Housing, financial stresses, and the regulatory role of the Reserve Bank

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Michael Reddell
www.croakingcassandra.com

Introduction

Thank you very much for the invitation to be here tonight.

The approach to address this audience came just a few weeks after I left the Reserve Bank, It was, I gather, prompted by some comments I had made on my blog about a somewhat-unconvincing speech on housing given by the Bank's Deputy Governor, Grant Spencer.

This evening I want to make some remarks under three headings:

- Highlight the two key factors influencing the price of houses (and urban land in particular), especially in Auckland?
- Question how good the Reserve Bank's analysis in support of LVR restrictions have been and whether those (actual and planned) restrictions fit with the statutory goals the Bank is required to use its powers to pursue?
- Identify how unusual the Reserve Bank's position as a regulator is, and suggest changes to the way in which the Reserve Bank is governed and is empowered to conduct regulatory activities.

House prices - what has driven them?

House prices in Auckland in particular are a social and political scandal. But they result from regulatory choices made (actively or passively) by successive governments. Writing in the *Herald* the other day, Brian Fallow talked of a market failure. This is no market failure. Instead, the market - in Auckland and in Sydney and London - has done what might reasonably have been predicted if people had stopped to do the analysis. In that sense, high average house and land prices are perhaps better thought of as a government outcome than a market one.

Median house prices in Auckland are now almost $750000, and those in Invercargill are a touch over $200000. If anything, that difference is probably understated. They have large sections in Invercargill and increasingly often tiny ones in Auckland.

This is about comparisons between prices in middling suburbs in Auckland, and those across the country. It is about comparisons between real prices in those suburbs now, and those 30 or 50 years ago. Those suburbs – places like Onehunga, Mt Wellington, and Mt Roskill -

are the sorts of places where young families might have reasonably expected to be able to buy. Instead, Auckland - which simply is not that big a city - now has among the higher house price to income ratios anywhere in the advanced world.

My proposition is that it is down primarily to the interaction of two sets of policies:

- the combination of regulatory measures (law and administration of law) which have made housing, and urban land supply, only sluggishly responsive to changes in demand, and
- The active choice to target high levels of inward (non-citizen) permanent and long-term migration.

Each set of policies was no doubt well-intentioned, but policies should be judged primarily by their consequences. Each in isolation might have done little harm in driving up house prices, but together they have been disastrous.

Let's take "supply restrictions" first. "Supply restrictions" is shorthand for a whole range of laws and policies, set by central and local government, which mean that when demand for housing increases, too much of the impact is seen in prices (especially land prices) rather than volumes. As Robert Shiller has demonstrated in the US, and Nigel Stapledon in Australia, in the days before tight land use restrictions, real urban house prices fluctuated, but with no particular trend. Real house prices in the US had been not much different in 1990 than in 1890. Perhaps even more striking is the famous series from Amsterdam's Herengracht – where there had been little systematic change in prices of the same canal-side houses over several centuries.

A nice note that accompanied the Productivity Commission's report last week reminded us how little "town planning" there was in New Zealand for a long time. People were more or less free to use their land as they saw fit. This is a bit of a caricature no doubt, but not too much so. Here[1] is a Minister introducing to Parliament New Zealand's first piece of town planning legislation in 1926:

> Cities and towns in the Dominion at the present time have no schemes of town planning and the sooner the controlling authorities have the power and set to work and draft such schemes the better for themselves and the people generally.

In fact, it wasn't until the 1950s that "town planning" became a major consideration. And, of course, the legislation changed repeatedly over the years, finally landing in the form of the Resource Management Act in 1991. Strangely - at least with the benefit of hindsight - key participants apparently regarded the RMA as being likely to result in less restrictive planning regimes. That belief would have been consistent with the general thrust of policy, again under both governments at the time.

Quite what the RMA - and associated powers in, e.g., the Local Government Act - actually meant for housing and urban land prices wasn't immediately apparent. . In the wider economic and policy community, the whole panoply of rules around site coverage ratios, protection of view shafts, rules giving effect to Council prejudices against "sprawl", and so

[1] http://www.justice.govt.nz/courts/environment-court/about-the-environment-court/History

on were all something of a mystery. Macroeconomists, in particular, struggled to come to terms with the idea that these microeconomic provisions might make so much difference.

But I don't think anyone now really doubts that supply constraints are an important part of the story. Councils will sometimes defend themselves, talking about how many years of supply they aim to release, but signals from the market (land prices) are pretty clear. Again, there are debates about "densification" vs "sprawl", but in this context "land supply" can encompass either - it is about the ability to use land efficiently. Personally, I'm a bit sceptical about the push for densification: New Zealand isn't exactly short of land, historical evidence is that as cities get richer they tend to become less dense, not more, and in any case data suggest that by New World standards, Auckland is already a relatively dense city.

It isn't that the Auckland Council and the land use rules here are necessarily any worse than those of councils around the rest of New Zealand. There are, no doubt, land use restrictions etc in Invercargill, but these things matter much more in Auckland because the population is growing quite rapidly. Mostly - and on average over time - it is still growing quite rapidly because of the large scale trend immigration of non- New Zealand citizens.

