Inquiry into the future monetary policy framework

Report of the Finance and Expenditure Committee

Forty-eighth Parliament
(Charles Chauvel MP, Chairperson)
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Contents

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Key findings

The Finance and Expenditure Committee

- confirms the importance of maintaining price stability as a vital component of a healthy and well performing economy.

- agrees that monetary policy remains the primary means for maintaining price stability.

- acknowledges that the Policy Targets Agreement between the Minister of Finance and the Governor of the Reserve Bank of New Zealand recognises the important role price stability plays in supporting the achievement of wider economic and social objectives, and that it requires the Reserve Bank, in pursuing its price stability objective, to operate monetary policy in a manner that avoids unnecessary instability in output, interest rates, and the exchange rate.

- acknowledges that New Zealand's monetary policy approach, emphasising central bank independence and inflation targeting, is standard among, small, open, and developed economies.

- acknowledges that New Zealand's monetary policy operates in a similar manner to countries with wider mandates, such as Australia and the United States.

- acknowledges that at times of strong inflation pressures, the costs of maintaining price stability are often borne disproportionately by the export sector.

- acknowledges that a range of economic factors and resource constraints have contributed to recent inflation pressures and to how quickly monetary policy has affected inflation outcomes.

- acknowledges that factors other than monetary policy—such as sustained improvement in trend productivity—play a key role in lessening the adjustments required to maintaining low inflation over the medium term.

- believes that constraints on the availability of natural resources, particularly crude oil, are likely to be increasingly significant contributors to inflation.

- heard extensive evidence concerning supplementary stabilisation instruments, such as a mortgage interest rate levy, an interest-linked savings scheme, and other taxes that might complement interest rates in managing inflation, but did not find the arguments in their favour compelling enough to support them being pursued further at this time.

Recommendations

The Finance and Expenditure Committee recommends to the Government that

Policy measures

- in conjunction with territorial local authorities, the Government consider streamlining regulations and planning laws regarding the provision of housing, and investigate the extent of urban land-banking of blocks of land for housing development—the aim being to reduce costs while maintaining standards to ensure the quality of housing and without compromising other urban development objectives. (page 24)
- the Reserve Bank consider making the results of its monitoring and evaluation of the housing market more accessible. (page 24)
- the targets for the number of permanent migrants entering New Zealand each year continue to focus on New Zealand's need for appropriately-skilled migrants. (page 25)
- recognition be made of the infrastructure requirements of increasing population, and that it ensure that neither immigration policy nor inadequate infrastructure act as constraints on non-inflationary growth. (page 25)
- further analysis be undertaken of the interactions between fiscal, monetary, and general economic policy, given the impacts of fiscal policy on output, inflation, and the exchange rate. (page 50)
- it maintain and enhance transparency as to the weight that it attaches to economic stability when setting fiscal policy. (page 50)

Statistical information

- Statistics New Zealand be empowered to utilise more effectively the fundamental economic information held by other Government departments and entities, rather than imposing new compliance measures in the collection of information. (page 57)
- it continue to support the development of Statistics New Zealand's official productivity data series, particularly in relation to the sectors that are not currently or adequately measured. (page 66)

Productivity performance

- high priority be placed on policy to raise New Zealand's productivity performance to the extent that this is consistent with the Government's other objectives. The weight given to these other objectives should also be considered in the light of any impacts they have on productivity. (page 69)
- it continue to cooperate with employers and employees to improve workplace productivity and to create a stronger and more systematic approach to the development and delivery of productivity initiatives. (page 72)
- options be explored for introducing a more systematic approach to reviewing the stock of existing regulation in New Zealand, including the cumulative effect on the productivity performance of a sector, and appropriate institutional arrangements, including a joint approach with Australia for conducting these reviews. (page 75)

- the impact of the 2007 changes to the regulatory impact assessment process be reviewed, and options be explored for strengthening the ex-ante review function currently conducted by the Regulatory Impact Analysis Unit. (page 75)
- it support non-distortionary measures (such as depreciation rules) to increase capital investment. (page 78)
- it specifically include policies to increase the efficiency with which the economy uses scarce natural resources such as oil, gas, fresh water, and the capacity of the environment to absorb wastes. These policies should include, but not be limited to, price signals. (page 84)
- the Reserve Bank continue to highlight the distinction between cyclical and structural inflation drivers such as resource scarcity. (page 84)

Recommendations (by majority)

The Finance and Expenditure Committee recommends, by majority, to the Government that

Prudential policy

- further to the advice tendered by our independent specialist adviser, the Government consider whether existing prudential legislation unduly restricts the Reserve Bank's capacity to respond to inflation through the use of its prudential tools, given the implications of the rapid expansion of credit for the risks in household sector balance sheets and for the inflation outlook. The National Party rejects any suggestion that the Reserve Bank could or should use its prudential supervision powers to achieve monetary policy objectives. In the context of a global credit crunch, the Reserve Bank has a critical role maintaining confidence in the financial system. Any change to the current objectives and method of prudential supervision would put New Zealand out of step with internationally accepted norms and could create costly confusion in an already stressed financial system. (page 46)

