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Avoiding a housing crisis or banking crisis?

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15 July 2016 | ContactUs@harbourasset.co.nz +64 4 460 8300

Once again there is a feeling that the RBNZ has become embattled. If it isn't bank economists confused about their OCR decisions, it's politicians openly applying pressure to take action with new macro-prudential tools. In our view, the RBNZ could more clearly set out that they are using macro-prudential tools to avoid a banking crisis, not to address a housing affordability crisis or to give themselves more room with monetary policy.

Last week RBNZ Deputy Governor, Grant Spencer, delivered a much-anticipated speech on the housing market. Coming after a stream of hints and suggestions from Bill English and John Key, expectations of an announcement of new mortgage lending restrictions were running high. So when no measures were forthcoming, the disappointment was palpable. Market pricing for an August OCR cut fell to just 30% and the NZ dollar rose to be just 5% short of its all-time high.

In our opinion, the best way to gauge the outlook for the OCR is not by reading a speech on financial stability, but to assess the RBNZ's Monetary Policy Statements (MPS).

In the June MPS, the RBNZ had an official easing bias, included one more OCR cut in its projections, and seemed comfortable with the market placing a 50% weight on that cut being delivered in August. While it is true that house price inflation has picked up again in recent months, the main news since the June MPS is the surprise vote for Brexit rattling global markets and the NZ dollar sitting some 9% above the RBNZ's projections. When combined, these factors reduce CPI inflation pressure, and should increase the chance of an OCR cut in August.

So why is the market getting confused about the RBNZ's policy decisions?

If the RBNZ has made any misstep since introducing macro-prudential tools, it has been falling into the trap of highlighting that house prices might cool as a side effect of these measures. Politicians have seen this as an opportunity to divert public attention on the "housing crisis" back onto the RBNZ.

For many years the RBNZ's independence from political interference was hailed as a key feature of our macro-economic framework, held up as a model for other countries to follow. However, as the affordability of housing has become a larger and larger media issue, the drum beat from politicians for the RBNZ to take action to address house prices has become louder and louder. Not only could this political interference erode the credibility of the RBNZ, it also confuses what the RBNZ has actually been trying to achieve.

One of the main lessons of the GFC is that central banks do not have a good track record of successfully identifying bubbles and exactly when they will burst. With that the case, the best thing that a central bank can do is to ensure the banking system is resilient to whatever nasty shocks come along. That idea has been the crux of global regulatory reform in the banking system since the GFC.

In other words, rather than trying to avoid a "housing (affordability) crisis", the RBNZ is trying to avoid a "banking crisis". They are doing that by trying to ensure that the New Zealand banking system is resilient to a fall in house prices, if and when it occurs. That is all about ensuring banks have plenty of reliable funding sources, plenty of capital to absorb losses from loans that turn sour, and only a limited amount of loans that would become unviable if house prices fell (loan-to-value restrictions). Put simply, the RBNZ is trying to force the banks to be prudent lenders, saving them from themselves.

If the RBNZ could refine its communication approach, it would be to say very plainly that they are all about avoiding a banking crisis, and trying to avoid complicating the story by saying that their macro-prudential policies will take heat out of house prices. Reacting to month-to-month changes in house prices with constant modifications to their macro-prudential measures would be a fraught exercise. It is a slippery slope to micro managing the economy that they would certainly want to avoid.

A clearer message would enable the public to better understand what the RBNZ is attempting to accomplish. The reason that Grant Spencer did not announce new restrictions in his speech last week is that the RBNZ did not see an urgent need to make the banking system even more resilient. They are consulting about introducing new debt-to-income restrictions, but for now they are comfortable with the measures taken to date. If they were more worried about the resilience of the banking system, they would have taken faster action.

For those hunting for clues on the next OCR move from Grant Spencer's speech, there is one key passage: the simple, solitary phrase that "the outlook for CPI inflation will ultimately determine the future path of monetary policy".

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