainable period of economic prosperity if it seems to be so overwhelmingly funded by borrowing offshore?

Wheeler Let me come back to the earlier point first about where the portfolio flow is going—John indicated, but they're also going into the equity market and into Government fixed-income market. If you look at foreign ownership of Government securities, Government bonds on offer, that ratio is now up to 69 percent, so a lot of foreign portfolio flows are going into there.

In terms of the current account, I mean, you know, New Zealand has lived with a current account deficit of the order of 5 percent of GDP for three decades. I think it's a concern if the current account deficit were to widen, and our forecasts indicate that that current account deficit will probably increase to around 6 percent over the next year or two. You know, can capital markets still finance those and not be worried about debt ratios? I suspect they can in New Zealand's case, but there comes a point when you can get big discontinuities and big adjustments, and that very quickly gets reflected in falling exchange rates and rising interest rate premia. So it's something that New Zealand needs to address over time, and, as John said, it's very much a structural imbalance, particularly in terms of the savings-investment ratios.

Barry My question is around foreign ownership of housing, which is something I've asked you about before. Have you been able to collect any data for us on what's happening in Australia, for example, or China even?

Wheeler In terms of data on Australia, no, we haven't got anything specific. What we have done is tried to get a feel for foreign ownership of New Zealand houses. It's pretty hard to get data, but as best we can tell from various sources, we think foreign ownership, in terms of the housing stock—so looking at the entire stock of housing throughout New Zealand—probably somewhere around 2.5 percent would be in foreign ownership. That includes New Zealanders who are overseas, so sort of non-resident holdings is the definition, so New Zealanders who have gone overseas and have a house would be included in that non-resident definition.

When we've looked at Auckland, our feeling is—and the data is hard to put together, it really is; I don't have huge confidence in this data. But in terms of non-residents holding houses in Auckland, we think it's probably somewhere between 5 and 10 percent. But that, again, includes New Zealanders who are overseas, and it also includes foreigners who may have bought and who may intend coming to live to New Zealand, so there's a lot of uncertainty around the data.

Barry So you have regional breakdowns and city breakdowns of the general terms, obviously not distinguishing between New Zealanders living overseas and foreigners directly buying, but there is a breakdown by region?

Wheeler Well, the Auckland data came from some realtors that had put together some data.

Barry Barfoot and Thompson.

Wheeler They were one of them, I believe. Do you have anything to add, Grant?

Spencer Yeah, it was based on the sort of survey-type information by real estate agents, so it's not particularly robust.

Barry And given it was Barfoot and Thompson, they were speaking to us in the Parliament last night and indicated that there was no proof that there was, you know, a significant amount of, for example, Chinese buyers coming to the Auckland market. There's been a lot of talk around that.

Wheeler Well, in fact, from what I've seen of the data—and again, you know, I don't believe it's sort of robust data in that sense—a lot of the foreign ownership is, in fact, European.

Cunliffe Governor, thanks for your report. I guess, having been down this road before and some similarities, it's now quite clear what the problem is. Just checking in with you—low inflation relative to target, relatively high exchange rate, therefore a reluctance to cut interest rates right now. On the other hand, a real and growing issue with regional house price inflation, housing affordability, and potential knock-on effects for consumption and saving effects, which don't help rebalancing the economy. So that's our central dilemma.

The question is how do we address it, and your report makes clear that your first tool now is not the OCR; that you're wishing to explore the use of a package of macro-prudential measures pursuant to the MOU that you've signed with the Minister. And you'll get no argument from the Opposition, the Labour Party, on that. On the macro-prudential tools, would you describe them now as unorthodox?

Wheeler No, I don't think you'd call them unorthodox. I mean, there's been just a huge growing interest in these tools post the global financial crisis because what you saw in the lead-up to the financial crisis in many countries, you saw inflation that was under control—for example, in Europe, in the US—but you saw very rapidly increasing housing prices in the US, for example. And so the debate amongst central bankers used to be, well, you know, shouldn't you be doing something to try and prick these asset bubbles? And the view of Alan Greenspan, which tended to dominate among central bankers, was that you're there once it gets pricked, and you pick up the pieces, etc.

That view, I think, is discredited, and so there's been a substantial look to see what macro-prudential tools can do. I'm aware of five countries that are currently using them. Norway, Sweden, Korea, Israel, and Canada have used these tools, mostly loan-to-value ratios of some form.

