RESERVE BANK
OF NEW ZEALAND

THE TREASURY
Kaitohutohu Kaupapa Rawa

6 March 2006

Hon Dr Michael Cullen
Minister of Finance
Parliament
WELLINGTON

Dear Dr Cullen

Supplementary Stabilisation Instruments

As you will be aware, in November 2005 we commissioned a team of senior Reserve Bank and Treasury staff to undertake the Supplementary Stabilisation Instruments project. The review looked at whether there might be useful tools, directly affecting the housing market and/or the market for residential mortgage credit, which could supplement the central role of interest rates in managing inflation. If such additional instruments were available, which were targeted more closely to the housing sector than the Official Cash Rate is, they might alleviate some of the pressures on the exchange rate which has been adversely affecting the performance of the traded goods sector.

In recent years housing market pressures have been particularly intense (indeed, on a number of measures the housing market is currently more stretched than at any time since the housing boom of the early 1970s). Large increases in house prices, and in construction costs, have been reflected both directly in the CPI, and indirectly through the impact that perceptions of rising housing wealth appear to have had on consumer demand and activity across the entire economy. We have sought to ensure that any measures would be applicable not only to the current cycle but also useful and robust in any future cycles in which housing-related pressures were to play an important role. The review team operated under relatively tight deadlines and was asked to provide an initial report to us by the end of January. We undertook to report to you subsequently.

We have attached the full initial report, which focuses on six main policy options. These take a variety of forms. Several involve permanent changes to features of the tax system or other regulatory arrangements. The thinking here is to identify any structural changes which might help dampen the magnitude of housing cycles, without requiring ongoing discretionary involvement. The review team also explore two possible options for additional discretionary stabilisation instruments, which could be used to supplement the OCR in periods of particular pressure in the housing market. Many other possible options have been quickly ruled out, on the grounds either that they offered few cyclical benefits or that they were outside the Terms of Reference for the project. Among the latter, we did not consider a capital gains tax on housing or a more active counter-cyclical approach to fiscal policy.

Having reviewed the report, we share the view of the authors that there are no simple, or readily implemented, options that would provide large payoffs in the near-term. Moreover, it is important to stress that significant house price cycles have been a feature of many, perhaps most, developed market economies in the last decade or so. However, there are some specific measures that we recommend be adopted and a number of areas where we believe more work would be warranted. Any changes to the tax system would need to be discussed with the Minister of Revenue.

Two features of the tax treatment of investment properties have been considered in the review. Under current tax law, income tax applies to gains realised on property sold when the property was acquired with the purpose or intention of resale (with an exemption, broadly speaking, for owner-occupied property). In practice, however, Inland Revenue has identified a variable level of non-compliance with the existing rules. In response, Inland Revenue has been actively raising the profile of these rules to improve taxpayers' understanding of them and this is planned to continue. In choosing how to allocate resources, we recognise that the Commissioner of Inland Revenue's current audit strategy is based with good reason on assessing revenue risks to the tax system. However, we consider that there could be merit in encouraging Inland Revenue to consider broader cyclical stabilisation objectives when determining the allocation of audit resources and the effort made to publicise the application of tax law to property sales. As the report notes, Inland Revenue has a number of concerns with this proposal and there are a number of issues to be worked through, including the impact on the department and the integrity of the tax system of having multiple objectives and the legislative basis for the Commissioner adopting such an approach. To the extent, this does not require legislative change, we think this option offers the best prospect for having some quick, albeit modest, impact on the current cycle.

The report notes that further measures could be employed to reinforce the existing income tax law applying to capital gains on housing. For example, a reporting requirement could be imposed in respect of all sales of residential properties occurring within (say) two years of acquisition, or the exemption for owner-occupied housing could be removed for properties sold within two years of acquisition.

As requested in the Terms of Reference, the project team also explored the option of ring-fencing operating losses on investment properties (that is, allowing losses on investment properties to be offset only against other property income, but not against, say, wage and salary income). This approach is adopted in a variety of other countries. At this stage, we do not consider that such changes would be warranted for reasons laid out in the report, but recommend that further work be undertaken to better understand the role of short-term holdings of investment and owner-occupied properties in accentuating housing cycles.

Overseas literature highlights the importance of regulatory provisions in shaping the ability of the supply of new housing to respond to signs of increasing demand. Locally, there is some suggestive evidence that such constraints may have exacerbated housing inflation pressures in certain regions. Were such pressures to be alleviated, the amplitude of housing cycles might be diminished. We welcome the work programme that the Department of Building and Housing and Housing New Zealand Corporation already have underway to help identify a variety of measures that might increase the responsiveness of housing supply, and we would expect Treasury to have an active role in encouraging and shaping the work programme.

