The Treasury

Tax, Housing and RBNZ Information Release

April 2021

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[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

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[40] Not in scope

[42] 18(d) - information requested is or will soon be publicly available

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Requiring the Reserve Bank to have regard to house prices

Date:	15 January 2021	Report No:	T2021/11
		File Number:	MC-1-1-1-2

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	Agree to the recommendations with respect to requiring the Reserve Bank to consider house prices in the formulation of monetary and financial policy	15 January 2021

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Neil Kidd	Principal Advisor, Macroeconomic and Fiscal Policy	[39]	N/A (mob)	✓
Ben Gaukrodger	Acting Manager, Macroeconomic and Fiscal Policy		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Requiring the Reserve Bank to have regard to house prices

Executive Summary

On 24 November 2020, you wrote to the Governor of the Reserve Bank (the Bank) to consult on a proposed change to their monetary policy remit, specifically whether to require the Monetary Policy Committee (MPC) to "seek to avoid unnecessary instability in house prices" whilst pursuing their operational objectives. The Bank's response indicated that they would prefer that consideration of house prices be explicitly required in their forthcoming financial policy remit, and possibly by issuing a section 68B direction, instead of their monetary policy remit. This report provides the Treasury's advice on your proposed change and the Bank's alternative.

We consider that there is more potential to deliver your housing objectives by issuing a section 68B direction or through an addition to the forthcoming financial policy remit.

Compared with monetary policy, there is less conflict between financial policy objectives and your broader objectives around housing affordability and house prices. The objectives are more likely to complement each other in many regards. Whilst it is still unclear how much of an impact a secondary, "have regard to" requirement would have on Bank decision making, there is the potential that a house price requirement could encourage the Bank to go further in using some of their financial policy tools than they would from considering housing as solely a financial stability issue.

If you wish to strengthen the Bank's role in relation to house prices, we recommend that you issue a direction under section 68B of the current Reserve Bank Act. This allows you to direct the Bank to have regard to a specific government policy when formulating financial policy. The effect of any section 68B direction could be carried over into the financial policy remit after the passage of the Reserve Bank of New Zealand Bill. An alternative to issuing a section 68B direction is to consult the Bank on a draft financial policy remit now, but this would only come into force after the passage of the Reserve Bank of New Zealand Bill.

The proposed change to the monetary policy remit could be a useful signal to send that you expect the MPC to consider the broader impacts of their decisions. However, the primacy of the MPC's economic objectives of stable inflation and sustainable employment mean the impact on house price inflation is likely to be limited.

The way in which the MPC considers house prices probably does not align with the broader concerns you have about high house prices. The MPC largely considers house prices to the extent that they are important for their economic objectives of price stability and maximum sustainable employment. Adding a requirement for the MPC to have regard to house prices is a useful signal that you expect some of the broader impacts of high house prices to be considered when formulating monetary policy.

However, we would not expect the addition of a requirement to have regard to house prices to have a significant impact on monetary policy decisions. Using monetary policy to reduce house price growth requires tighter monetary policy, which, all else equal, leads to lower inflation and higher unemployment. In the current economic context, if monetary policy were used to moderate house price growth, it would likely come at the expense of the MPC's primary economic objectives. Given that the proposed requirement to consider house price instability would be secondary to the MPC's economic objectives, the MPC is unlikely to adjust policy in any substantial way and the impact on house price inflation is likely to be limited. To some extent, this is also true of some existing requirements in the MPC's remit.

For example, the requirement to "seek to avoid unnecessary instability in interest rates" would, at times, conflict with the primary objectives and likely be given relatively less weight.

If you wish to include a reference to house prices in the monetary policy remit, we think the wording you proposed in your letter to the Governor is the best option.

We have considered the alternatives identified by your office but consider that these risk representing your concerns about house prices as solely a financial stability or macroeconomic stability issue, rather than representing your broader concerns about house prices. We also considered an update to the specification of the Government's economic objective set out in the remit but think that this would carry less weight than requiring the Bank to "have regard to" house prices. Finally, we considered specifying a housing affordability consideration, rather than a house price consideration, in the monetary policy remit but think this could be difficult to capture in a clear way, given that interest rate changes have different impacts on housing affordability for different groups.

If you wish to proceed with changing the monetary policy remit and/or issuing a section 68B direction or commencing work on the future financial policy remit, we recommend you:

- Direct Treasury to consult with the Bank on the wording for either a section 68B direction or for the future financial policy remit that would best enable them to contribute to your housing objectives.
- Write to the Governor indicating your decision on the monetary policy remit. An order in Council is then required to implement the change.