Tax measures

- the system for taxing all forms of income be investigated to ensure that it is neutral and not biased towards some forms of investment. The majority of us consider that it is desirable for the tax system to be neutral towards all forms of capital investment in a manner consistent with other policy objectives. The Green Party supports a capital gains tax on all investment income, other than the primary family home, as a way of improving the neutrality of the tax system. The National Party recommends no change to existing law on the taxation of capital gains. (page 64)

Minority view of New Zealand First Party

The select committee has heard evidence during the inquiry that the Reserve Bank, when setting the official cash rate, does take into account factors such as employment, exporting competitiveness, and the exchange rate. However, New Zealand First rejects the conclusion that for these reasons the Reserve Bank Governor's targets or contract do not need to specify these objectives.

The unintended consequences of a singular focus on using interest rates as a blunt instrument to curb inflation are increasingly evident, as is the weight of academic argument supportive of a broader focus on the Reserve Bank Act. Quite clearly, if these factors were established in law, then we would not see the current situation of a disproportionately high dollar hurting both our exporters and our growth potential on top of the other economically stifling impacts of high interest rates.

New Zealand First's view is that the three broader economic indicators—employment, exporting competitiveness, and the exchange rate—must be explicitly written into the Reserve Bank Act to ensure that they are weighted equally with keeping inflation within a 1 to 3 percent band.

1 Introduction

Our inquiry

1 The conduct of monetary policy is the responsibility of the Reserve Bank, and the rate of inflation lowered with the introduction of the Reserve Bank Act in 1989. The Finance and Expenditure Committee undertakes regular scrutiny of the Reserve Bank's monetary policy operations in quarterly sessions with the Reserve Bank Governor on Monetary Policy Statements. We have observed a gradual increase in interest rates over recent years, and an accompanying rise in the exchange rate to levels not seen since exchange rate controls were dismantled in 1985.

2 Most commentators expect inflationary pressures to persist and monetary conditions to remain firm, leading to subdued economic activity. In these circumstances we considered it appropriate and timely to undertake a full inquiry into New Zealand's monetary policy framework.

3 In this inquiry we examined the possible need for changes to the monetary policy framework, and the effects of other economic policies on monetary policy and on productivity. We make recommendations for strengthening the monetary policy framework and improving our overall economic performance.

4 Our report first outlines the current monetary policy framework, and summarises our views on the framework. We then examine in more detail the essential elements of the framework, beginning with inflation and price stability and the effect of monetary policy on inflation. We consider specific factors that have contributed significantly to inflation in recent years, including the housing cycle, retail banks' lending policies, immigration, and commodity prices. We also inquire into the contribution of charges for Government services.

5 We comment on the effectiveness of monetary policy in pursuing its price stability objective. We discuss the effect of monetary policy changes on the economy, and consider whether other approaches might deliver superior outcomes. Suggested alternatives include changing the legislated objective of monetary policy and fixing the exchange rate, and lesser changes such as altering the inflation targets or internal procedures of the Reserve Bank of New Zealand.

6 We discuss alternative policies for supporting monetary policy. These instruments tend to fall within the domain of fiscal or regulatory policy rather than monetary policy. They include tax policy changes, and measures such as an interest-linked saving scheme. Mortgage levies and cyclical banking controls are also examined in the context of the 2006 review of supplementary stabilisation instruments.

7 We examine the housing market and look at the role of productivity in lifting the capacity of the economy to grow before inflation pressures build. Finally, we comment on New Zealand's productivity record, and look at ways to raise productivity through

education and training, the case for tax changes, and the case for an institution on the lines of a productivity commission.

Approach to inquiry

8 We announced our decision to undertake an inquiry into the future monetary policy framework on 24 May 2007, and invited written submissions on the following terms of reference:

- To consider the causes of inflationary pressures.
- To consider the effectiveness of current monetary policy in controlling inflation.
- To examine the interaction of monetary policy with other elements of the economic policy framework including fiscal policy.
- To examine the New Zealand economy's capacity for non-inflationary growth, and how it can be improved.
- To examine the role of productivity in the economy, how it can be improved, and the constraints upon it.
- To examine the recommendations from recent examinations of monetary policy including the joint Treasury and Reserve Bank of New Zealand's report entitled *Supplementary Stabilisation Instruments*.
- To consider additional measures that could enhance monetary policy in New Zealand.

9 On the basis of the written submissions, we decided which submitters we wished to hear evidence from. In choosing the oral submitters, we sought to hear from those that represented the views of the domestic and international banking sectors, academics, non-governmental organisations, businesses, and private individuals. We also invited submissions from businesses in the export and import sectors.