Graeme Wheeler recently suggested that one problem was that among advanced countries only in Iceland did the biggest city represent a larger share of total national population than is the case in New Zealand.

But this is just wrong. Quite a number of small advanced countries have big cities that make up a very large share of the national population. Definitions matter, of course, - what is the limit of the metropolitan urban area - but when I worked my way through a list of advanced countries Auckland's size (in a country of 4.5 million) just didn't look that unusual by international standards. Tel Aviv makes up 45 per cent of Israel's population, and Dublin almost 40 per cent of Ireland's. Copenhagen, Vienna, Valetta, and Riga each look to make up at least as large a share of their respective country's total population as Auckland's does. Tallinn and Lisbon don't look to be much behind.

What marks Auckland out from most of these cities is not total size, or even size as a share of the whole population, but the sheer pace of growth of Auckland. I did some work a while ago trying to look at population growth in the largest cities of each advanced country in the post-war era. Across all advanced economies, as far as I could tell, only Tel Aviv had grown at a faster rate than Auckland[2]. The issue has come into sharper focus as population growth in the rest of the country has slackened, or even started to go into reverse.

I'm not here today to discuss whether rapid population growth is a good or bad thing. But if we are going to have rapid population growth in Auckland, and yet we don't have policies that enable new houses and land to come to market quickly and affordably, then it is no surprise that we have the affordability problems we do.

Of course, New Zealand's population has been growing for a long time but high house prices haven't always been a problem.

[2] There are other cities that have had larger absolute increases in population, but pressures of growth (including those around utilising land) tend to be proportional rather than absolute.

Part of that was because of the different combination of rules. There was much less aggressive urban town planning. And in the post-war decades, people wanting Housing Corp loans - the way most young couples (including my parents) got into their first homes - had to use them to build a new house. The whole focus of policy was on home ownership, and homeownership meant construction. It was similar story in other countries - the UK and Australia for example[3]. Norman Kirk, who built his own house, was Mayor of Kaiapoi in the 1950s - one suspects the local borough council had a different attitude and perspective than most of those today.

That mix of policies and attitudes all broke down in the 1970s and 1980s. The government largely got out of housing finance, and when finance was provided it could be used for new or existing houses. And deliberately or otherwise the powers of local government officials and councillors grew, and their interests seemed to diverge from those of residents wanting affordable housing. For 15 years there also wasn't much population pressure on housing. But then immigration policy was reversed again in the late 80s and early 1990s.

Part of that change of policy involved a rather strange notion that we should replace people that were leaving, as if the government knew better than people about the opportunities in New Zealand. There wasn't much public debate (or even, as far as I can tell, a very active one within government circles). It just happened - the sharp increase in migrant numbers didn't need Parliament's direct approval and even today the target level of non-citizen migration is just set by the Minister of Immigration (currently 135000-150000 permanent residence approval on a rolling three year basis). Many otherwise well-informed people are surprised to learn that there is even a target. But as a result, New Zealand has had among the very largest average rates of non-citizen inflows (net) anywhere in OECD.

We aren't bound by treaty to let people in. We don't have porous borders resulting in a big flow of illegals. Instead, our government chooses how many non-New Zealanders we allow in each year[4], and does so knowing that the bulk of them will gravitate to Auckland.

That immigrants disproportionately come to Auckland isn't unusual - it is what we see around the world. Many of the people coming are used to bigger cities (whether from China, the UK, South Africa, India or the Philippines). Migrants might want the opportunities of a new country, but they always want connections to their own culture. Migration research shows that (quite sensibly) people congregate where people like them already are.

Debates about the role of immigration get frustrating around this point. As we all know, lots of New Zealanders come and go - more go than come back, but the cycles are large. Immigration policy is not about New Zealanders - it never has been and never will be in a free society. And year to year fluctuations shouldn't be what bother anybody concerned with medium-term economic policy either.

In the 1980s we had an average inflow of around 10000 non-citizens a year. We more actively target things now, and have had an average net inflow of non-citizens of 40000 per annum since 2000. Those are really big differences (750000 people over 25 years). In fact,

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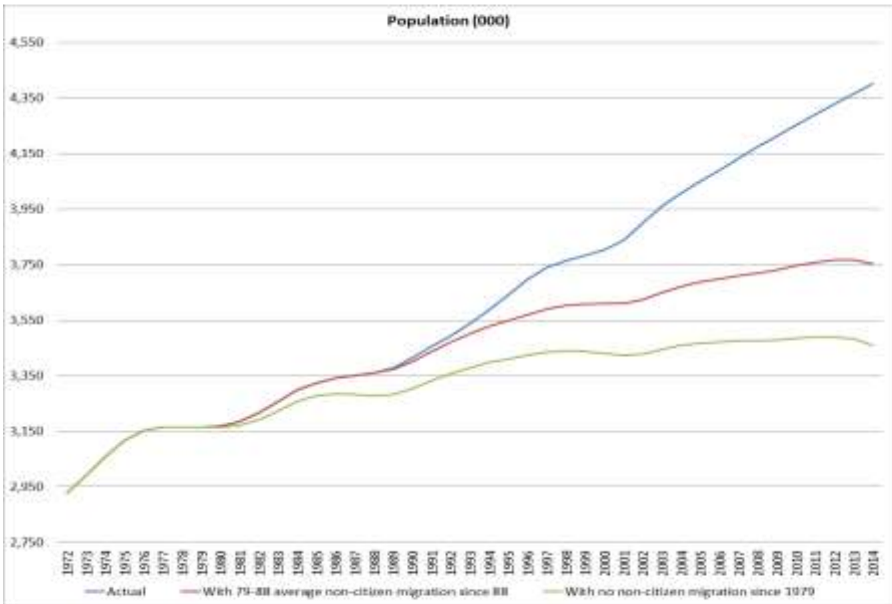
[3] John Kay discusses the UK experience here http://www.ft.com/intl/cms/s/0/14cd1280-f25d-11e4-b914-00144feab7de.html#axzz3aSTV7oXE