Cunliffe Would you say, therefore, that in the absence of macro-prudential tools, New Zealand would have the optimum or world's best practice monetary policy settings, or are they now seen increasingly as an important complementary tool in the toolbox?

Wheeler I think they're seen as an important complementary tool that central banks, or the monetary authorities, should have.

Cunliffe I think that does show us, Governor, how much the world has changed over the last 2 years since the Labour Opposition's been calling for their use, and we appreciate that. Governor, the—[*Interruption*] Well, you know, it was the Minister of Finance who said in the House that we had the policy. That's his quote, which you've contradicted, and I appreciate that. That was some time ago. That was 6 months ago, before he signed the MOU.

Goldsmith Let's go on, David.

Cunliffe Right. So, look, the next question is, taking the macro-prudential toolbox as a whole, including the loan-to-value ratios, how much do you think it's worth in terms of cooling impact on the Auckland property market, say, relative to a basis point increase in the OCR and that market? We've had some rough prior estimates, I think, from the Deputy Governor that it might be adding up to around 25 basis points. Now that we've become closer to implementation, is there any sense of where that estimate might be?

Wheeler I think if you look at could tools such as setting a speed limit, for example, on LV ratios, be effective in trying to cool the housing market, the evidence overseas—and it's not extensive, but the IMF did some work on this quite recently. Their analysis suggested that, yes, it can have some impact in trying to reduce the rate of price increase. You know, we wouldn't say that this is a panacea that's going to stop the housing market. I mean, the supply-demand imbalance in Auckland is very large. The backlog's 20,000 to 30,000 houses, 13,000, roughly, needed each year, and we've been doing 4,500 or thereabouts. So that's the problem we face.

If you look at interest rates, in terms of the interest rate hikes, if you like, that were needed in the last housing boom, in 2003 to 2007, you know, that was partly driven by other factors. Migration was very strong. But, you know, the interest rate increases were 325 basis points.

Cunliffe Which would have a detrimental effect both on our exchange rate and on our growth settings and employment.

Wheeler Yeah, I believe so.

Goldsmith I'd like to come to the end—

Cunliffe So, final question, if I can, Chair. So there's obviously a gap, which, presumably, might be filled by measures like an extensive house-building programme; taking the OECD's advice, a capital gains tax. I'm wondering if you have a view on that, and, given the savings gap implication that others have referred to—Dr Norman—presumably a pretty strong savings policy. Would those be potential elements of a broad-based menu to assist the rebalancing going forward?

Wheeler I think in terms of the supply-demand imbalance, anything that can be done on the supply side would be important, so meeting the objectives in the accord—the 39,000 houses over 3 years—would be helpful. Anything that could be done in terms of improving the productivity in the building sector, like the Productivity Commission's report referred to, would certainly be very helpful.

On capital gains tax, you know, it's really a very interesting one, because most countries that have a capital gains tax end up exempting residential housing, at least the first home, in any event—the first home. And you then say, well, you know, if somebody is buying multiple homes and trading in that, then the IRD will pick them up. It's if they hold on to them and get around the trading clause, that's when a capital gains tax could be—

Cunliffe On that, Governor, the IRD's getting about $7 out for $1 in return on investment in chasing speculators, which means they haven't reached the marginal cost equals marginal return point on the—

Wheeler I wasn't aware of those figures, so thank you. But, you know, you look at many other countries that have capital gains taxes, and you've seen housing booms in many of those countries.

Cunliffe No, nobody's arguing it's a whole solution on its own.

Williams Governor, figure 4.20 in relation to regional construction cost. You mentioned in your comments before, you said 20 percent of GDP is as a result of Canterbury. When you look at those figures and the growth in regional construction cost passing 12 percent in Canterbury, while in Auckland they're declining and have gone to under 2 percent and on a downward decline, doesn't that raise huge alarm bells that much of this GDP growth and much of the fuelling of the economy is actually because there's extraordinary extortion across the building and construction going on in Canterbury, and, as we've alluded to, there seems to be a bit of a rort going on.

Cosgrove You mean a legal monopoly, don't you?

Williams A legal monopoly.

