

Alan Bollard: Easy money – global liquidity and its impact on New Zealand

Speech by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, to the Wellington Chamber of Commerce, Wellington, 15 March 2007.

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1. What has been happening to global liquidity?

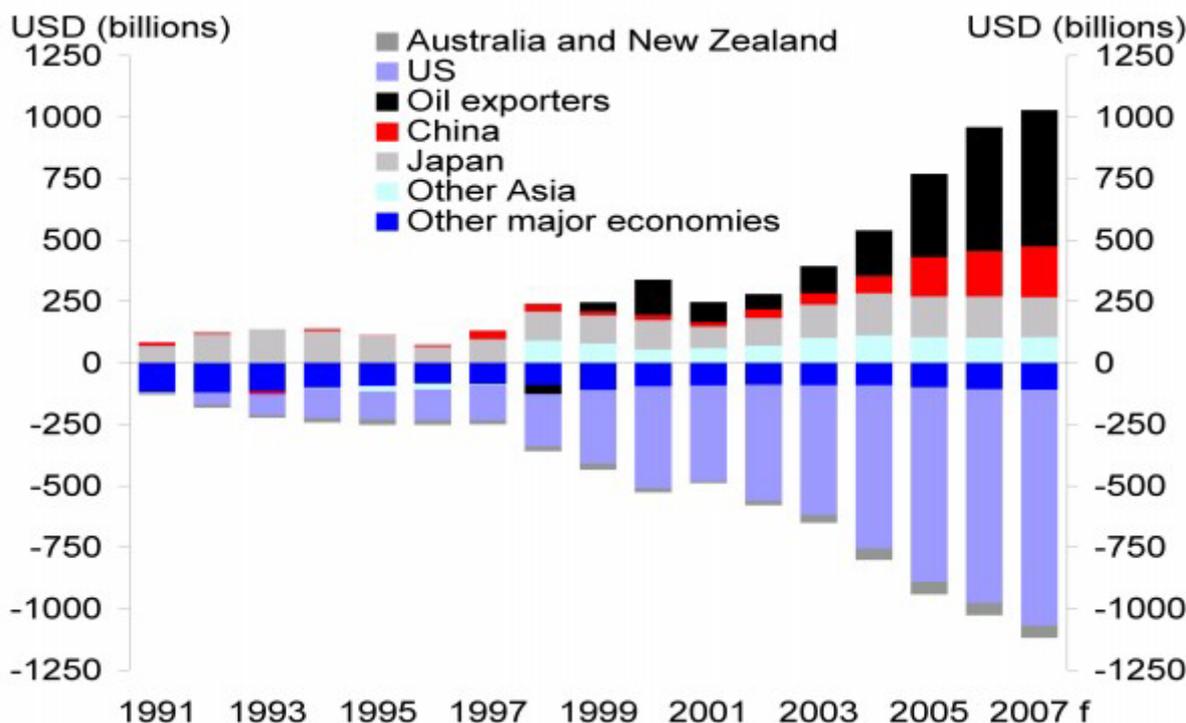
Globalisation has had major effects on the New Zealand economy over the last decade or two. Monetary policy has certainly not been immune. Some of the impact has been very helpful to us in our primary task of achieving price stability. We have enjoyed a useful disinflationary impact from the flood of cheap manufactures available from China and other newly industrialising countries. We have enjoyed the benefits of trading with a buoyant world that has been enjoying good stable growth rates with stable prices. More recently however, we have had to focus on a related phenomenon which has had some unanticipated effects: the growth of global liquidity.

Global liquidity has increased dramatically over recent years. In our part of the world, this reflects:

- a surplus of savings relative to investment in the East Asian and oil-exporting countries;
- new players, new products, new transactions and markets; and in particular
- the impact of the “carry trade” fuelling investment flows into a range of markets.

A feature of the period of relatively strong growth in the world economy over the past several years has been large and growing financial imbalances among the world's major economies. The US current account deficit has increased significantly over this period, although it has stabilised over the past year relative to the size of the US economy. Meanwhile, most East Asian countries have consistently run current account surpluses since recovering from the 1997/98 financial crisis, when many experienced deficits. More recently, the rise in oil prices has underpinned a substantial increase in the surpluses of the oil exporting nations.

