The Treasury

Reserve Bank Act Review Phase 2 Submission Information Release

October 2019

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Consultation Document 2A

Submission to Phase 2 of the Reserve Bank Act Review

Submitted by: Martin Taylor
Date: 16 August 2019

I am submitting as a member of the public.

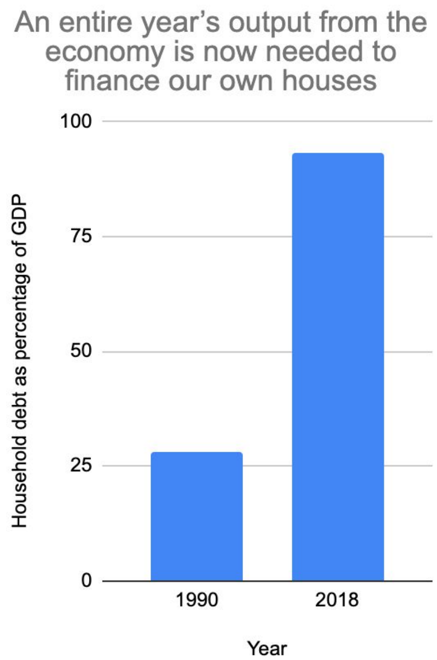
Rationale

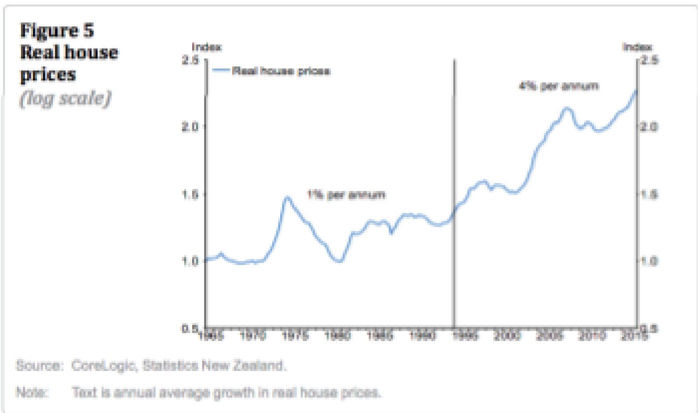
My submission and the detailed responses to questions are aimed at addressing the failings in the current Act in regard to **land inflation and land-based debt** (which is most private debt in New Zealand).

While many of the in-principle proposed changes are good, they are still inadequate to address this critical (and crisis) area.

1. **Land price inflation**, and its associated increase in private debt, have reached levels that are harmful to both financial and social stability
2. **Land is unique and requires an explicit objective.** This is because of (1) its **financial stability role** — it underpins most private credit; (2) its **well-being role** — it has a huge impact on social stability through its shelter and wealth distributional impacts; and (3) its **scale** in the financial system and the real economy.
3. Land price inflation has been fueled directly by Reserve Bank actions and is a systemic failure of the Act. House price inflation has been deliberately supercharged (and ignored) from decades of boosting economic growth by driving debt growth, mostly through easy mortgage lending and its corresponding 'wealth effect'. For the economy, this is both damaging and inefficient.
4. The proposed changes to the Act won't deal adequately with this. The Act requires a **high-level objective**, including **a specific land inflation target**. It cannot be treated as simply another 'side effect' or unfortunate externality of monetary or prudential policy actions.
5. The RBNZ's limited interest tool and its narrow mandates in monetary (general prices and employment) and prudential areas (financial system stability), exacerbate the economic and social "collateral" damage. The economy is too complex for these narrow goals and "blunt instruments". 'Simplicity' and (narrow) 'accountability' have their limits.
6. In fairness to the RBNZ, successive governments' austerity programmes (taxing more than they spend, reluctance to borrow to invest in long-term infrastructure, etc) means aggressive monetary policy has been used to fill the gap. So **a key part of the solution must be closer connection of monetary and fiscal policy**, and more of the heavy-lifting to be fiscal.

