The Treasury

Macro-prudential Policy Memorandum of Understanding Information Release

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Release Document

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[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people

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To: Minister of Finance

AIDE MEMOIRE: MACRO-PRUDENTIAL POLICY

Following the Global Financial Crisis, many countries are looking at whether macro-prudential tools could help to improve financial stability. This area is receiving much attention from international agencies such as the IMF and Bank for International Settlements as well as Central Banks, regulatory authorities and Finance Ministries. While the literature around macro-prudential tools is growing rapidly, there is relatively little analysis that carefully ties back proposed policy tools to what actually went wrong in various countries in the last boom.

The Reserve Bank recently held a workshop on macro-prudential policy, which attracted a number of international speakers, and last week the Governor of the Reserve Bank made a speech setting out the Bank's current views on some of the key elements of a macro-prudential framework; these are summarised below. You may want to discuss these views at the next Financial Systems Issues meeting on 11 May.

The primary focus of much of the international work is around the contribution to financial stability, rather than focusing on how macro-prudential tools could potentially contribute to broader macro stabilisation. The latter effect is seen as a secondary benefit and likely to be marginal, although financial stability itself contributes to macro stability by avoiding the conditions that often end up with deep recessions. Countries are in different stages of development in terms of their use of macro-prudential tools. The IMF has been focusing on developing a framework for macro-prudential policy drawing on lessons from those countries (mostly developing countries) that have used macro-prudential tools. Thinking in the UK seems more advanced than other countries, which is not surprising given the financial crisis it experienced.

New Zealand has a potentially broader macro stability interest in macro-prudential policy than most other countries, reflecting our experience during the last cycle when the high interest rates necessary to cool demand, fuelled in part by the overheated housing market, led to significant pressure on the exchange rate. The sustained high level of the exchange rate, while not uncommon internationally, is widely seen as having harmed the tradable sector. This broader interest in the objectives of macro-prudential policy may also reflect the fact that we did not have a domestic financial crisis.

In terms of the overall macro framework, there seems to be broad consensus that monetary policy, conducted through adjustments to the OCR in New Zealand's case, will remain the primary stabilisation tool. However, following the Global Financial Crisis there is now greater recognition that monetary policy alone may not be enough to ensure macro and financial stability. As well as macro-prudential tools the international debate is also encompassing issues like inflation target specifications, capital controls and taxes, prudential policy settings themselves and, albeit to a lesser extent, the limits of regulation.

Our experience in the past cycle suggests that other policy settings have an important role to play in assisting monetary policy meet its price stability objective. These include:

- Ensuring that fiscal policy is not procyclical, particularly near the peak of the cycle, to avoid placing undue pressure on monetary policy.
- Reducing distortions in micro settings that contribute to macro cycles.
- Reducing any procyclicality in existing prudential tools (of which there is probably less in New Zealand compared to some other countries).

Beyond this, a macro-prudential overlay may assist in dampening the credit cycle, particularly at the extremes of the cycle. However, consistent with the results of the earlier Supplementary Stabilisation Instrument report[1], there are unlikely to be any silver bullets when it comes to macro-prudential or broader stabilisation instruments. While macro-prudential tools may make a contribution, this is likely to be at the margin.

Given the stage of the credit cycle, the need for macro-prudential tools is not pressing. However, the Reserve Bank is developing its macro-prudential toolkit now to ensure it is prepared in advance of the next cycle.

Some of the key messages in the Governor's speech include:

- Macro-prudential tools used infrequently (e.g. perhaps once every 10-20 years) may make a contribution to moderating the cycle at the margin, particularly if a number of tools are used in combination.
- The Reserve Bank's modelling points to modest effects of macro-prudential tools on the credit cycle via the cost of funds or credit constraints; however there may be additional 'moral suasion' effects whereby the signalling of the Reserve Bank's intentions may affect lending and borrowing behaviour. The size of such effects are unknown and difficult to model, but the Reserve Bank is cautious about the strength of any such effects.
- There is a need to be mindful of unintended consequences of macro-prudential tools, such as reducing efficiency in the financial system or driving lending to unregulated sectors, and New Zealand's own experience with prudential tools from the 1960s-1980s reminds us of the need for caution.
- The Reserve Bank considers its current mandate appropriate – the Reserve Bank Act currently allows macro-prudential tools to be used primarily to enhance financial system stability, but not purely for macro stabilisation.
- Although there is no international consensus on appropriate governance arrangements, the Reserve Bank argues in favour of the central bank being the macro-prudential regulator.
- The Reserve Bank prefers prudential tools that operate through the cycle along the lines of automatic stabilisers, rather than tools that need to be adjusted.
- If distortions exist that lead to larger economic cycles, these should be addressed at source rather than using macro-prudential policy.

[1] Blackmore, M, P Bushnell, T Ng, A Orr, M Reddell and G Spencer (2006) "Supplementary stabilisation instruments: Initial report to Governor, Reserve Bank of New Zealand and Secretary to the Treasury"

Treasury largely agrees with the Reserve Bank's position on these issues, although we are continuing to do further work in some areas. In particular:

- Investigating whether there is scope for macro-prudential tools or other policy instruments to have a greater impact on macro stabilisation beyond the gains that come from enhanced financial stability. The Reserve Bank's view with respect to tools likely to be under its control is that this is unlikely to be the case, and this is consistent with the Reserve Bank's current mandate that permits macro-prudential policy to be used primarily for financial stability.
- Understanding the likely costs and benefits of macro-prudential tools, drawing on the Reserve Bank's analysis and experiences of other countries that have implemented such tools. This will help us to understand how macro-prudential policy may impact on the economy and the potential role of macro-prudential policy within the overall macro-stabilisation policy framework.

There are many outstanding issues being addressed in the literature relating to the appropriate use of macro-prudential tools and governance arrangements. Much of the focus of international agencies is on developing best-practice frameworks for macro-prudential policy. While this is useful, it is likely that any frameworks will need to evolve in the light of experience once advanced countries begin implementing macro-prudential tools. There remain a number of outstanding questions that the literature is not able to answer at present.

We are aiming to complete the above work this year. The role of macro-prudential policies and/or other stabilisation tools will likely feature in some way at the joint Treasury/Reserve Bank/VUW policy forum "New Zealand's Macroeconomic Imbalances: Causes and Remedies" to be held at the end of June, and this may prompt further work in the second half of this year. Alongside this is the Treasury's review of the Public Finance Act, which will consider the appropriate contribution of fiscal policy to macro stabilisation. We will consider the implications of these work-streams together for the overall macro-stabilisation policy framework.

Renee Philip, Senior Analyst, Macro Policy, Macroeconomic and Fiscal Environment, 917 6046
Mark Blackmore, Principal Advisor, Macro Policy, Macroeconomic and Fiscal Environment, 917 6247