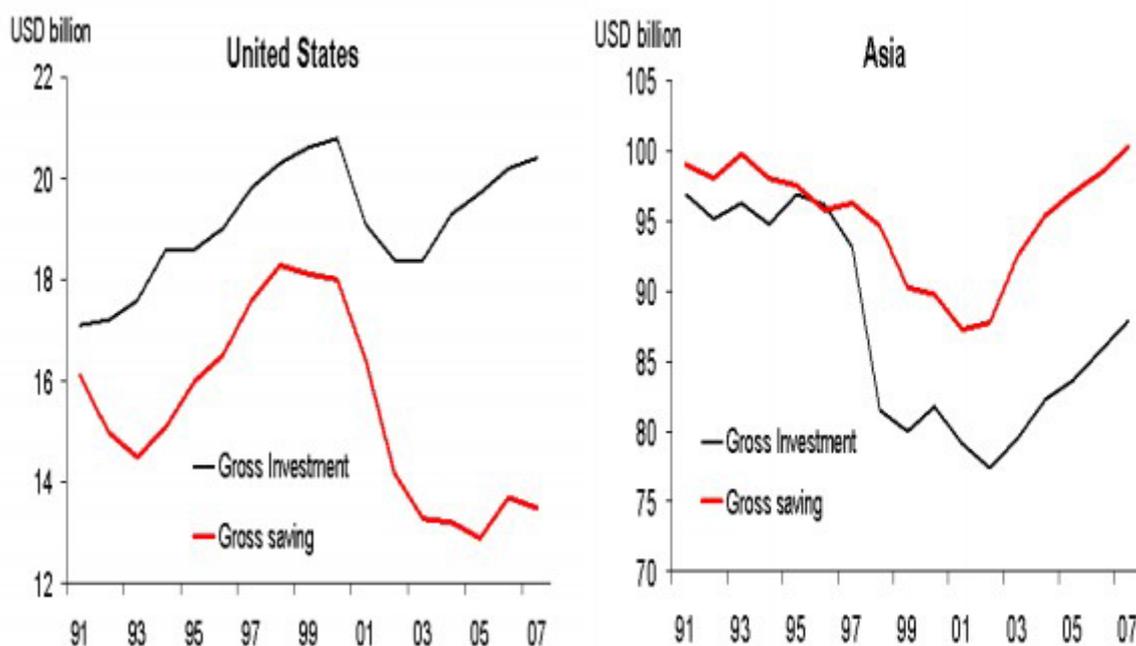
Figure 1: Current account balances



Source: IMF World Economic Outlook, September 2006; RBNZ

These relative current account positions broadly reflect the contrasting balances between saving and investment in these countries. In the case of the deficit countries – such as the US, Australia and New Zealand – investment has exceeded saving, with the excess savings of surplus countries financing the shortfall. Excess savings relative to investment amongst the surplus countries has increased substantially since the late 1990s, led by Asia, a range of developing countries and more recently the oil exporters. This has given rise to a phenomenon that US Federal Reserve Chairman Ben Bernanke has referred to as a “global savings glut”.¹

Figure 2: Gross saving and investment

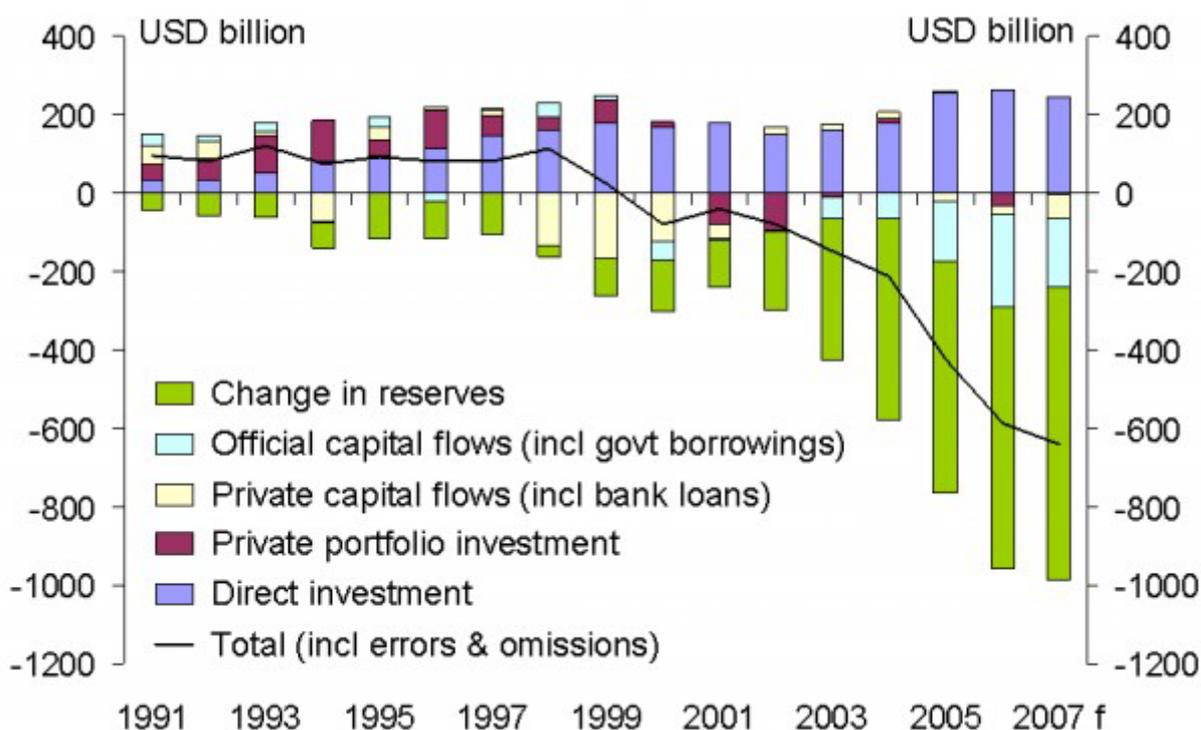


Source: IMF World Economic Outlook, September 2006; Economics@ANZ

For many of these countries – particularly the developing economies – this represents a considerably different set of circumstances to that existing prior to the late 1990s, when developing economies (including many of those in Asia) were net recipients of capital. In the case of the developing economies in Asia, the response to the 1997/98 financial crisis has been to focus on export-driven growth and the associated accumulation of foreign exchange reserves – a strategy that most are continuing to pursue almost a decade after the crisis. The strength of exports relative to domestic demand has seen saving outstrip investment in most of these economies – even in the case of China, where investment growth has been very strong. Accordingly, we have the ironic situation whereby a range of developing countries are (in net terms) the providers of capital to some of the world’s most developed economies. This rapidly rising “savings glut” has been a principal source of increased global liquidity.