7. This is not just good for rebuilding public infrastructure and services, it’s better economically. Debt and the ‘wealth effect’ have proven to be a very inefficient growth driver compared to direct government and consumer spending.
8. In spite of its failure — excessive private debt and land inflation — the RBNZ is still the best-placed, perhaps the only government entity, to fix this.
9. **If not RBNZ, who can fix this?** The twin disasters of land-based debt and housing price blowouts have been supercharged because it was within the RBNZ’s potential power — but not its mandate — to moderate it. As the Bank’s Deputy Governor states: “**To be clear, the Reserve Bank does not have housing affordability as an objective**”.
10. **That position must change.** If RBNZ wants the near-exclusive role to regulate banks and control the money supply, it must have a matching requirement to mitigate the damaging consequences that can flow from it.





Source: CoreLogic, Statistics New Zealand.
Note: Text is annual average growth in real house prices.

“There was a large, statistically significant upward shift in real house prices in 1994–5 Between 1965 and 1994, real house prices grew 1 percent per annum, but after this they grew 4 percent per annum on average (figure 5).” — Reserve Bank Bulletin (Vol. 79, No. 1, January 2016)

During the period of the Reserve Bank Act 1989, we have trebled the amount of economic output needed to finance sales of our own land to each other.

In spite of the impact of the RBNZ’s monetary and prudential decisions on this sorry statistic, it is barely mentioned by the RBNZ or among economists and commentators following its decisions. Nothing will change until this silence changes.

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Question 2.A What other objectives should the Reserve Bank have?

Proposed new objective:
Manage credit to reduce land price inflation

1. This should be **a high-level objective**
2. It should have an associated target which could be specified in the Policy Target Agreement as a medium term inflation target.
3. An index should be created.
4. It is suggested that the index should be **based on urban land prices**.
5. This is both easily tracked and measured, and is where most of housing inflation resides.
6. It requires active management on the Bank's part, including use of **macro-prudential tools** and **credit allocation measures**. The latter is not about "picking winners". It is about pulling banks back from creating losers, both economic and social.
7. A secondary index could be developed for rural land to address the challenges of farmland inflation which risks moving our farming sector from a traditional family owner-operator, to an absentee corporate landowner model.

Reasons that it must be a high level objective rather than a 'consideration' or other looser goal:

1. **Land is unique** because of its (1) **financial stability role —** it underpins most private credit; (2) **well-being role —** it has a huge impact on social stability through its shelter and wealth distributional impacts; and (3) **scale** in the financial system and the real economy.
2. **Nothing will change without an explicit objective to consider, communicate and monitor.** The absence of any formal objective or target has left the negative impacts largely ignored by the RBNZ and commentators. It is clear from 30 years of Reserve Bank Act 1989 operation that the issues of housing inflation and rapid private debt growth have barely featured in any commentary (bank or external), MPC decision, research, data gathering and tracking, or prudential action (beyond stability). Out of sight, out of mind.

For more detail on this, please see my submission to Phase 1 of the Reserve Bank Act review. (*Submission to Reserve Bank of New Zealand (Monetary Policy) Amendment Bill Martin Taylor, 5 September 2018.*)

Category A: Objectives covering specific elements of financial stability

A3. Mitigating excessive variability in the financial cycle

- this objective would encourage the Reserve Bank to adjust regulatory settings over time in response to movements in the financial cycle.

The RBNZ needs to **act much earlier in the cycle** to nip land/housing inflation in the bud, not wait – as it does currently – until the runaway train of a speculative bubble has already left the station. RBNZ does act early against general price inflation. It must act in the same way to manage the credit-driven component of land/house price inflation.

Category B: Objectives covering elements of financial system efficiency

B5. Promoting efficient credit allocation –

> *"Interpreted broadly, it could enable the Reserve Bank to direct credit to particular sectors of the economy if the market were providing inadequate access to finance."*

1. **AGREED**. The RBNZ must actively make credit allocation decisions in regard to land-based lending.
2. It is patently clear from three decades of “light-handed regulation” and dramatic house price inflation that **banks’ credit allocation decisions can be good for banks but bad for the economy and/or society**.
3. We do not need more lost decades to know that banks by themselves will over-allocate credit to home buyers. **The RBNZ must actively and continually counter this**.