The Reserve Bank is currently implementing a new capital adequacy regime for banks (Basel II) designed to better align capital requirements with the underlying risks that banks take. An important part of implementing that framework will be working with banks to ensure that the risk models they are using appropriately reflect risk profiles through the business cycle as a whole (and avoid generating incentives to assume larger and riskier loans near the peak of the cycle). The Reserve Bank will also be exploring the extent to which capital requirements under this regime may be designed to provide counter-cyclical macroeconomic benefits, consistent with the paramount consideration of promoting financial stability.

The report examines two discretionary tools that could be applied, to supplement the OCR, at periods of particular stress in the housing market. Both could provide some cyclical management benefits, easing house price inflation and hence reducing the need for higher interest rates and potentially reducing the extent of upward pressure on the exchange rate. However, both would also pose significant ongoing enforcement challenges. The first discretionary option is a comprehensive loan to value ratio limit, applicable to all loans secured on residential property by all lenders. This measure would have a direct impact on the most leveraged portion of the housing market. However, the rules for such a limit would be difficult to define and difficult to enforce. The pressure for disintermediation would be very great. The report also notes that the segment of the market most affected by this measure contains a high proportion of low income earners and first home buyers.

The second discretionary option is an adjustable mortgage interest levy, which could be imposed on all mortgages on residential property and designed to force a wedge between the price paid for credit by mortgage borrowers and the returns available to the savers financing those loans (especially the interest-sensitive foreign savers). While such a measure might be expected to dampen the exchange rate cycle, it would be a step well beyond the mainstream of policy thinking, with no international precedent. In addition to significant disintermediation pressures, enforcement challenges and adverse distributional impacts, this measure would also raise a number of issues around the delegation of power to impose such a levy. Even if Parliament were to agree to it being set by the Minister of Finance on the recommendation of the Reserve Bank, this could impinge adversely on the

Bank’s operational independence, by involving the Minister and Treasury more closely in short-term assessments of inflation pressures and the need for discretionary policy adjustments.

Were you to wish to explore this option seriously, a considerable amount of further development work would be required, making such a tool an option for future cycles rather than for the present one. We would also advise that any further consideration of the mortgage interest levy should also include an assessment of other potential discretionary fiscal instruments. Some of these alternatives, for example, a variable expenditure or property tax, might achieve the overall demand management benefits of a mortgage interest levy, without giving rise to such significant ongoing enforcement and implementation challenges. These broader non-housing options were beyond the scope of the Terms of Reference for the current study.

To summarise, we recommend that you:

a. **Agree** in principle that the Commissioner of Inland Revenue should be encouraged to have regard to broader cyclical stabilisation considerations when assessing the priority given to enforcement of the existing income tax provisions relating to capital gains on residential properties purchased with the intention of resale.
b. **Note** that the Inland Revenue has a number of policy concerns with this proposal.
c. **Note** that Treasury and Inland Revenue are discussing the legislative basis for an approach as per (a) above.
d. **Agree**, if you agreed with (a), that the issue be discussed with the Minister of Revenue and a suitable basis for proceeding determined.
e. **Note** that undertaking additional enforcement activity may involve additional resources.
f. **Note** that the Reserve Bank and Treasury intend to undertake further work to better understand the role in the housing cycle of property investment for short-term capital gain.
g. **Note** that, depending on the results of this work, it may be appropriate to consider further tax measures such as tightening the tax net on profits made on properties held for relatively short periods and/or the ring-fencing of operating losses on investment properties.
h. **Agree** that the Treasury should take an active role in encouraging, and shaping, the work currently being undertaken by the Department of Building and Housing and Housing New Zealand Corporation on potential factors that may be slowing the supply response of new housing at times of strong demand.
i. **Note** that as the Reserve Bank implements the new Basel II international capital adequacy regime for banks it will be working to ensure that the regime does not have a pro-cyclical impact on the supply of housing credit, and to explore the potential for counter-cyclical elements, consistent with the aim of financial stability.

j. **Note** that a discretionary mortgage interest levy could offer some benefit in terms of relieving exchange rate pressure at cyclical housing peaks. However, extensive further work would need to be done around the serious implementation and enforcement issues (including consultation with the Minister of Revenue), and to ensure that the operational independence of the Reserve Bank in the conduct of monetary policy was not adversely affected.
k. **Note** that we will further consider discretionary fiscal instruments of this nature in the context of our research programme on the broad macroeconomic policy mix. In particular we will be assessing the potential scope to assign a demand management role to fiscal policy.

We expect that the report will be publicly released (we already have several requests for it under the Official Information Act) and would be keen to discuss with you the timing and management of that release.

Yours sincerely

Dr A E Bollard
Governor
Reserve Bank of New Zealand

John Whitehead
Secretary to the Treasury