¹ “The Global Saving Glut and the US Current Account Deficit”, March 2005

Figure 3: Capital flows to developing economies



Source: IMF World Economic Outlook, September 2006; Economics@ANZ

2. How is this being recycled?

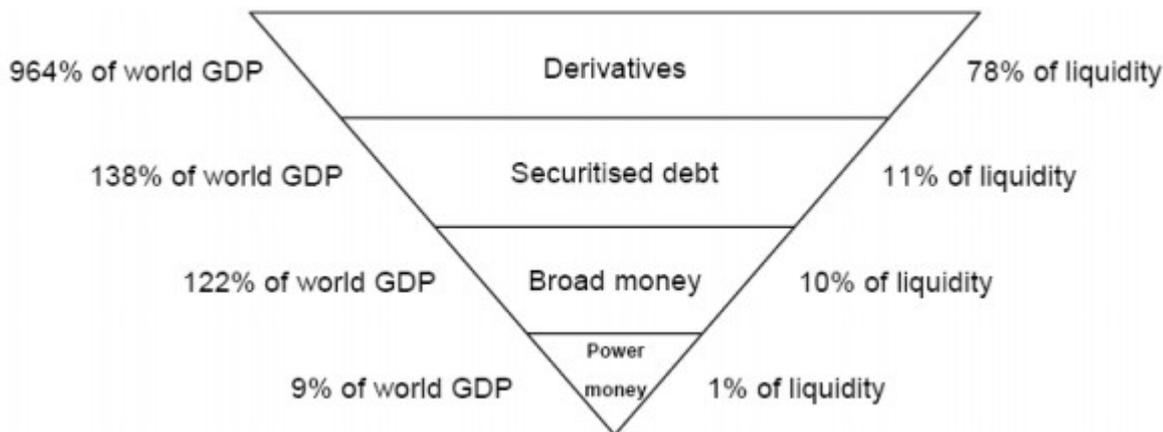
Along with financial deregulation and the general opening up of economies, the flow of increased global liquidity through markets has provided the impetus for many changes. In a recent speech², Malcolm Knight, General Manager of the Bank for International Settlements, highlighted a number of important new features:

- the unbundling and re-pricing of risk through major advances in financial engineering, resulting in improved ability to lever lending via new markets such as for credit transfer products;
- the emergence of new financial players such as hedge funds and private equity firms that have not been traditional intermediaries;
- more reliance of financial firms on markets to handle growing complexity;
- a reliance on market liquidity even in stress situations; and
- a surge in volume and value of transactions.

The search for means to generate a return on this liquidity has spurred massive growth in securitisation of debt and the development of a vast array of derivatives. The propagation of these instruments can itself be seen as a source of liquidity growth and, by some estimates, a substantial one at that. From a monetary policy perspective, this implies a very big increase in the liquidity that is not directly controlled by central banks.

² "Now you see it, now you don't: risk in the small and in the large", February 2007

Figure 4: Estimates of global liquidity



Source: Independent Strategy

A particular development of interest to us has been the increasing integration of housing finance into these liquid international markets. A recent article in the Financial Times³ reports on a significant slice of new mortgages in Hungary being issued in Swiss francs while households in Latvia and Romania are borrowing in yen. The article then goes on to focus on what they see as one of the biggest flows, the bonds denominated in NZ dollars by European and Asian issuers.

3. What are the global effects of this liquidity?

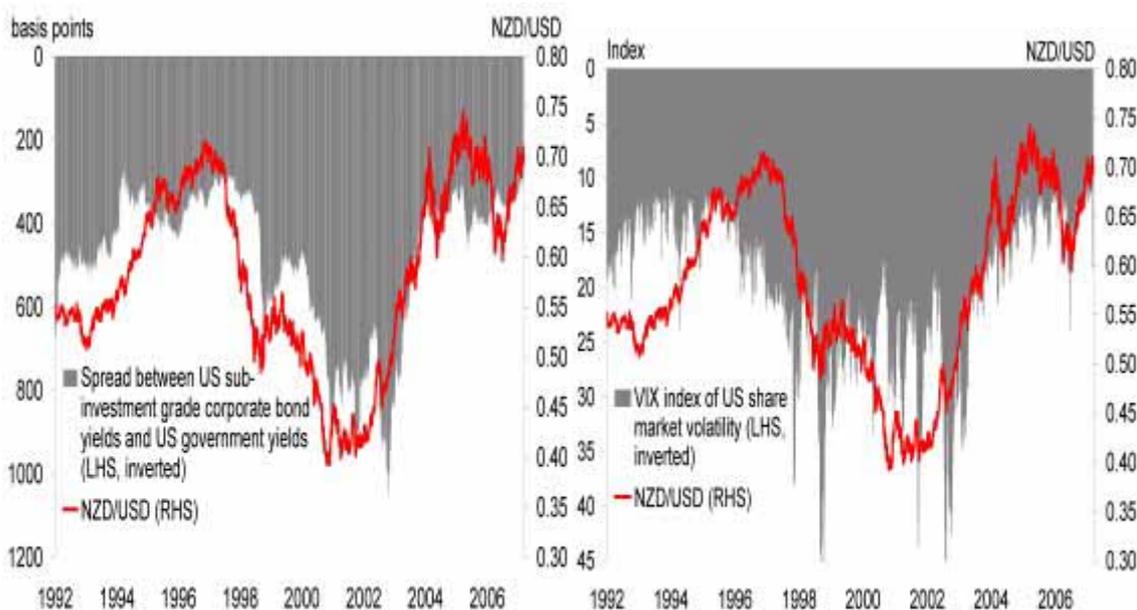
The flows associated with the growth of global liquidity has played a role in helping to prolong the period of strong global growth seen in recent years. The associated search for yield has pushed down interest rates, bid up equity prices and generally put downward pressure on returns across a range of asset classes.

Many of these effects have been clearly welfare-enhancing. But in contrast to how markets might have reacted a decade ago, it has also allowed less disciplined economic behaviour by some households and firms. It has allowed global imbalances, particularly those associated with the contrasting current account positions of the major economies, to build up and persist beyond what might have previously been considered sustainable. It has meant that when large economies operate with distortions in their own markets, those distortions can be felt halfway around the world.