[4] Australian immigration to New Zealand is unrestricted, but the numbers involved are small and quite stable.

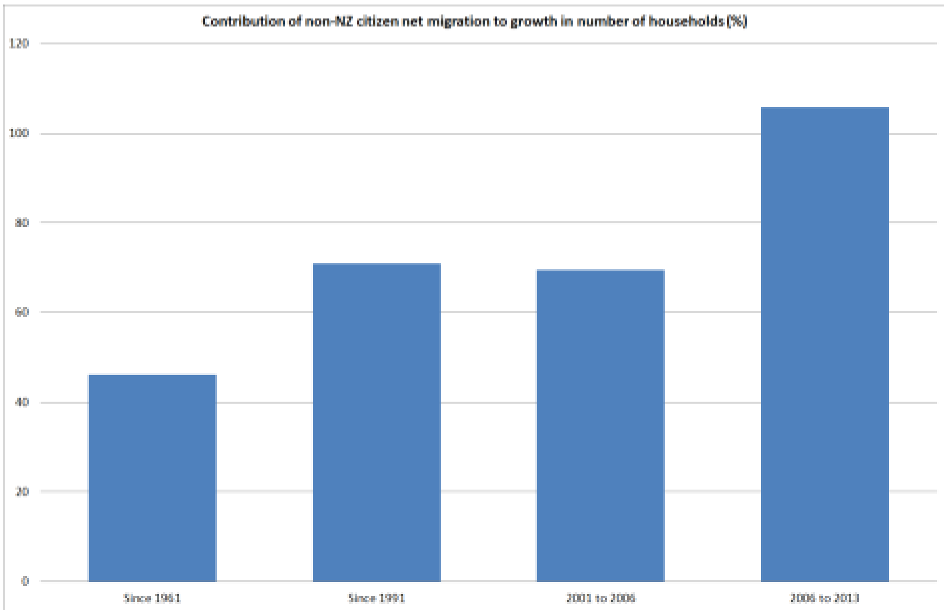
the difference is so large that if we went back to 1980s non-citizen immigration levels, New Zealand's population would now be flat or falling.



In their recent book, *Generation Rent*, Shamubeel and Selena Eaqub argue that immigration policy is not particularly important to understanding house prices. They do an interesting exercise breaking down household formation over the last 50 years down between natural increase, change in average household size, and net migration. Net migration accounted for only 9 per cent new New Zealand households over that period. But that is, in many ways, quite misleading. Most of the outflow of New Zealanders was happening away - it was large in the 70s and 80s when inward migration was much more restricted. The opportunities in Australia, in particular, were just better. That outflow took pressure off resources in New Zealand - and, in particular, off the housing and urban land market. And the government has no direct control over the activities of New Zealanders. But foreign citizens can come, and stay, only with the permission of the New Zealand government. All the inflow of non-citizens is a policy choice.

And when I looked at the data this way, I found that since 1961 non-citizen immigration accounted for 45 per cent of all household formation, since 1991 about 70 per cent, and between the last two censuses, more than all the new household formation was accounted for by non-citizen immigration. Natural increase is now quite small, the number of people per house hasn't changed recently, and there was a continuing outflow of New Zealanders. In other words, all (or almost all)[5] the pressure to build new houses results from the net migration of non-citizens - it is a direct policy choice.

[5] With lower house (and land) prices it is likely that we would have seen the average number of people per dwelling continue to drop.



Nor is there any basis for simply saying that fast population growth makes house and land inflation pretty inevitable.

Houston is the best-known example of the alternative approach, where housing and urban land supply are much more responsive to changes in demand. Since 1979, the population of the Houston metropolitan statistical area has more than doubled, from 3 million in 1979 to 6.5 million last year. Over that period, real house prices have fallen in Houston. By contrast, since 1979 Auckland's population has less than doubled, and Auckland house prices have much more than doubled. Houston is not the only US example.

I'm not here to discuss what to do about housing. With a much more responsiveness housing market, rapid government-led population growth wouldn't be a problem. It isn't in Houston. Then again, I'm not aware of any major urban area where the planning and control regime has been successfully wound back. If the political process makes that sort of wind back impossible, then in a sense New Zealand is fortunate to be able to do something about its population pressures. They arise now entirely from the inward immigration of non-New Zealanders, and that immigration is entirely under the New Zealand government's control.