We are also aiming to provide you with some further advice in February on options for Ministerial involvement in the future Deposit Takers Act, for example in the setting of standards for bank regulation, that could progress your broader government objectives.

Recommended Action

We recommend that you:

a **agree**

i. to proceed with work on a section 68B direction for the Bank to have regard to a government policy on housing in relation to its financial stability functions and consult with the Bank before issuing a direction

Agree/Disagree

or

ii. to consult the Bank on a draft financial policy remit before the Reserve Bank of New Zealand Bill is passed, including a requirement for the Bank to have regard to the Government's housing policy objectives

Agree/Disagree

b **indicate** if you wish to proceed with amending the monetary policy remit as proposed in your letter of 24 November

Yes/No

If yes:

c **agree** to write to the Governor setting out your decision on adding a house price consideration to the monetary policy remit

Agree/Disagree

d **note** the Treasury will provide you with a draft Cabinet paper proposing the change for your agreement

e **note** that further advice on the appropriate level of Ministerial involvement in financial policy under the future Deposit Takers regime will be provided to you in February.

Ben Gaukrodger
Acting Manager, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

Treasury Report: Requiring the Reserve Bank to have regard to house prices

Purpose and Background

1. This report sets out some considerations in adding house prices to the monetary policy remit and forthcoming financial policy remit, and provides advice on what the wording of any change to the monetary policy remit should be.

2. This advice follows from your 24 November 2020 letter to the Governor of the Reserve Bank (the Bank) that consulted on a change to their monetary policy remit. Your proposal was to require the Monetary Policy Committee (MPC) to "seek to avoid unnecessary instability in house prices" whilst pursuing their operational objectives. The Bank replied that, amongst other things, they would prefer that consideration of house prices be explicitly required in their forthcoming financial policy remit, and possibly by issuing a section 68B direction, instead of their monetary policy remit.

Analysis

3. The MPC and the Bank, when setting monetary and financial policy, already considers house prices and housing costs to an extent. However, the way in which they consider them probably does not align with the broader concerns you have about high house prices.

4. Housing costs – for example, rents, maintenance and the cost of construction of a new house – enter into the measure of the Consumer Price Index (CPI) that the Bank target. However, the CPI does not include house prices directly, and it gives little weight to the cost of land (there is no measure of the cost of land for owner-occupiers in the CPI - the homeownership component only includes the cost of the building). Since land has been the main component of the increase in house prices over recent decades, these exclusions may mean the CPI gives an incomplete picture of housing inflation for policy purposes.

5. Residential lending is an important channel for the transmission of monetary policy, which provides another lens through which the Bank will consider house prices. Importantly though, the MPC considers housing costs, and to a lesser extent house prices, to the extent that they affect the MPC's economic objectives as opposed to being given weight as they affect broader government objectives. Similarly, for financial policy, the Bank are not required to consider the impact that house prices have on broader government objectives, only financial policy objectives.

Including a house price consideration in the monetary policy remit

6. The Reserve Bank Act allows you to specify, in the remit for the MPC, a requirement for the MPC to have regard to one or more matters in connection with seeking to achieve an economic objective.

7. When interest rates are at the extreme range of the cycle, it is possible that requiring the Bank to have regard to house prices might result in <u>slightly</u> higher interest rates and lower house prices than otherwise. Whether this is welfare enhancing would depend on the benefits of greater house price stability outweighing any costs that might arise from marginal impacts on the Bank's primary economic objectives.

8. However, we would not expect that the MPC would be able to have a significant impact on house prices in the long-run. Persistently higher interest rates than warranted by the MPC's economic objectives are likely to be costly. The primacy of the MPC's economic objectives of stable inflation and sustainable employment mean the impact on house price inflation is likely to be limited.

9. As the Reserve Bank set out in their response, monetary policy is a cyclical tool: it aims to adjust interest rates relative to their natural level (the level of interest rates that are neither stimulatory nor contractionary). Over time, a large reduction in the natural level of interest rates has contributed to rising house prices. The MPC have little control over the natural level of interest rates: they set the OCR (or use alternative monetary policy tools) to influence interest rates relative to this natural rate in order to manage the economic cycle. In theory, alternative monetary policy tools could offer a way to stimulate the economy whilst focussing stimulus away from the housing market. However, to date, these have worked primarily by further reducing market interest rates, and we expect have affected house prices in a similar way to reductions in the OCR.