Risk appetites in global financial markets have generally been very strong in recent years. This perhaps reflects the extended period of relatively strong growth in the world economy underpinning investor confidence. This confidence has been bolstered by generally low market volatility, which has also lowered perceptions of risk.

³ "Why the yen borrowing game could end in players taking a tumble", 14 February 2007

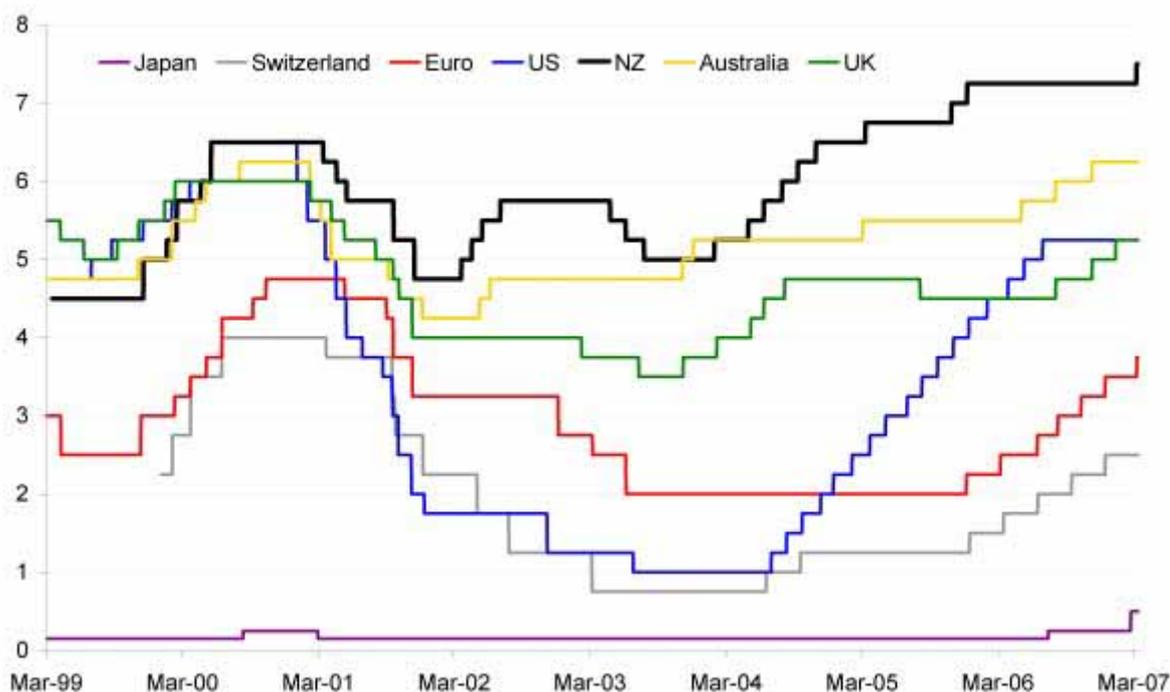
Figure 5: Risk aversion and market volatility



Source: Bloomberg; DataStream

Perceptions of a relatively benign risk environment have provided the basis for investors to engage in a vast range of so-called “carry trades”. These involve borrowing to invest in an asset that is either yielding – or is expected to yield – a higher rate of return than the borrowing cost. In this regard, relatively low risk aversion and market volatility are important conditions for carry trades, so that traders are less fearful that sharp market moves could eliminate the expected yield differential. Currency carry trades, whereby investors borrow in low interest rate currencies to invest in higher interest rate currencies, have been some of the most popular. Relatively low interest rates in some economies, particularly Japan and Switzerland, have been used as the basis for a raft of leveraged investments and in so doing have further fuelled global liquidity.