10 The membership of the committee and the procedures for undertaking this inquiry are set out in Appendix A. A list of submissions received is set out in Appendix B, along with details of the advice we received and the material that we considered. Attached as Appendix C are the transcripts of the hearings of evidence.

2 The monetary policy framework

Overview of current framework

11 The Reserve Bank of New Zealand Act 1989 established a monetary policy framework with a single objective of price stability. This was a departure from the 1964 Reserve Bank of New Zealand Act, which required that monetary policy should be aimed at a number of objectives. These were

> … the maintenance and promotion of economic and social welfare in New Zealand having regard to the desirability of promoting the highest level of production and trade and full employment, and of maintaining a stable internal price level.[1]

12 The Finance and Expenditure Committee that considered the 1989 legislation supported the change to the framework, but at the same time commented that other economic policy initiatives would need to be taken in conjunction with monetary policy to achieve the wider range of economic objectives.[2] Under the 1989 framework, the primary function of the Reserve Bank of New Zealand is to

> … formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.[3]

13 The Finance and Expenditure Committee felt that the "clarity of this objective will assist public- and private-sector planning, help consolidate lower inflationary expectations, and boost business confidence in the medium term by the adoption of a consistent approach to monetary policy."

14 The 1989 legislation increased the Reserve Bank's autonomy by making it responsible for the formulation and implementation of monetary policy to achieve the price stability objective. This independence is, however, moderated by the requirement that the precise policy targets for the implementation of monetary policy are negotiated and agreed to by the Minister of Finance and the Governor of the Reserve Bank during that governor's term of office. The current Policy Targets Agreement[4] requires the governor to keep future inflation, as measured by the All Groups Consumers Price Index (CPI) published by Statistics New Zealand,[5] to between 1 and 3 percent on average over the medium term.

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1 Section 8(2) of the Reserve Bank of New Zealand Act 1964.

2 Finance and Expenditure Committee, *Report on the Reserve Bank of New Zealand Bill*, December 1989.

3 Section 8(1) of the Reserve Bank of New Zealand Act 1989.

4 Reserve Bank of New Zealand, *Policy Targets Agreement between the Minister of Finance and Governor of the Reserve Bank May 2007.*

5 The All Groups Consumers Price Index records the change in the price of a weighted basket of goods and services purchased by an average New Zealand household. The contents of the basket are specified by Statistics New Zealand and the percentage change of this index is commonly referred to as CPI inflation.

15 The 1989 Act also formalised some of the essential elements of monetary policy as it had been practised since the fixed exchange rate system was replaced by a floating exchange rate system in 1985, and it improved the transparency and consistency of monetary policy. The Act requires the Reserve Bank to report publicly on its implementation of monetary policy, which it does in its quarterly monetary policy statements. Typically, following the release of this report the governor also appears before the Finance and Expenditure Committee. These processes ensure that the governor explains to the public the reasons for, and the consequences of, his or her policy decisions.

Official cash rate

16 The Reserve Bank's main instrument for achieving price stability is the official cash rate, which determines the short-term wholesale interest rates that influence retail deposit and borrowing rates. Changes in the cash rate also affect the exchange rate by changing the relative attractiveness of New Zealand-dollar investments and thus the prices of imports and exports. The bank reviews the official cash rate eight times a year and issues a monetary policy statement on four of these occasions.

17 The effect of changes in interest rates and the exchange rate is to stimulate or dampen aggregate demand, and thus the rate of change in the prices of domestically produced goods and services. Inflation in domestically produced tradeable and non-tradeable final goods is the main component of CPI inflation, and imported final goods are another substantial component. When inflation is forecast to move outside the 1 to 3 percent range in the medium term, the official cash rate can be altered to bring inflation back within the band.

Objective of monetary policy

18 The primary objective of monetary policy reflects a wide consensus that monetary policy affects mainly nominal values in the economy, such as retail prices, capital, wage rates, and levels of profits; and that in the long run monetary policy has little or no effect on the real value of these variables. While it can determine the dollar value of a basket of groceries, it has little effect on how many hours must be worked to buy it. The factors that determine how many hours must be worked to buy a specified quantity of goods are real factors, including the productivity of inputs and their determinants, such as the skills and education of the workforce; the choice of outputs produced and their determinants, such as natural resources and access to international markets; infrastructure; and regulatory policy.

19 While most submitters believed that price stability is a vital component of a healthy and well performing economy, they were divided as to whether price stability should be the sole objective of monetary policy, or whether a broader mandate would help to produce better results. Some submitters suggested that a dual mandate, similar to that of the Reserve Bank of Australia or the Federal Reserve System of the United States, was a way to moderate the monetary policy cycle and thus the exchange rate cycle. One submitter suggested that specific reference to the impact of a high exchange rate on export performance and employment be included in the Reserve Bank Act. Many others, however, did not support change; and one reminded us that in the 1970s and 1980s the Reserve Bank had multiple objectives, and ended up going to extremes and failing on all of them.