10. Attempting to use monetary policy to change the long-run level of house prices would require a persistently higher level of interest rates than warranted by the MPC's economic objectives. At most, we would expect that the MPC would only mitigate the extremes of the interest rate cycle. Even then, if that entailed significant trade-offs with their economic objectives, then the requirement to have regard to house prices is unlikely to result in a significantly different monetary policy stance. This is likely to be the case presently, where there is a risk of further high house price growth but unemployment is elevated and CPI inflation is below the midpoint of the target band.

11. This is likely to be true for other, existing requirements in the MPC's remit too. For example, the MPC is currently required to "seek to avoid unnecessary instability in output, interest rates, and the exchange rate". At times, this requirement will be complementary to the MPC's primary objectives and at times in conflict. When it is in conflict, the MPC likely do not place significant weight on it – or they consider that the instability in output, interest rates and the exchange rate is necessary, not unnecessary.

12. Finally, there is a risk that requiring the Bank to have regard to house price instability creates uncertainty as to the MPC's commitment to their economic objectives. It could come at the cost of higher expected interest rates – for example, following your letter to the Governor, market expectations of interest rates for the 3rd quarter of 2021 shifted up by 9 basis points and the NZD/USD exchange rate by +0.7 per cent.

13. While a requirement to have regard to house prices is unlikely to significantly affect decisions, there is value in requiring the Bank to have regard to the secondary consequences of their decisions. The monetary policy remit already identifies a number of impacts the bank should have regard to e.g. unnecessary instability in output, interest rates and the exchange rate. Adding house prices to the list of considerations might result in the Bank informing the market more fully as to how they have considered the impact they have on house prices and could, when interest rates are at their extreme, result in slightly different choices.

What wording would the requirement take?

14. What wording to choose depends on what government objective you are aiming to achieve when requesting the MPC to have regard to house prices. For example, if you were concerned with the impact that monetary policy might have on levels of inequality, then house prices would only capture one part of that impact and ignore other impacts such as broader asset prices and any offsetting impacts from low interest rates e.g. higher than otherwise employment for those on the margins of the labour market. Having said that, house prices will capture some aspects of the wealth inequality

generated by high house prices, which create a large transfer of wealth towards property owners.

15. We understand there are three main options that have been identified by your office to require the Bank to have regard to house prices. These are marked up as potential additions to the monetary policy remit in bold below.

    "In pursuing the operational objectives, the MPC shall:

    i. *have regard to the efficiency and soundness of the financial system,* ***as well as the stability of house prices*** *(option 1);*

    ii. *seek to avoid unnecessary instability in output, interest rates,* ***house prices*** *and the exchange rate (option 2);*

    iii. *discount events that have only transitory effects on inflation, setting policy with a medium-term orientation.*

    iv. ***give consideration to the effect of monetary policy decisions on house prices and the potential associated risks to macroeconomic stability*** *(option 3)"*

16. Our preference is for option 2, to "seek to avoid unnecessary instability in house prices". It places house prices alongside unnecessary instability in output, interest rates and the exchange rate, which are *some* of the other potentially negative economic impacts that could be generated as the MPC pursue their economic objectives. That the wording would be to seek to avoid <u>unnecessary</u> instability helps to further clarify that this is a secondary objective – presumably there would be times when the MPC considered that house price changes were a necessary consequence of meeting their economic objectives.

17. Option 1 risks making consideration of the stability of house prices more of a financial stability consideration, whereas your letter to the Bank makes it clear that your concern with regard to house prices is broader than just financial stability. Option 3, "to give consideration to the effect of monetary policy decisions on house prices" does not make it clear what you want to happen to house prices, and the bank already consider the effect of monetary policy on house prices to the extent it impacts on their operational objectives. It also makes house prices a consideration with respect to macroeconomic stability, as opposed to your broader considerations. Our second preference would be option 1, rather than option 3.

18. In addition, we understand there has been a proposal that instead of a requirement to have regard to house prices, that house prices could instead be added to the Government economic objective that is specified in the remit. We think that adding a reference to house prices to the Government economic objective would carry less weight than adding an additional requirement to the remit.

19. A final alternative would be something that more explicitly specified the outcome that you are trying to achieve e.g. have regard to housing affordability, perhaps for specific groups. However, it might be that the objective is complicated to specify, given that you will have concerns about a number of different groups e.g. prospective first home buyers, recent buyers with large mortgages, as well as any flow on impacts on the rental market. It would be necessary to specify what groups you wanted to improve housing affordability for, as interest rates are a blunt tool and they would have different impacts on affordability for different groups.