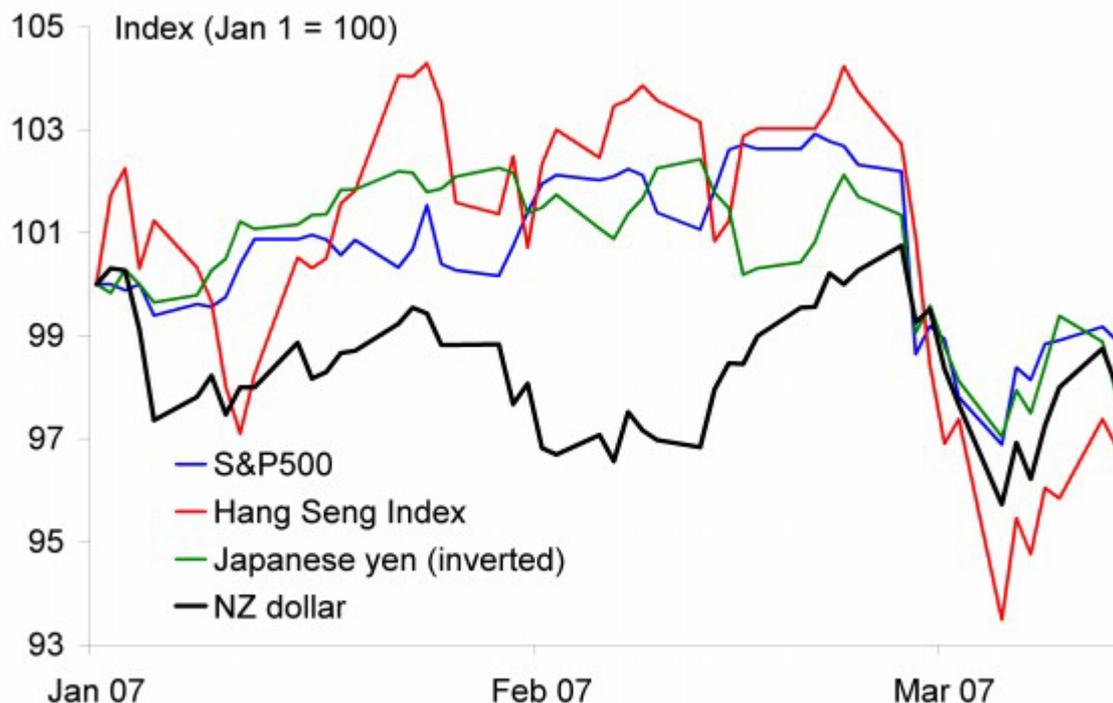
Figure 6: Global policy rates



Source: DataStream

The events of the past few weeks have provided a timely reminder of the importance of low risk aversion and market volatility for the carry trade. Fears sparked by a sharp retracement in China's share market and growing concerns regarding the ramifications of problems in the US sub-prime mortgage market saw investors rush to reduce positions in a range of markets. Notably, this episode saw currency carry trades scaled back, with funding currencies strengthening and recipient currencies weakening – although the sell-off proved highly correlated across a wide range of asset classes. This period of turbulence has proved relatively contained to date, with risk appetites and markets recovering. But it does demonstrate the potential widespread impact of an increase in risk aversion and market volatility.

Figure 7: Market developments since the beginning of the year

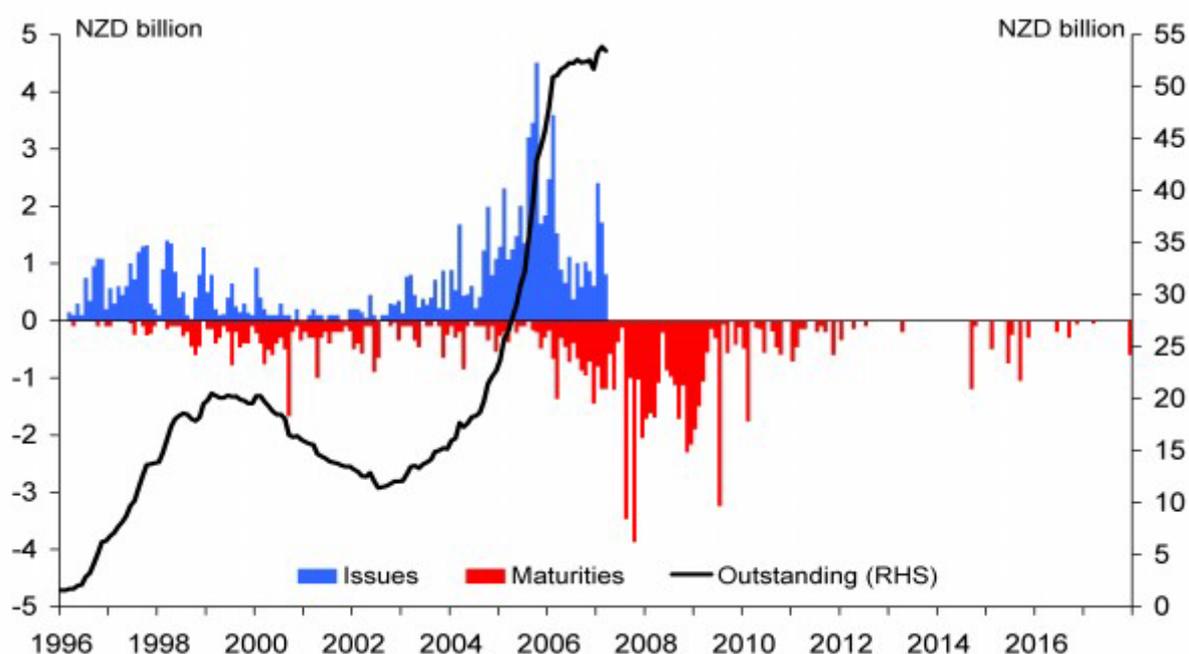


Source: Bloomberg

4. How does it impact on the NZ economy?

Given our relatively high interest rates, New Zealand has attracted a disproportionate share of global liquidity in recent years, putting upward pressure on the NZ dollar despite a relatively large current account deficit. These flows have come in many forms. One particular avenue has been the issuance of NZ dollar denominated bonds in offshore markets: Eurokiwi and Uridashi bonds. The derivative transactions associated with Eurokiwi and Uridashi issuance have provided a mechanism for the New Zealand banks to hedge the interest rate and currency risks associated with their offshore borrowings at cheaper rates than would otherwise have been the case. The upward pressure this has put on the New Zealand dollar and downward pressure on interest rates has exacerbated the current problematic imbalance between traded and non-traded sectors in New Zealand.