Because I want to focus most of the rest of my remarks on the Reserve Bank and its responses to the housing market, I don't have time to deal extensively with other factors that are often blamed. But just quickly:

- How about the tax system? We have a national tax system, and yet affordability issues are concentrated in Auckland. And in the last 20 years there have been no material changes to the tax system that would have systematically boosted house and land prices. Yes, we are unusual in not having an explicit capital gains tax, but there is no international evidence suggesting that CGTs in other countries have materially altered house price levels or cycles. There may, of course, be useful things that can be done at the margin, such as a move back towards land-value rating.
- How about bank capital requirements? Yes, banks hold less capital against each dollar of housing loans than against most other loans. That is because lending

secured on housing is generally much less risky than lending for other things. This is a result across many countries and many decades. And New Zealand banks have higher risk weights on housing lending than their peers in most other advanced countries. For a dollar of housing lending in New Zealand, more capital is held than would be held on the same sort of loan made in Australia, Canada, Sweden, or the United Kingdom.

- What about low interest rates? Remember (a) that interest rates are low for a reason (about overall demand at that level of interest rates, and (b) that despite low interest rates, real house prices in much of the country are now well below those in 2007. And interest rates should only affect land prices, so if land supply were not so heavily restricted, changes in interest rates would not, even in theory, make much difference to urban property prices.
- What about foreign buyers? Perhaps it is not a trivial issue - we don't know (and don't really need to know) – but, at bottom, it is a land supply issue too. In supply-responsive markets increased demand to buy houses does not push up prices much, or for long. But whatever the story right now, and new scare headlines in the *Herald* yesterday, the Chinese foreign purchasers story has been around for only a year or two, and Auckland prices have been absurdly high for a long time
- Construction costs are often cited as a factor in the story of high New Zealand house prices. There may be something to this, but intensive scrutiny has not pointed to obvious areas where policy choices are responsible. Moreover, any issues around construction costs are not, disproportionately, an Auckland phenomenon

You might wonder why I have gone on at such length trying to make the point that high house prices are largely a response to two specific sets of government policy interventions.

It is because the implications, and risks, from high house prices depend greatly on what has taken them to current levels. The Reserve Bank in the last couple of years has moved to actively use direct controls on borrowers' access to housing finance through the banking system. And yet it has done so without any disciplined and systematic analysis of what has being on, or how the New Zealand situation compares to that abroad.

Graeme Wheeler lived in the United States through the house price boom and subsequent bust. As I've written previously, my impression is that he is (reasonably enough) determined that New Zealand should not experience anything quite that bad. That is a laudable ambition, but the US experience is only useful if we correctly understand what happened there. We don't want to repeat their mistakes, but we need to know what the US mistakes were. Nasty housing busts don't happen in a vacuum, or as an unlucky draw by a random number generator.

Of all the explanations for the US housing finance boom and bust, I've found Peter Wallinson's book *Hidden in Plain Sight* most convincing. To cut a long story short, Wallinson documents the huge deterioration in housing lending standards that took place over the 10 or so years prior to the crisis. Most of it appears to have been due to directions from Congress and the federal government, both to the "agencies" (Fannie Mae and Freddie Mac) and to banks more generally who needed to stay on the right side of their regulators. Not every lender was directly affected, but pressure on, and choices of the, agencies in particular (who played such a huge role in the hugely distorted US housing finance market), drove down lending standards across the entire market. The data are pretty compelling. In other words, the US housing finance, and house price, boom and bust was, to a very substantial degree, a failure of government.

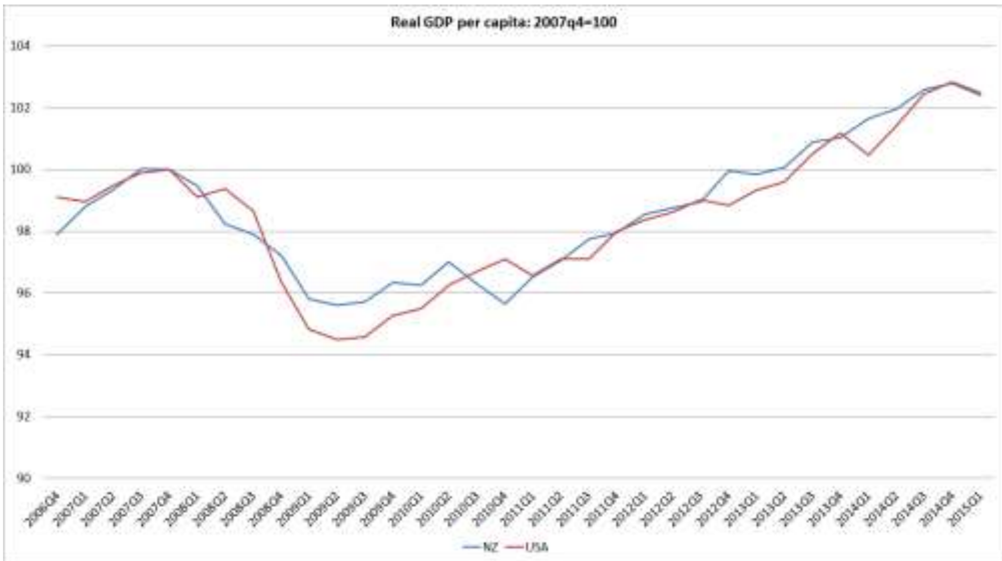
Unsurprisingly, we saw nothing similar in New Zealand or in other OECD countries. The housing finance markets in NZ, or Australia, or the UK, are private markets where government, Parliament and the Reserve Bank have historically played no real role in trying to influence lending standards. Yes, banks lent a great deal to housing borrowers during the boom, and no doubt credit standards eased to some extent during that period, but the incentives (and, not unrelatedly, the results) were very different from those in the United States. Of course, the UK had a financial crisis, but that had very little to do with losses on UK residential mortgages.

