Alan Bollard: Financial stability challenges for small open economies

Remarks by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, at the International Symposium on "Globalisation, Inflation and Monetary Policy", organised by the Bank of France, Paris, 7 March 2008.

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Two asset prices that are of particular interest for policymakers in most small open economies are house prices and the exchange rate. Over the past decade, the "global savings glut", declining interest rates and a search for yield drove up exchange rates for many small open economies such as Australia and New Zealand and also helped fuel a sharp increase in house prices in many countries. Recent developments in global markets stand to have further impacts on housing markets and exchanges rates and create some new challenges on both the monetary policy and financial stability fronts.

The experience of the past decade is now doubtlessly familiar. The decline in interest rates was reinforced by the "great moderation" in the apparent variability of most economies. Investors became more willing to accept risk, partly in order to maintain returns as risk free interest rates dropped, and partly because the risks seemed smaller.

From a monetary policy perspective, the past decade highlighted some of the challenges that we face in trying to run an independent monetary policy in a connected world. In targeting inflation, as many small open economies do, we set a domestic policy interest rate, which has some bearing on domestic monetary conditions. But domestic monetary conditions also hinge on what is happening to interest rates across the rest of the world. Sometimes global interest rate developments are "in sync" with domestic monetary policy and support it. At other times, they are "out of sync" and can work against it, making monetary policy spongier, and perhaps less effective at the margin than would otherwise be the case.

At times over the past decade, monetary policy in New Zealand and some other smaller open economies had to contend with global interest rates that were considerably lower than domestic economic conditions would warrant. Financial institutions in these countries were able to access cheaper funding than they could obtain domestically, exchange rates rose to uncomfortable levels on the back of the carry trade and some asset markets – such as housing – were able to surge on the back of lower effective interest rates than domestic policy settings might suggest.

A strong element of the capital flow into New Zealand – and this is a financial innovation, though now a relatively old one – has been the issuing of fixed income NZ Dollar securities to international retail investors by very high quality international names such as the World Bank. The willingness of these investors to take NZ Dollar risk at elevated currency levels has helped keep the currency relatively high and short term interest rates a bit lower than would otherwise have been the case. This has been far from an ideal mix of monetary conditions at a time when most of the inflation pressures have been concentrated in interest rate sensitive sectors like the housing market. The possibility of collateral damage on the country's tradable sector has to be taken seriously. In New Zealand, we have done significant work, documented in a number of studies on our website, on whether there might be additional regulatory measures or other policies that may have helped adjust the balance of monetary policy pressure to better match the underlying inflation pressure. It will not surprise anyone in this room to know we have not found a "silver bullet", although analysis continues.

Besides retail investors, we have also seen the presence of institutions such as hedge funds engaged in the "carry" of funds borrowed in low yielding markets to invest in markets like New Zealand. An unresolved debate is whether these hedge funds actually provide additional market liquidity for smaller economies or whether they effectively soak it up – particularly in troubled times. The role that these hedge funds can play at the stage where an over-valued exchange rate begins to adjust back to a more normal level is also unclear. Whether hedge funds assist the adjustment process or whether they make it more abrupt and costly, is debatable.

Many countries have seen pronounced strength in property markets over the past decade. Strong residential property markets have often gone hand in hand with strong consumer spending. New Zealand has been a leading example. House prices have risen substantially as a ratio to income over the past five years. As longer term interest rates have risen recently in New Zealand, and housing turnover has slowed, the elevated level of house prices has looked increasingly unsustainable.

One interpretation of recent housing cycles is that a "glut of capital" lowered interest rates and putting upward pressure on house prices, creating a persistent tail wind for some economies. As houses change hands and are more heavily borrowed against, equity is withdrawn by the seller, who may often choose to spend the money. This has helped to keep demand very robust in New Zealand for a number of years and seems to have supported consumer spending as well.

With recent developments in global finance markets, we now seem to be moving into a new era and policymakers are facing some new challenges on both the monetary policy and financial stability fronts. We are only just beginning to understand what is prompting such a marked shift away from risk taking and the pursuit of yield to heightened risk aversion. A ready pool of investors and an appetite for risk appears to have encouraged substantial financial innovations and the creation of a new set of financial instruments, some of which ultimately proved to be a lot riskier than they initially seemed. Much of this activity was concentrated in the US.