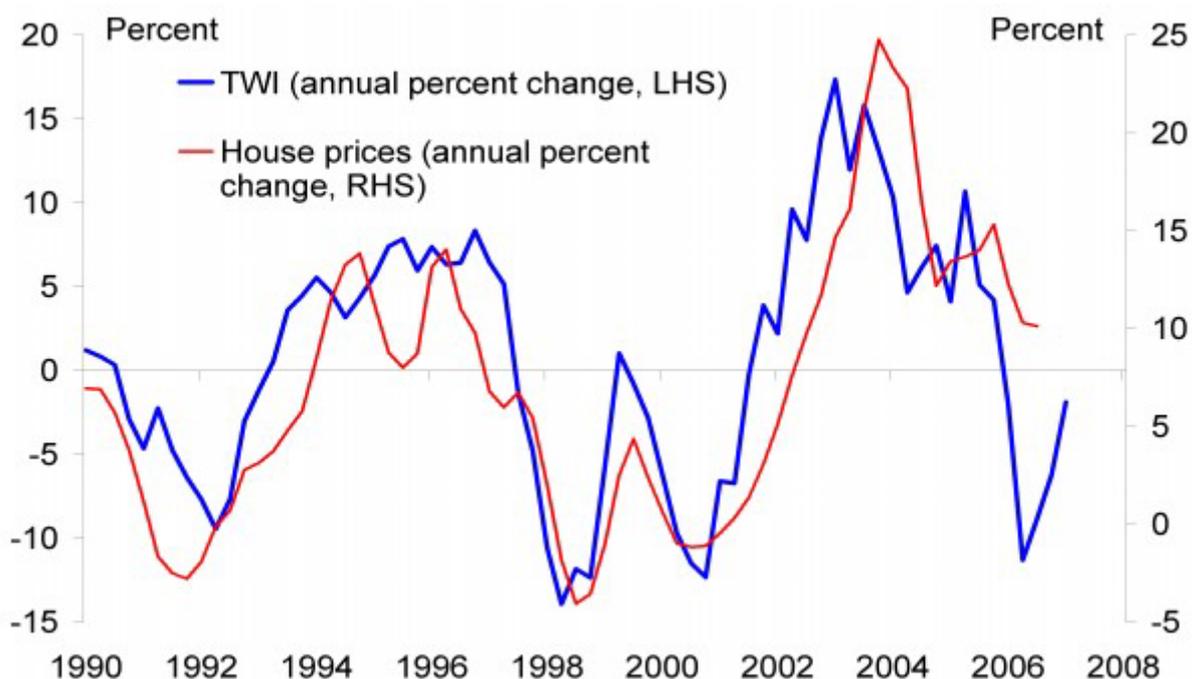
Figure 8: Offshore NZ dollar denominated bond issuance (Eurokiwi & Uridashi bonds)



Source: Reuters; Bloomberg; RBNZ

But it is important to recognise that the attractiveness of the NZ dollar for offshore investors is not just a reflection of the current level of interest rate differentials, but also investors' views regarding their sustainability. In this regard, it is interesting to note the relatively close correlation between house prices and the NZ dollar over the last 15 years. Without claiming a direct relationship between the two, this goes some way to illustrate the extent to which persist domestic inflation pressures have underpinned the outlook for interest rates, which in turn has maintained upward pressure on the NZ dollar. Accordingly, a sustained retracement in the NZ dollar from the highs seen in recent years could be contingent on our efforts to rein in domestic inflation pressures.

Figure 9: House prices and the NZ dollar Trade Weighted Index (TWI)



Source: Quotable Value; RBNZ

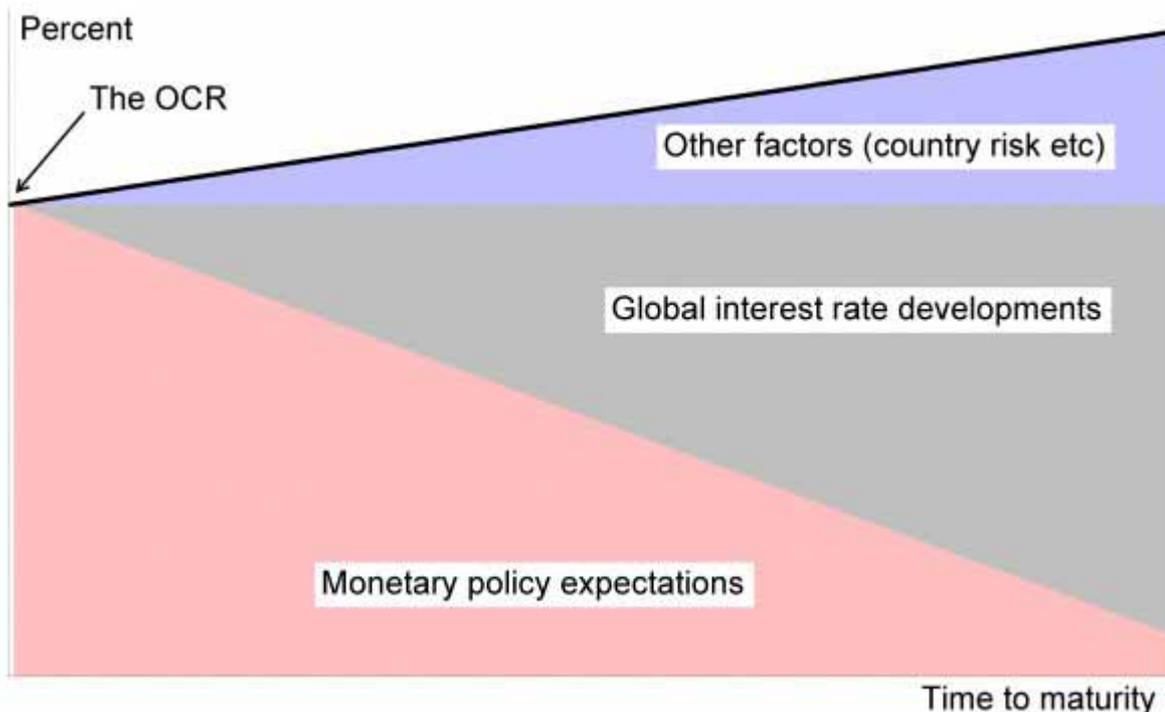
Of course the inward capital flows that have kept pressure on the NZ dollar would not have happened without a strong domestic demand for borrowing. In this case it is New Zealand households' desire to keep investing in housing, while at the same time consuming strongly, that fuels their demand for funds, and represents the other leg to these international transactions.