Including a house price consideration in the formulation of financial policy

20. There is less likely to be a conflict between financial policy objectives and a requirement to consider house prices when setting financial policy, compared with the

trade-off involved for monetary policy. More often, moderating house price growth will reinforce financial stability. Financial policy tools can also be more targeted to specific sectors of the housing market e.g. residential investors, in contrast to interest rates, which are quite a blunt tool.

21. Section 68B of the Reserve Bank of New Zealand Act allows you to issue a direction to the Bank to have regard to a government policy that relates to the Bank's financial policy functions. If you wish to proceed with a section 68B direction, you will need to consult with the Bank before giving a direction. This will need to be set out in a signed written statement, presented to the House of Representatives and published in the Gazette. The effect of any section 68B direction could be carried over into the financial policy remit after the passage of the Reserve Bank of New Zealand Bill.

22. Whilst choosing similar wording as for the monetary policy remit could be an option, section 68B refers to "a government policy", which the Bank would be required to have regard to. We have not done a full assessment of the extent to which financial policy tools could impact on housing objectives. Given the potential for financial policy tools to provide a more targeted approach in certain areas (for example on LVR settings), it would be important to consider exactly how to specify the government policy the Bank should have regard to and how the Bank would interpret any direction in carrying out its financial policy functions.

23. An alternative to issuing a section 68B direction is to begin consulting the Bank on the forthcoming financial policy remit. The financial policy remit will set out matters the Bank board should have regard to when pursuing the financial stability objective. However, this would only come into force once the Reserve Bank of New Zealand Bill is passed.

24. If you prefer this option, we can begin a process with the Bank of drafting a financial policy remit for your agreement before the Bill is passed, which includes a request for the Bank to have regard to the Government's housing policy objectives. [33]

Next Steps

25. As you have already consulted the Bank on the change to the MPC's monetary policy remit, if you are minded to proceed, no further consultation is necessary. However, we would recommend a letter be sent to the Reserve Bank informing them of your decision. This could also set out your decision on the section 68B direction or the future financial policy remit and that you would like to work with them to consider how best to articulate this. If you agree, we can draft the letter. An order in Council is then required to implement the change.

Ministerial involvement in financial policy under the Deposit Takers Act

26. In the future Deposit Takers Act (DTA) regime, there will also be a new process for how financial policy is developed and implemented. The Treasury and the Reserve Bank are currently considering the role of the Minister in financial policy decisions under the DTA (including standards for bank regulation). We are aiming to provide you with some advice in February on options for Ministerial involvement, for example in the setting of standards for bank regulation, that could progress broader government objectives.

Annex 1: Sample Financial Policy Remit

[33]

[33]

[33]

Annex 2: Current monetary policy remit

The Government's Economic Objective

The Government's economic objective is to improve the wellbeing and living standards of New Zealanders through a sustainable, productive and inclusive economy. Our priority is to move towards a low carbon economy, with a strong diversified export base, that delivers decent jobs with higher wages and reduces inequality and poverty.

Context

Monetary policy plays an important role in supporting the Government's economic objective. The Reserve Bank of New Zealand Act 1989 (the Act) requires that monetary policy promote the prosperity and wellbeing of New Zealanders, and contribute to a sustainable and productive economy. Monetary policy contributes to public welfare by reducing cyclical variations in employment and economic activity whilst maintaining price stability over the medium term.

This remit is issued by the Minister of Finance to the Monetary Policy Committee (MPC) under Clause 3, Schedule 1 of the Act.

1) Monetary Policy Objectives

Under Section 8 of the Act the Reserve Bank, acting through the MPC, is required to formulate monetary policy with the goals of maintaining a stable general level of prices over the medium term and supporting maximum sustainable employment.

2) Operational Objectives

For the purpose of this remit the MPC's operational objectives shall be to:

i. keep future annual inflation between 1 and 3 percent over the medium term, with a focus on keeping future inflation near the 2 percent mid-point. This target will be defined in terms of the All Groups Consumers Price Index, as published by Statistics New Zealand; and

ii. support maximum sustainable employment. The MPC should consider a broad range of labour market indicators to form a view of where employment is relative to its maximum sustainable level, taking into account that the level of maximum sustainable employment is largely determined by non-monetary factors that affect the structure and dynamics of the labour market and is not directly measurable.

In pursuing the operational objectives, the MPC shall:

i. have regard to the efficiency and soundness of the financial system;

ii. seek to avoid unnecessary instability in output, interest rates, and the exchange rate; and

iii. discount events that have only transitory effects on inflation, setting policy with a medium-term orientation.