High-level policy panel on the development of financial markets

Grant Spencer[1]

It is a pleasure to be here, and thank you to the People's Bank of China and the BIS for inviting me to the conference.

Panel members have been asked to frame our comments within three questions.

The first question is: "How did market developments worsen or mitigate the impacts of the current crisis?" In other words: "What characteristics of the New Zealand financial system assisted or detracted from our ability to handle the crisis?"

- In the case of New Zealand, the positive factors included: soundly managed mortgage books at the major banks; the fact that the external debt of the banks and the country was fully hedged in terms of foreign exchange risk; and to some extent the internationalised nature of the New Zealand dollar was also a plus, in that it facilitated hedging and funding activity by the banking system.
- The negatives were: first, the fact that there had been a housing boom over the 2003–07 period, which meant that the household sector and the banking sector were somewhat stretched in terms of their balance sheets; second, and this is quite important from New Zealand's point of view, the banks' balance sheets were 40% funded offshore, and a large part of that was funded in the short-term wholesale markets. This left the New Zealand banking system vulnerable to the liquidity shock and credit contraction arising from the financial crisis. Finally, the fact that the NZ dollar was internationalised, ie commonly traded in the international markets, also meant that the NZ dollar was somewhat exposed following Lehman's failure and the very sharp reversal of risk appetite in the international financial markets. So, as a consequence, the NZ dollar substantially depreciated in late 2008/early 2009.

Those are the sort of characteristics that either assisted or detracted from New Zealand's ability to respond to the crisis.

The second question asks: "What measures were taken to restore confidence, and what exit strategies are planned from those measures?"

- As seen in the slide (Q2. 3x3 table), we have had three broad categories of crisis policy responses. The first one was the macro policy easing, where both monetary policy and fiscal policy were eased in response to the global crisis. The exit strategy is reasonably clear. Monetary policy would be expected to start tightening once we see a cyclical adjustment back to normal following the recession that we are currently experiencing in 2009. We would also expect fiscal policy to start to come back to normal, or at least return to a more sustainable position, in order to give long-term debt ratio projections that are stable. If that is not achieved then we would be at risk of seeing a potential credit downgrade for New Zealand.
- The second category of policy responses involved boosting liquidity management operations and widening the access to those operations by broadening the range of discountable assets. The exit strategy here, once liquidity returns to a more normal

[1] Deputy Governor & Head of Financial Stability of Reserve Bank of New Zealand

situation and confidence returns to the financial system, is to return towards where we were before, but not fully. We will probably continue with a broader range of discountable assets that are acceptable as collateral than we have before. And one of the key reasons for this is a desire to support the liquidity of key markets which we see as an important role for the central bank, and a role that has been underlined by the events of the global crisis.

- The third category of policy responses is the bank funding guarantees, where both retail and wholesale guarantees were introduced post-Lehman in September/October 2008. Our definite intention is to remove these guarantees as confidence returns to the financial system. The sooner these can be removed, the sooner we can remove the distortions and moral hazard that inevitably result from such policies.

The third question put to the panel is: "What is the attractiveness of international currencies from our own national perspective?"

- I would firstly say that the internationalisation of the NZ dollar overall has been positive from our perspective. Not all aspects are positive and the internationalisation of the currency has made domestic monetary policy more difficult to implement because of the scope for higher interest rates in New Zealand to attract foreign interest, which means that our exchange rate has been relatively sensitive to domestic monetary policy actions. However, the international currency has facilitated adjustment in the New Zealand economy to external shocks. It has also facilitated foreign exchange hedging of debt and therefore helped to insulate domestic balance sheets from foreign exchange fluctuations.
- My second point relates to the internationalisation of other currencies. Our view is that internationalisation of the Renminbi would be welcome. At present we are seeing rebalancing of the external imbalances, ie reductions in the US deficit and the Chinese surplus through expenditure reduction in the US and expenditure expansion in China; we are not seeing expenditure switching. More flexibility in currencies would obviously promote this adjustment by adding in a switching component to the rebalancing. Furthermore, if the Renminbi was internationalised, it would take the pressure off the NZ dollar and also similar currencies such as the Australian and the Canadian dollars, which because of their commodity nature, have become proxies for the Renminbi. If the Renminbi itself was made more flexible, this would take some of the pressure away from proxy currencies such as our own NZ dollar.

These are some New Zealand perspectives on the three questions posed to the panel. I thank you very much for your attention.