5. How does it affect monetary policy?

No central banker today can ignore these effects on domestic monetary policy. A recent speech by Ben Bernanke⁴ observed that financial market globalisation has made the Fed's analysis much more complex. He notes that even for the US there is no such thing as total monetary independence. For example, correlations between long term interest rates in the US and other industrial countries have risen significantly. Having said that, he concludes that, despite Alan Greenspan's term of "conundrum", this has not significantly constrained their ability to influence domestic financial conditions.

This is more problematic for a number of small open economies with higher interest rates – not only New Zealand, but also Iceland, Hungary, Australia and South Africa. The downward pressure created by abundant global liquidity on market interest rates has had implications for the operation of monetary policy. In general terms, the Reserve Bank has most impact on the shorter end of the yield curve, both by setting the OCR itself and influencing market expectations about the outlook for monetary policy. But further out the yield curve, other factors – including global interest rate developments and country risk premia – also influence interest rate levels.

Figure 10: A stylised representation of the relative influences on the yield curve

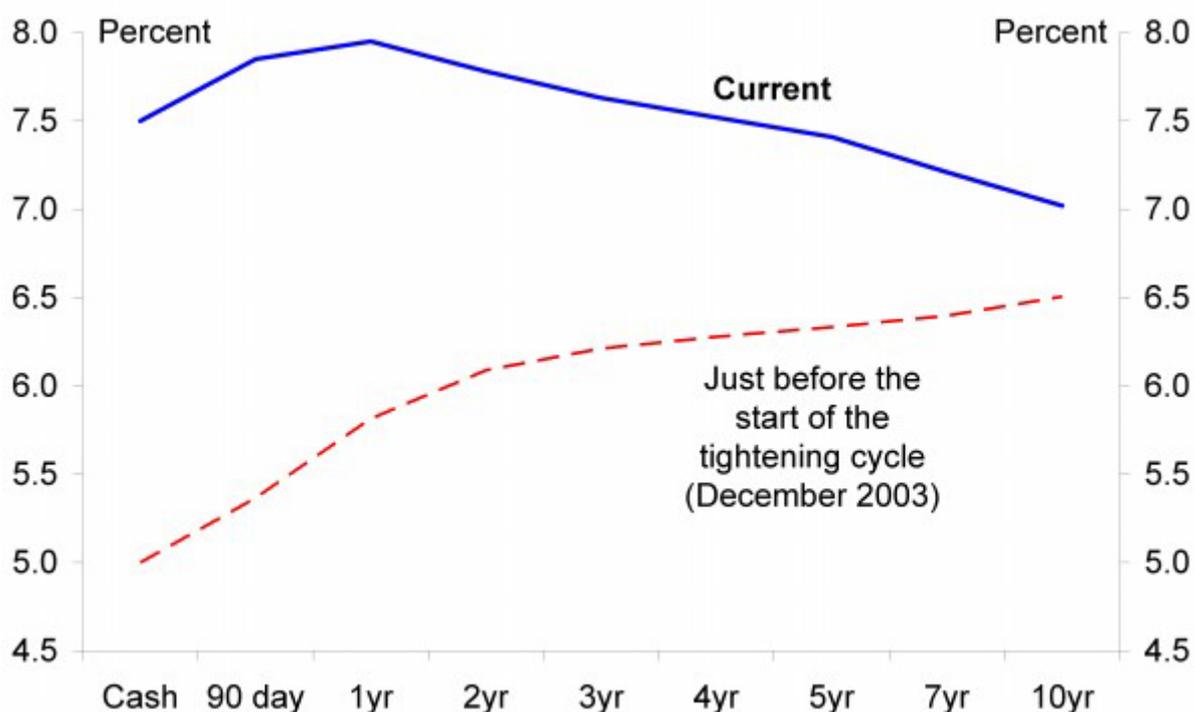


Source: RBNZ

Low global interest rates have restrained the rise in longer-term interest rates relative to the upward pressure monetary policy has been able to exert on shorter-term interest rates during this tightening cycle. This has seen the yield curve progressively flatten and become negatively-sloped during the past few years.

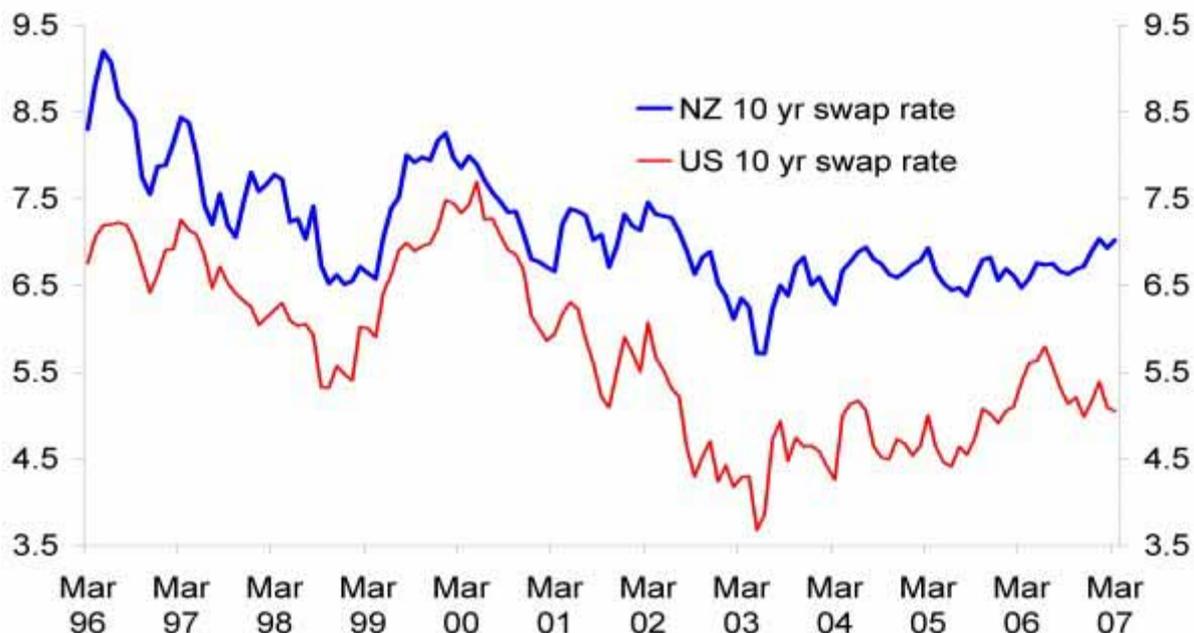
⁴ "Globalisation and Monetary Policy", March 2007

