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Discussion Panel Comment

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As you know I am filling in at the last minute because unfortunately one of our panellists is still in Australia due to the ash cloud. What I want to do very briefly is highlight the thinking behind the steering group. You might have noticed the eclectic set of papers in the forum and in fact one of our speakers actually said he felt like a fish out of water. Normally we organise workshops around themes and we'll have one dedicated to housing, one dedicated to fiscal policy, or one dedicated to macroprudential issues. And we will all learn something specific and quite narrow sometimes. Don't get me wrong, we have not abandoned specialisation. As economists we still think it's a good thing, but every now and again there is benefit from taking a broader perspective, looking at many different things at once, and trying to understand what the interconnections of those ideas are.

There's no way in just a few moments I can summarise all the papers so instead I am going to highlight the inter-linkages between some of the ideas discussed.

Let me start with Craig's paper. It is always dangerous in a broad policy forum to start talking about option pricing and the theories of options. But quite cleverly, with various smiles and smirks, Craig managed to emphasise this idea of what we might call the peso problem.

Strictly speaking the peso problem occurs in fixed exchange rate regimes. However, even in a floating exchange rate regime there is still a risk of a sharp depreciation at times. To avoid the adverse consequences of such a sharp depreciation you somehow have to pay somebody offshore to take on the exchange rate risk. This hedging can be expensive and so it is hardly surprising to find, as Craig does, that the carry trade is profitable.

How does peso-like mechanism work? Well if you think about New Zealand being a country with a large stock of net foreign liabilities, every time there is a drop in confidence in international financial markets, home bias increase. We bring some of our funds home and foreigners take some of their funds home. But since the foreigners have more assets invested in New Zealand than we have invested overseas inevitably there is more money flowing out than in and so the currency adjusts rapidly downwards.

If you are confronted with such a risk you should, as a number of speakers but particularly Sebastian suggested, cast the policy responses in an "insurance framework". In fact I believe such a framework was lurking behind many of the New Zealand policymakers' discussions. What is true is that there is no explicit outline of an insurance framework and we should move to making it explicit because it would be a nice unifying theme.

There are a number of question as to what elements should be included in an insurance framework. Should we have a stabilisation fund? Do macro-prudential tools offer us insurance? Should we have faster fiscal consolidation, which Anne-Marie started talking about, so the government has more choices when an adverse shock hits?

In relation to this question first consider Prasanna's paper gives us a perspective on macro-prudential issues. These imbalances building up are largely being inter-mediated through the banking system. Thus anything that goes wrong is going to emerge there first. So what are the tools that you can put in place? What are the remedies where you can make yourself more resilient?

Of course there are a number of questions that the locals keep asking. For example, could we use macro-prudential tools themselves as stabilisation tools? I always get worried when we are asking that question because these tools are new, we do not know how they will operate. And I can envisage many scenarios where a lot of these tools are not counter-cyclical but are actually pro-cyclical. I believe we have to be very careful when thinking along those lines about what unintended consequences we might introduce.

The next link along the chain after the banking sector is the housing sector. We all think we are experts in the housing market, in part because many of us own a house. However, Peter's address demonstrated that we are probably not as knowledgeable as we think. The details matter and there are a huge amount.

One of the points that struck me in Peter's talk was the fact that it is *who* is coming to New Zealand that often shapes the developments in the housing market. Peter highlighted that many of the immigrants to New Zealand are highly skilled. Such immigrants will have a high propensity to buy a house, because the quality of rental houses in New Zealand is quite poor. Rental housing in New Zealand is a do-it-yourself industry. This do-it your-self approach results in very low margins on rental activity. In turn these low margins probably drive out professional activity in the rental market.

Therefore the same people, who come to New Zealand and desperately want to buy a house, would in another country quite happily rent in high density housing. I say that from personal experience. I lived eight years in the US and rented in high density housing but I have no desire to do that in New Zealand.

Another issue raised in the forum was tax and how the tax system interlinks with housing. One of our discussants, Christoph, asked 'isn't it obvious that tax drives behaviour?'. Again as economists we should think about incentives and I think there is probably something to how the tax system incentivises housing investment. Quite simply, people chase tax preferred options when they are thinking about their assets and their behaviour. In the US the famous 401K accounts are almost automatic. It's a natural behavioural response. In New Zealand we do not have that but housing is largely a tax free investment vehicle. So while our tax system itself might be simple and efficient, its current structure may produce undesirable outcomes.

Turning to broader fiscal policies issues Anne-Marie's paper introduced the idea of using fiscal policy to stabilize the economy. In particular, the idea of a stabilization fund and a fiscal council was mooted. Both ideas sit with the insurance framework mentioned earlier. Of course, this is about getting the structural issues right. But there might be other consequences about how we drive behaviour that we haven't yet thought about.

I have already mentioned immigration but that issue was raised in a different context by one of the discussants, Michael Reddell. Michael brought up quite a lot points about immigration in his brief talk. I can't possibly cover them all here but he provided an essential message linking immigration to housing and how the additional residential investment crowds out business investment. Again we see the need to think about these things in a holistic way.

My final point is to note that we have a system, however we got there, with a very large net foreign current liability position, and how do we manage that risk going forward? Philip Lane was emphasising the risk of a large net foreign current liability position. He highlighted what you might have thought constituted good systems before the global financial crisis, might not be considered so good afterward. Surely there are new lessons to be learnt from the biggest financial crisis in 80 years. And so in the wake of the fog of uncertainty with a big foreign currency liability, maybe we do now need to think about what are different strategies and options.