

Graeme Wheeler: Cross-border financial linkages – challenges for monetary policy and financial stability

Speech by Mr Graeme Wheeler, Governor of the Reserve Bank of New Zealand, to the Bank for International Settlement (BIS) Conference on Cross-border Financial Linkages, Wellington, 23 October 2014.

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On behalf of my Reserve Bank colleagues, I bid you a warm welcome to Wellington. I especially want to thank the conference organisers, and the participants and presenters who have travelled far to join us.

It is a great pleasure to co-host a conference with the BIS on Cross-Border Financial Linkages, as we think about these linkages a great deal. As the BIS triennial data indicates, the New Zealand dollar is the tenth most traded currency in the world with daily turnover of around USD105 billion. This is magnitudes beyond New Zealand's economic weight by any metric – and about 250 times our daily external trade flows.

In contrast with most other regions, the Asia-Pacific region has seen rapid growth in financial flows since the GFC. Asia-Pacific currencies are currently represented on 40 percent of global trades, up from 30 percent in 2007.

However, cross-border financial integration is much more than capital flows. It also embraces trade linkages, incipient flows, remittances, price arbitrage, and risk transfer instruments. In its broadest form financial integration offers enormous benefits, particularly when it finances efficient resource allocation, smoothes consumption, and distributes and diversifies risk. It is especially important when linked to the global transfer of skill-enhancing technologies, and the financing of innovation and catch-up technologies.

Cross-border flows can, however, present challenges for monetary policy and financial stability and it's to these issues that I turn.

Cross-border financial linkages and monetary policy

Cross border financial linkages can present difficult challenges for monetary policy for two main reasons. First, although the exchange rate is often the primary transmission channel for monetary policy, this channel is often stronger than we would wish. Second, and just as problematic, we often do not know what factors are driving the exchange rate and how efficient this transmission channel is.

In an economy with an open capital account, with active arbitrage it is possible to have either a stable exchange rate or an independent monetary policy capable of delivering price stability.

Like New Zealand, many of the Asian economies have experienced an appreciation in their real exchange rate in recent years. In a floating exchange rate environment, this lowers inflation in the tradables sector and raises the real disposable incomes of many consumers. It also makes it cheaper for firms to acquire imported capital goods and new technologies, and can spur greater innovation and productivity in the tradables sector.

However, large swings in the real exchange rate impose significant adjustment costs for firms that are forced to exit and re-enter markets due to large movements in competitiveness. And it can generate particularly difficult headwinds for those export producers not experiencing high prices for their products, and for firms competing against cheaper imports.

An important issue for policy makers is whether the appreciation in the real effective exchange rate is *justified* and *sustainable*. A real effective exchange rate is unjustified when its level is inconsistent with the economic factors (such as commodity prices, economic

growth, interest rate differentials) that can normally explain its movement during the business cycle. The level of the real effective exchange rate can be considered unsustainable when it is clearly deviating from its long-run equilibrium at the level that it would be expected to settle when business cycle factors have fully dissipated. In such a situation, persistent deviations from equilibrium are likely to result in external debt ratios that become unmanageable and cause misallocations of resources that can inhibit the country's long term growth potential.

Domestic monetary policy and changes in exchange rate regimes can do little to alleviate an overvalued real exchange rate. New Zealand has tried a variety of exchange rate regimes over the past 40 years – including a fixed exchange rate, crawling peg and floating exchange rate. However, the medium-term level and volatility of our real effective exchange rate has been largely unaffected by the type of exchange rate regime in place.

Often the appropriate policy response lies with measures to reduce demand pressures, or improve competitiveness and raise potential output growth. Such measures might include a better balance of fiscal policy, addressing impediments that distort saving and investment decisions, and undertaking reforms that raise productivity and improve competitiveness. They might also include prudential policies that address rising vulnerabilities directly.

Commentators, including the IMF, sometimes suggest that capital controls might play a role, but this is seldom a desirable option for countries with open capital accounts. An open capital account provides powerful incentives for improving productivity as it signals to domestic producers that they need to be competitive if they wish to attract capital and financing domestically and from offshore. Opening the capital account is therefore one of the most powerful economic reforms that a government can undertake. This is partly because of the benefits of the policies that are usually pre-conditions for removing capital controls. Such pre-conditions include achieving a reasonable degree of economic stabilisation, some liberalisation of the domestic financial market, and lower border protection (so that domestic savings do not flee offshore from a highly protected domestic capital market, and offshore capital does not flow into domestic sectors with high effective rates of protection).

Although much is known about the factors that influence exchange rates in theory, empirical links between exchange rates and their driving factors have been difficult to pin down. Exchange rates are closely linked to interest rates in theory through uncovered interest arbitrage but, empirically, the connection is weak. Internationally, we see markets adopting risk-on and risk-off strategies that are often linked to expectations of the timing of monetary policy decisions by the Federal Reserve. And sometimes capital flows seem to matter: we see flights to quality and to more liquid markets accompanied by large exchange rate movements when risk and uncertainty increase.

In our own economy, several factors appear to play a role in foreign exchange markets: actual and expected movements in commodity prices, information relating to expected future movements in policy rates and appetite for New Zealand dollar risk. But, without a strong empirical understanding of what determines the exchange rate there is considerable uncertainty regarding the efficiency of the exchange rate transmission channel.