The Reserve Bank also often cites Ireland. But there has been no obvious effort to analyse what made Ireland different from, say, New Zealand, Australia, or the UK. In particular, the fact that Ireland had no monetary policy autonomy, and so had German interest rates through a period when their economy needed something more like New Zealand interest rates. Same goes for Spain. We certainly wouldn't want to repeat the Irish (or Spanish) mistake, and I hope their example is adduced if, say, anyone proposes New Zealand adopting a common currency with the United States.

Countries with floating exchange rates, banks with well-hedged balance sheets, and housing finance markets in which the government does not play a substantial role, just did not find themselves with serious housing credit crises in the post 2007 era. That is so even though in many of those countries credit had grown rapidly, and house prices had grown rapidly, and even though the post -2007 recession was the most severe in decades for most advanced countries. Common sense, borrower self-discipline, and lender restraint (and diversification) worked.

If I am right that the New Zealand house price issues result from the interaction of our planning regime and our immigration policy, then these are structural policy choices that systematically overprice houses, largely independently of the banking and financial system. They are not ephemeral pressures - here today and gone tomorrow. They have been building for decades. I hope they are reversed one day, but there are no market pressures that will compel them to be (any more than there are market pressures that will compel the reversal of planning restrictions in Sydney, London, or San Francisco). These distortions are not making credit available too easily and too cheaply right across the economy (and that is the single big difference between NZ or Australia, and say the Irish, US or Spanish situations). The structural policy distortions are simply making houses less affordable. The Reserve Bank has no better information than you, I, or the young buyers in Auckland do, on whether and when those policy distortions will ever be reversed. And even if the policy distortions were corrected, it is pretty clear that real excess capacity (too many houses, too many commercial buildings) is a much bigger threat than simply an adjustment in the price of banking collateral. No one thinks Auckland has too many houses, or too much developed land.

But these are not points that you hear brought out in the Governor's speeches, or in research or background papers. Instead, we are treated to lofty observations that New Zealand is one of the few OECD countries not to have had a substantial sustained fall in house prices in the last 45 years (which is not even really true, given the sharp fall in real prices in the late 1970s). Or a sense that "something should be done" about the tax system, which turned out (when I OIA'ed it) to have been based on no analysis at all. Or scare stories about the US economy post-2008, without any systematic effort to explain how much of the US experience is down to financial crisis effects, and how to reconcile that story with the hard data which shows that the NZ and US economies have performed almost identically since 2007.



It is surprising how little research the Bank appears to have been doing in the area - some on tools, but almost none of the underlying diagnosis and the nature of the New Zealand specific issues. And yet the Bank has made, and is proposing to make, the most far-reaching interventions into the housing finance market for many decades (in this area, they go beyond what we had pre-1984). We might be used to politicians making ad hoc policy interventions - e.g. increased first home buyer subsidies – on the basis of little background research. We should expect much more from autonomous public sector agencies.

The Bank has been pretty poor in the way it has drawn lessons from the international experience. But it has been weak in how it has

- engaged with the New Zealand experience of 2005 to 2010, and the lessons from that experience.
- lined up its LVR policies and proposals with the results of its own recent New Zealand stress tests.

Take the pre-crisis period first. In the 2000s, bank lending rose very rapidly - at around 15 per cent for several years. Rapid bank lending growth (well in excess of rates of nominal GDP growth) has often been a precursor to financial crises. No financial crises that I'm aware of have arisen without strong recent growth in credit, but most countries that have experienced rapid growth in credit have not experienced a financial crisis.

And so in 2007 there was some reason to be a little anxious in New Zealand. Credit had been rising rapidly, across all components of bank lending books, and well ahead of rates of growth of nominal GDP. And asset prices had been rising rapidly for years - houses, farms, and commercial property. And the economy had also been booming for some years - rapid income growth, and very low unemployment. Interest rates had to be raised again and again - and arguably monetary policy has been too loose for too long.

And yet through the crisis the Bank and Treasury swore to the soundness of the banking system assets. And they were right to do so. The banks came through unscathed - there were modest increases in loan losses, and nothing more.

By contrast to the situation in 2007, consider the situation now:

- Credit to GDP (whether household or total) is still below levels reached in 2007
- Real asset prices, in most of the country, are well below levels in 2007(not just for houses)
- Unemployment is still quite high
- Wage growth has been subdued
- Housing turnover, relative to population, remains well below levels in the previous boom.
- Bank capital ratios are materially higher than they were then, as are risk weights on housing loans.