“A large majority of stakeholders argued against the broader interpretation on the grounds that it could create distortions in the market (it is similar to the Reserve Bank ‘picking winners’)”

- This is nonsense — banks themselves have created a huge distortion in land-based lending so cannot be trusted alone to ‘pick winners’ for the economy and society. They can certainly be trusted to pick winners for themselves but it’s now clear that the notion that ‘what’s-good-for-General Motors-is-good-for-America’ doesn’t apply here.

“compromise the Reserve Bank’s independence, as any credit allocation decisions include a political judgement”

Allocative decisions are partly politically but that’s a bad reason to avoid them if they are clearly causing damage. It is a reason to make the decisions in cooperation with government.

The problem of excessive borrowing for housing has been recognised by governments of both sides, economists, local and overseas commentators as damaging so this a clear case where it demands an allocative intervention.

Category E: Behaviour goals to coordinate policy

E1. Subject to achieving financial stability, the Reserve Bank should use its prudential tools and powers to support the objectives of monetary policy

“the Reserve Bank’s Monetary Policy Committee (MPC) “shall have regard to the efficiency and soundness of the financial system” when setting monetary policy – but there is no legislation-based requirement for the Reserve Bank to consider the objectives of monetary policy when formulating prudential policy.
This objective would provide that link and help to encourage policy coordination between the MPC and the rest of the Reserve Bank. A number of stakeholders supported this Objective.”

AGREED. The close connection between MPC and prudential decisions is essential to the management of land-based inflation and credit allocation issues. The lack of coordination - indeed the complete absence of connection to other tools such as prudential – has been at the root of the credit-fuelled land inflation problem. It is ESSENTIAL that the MPC no longer make its decisions in isolation.

E2. In pursuing its financial stability objective, the Reserve Bank shall seek to work with other agencies (including the Treasury and the FMA)

– this objective mirrors the wording in the UK legislation for the BoE.

AGREED. For the same reasons as E1 above, the failure of the MPC process to connect to other aspects of government policy-making — and to work in concert with fiscal measures — has amplified the credit-driven component of house price inflation. Too much of the 'heavy-lifting' for the economy has been shouldered by disconnected, RBNZ-driven monetary policy.

Category F: Other economic objectives

2.C Where in the legislative hierarchy should any additional objectives sit

– as 'secondary objectives', or as 'considerations' that the Reserve Bank must look at?

1. The Objective '**Manage credit to reduce land price inflation' (see 2A above)** must sit as a secondary objective with a specific medium-term inflation target.
2. It is fundamental to the health of the financial system, economy and social well-being and too important to be merely a 'consideration'.
3. The Bank's objectives must move beyond merely considering the financial health of private banks in this area.
4. It should be at a level similar to general prices and employment and specified in a way that requires the MPC as well as prudential regulator to consider it.
5. The specific target level or 'band' of land price inflation can be specified in a policy remit from the Finance Minister

4.C Should the Reserve Bank be given discretion to extend the perimeter

within clearly specified parameters to avoid regulatory arbitrage (such as designating in entities with business models economically similar to deposit takers)?

AGREED. If allocative decisions are made, or restrictions on credit availability for land-based lending, it is essential that the RBNZ be able to enforce this with other players.

Consultation Document 2B

For Phase 2 of the Reserve Bank Act Review

Submitted by: Martin Taylor
Date: 16 August 2019

I am submitting as a member of the public.