McDermott You need to build a lot of buildings in Christchurch. We need as a country to move resources to that region. The one way the market allows that to happen is to give bigger incentives for people willing to either work there or move materials into there, and that's what we're seeing. This is what we would expect to see—higher prices where there is more demand. What would be of concern for monetary policy purposes is if that spread to the entire country—so we saw people putting up prices in Timaru simply because of what was going on in Christchurch. We are not seeing that, so for the moment this is positive news from a monetary policy point of view.

Williams But would you not agree that if the competition in Christchurch is significantly limited through certain major players who control the markets, essentially, and you seeing this sort of percentage, it would be an indicator that we should perhaps be opening up to much wider competition to try to address that staggering percentage in construction costs?

Wheeler I think you have an interesting point. The point I think that John's making is a really important one. If you want to shift resources, you need relative price increases to create the incentive to shift. So we're not too concerned about the relative price shifts that are occurring in Christchurch at this point, but we would become very concerned if it spreads into generalised inflation. I think it would be concerning if there were monopoly practices or there was insufficient competition, and my understanding is that MBIE are doing some work on that in terms of looking at the costs of certain materials and the potential for more providers.

Williams And the other elephant in the room about this staggering figure that up to 10 percent of Auckland property could be owned by non-residents, compared to 2.5 percent nationwide average, and you say you're not too

sure—it could be 5; it could be 10. Would this not be a very good reason to have a land register, so once and for all we could work out who owns the land in this country? Rather than you relying on Barfoot and Thompson and others—

Goldsmith Feel free to answer that in so far as your capacity—

Wheeler To be frank, I don't really have a strong view about that.

Cosgrove Just on my colleague's issue about monopoly issues in Christchurch. You are aware, of course, that there is a legalised monopoly in terms of certain large-scale project management work—namely, Fletcher's—because the Government took the view, somewhat strangely, that if you have one provider for project management work rather than one plus a number, that is competition; if you have no competition, prices would be forced down. My fifth-form economics tells me differently, but maybe I am wrong. Given that you're going to have a look at monopoly practices, will you specifically have a look at that legalised monopoly and how it's reacting, because that may well be a factor in relation to this graph?

Wheeler Sorry, let me correct a misunderstanding. The central bank won't be looking at monopoly practices. What I did say is MBIE—

Cosgrove Sorry?

Wheeler The ministry are doing it.

Cosgrove OK. Do you have a view, then—forgive me—on the impact of that monopoly practice in what is the biggest construction site in New Zealand?

Wheeler No, but what I would hope does eventuate is that you've got 10 years of really intensive construction taking place in Canterbury. You know, a considerable amount of repairs has been done. The new building required on building new houses and building the central business district very much still lies ahead—

Cosgrove As does most of the residential.

Wheeler Right. And Auckland has a very substantial building programme ahead of it, as well. Now one would hope that that creates an opportunity for new entrants to come in and say "Look, there is a decade or whatever or very intensive construction in these two regions of the country."

Cosgrove I accept that, but surely that proposition is hampered whereby a legalised monopoly is permitted in one large particular area of construction in Canterbury.

Wheeler I don't have the details to comment.

Twyford We've been a little bit critical of the Government's very tight focus on land supply as a response to the housing crisis, and I think everyone recognises in Auckland that land supply's a very significant factor. But as the Productivity Commission pointed out, there is quite a long list of factors that are causing the current problem. I wonder, in light of the earlier question, whether the bank would consider referring the issue of lack of competition in the industry supplying building materials—whether you

would consider referring that—to the Commerce Commission for investigation or an inquiry, given what a significant factor that is in the price of houses?

Wheeler I'm not sure that the central bank is the right body to do that. I was talking to the head of MBIE the other day, just 2 days ago, and we were discussing this issue and to what extent competition can come into the market, and is that likely to happen. So I think probably MBIE is the central point on all that.

Twyford The Auckland Unitary Plan is a comprehensive approach to opening up more housing construction—much more comprehensive than the accords bill that you mentioned earlier. Have you looked at the unitary plan? Do you have a view about how useful it would be in terms of dealing to the overheated housing market in Auckland?

Spencer Well, the plan focused a lot on inbuilding—you know, more intensive building within Auckland—and I think that's a sensible solution, as well as making land more readily available around and outside the municipal limit. So I think the mixture that they are talking about in the accord is a sensible one.

Twyford Would you support the unitary plan being speeded up?