There is almost nothing there that should give serious bank supervisors great reason for concern. Of course, supervisors are paid to worry and to be vigilant, but we should need more than perennial worry to justify the sorts of new intrusions on our ability to leverage what is, for most of us, our largest asset. Crisis risks don't arise from 10 year old debt, but from new debt. It is difficult to take very seriously suggestions that the level of risk is greater than it was in 2007, and yet the system came through the post-2007 unscathed, even though the buffers were smaller then. Again, the Bank has never been willing to explain why this is not a reasonable argument against heavy-handed interventions now

And the Bank has not really engaged openly with the results of its own stress tests. "Stress tests" are exercises in which supervisors provide banks with a severely adverse economic scenario and ask banks to estimate what such a shock would do to their loan losses and capital. The process involves several iterations, and interactions between regulators and banks. As compared to using risk-weighted capital ratios (which also look very solid, but which are much less transparent, to supervisors and to outsiders) it is as good as it gets (albeit not perfect) in checking out the resilience of a banking system.

Cynics suggest the supervisors only do these exercises when they already know the answers, and that if supervisors are really worried they condition the scenario to deliver the answers they want.

But our Reserve Bank has a long history of worrying about housing debt and the potential vulnerabilities to which it might give rise. In fact, this stress test was done a few months after the first LVR restrictions were imposed, when the Governor was already presumably quite uncomfortable with the risks in the banking system. So for the Reserve Bank, relatively adverse stress test results might have been quite welcome. I'm not suggesting they would have wanted results that really scared investors, but the actual results, in which losses were so low that no bank lost money in any year, despite a very severe shock event, weren't what my then colleagues at the Reserve Bank were expecting.

How severe was the stress test? Well, the Bank assumed that house prices fell by 40 per cent nationwide, and 50 per cent in Auckland, and that the unemployment rate rose to 13 per cent. The biggest nationwide house price fall seen anywhere in modern times is around 50 per cent (and in much of New Zealand, real prices have been falling for some years already). As for the unemployment rate, New Zealand's has not got to 13 per cent since the Great Depression, and the scenario involved a larger increase in the unemployment rate than has been seen in any floating exchange rate country in the post-war era. Stress tests should be tough - but these ones were, and the banks came through unscathed. Perhaps the results are a bit too good to be true, but the Bank has never claimed that it thinks so.

Unfortunately, the Governor has never properly engaged with the question of how his latest proposal to restrict lending to people running rental services businesses can be squared with the extensive work that lead to the stress test results. When he was asked by an MP at FEC, for example, he avoided answering the question and answered a different one instead. The Governor doesn't really seem to believe the stress tests - certainly his actions are inconsistent with them. Perhaps he is right. But he owes it us to articulate his case. At present, we are in a curious situation:

- We don't have detailed or systematic analysis of the many of the sorts of issues that should be relevant to decisions on far-reaching interventions, and
- The one piece of careful and detailed work that the organisation has done, that should be directly relevant to the issue, goes in the opposite direction to the Governor's policy choices.

One reason why the good stress test results should not be unduly surprising is the results of international work looking at what banks lose money on in financial crises. You won't hear it from the Governor, but in a quite recent issue of the *Bulletin* - and the *Bulletin* has always been presented as Bank views - the authors reminded us the banks very rarely fail from vanilla housing loans. It is typically commercial property, and particularly property development loans, that bring down banks. Thus it was in New Zealand in the late 1980s, in the Nordic crises of the late 1980s and early 1990s, and in Ireland most recently. Thus, in fact, it was for the New Zealand finance company sector. The Nordic case is an interesting one. House prices in Finland, for example, fell by 50 per cent quite quickly in the early 1990s and there were significant loan losses on the residential mortgage books, but those losses were nowhere enough to threaten the health of well-capitalised banks operating nationwide.

This brings us back to the current New Zealand situation. Overall credit growth is modest, as is lending for property development purposes. Commercial property prices are rising, but are not exuberant, and the level of development activity, outside Christchurch is not extraordinary (contrast the cranes on Manners St or the Terrace in late 1980s). Private sector banks simply do not fail in these circumstances; with the sort of loans (nature of exposure, age of exposure) they have on the books now. The Governor may not like

Auckland house prices - his predecessor was uncomfortable with them eight years ago - but they pose no realistic or credible threat to the soundness of the financial system. And that is the statutory test. By contrast, the controls do pose a threat to the efficiency of the financial system – and I imagine non-deposit-taking lenders are gearing up their business models to cope with increased demand from Auckland landlords.

The Reserve Bank Act, as passed by Parliament in 1989, instructs the Bank to use its prudential powers over banks to "promote the soundness and efficiency of the financial system". The mandate is not to target house prices, or even credit growth - and rightly so, since the Bank has no good basis for defining target or "equilibrium" levels. It is not even to "ensure" the soundness of the financial system (let alone just the banks), just to promote it.

And, as importantly, the statutory obligation is to promote the "efficiency" of the financial system (again not just the banks). People have intense debates about what efficiency might mean. But I think it is pretty clear what Parliament had in mind in 1989 - it was about avoiding doing bank supervision through a panoply of controls that resembled some of the worst of what New Zealand had in the post-war decades. It was about avoiding having regulators favour particular classes of borrowers (whether by security, purpose, or region), or particular types of lenders, about encouraging and facilitating competition and competitive neutrality. The efficiency provisions were supposed to act as a real constraint on the sorts of regulatory measures the Bank adopted. And yet efficiency considerations have been scarcely addressed at all in the Bank's discussion of its original LVR limits, or of its new proposed controls.