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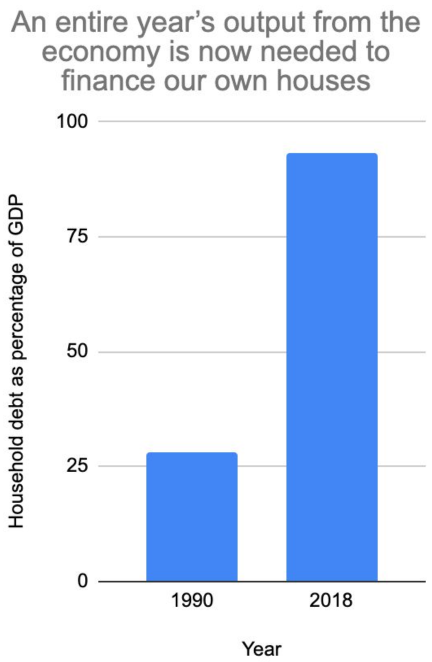

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2.B What are your views on the conduct of macro-prudential policy in the past five years?

Macro-prudential policy has been a small step in the right direction. It has (finally) used prudential regulation to begin to moderate credit volumes in the housing market but its use is hamstrung.

Its limitations are:

1. **Purpose**: It should have an explicit purpose of moderating house price inflation because excessive inflation is bad for economic and societal well-being, as well as a threat to financial stability. Instead, current rules and procedures mean it can only be used for the financial stability goal.
2. **Timing**. As a result of its purpose, it was applied far too late in the cycle — it should have been applied at the first sniff of inflation (in the same way that monetary policy attacks CPI inflation early). Once the runaway train has left the station, the inflation slow-down effect will be minimal (as it was). Its value at this late point in the cycle was mainly from the gain in banks' collateral.

2.C Is it appropriate to regulate lending standards (e.g. LVRs)? How broad should these powers be (should they include other tools such as debt-to-income restrictions)?

Yes, it's essential to tightly regulate banks' lending standards, especially in land-based lending (which is most lending).

- **Mismatch**. Left to themselves, banks' lending decisions have been based on what is good for banks and our 'light-handed' regulatory framework has supported this. It's now clear that "what is good for banks" does not always equal "what is good for our economic and social well-being".
- The housing crisis and the social stresses created by it demonstrate this mismatch. It is naive to believe that these interests are always aligned yet the RBNZ's legislation is written as if they were — or as if it didn't matter because 'someone else' would be better placed to fix it.
- The RBNZ has an outsized role in encouraging and potentially mitigating this damage, so it is bad legislative design that supports this statement from the Bank's Deputy Governor: "**To be clear, the Reserve Bank does not have housing affordability as an objective**".
- Where the banks' self-interest is misaligned with social and economic well-being, regulation must tilt the playing field. We have no other viable regulator than the RBNZ so it must be prepared, and legislatively equipped, to step up.

Macro-prudential tools are among the few that can directly address these mismatches/market failures.

1. **The debt-to-income tool** should applied and retained *permanently* and with a signalled long-term reduction in the ratio. 'Long term' = a generational time-scale, the same one that got us into this land inflation mess.
2. **Sectoral credit guidance** should be made explicit and banks should understand that guidance will be backed by more intrusive rules if they don't voluntarily adjust. In respect of land inflation, this is not about 'picking winners', it is about stopping banks from picking losers for the rest of us.
3. **Sectoral lending ratios** based partly on risk to the economy and well-being, not just credit risk to the banks as it is today.
   For example, because home mortgage lending carries the lowest bank risk, banks have been allowed to leverage capital further in this sector. This has had the perverse effect of increasing lending to the housing sector at the expense of the wider economy and well-being.
   The RBNZ should take a more holistic view of bank risk by allowing more cross-subsidy of risk, ie increase the capital against low-risk lending in order to lower it against higher risk lending such as business lending secured by cash flow or forward order books.

3.D Do you think the Reserve Bank should take a more intensive approach to verifying supervisory information? Which verification model do you favour?

AGREE: It's clear from revelations around something as fundamental as the ANZ's capital modelling that (1) the level of trust placed in banks' self-reporting is misplaced, (2) the consequences to banks of misreporting on a colossal scale are minor, and (3) the RBNZ is under-resourced in its prudential supervision.