Figure 11: The change in the yield curve since the beginning of the tightening cycle



Source: Bloomberg

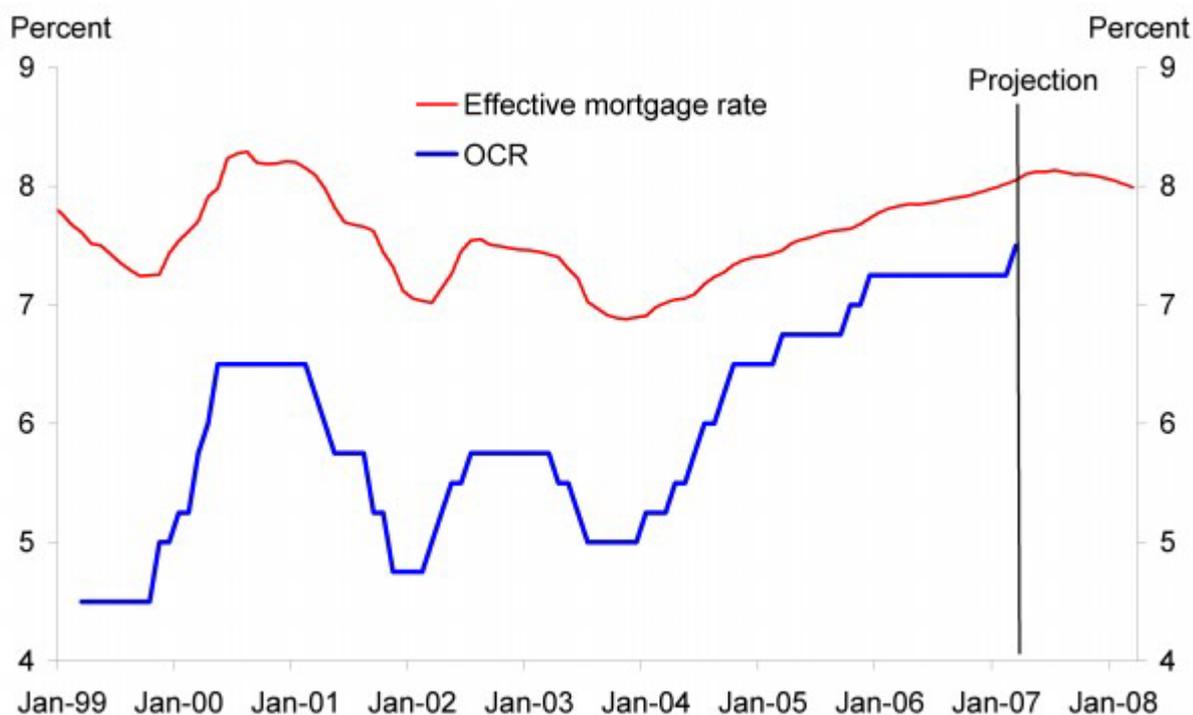
Figure 12: New Zealand and US long term interest rates



Source: Bloomberg

A negatively-sloped yield curve has encouraged borrowers to take out term loans at relatively lower rates. Households in particular have favoured fixed rate mortgages, which now account for more than 80 percent of mortgage borrowing, and increasingly for longer terms. This has muted and delayed the impact of policy tightening in this cycle, although we have now seen the effective mortgage rate rise by around 110 basis points since its lows in late 2003.

Figure 13: The OCR and the effective mortgage rate



Source: RBNZ

A further practical constraint for us has been that, although the TWI is influenced by a wide range of global events, in recent years we have not wished to add to upward pressure on the NZ dollar. We have also remained conscious of our obligation to avoid unnecessary instability in output, the exchange rate and interest rates, as required under section 4b of the Policy Targets Agreement. This has meant we have been more cautious in our OCR tightening path than might otherwise have been the case.

6. New Zealand policy in a global context

The circumstances we face at present do not necessarily represent an enduring structural change in the environment in which policy operates. At some stage in the future when the large East Asian trading blocs are able to trade currencies and products with the world at more sustainable prices, a significant distortion to our own rate setting process will be removed. However, for that we must wait for G-7, Doha and other international forces to do their work.

As for New Zealand, we need to see realisation amongst borrowing households and lending banks that this recent period of cheap international money has been unusual, and at some point will revert to more normal financial conditions. That means thinking about other eventualities ahead, and in some cases showing less exuberance.

Monetary policy always impacts with long and variable lags. Those lags have been longer in this cycle, but as household debt grows the OCR becomes a more potent policy instrument. We are continuing to assess alternative measures that might support the OCR, working with the relevant government agencies. These include a tightening of tax rules applying to housing investment and changes to bank capital requirements to help moderate the amplifying effect of credit on the housing cycle. However, we will continue to rely on the OCR as the primary instrument of monetary policy.