The efficiency issue becomes even stronger in the context of the new investor property proposal. The initial LVR limit had the merit of being a "speed limit" - no more than 10 per cent of mortgage lending could be in high LVR loans - and imposed no limits on where banks could lend or to whom. That recognised that in a portfolio of loans it would be reasonable, and prudent, for banks to have a range of different types of credit, including some higher risk loans and some lower risk ones.

But in the most recent proposal, the Bank has concluded that New Zealand banks are so badly run, and New Zealand borrowers apparently so reckless, that not a (practical) cent, in huge balance sheets, can be lent safely to rental service providers in Auckland on LVRs in excess of 70 per cent. It differentiates by region and by type of borrower, not just by collateral or income. Where, we might ask, is the evidence that such lending is so unsafe that the coercive powers of the state should be exercised to ban it altogether?

The share of lending to investment property buyers has certainly increased in the last 18 months or so. But not to unusually high levels, and such increases are what one would expect when the initial LVR controls were put in place, which were generally expected to fall most heavily on first home buyers (people who have, for decades, typically taken an 80 or 90 per cent loan to get into their first house). It might also be what would expect when there is an upsurge of immigration, including those on student visas. In other words, an increased demand for the rental services provided by investment property owners. The Bank has so far presented no evidence that bank lending standards around investment properties had deteriorated markedly, that capital requirements to cover the risks are inadequate, or that its own judgements and biases - or its implicit view of where nominal prices will be in say five or ten years' time - were more likely to be accurate than those of the borrowers, lenders (and market funders).

What is going on now simply does not seem like banking regulation focused on the soundness and efficiency of the financial system, but rather direct discretionary intervention and regulation of the type we thought we had got rid of in the 1980s. And it is not supported by the level of rigorous analysis that we should have hoped for from a powerful autonomous agency.

The economic case for LVR controls - anywhere, on any type of borrower - looks pretty weak, to non-existent. At very least, the Bank has not made a powerful case, in public, benchmarked against the provisions of its own legislation.

Perhaps as disconcertingly, despite the Reserve Bank's assertions in their consultative documents, there is no discussion of the implication if they were wrong in their view. We all know - and they know - that forecasting is a mug's game, never more so than with asset prices. The Reserve Bank has said that if they could rerun history, they would have put such controls on back in 2005 or 2006. But if so, how many lives and business plans would have been disrupted for a correction that, eight years on, has still not come? Even if there had been some slight gain in system soundness - itself arguable - how should we trade off the efficiency costs and the uneven distributional effects? A first home buyer squeezed out in 2006 might finally have been able to afford her house, with a higher deposit, in 2008, but only at a much higher price. Or someone just planning to get started in the business of providing rental property services in Auckland finds his or her plans disrupted because a single official in Wellington concludes that no bank can legally make such loans. Or the person from a family without substantial financial resources is squeezed out now in favour of one whose family can provide supplementary loans to get around the effects of the LVR limits. How is this an efficient financial system, let alone a fair one?

Reserve Bank regulatory powers and governance

Recent interventions appear ill-judged - inappropriate and unnecessary. But in this section I want to pose the question as to whether the Reserve Bank and the Governor in particular simply has too much power.

As the Productivity Commission's report on regulation last year noted, the Reserve Bank is quite an anomalous organisation in the New Zealand government organisation chart. Here are some of the anomalies:

- All Reserve Bank decisions are taken by the Governor alone. He may take advice from staff, and from outsiders, but the decisions are his alone. In Crown entities, by contrast, major decisions are made by Boards.
- The Reserve Bank has the ability to impose quite stringent new policies by varying conditions of registration for banks. It does not need the involvement of Ministers to issue regulations. This might perhaps have been acceptable:
    - when policy only directly affected a small group of banks, but the Productivity Commission points out that reasonable public expectations

might be different when an organisation's powers reach extensively into the private choices of many firms and households.
    - when little **policy** discretion is being exercised, but to stretch the provisions of the Reserve Bank to allow such intrusive LVR restrictions (quite a departure from the intention of Parliament) involves considerable policy discretion
- The Reserve Bank is responsible for its own legislation and for policy in its areas of responsibility. Outside core government departments, that is. I gather, without precedent in New Zealand.
- The Reserve Bank is not funded by annual parliamentary appropriation. Rather once every five years, the Minister of Finance and the Governor agree a "funding agreement" which is then ratified by Parliament. There is no equivalent of the sorts of estimates hearing other departments or agencies face, and no detail is provided to Parliament or the public when the funding agreements are signed. As I noted recently, the level of disclosure around the Funding Agreement is about the same as that in the Estimates for the SIS, except that at least the SIS is funded annually, while the Reserve Bank is funded for five years at a time.
- In terms of monitoring the Governor, the Bank's Board has the primary responsibility. But the Governor is a member of the Board, the Board meets on bank premises with senior staff regularly in attendance, the Board Secretary is a staff member, and the Board has no independent resources of its own. At best, it is very weak reed, and provides ex post monitoring only.