I support Option 3: Regular on-site inspections of individual banks
This option would entail a verification approach that is broadly consistent with those of prudential authorities such as APRA, the UK's PRA, and Canada's OSFI, all of which inspect firms on a periodic cycle.

4.B If the Reserve Bank were to launch an asset purchase programme (quantitative easing)

Do you believe it should be able to make its own decisions to purchase government debt, but
require ministerial consent to purchase other assets?

DISAGREE.
(1) The RBNZ should not be able to embark on any form of QE without ministerial consent. This is to provide proper **coordination with fiscal policy** to ensure that QE money gets into the real economy quickly, and is not trapped in financial asset bubbles.
(2) The minister should be able to instruct the RBNZ to **purchase new government debt** as well as existing government debt. New debt would be spent into the economy directly by the government whereas existing debt purchases inject money into the financial system.

Are there other implementation issues around asset purchase programmes that should be considered?

- The international experience with QE shows that, whatever the very short term bank liquidity benefits might have been, it led to massive asset price inflation and minimal "trickle-down" into the real economy.
- This was due to its design, specifically its transmission mechanism – it injected liquidity into the financial system rather than directly into the real economy.
- The financial system players demonstrated that, left alone, they will direct this cash windfall into financial assets, not productive business lending and consumer (non-asset) spending.
- This rapid and large asset inflation made it hard to turn off the taps so **QE has created long-term dependency on itself** due to fear of bursting the asset bubble.

Lessons:

(1) **Go direct to the real economy**. Set up mechanisms in advance of a crisis to allow injection of money into the real economy at short and medium timeframes. Short-term timeframe: helicopter money injection - a one-off cash payment for all, or benefit/superannuation one-off payments, or a payment for a valuable product or

service such as solar panels or home heating. Medium term: school/hospital building programme, infrastructure brought forward, EV charging stations, tree-planting etc

(2) Do not inject QE directly into the financial system **unless it can be ring-fenced for real-economy lending**, not more asset purchases.

(3) **Turn off QE** at the first signs of asset inflation.

4.D Do you have any other comments on the balance sheet functions described in Chapter 4?

- The RBNZ should use its balance sheet to directly finance a large-scale land purchase and development programme on behalf of the government
- An example would be a leasehold land bank for the provision of public and private housing on Crown leased land. A land bank would ensure that the Bank's grows a high quality asset base at the same rate as its financing. A multibillion dollar Crown land bank with public and private leases on favourable terms could help to unwind some of the damage from inflated land prices.

6.B What would you change about current (coordination) arrangements, and why?

Formalise coordination between monetary and fiscal policy.

- **The extreme independence granted to the Reserve Bank** and its monetary policy has created much of the problem we have today with the explosion in private credit. Governments of both stripes have, unfortunately, been complicit in this. They conveniently, on too many occasions, left stimulation of the economy to the RBNZ via its frequent drives to get banks lending. This meant governments could run austerity budgets and fiscal surpluses. But the result has been a massive build-up of private debt, most of it unproductive.
- A closer, more formal connection between the RBNZ and Treasury could — and should — **allow planning as well as information sharing**.
- **Well-targeted fiscal spending is more efficient than poorly targeted private borrowing**. The RBNZ's own research shows that a one dollar rise in house prices produces a mere eight cents of spending in the real economy — and that dollar will lead to higher borrowing with its matching interest payments. The 'wealth effect' is both damaging and inefficient as a way to boost economic activity. On the other hand, overseas research shows that a dollar placed directly into the pocket of a low income earner will generate two dollars of economic activity.
- **Macro-prudential policy** would also benefit from this closer coordination as it would start to reduce the "not my problem" approach that the RBNZ has well-being when its policies and actions create "collateral damage". The damage to housing affordability and wealth disparity that its operation of monetary policy has done is a glaring

example. It is bad enough that the monetary side caused the damage, but failure to actively use macro-prudential tools and other measures to mitigate the damage just shows how important it is to treat the coordination relationship wholistically.