Spencer Yes.

Twyford You would.

Goldsmith Thank you very much.

Cosgrove Hang on, just taihoa. There's 5 minutes on the clock, with respect. We don't sort of leave work early.

Goldsmith Right. We need to have time to get in there for question time, and we're 2 minutes away.

Cosgrove No, no, this meeting is constituted till 2 o'clock.

Bennett You don't know; we've still got other business to do.

Cosgrove You guys can leave if you want to. We're quite happy to carry on.

Goldsmith No, no, we've got general business to move on to. So thank you very much for coming in—

Cosgrove Point of order, Mr Chairman. We have one very minor item of general business that you and I have just agreed to hold over, and we have 5 minutes on the clock, and we have members who want to ask questions. You cannot guillotine a meeting when the agenda says its going to finish at 2 o'clock. It's out of order.

Bennett So you've agreed—

Cosgrove You can't guillotine a meeting, and we've always met—

Goldsmith Speaking to the point of order—

Cosgrove —up until the ringing of the bells finally stopped.

Bennett Point of order. Clayton, we're not aware of that. We're just aware that there's another point of general business.

Cosgrove It's been disposed of.

Bennett Well, perhaps we dispose of that now, then we're sweet.

Goldsmith If you want to move to dispose of that matter now and then we can carry on.

Cosgrove No, you and I just agreed that we'd hold it over, and we're wasting time.

Bennett So it's going to be held over, then.

Hayes I move that we hold over Clayton Cosgrove's letter until our next meeting.

Goldsmith Very happy to do that. Does anybody want to speak to that? We're happy to do that. OK. Right. Thank you.

Cosgrove Peter Dunne will be back by then.

Norman Open bank resolution and/or deposit insurance—right. The OECD's country report on New Zealand said "You should have deposit insurance." It said "Your OBR, well, it's very novel and interesting." and that deposit insurance is an essential component, because, basically, at the end of the day, everyone expects that we're going to bail out the banks anyway, regardless of what we say now, because that's exactly what we did last time, because it's a very concentrated banking sector, they're too big to fail, and the Government will have little choice but to step in. Do you agree with the OECD or are you sticking to your guns against deposit insurance? Because the OECD agrees with me, for once, and capital gains tax.

Spencer We've always said there are arguments for and against deposit insurance, so it's not a black and white issue—we agree with that. But the current policy is that deposit insurance is an issue from the point of view of moral hazard and that it is appropriate not to have deposit insurance at this point in time.

Norman Are you worried that we have that moral hazard regardless, given what happened during the last GFC when we bailed them out?

Spencer The OBR policy itself will contribute to reducing the prospect of moral hazard.

Cunliffe Given the shortness of time, this is probably best dealt with as a supplementary information request. You've talked about the gap between the OCR equivalent suppression needed to cool the house bubble—325 basis points last time. We know that the macro-prudential stuff's worth around about 25 basis points. There's a big gap. Could you come back to us with a rough estimate on the OCR equivalent impact of a hypothetical, flat-rate capital gains tax on properties, excluding the first home, of a 15 percent flat rate—just a ballpark. How much of that gap will it fill?

Spencer I think we should just clarify your opening comment with regard to the 25 basis points. My comment at an earlier meeting was with respect to the three of the four instruments—in other words, the price-based instruments,

such as the capital overlay. On the other hand, an LVR restriction or speed limit will have a greater impact than the equivalent of 25 basis points.

Cunliffe Could you come back with any estimates of the relative impact of the LVR speed limit—that will be really helpful. But I guess even with that—and we very much welcome that—

Goldsmith Can we just wrap it up, please?

Cunliffe Could you please estimate, roughly speaking, the value that might be derived—

Bennett Point of order. We've run out of time, and at the end of the day that's not an appropriate thing to ask for.

Cunliffe Speaking to the point of order. Sorry to detain the meeting, but the Governor, in response to a previous question, answered in the affirmative that a range of potential policy measures that might help address the gap, without prejudice, included strong savings policy, various measures to improve housing supply including the housing accord proposed by the Government.

Cosgrove Governor, are you prepared to supply that information?

Goldsmith Have you got enough information to understand what you need to reply for?

Wheeler I believe we've got enough information.

Goldsmith Thank you very much and thank you for coming in today. We very much appreciate it.

conclusion of evidence