The Reserve Bank Act of 1989 was a major step forward in its day. But a great deal has changed since then. Even in respect of central banking and bank supervision, there is no international precedent in advanced democracies for a single unelected official to have such extensive powers. Domestically, we now have the entire Crown entities framework, which has established a much more disciplined framework for the creation and management of secondary and tertiary legislation. There is certainly good reason for the administration of bank supervision policies to be kept at arms-length from ministers, but the case for major policy initiatives to be made by ministers, or even by Parliament seems equally strong. If LVR limits are good policy, let an elected official, whom we can vote out, make the call, not an unelected one over whom the public has no leverage. We don't let Police make the law, or ministers decide who to lay charges against.

One of the gains from reforming the system would be to establish some more arms-length relationship between the analysis and argumentation and the decision-making. At present, we have a situation where the Governor comes up with the idea of an LVR limit, has his own staff (rewarded and remunerated by him) do the associated analysis and prepare consultative documents and regulatory impact statements. Submissions are made which, unlike those to Select Committees, are not routinely published. The Governor then deliberates, in secret, on those submissions, and finally publishes his decision. Nowhere in the process are there any adequate checks and balances. The Governor is effectively prosecutor, judge and jury in his own case.

Institutions are not built for saints, or for the best conceivable leader. They are built to cope with real people - who, on average, will be average - and to be resilient to less good people in top roles.   It is difficult to see how the Reserve Bank Act at present passes that test. All power is vested in a single person, who faces few hard budget constraints, operates with (in the financial stability areas) very loosely specified objectives and hence has a great deal of policy discretion, and would be difficult to remove short of some totally scandalous behaviour. I think the experience with the LVR restrictions helps illustrate these problems - it seems to come uncomfortably close to the rule of men rather than the rule of law. But I should stress that I have favoured a move away from a single decision-maker model for many years (as Don Brash would no doubt vouch for). It is now past time to reform the governance of the Reserve Bank[6].

Governance choices are, of course, matters for ministers and Parliament. So any criticism of the institutional design is not a criticism of the Bank. Nonetheless, there are things the Bank could do, of its own accord, to begin to address some of the weaknesses in the system. For example,

- All submissions on proposed regulatory initiatives could be routinely published on the Bank's website (rather than forcing to go through the OIA, where the Bank is at least as obstructive as many other agencies).
- The Bank could pro-actively release internal working papers relevant to policy proposals (in the spirit of pro-active release of Budget papers).
- The Bank could use a genuinely arms-length agency to assess the adequacy of its own regulatory impact assessment, rather than (as at present) having them tested by people working in the same team as those advancing the policy proposal.
- The Bank could publish, at functional level, the detailed budgets that lie behind the Funding Agreement, preferably before Parliament votes on each agreement.

More far-reaching change would require ministers to pick up the issue.   I'm not sure who, if anyone, would now defend the single decision-maker system (not Treasury, not market economists, not probably the Governor) although of course the devil is in the detail.

Conclusion

This has been a pretty long presentation and I won't try to repeat much of it in wrapping up.

The country has been pretty badly-served by the Reserve Bank in respect of the housing market and housing risks in recent years. The Bank has intervened quite heavily and intrusively, on the basis of pretty threadbare and unconvincing analysis. The public "mood" might have been that "someone must do something" but that is not a good basis for anyone to do just anything, especially not for an independent central bank. The Bank has presented nothing more to justify its intervention than the idea that house prices are high, and that in a few other countries there have been nasty crashes. There is no sustained or disciplined effort to analyse similarities and differences, and no sign that the Reserve Bank really recognises the importance of overall credit conditions in an economy. In fact, there is nothing in the housing, or housing finance, market to have suggested a need for new interventions: credit growth has been subdued for years, capital ratios are high, and what

[6] The argument for which is developed in a paper here http://croakingcassandra.com/2015/05/30/time-to-reform-the-governance-of-the-reserve-bank-2/

has gone on with house prices is quite easily explained by the interaction of supply restrictions and immigration policy. In other words, house prices are of the government's making, not the banks, and there is little is sign of either source of policy pressures being sustainably reduced any time soon. Even if things were to go badly wrong, the Bank's own numbers suggests that the buffers are ample.

And the Bank - in the form of a single over-powerful individual - seems disconcerting oblivious to the limitations of its own knowledge, and the implication for ordinary people if the Bank has things wrong. The efficiency of the financial system is being impaired, and ordinary and citizens and businesses are being forced to invest time, and effort, to monitor and manage the risks around financial regulatory interventions in a way we have not seen for decades. In the longer-term, the Bank is risking undermining wider political tolerance for its autonomy in monetary policy

These concerns bring into focus the weaknesses that have become increasingly apparent in the Reserve Bank Act. That Act was a considerable step forward in 1989, at a time when only a modest and limited role was envisaged for the Reserve Bank. But it is now 2015, and the legislation is not consistent with the sorts of discretionary policy activities the Bank is now undertaking, with modern expectations for governance in the New Zealand public sector, or with how these things are done in other similar countries. Doing some serious work on changing the single decision-maker model would be an excellent place to start, but it is only a start. A much more extensive rethink and rewrite of the Act, and the Bank's powers, is needed to put in place a much more conventional model of governance and accountability, especially in these regulatory areas.