The creation of these instruments involved the following elements which I only mention here, but are likely to be worthy of further study and analysis in years to come:

- Origination of credit on riskier terms. A clear example is the covenant-lite debt that private equity firms were able to obtain until 2007, and the increased flow of mortgage lending in the US that would previously not have occurred.
- Contracting out of origination, and securitisation of the completed loan, both of which have at least the potential to create moral hazard.
- Pooling of risk and assumptions about correlation which were based on historical data but did not always prove accurate ex post.
- Credit guarantees, often from the so-called "Monoline" insurers.
- The use of conduits by financial institutions to expand credit creation and asset holdings above and beyond the usual balance sheet constraints.
- A relatively relaxed approach to liquidity risk, with an implicit assumption that wholesale funding was not at risk – as seen in the Northern Rock case, for example.

These events are having important implications for smaller open economies, including New Zealand, Australia and the economies of Scandinavia and Eastern Europe which have a substantial reliance on the international capital markets. Most of these countries have not been very directly affected by the problems arising from the complex innovations described above. In New Zealand, for example, we have not really seen the development of any of the complex financial instruments at the heart of the US's current financial problems. However, as a net borrower and a participant in international markets, New Zealand is certainly affected by the sharp changes in interest rates, credit spreads and exchange rates that have occurred as a result of recent developments. We are currently seeing increased funding costs in global markets for reasons that are largely not of our own making.

We currently face something of a mixed bag at present in terms of global interest rates. At one level, a loosening in monetary policy in the US and some other countries is putting downward pressure on medium to longer-term interest rates. For those smaller economies like New Zealand and Australia which are facing relatively strong inflation pressures at present, that would ordinarily make the monetary policy challenge harder. On the other hand, higher credit spreads are actually increasing the effective cost of funds for many of our financial institutions and businesses accessing funds through the global capital markets. So we actually face some quite difficult judgements in assessing how policy settings and global conditions will affect domestic economic activity and inflation in the months ahead.

Despite increased global risk aversion, it is not yet evident that the carry trade is dead. We have still seen a relatively strong issuance in the New Zealand dollar in recent months via Uridashi bonds for example. The New Zealand dollar remains at relatively high levels and has recently been at a post-float high against the US dollar, albeit largely reflecting the weakness in the US dollar itself. However, as one might well expect, exchange rate volatility has been high of late and there is perhaps more than the usual uncertainty around the likely path of the exchange rate over the months ahead.

With banks' funding costs on the rise, mortgage rates have been increasing in New Zealand and Australia and in some other small open economies recently. This occurs at a time when New Zealand's housing market is already slowing due to the effects of past policy tightening. Whilst we are projecting the housing slowdown to be of the soft landing variety, there is obviously some risk of a more pronounced slowdown. History shows us that either scenario can happen. Clearly, the path of global interest rates from here on will have some bearing, given their influence on bank funding costs.

Of course, monetary policy is not our only focus. Global market developments also have important ramifications for financial system stability in smaller open economies. The banks in many of these countries are net borrowers in global markets, New Zealand and Australia being two examples. Recent events have highlighted some risks and vulnerability that institutions and regulators need to ensure are properly managed. We always used to talk about these risks but they have come into sharper focus. Our institutions need to be able to cope with sharp changes in the cost of funds in the global market place. But as we saw in July last year, we also need to confront the possibility that global funds may not always be as readily available as we perhaps used to think. Financial market liquidity policies and the management of funding by financial institutions are two areas that are likely to receive considerable policy attention in many countries over the coming months.

Specifically, I note a very timely and comprehensive analysis of liquidity issues was prepared in a Special Financial Stability Review by the Bank of France in February. In New Zealand, we have also been keenly aware of the liquidity risks that recent events have demonstrated. Banks have had an important role intermediating capital account flows into New Zealand (and Australia), and have accepted a significant amount of short term capital flows in order to minimise funding costs. We want to look at whether the vulnerabilities that this can create have been adequately priced and managed – noting that some of the costs of a liquidity event are probably externalities that would ultimately be borne by other New Zealand parties.

Breakdown of short term lending markets is one specific challenge we would expect to confront if the financial stability situation deteriorates markedly further in one or more of the major advanced economies. There will doubtless be other flow-on effects as well. Like the transmission of subprime issues to monolines and seemingly unrelated markets, many of these flow-on effects could surprise us. However, the potential for a deterioration in financial stability to further intensify risk aversion seems significant. For countries like New Zealand with substantial borrowing from abroad this could clearly have an impact on our cost of funds and/or our access to funds in some global financial markets.