Cross-border financial linkages and financial stability

Cross-border financial linkages can have important implications for financial stability when large institutions react in a similar manner and herding behaviour causes financing flows to amplify financial market shocks. We have seen this desperate search for yield across borders many times before with investors taking on more and more risk and in doing so significantly lowering risk premia. Rather than requiring higher risk premia from increasingly leveraged borrowers, investors continue to provide financing at declining spreads, fearful of missing out on the returns of those who preceded them.

I would like to focus a little on the role that macro-prudential policy and liquidity management can play in reducing systemic risk in financial markets and will illustrate with reference to the New Zealand market.

Residential property prices have been rising rapidly in several Asia-Pacific countries in recent years. In New Zealand, these pressures have been accentuated by housing supply shortages, historically low mortgage rates, tax preferences that favour investment in housing, and offshore investor interest. Strong housing demand can add to financial stability risks, especially when accompanied by high household indebtedness. Housing market exuberance can be particularly problematic when interest rate responses are not warranted because economic growth is well below potential, and inflation in factor and product markets is benign.

Macro-prudential policies can be helpful in addressing financial stability concerns in such circumstances. But the introduction of macro-prudential policy requires policy makers to be clear about its goals, the duration of the measures, and how such measures might interact with monetary policy.

The Reserve Bank introduced macro-prudential policy in the form of speed limits on loan-to-value ratios (LVRs) in the residential housing market, on 1 October 2013. House prices – which were already significantly overvalued based on historical and international indicators – were accelerating rapidly in our two largest cities (that account for around half of the national market). In addition, household debt was at high levels, and banks were competing aggressively for mortgage lending to borrowers with small deposits. At the time, annual consumer price inflation was running at 0.7 percent, the exchange rate was strong, and the economy had a negative output gap. It was not appropriate to raise interest rates, but the potential for further rapid house price inflation was considerable as sizeable supply-demand imbalances seemed likely to continue for several years.

We introduced a requirement that banks reduce their high LVR lending (defined as LVRs over 80 percent) to an average of no more than 10 percent of their mortgage commitments, and made this a condition of bank registration. The measure led to a significant reduction in high-LVR lending, a decline in house sales, and fall in house price inflation. While other factors, such as subsequent interest rate increases over the period March 2014 to July 2014 are also helping to constrain demand, annual house price inflation fell from around 10 percent to 5 percent currently, despite high levels of net immigration.

We established clear and separate primary objectives for monetary policy and macro-prudential policy. These primary objectives are price stability and financial system stability respectively.

There is an appropriate role for coordinating the use of monetary policy and a macro-prudential policy instruments provided they both affect outcomes relevant to the achievement of both policy objectives. This condition is likely to be met when the real and financial cycles are in sync and each policy can allow for the complementary effects of the other. The two policies will be in greatest potential conflict when the real and financial cycles are in opposite phases.

While LVRs have a financial stability goal, they have been an important consideration in our monetary policy assessment. We believe the dampening impact of LVRs on house price inflation and credit, and the diminished “wealth effects” on spending associated with it, have reduced consumer price inflation pressures by an amount similar to a 25–50 basis point increase in the OCR. In essence, the reduction in housing pressures allowed us to delay the tightening in interest rates, thereby reducing the incentive for any additional capital inflows into the New Zealand dollar in search of higher yields.

We have seen little financial sector disintermediation to date, and have indicated that the LVR speed limit is not intended to be permanent. It will be removed once housing market pressures have moderated and when we are confident there will not be a resurgence in

house price inflation. We will be reviewing these criteria and their implications for LVR restrictions in next month's Financial Stability Report.

My final comment is on liquidity risk

Liquidity risk and rollover risk are often the two major financial shocks that hit economies, and especially smaller economies, during episodes of financial market contagion.

Unsurprisingly, given current yield curves, debt issuance almost everywhere has shifted towards longer-term funding.

We still have much to learn around liquidity risk and the emergence of "black holes" in funding and asset markets. Liquidity risk is a key concern for countries with large external borrowing needs, especially if investors become skittish, trading volumes begin to thin and some price gapping occurs. Left unabated, liquidity problems can mutate into solvency problems.

The Reserve Bank introduced a prudential liquidity policy in April 2010. This policy includes minimum liquid asset requirements, and a minimum core funding ratio. Like the Basel III net stable funding requirement scheduled for 2018, the policy requires a minimum proportion of total lending to be funded by more stable "core funding" instruments such as retail deposits and long term borrowing (beyond one year).

In New Zealand, the commercial banks' core funding ratios fell to around 60 percent prior to the GFC. Today the banks' core funding ratios stand at around 85 percent (against a minimum of 75 percent) and the vulnerability of New Zealand banks to developments in offshore wholesale funding markets has been substantially diminished.

Concluding comments

One of the eight lucky signs of Buddhist philosophy, *drami* or the "endless knot", illustrates how individuals and institutions across the world and over time are connected in a web of mutual interdependence.

Another valuable insight from Asia is that of the four friends (the elephant, the monkey, the rabbit, and the bird). By standing on each other's shoulders the bird is able to reach the fruit for all of them.

Preventing future global financial crises requires us to understand the web of mutual interdependence characterised by the endless knot, and the wisdom of the four friends.

Despite the invaluable data gathering and research by the BIS, our understanding of the drivers and impact of cross-border financial linkages remains limited in many areas. Our theoretical benchmark for much policy analysis continues to be based on capital-free arbitrage that assumes efficient and smooth changes in asset prices, with no material effect for capital flows.

We have excellent speakers and papers over the next two days and an opportunity to explore many of these and other important issues. I wish you productive discussions and deliberations. Certainly, my Reserve Bank colleagues and I will take a great deal of interest in the conference sessions.