20 Monetary policy in Australia and the United States have dual objectives, as both price stability and maximum employment share equal ranking in their governing legislation. In contrast, the mandates for monetary policy in the United Kingdom (and New Zealand) have hierarchical or primary objectives for price stability. In practice, however, the differences appear to be variations on a theme rather than fundamental differences of approach. For example, the Policy Targets Agreement requires the Reserve Bank, in pursuing its price stability objective, to seek to avoid unnecessary instability in output, interest rates, and the exchange rate.

21 The common view implicit in the monetary policy frameworks of all these countries is that ultimately the growth of the economy is determined by the economy's real productive capacity, and it cannot be constantly stimulated by relaxing monetary policy. Any attempt to do so simply results in rising inflation, and will ultimately undermine the productive capacity of the economy, with adverse consequences for household income and employment.

Effects of monetary policy on the business cycle

22 Monetary policy works to control inflation by temporarily restraining or stimulating the demand for real resources. As a former Governor of the Bank of England, the Rt Hon Lord George, told the UK House of Commons, the task of monetary policy is "to keep aggregate demand growing approximately in line with the underlying supply capacity of the economy to meet that demand."

23 The supply of real resources, on the other hand, is largely determined by factors other than monetary policy. For example, the supply of labour is driven by factors such as demographics, wages, people's preferences, migration, and the structure of taxes.

24 In general the supply of resources tends to be quite stable; for example the labour force and the capital stock tend to grow at fairly steady rates. Clearly there are exceptions–-droughts, for example, can have large impacts on the supply of agricultural products–-but for the most part changes in current output are determined by changes in aggregate demand.

25 The view that the supply of resources and the productivity of their utilisation are the primary determinants of the rate of growth in the long run, and that in the short run actual output is determined by the demand for resources, gives rise to the concepts of *potential output* and the *output gap*. Potential output corresponds with the rate of growth that is sustainable in the long run, and is therefore largely a function of the rate at which the supply side can grow. The output gap is a measure of the difference between current output and potential or long-term sustainable output. A positive output gap develops when current output exceeds the long-term potential output, and this generalised excess of demand over supply puts pressure on prices to rise. By raising interest rates monetary policy reduces overall demand and restores the broad balance between supply and demand, which in turn alleviates price pressure and maintains a low and stable inflation rate.

26 In practice the application of these concepts to guide policy-making is challenging. In a 2001 report Professor Svensson observes that "potential output is certainly an abstract and difficult concept, and estimating it is one of the greatest challenges facing monetary

policy."[6] Frederic S. Mishkin of the United States Federal Reserve Board echoes this view, saying that there are serious limitations to the science of monetary policy.[7]

27 Monetary policy makers need nevertheless to form some view about the economy's ability to produce on a sustained basis. The output gap is of course not the only determinant of inflation, which is also affected by various unpredictable shocks and disturbances. The wide variety of the factors that can give rise to inflation highlights the importance of considering multiple indicators in the labour, product, and financial markets, and data on prices, to assess the overall balance of supply and demand in the economy.

28 The Reserve Bank Board told us that when the Reserve Bank Act was being drafted in the late 1980s there was a discussion about what happens when there is an imbalance in the economy, and the bank has to tighten monetary policy to control inflation. The answer was that Reserve Bank has to control inflation and it makes that imbalance manifest. For example, the imbalances in the economy that led to this inquiry have been manifested through the high exchange rate. Further, it is worthwhile seeing broader economic responses to those imbalances and considering additional stabilisation instruments that can be used to mitigate some of the effects of those imbalances.

29 Submitters agreed generally that our monetary policy framework has proven effective in controlling inflation, although many pointed out that thus control had come at some cost, which seemed to have increased over the most recent cycle.

Sustaining success

30 Macroeconomic outcomes have improved significantly since the early 1990s. Output has expanded at an average rate of more than 3¼ percent per year for the past fifteen years, and unemployment has fallen to around a third of what it was at the beginning of the period. This period has also been associated with low and stable inflation. The fiscal position has improved, moving from deficit to sustained surplus and reducing public debt. Economic policy has therefore permitted more sustained and stable growth in this period than probably any other in New Zealand's history.

31 The exchange rate has, however, been volatile and subject to prolonged periods of under and overvaluation, potentially constraining growth in both the value and the volume of New Zealand's exports. Labour productivity made a strong contribution to the growth in output over the 1990s, but has been more subdued since 2000. Labour inputs have, however, continued to grow strongly, reducing unemployment to its lowest rate in a generation. In other words, while growth has been strong in both the 1990s and 2000s, the sources of growth have shifted.

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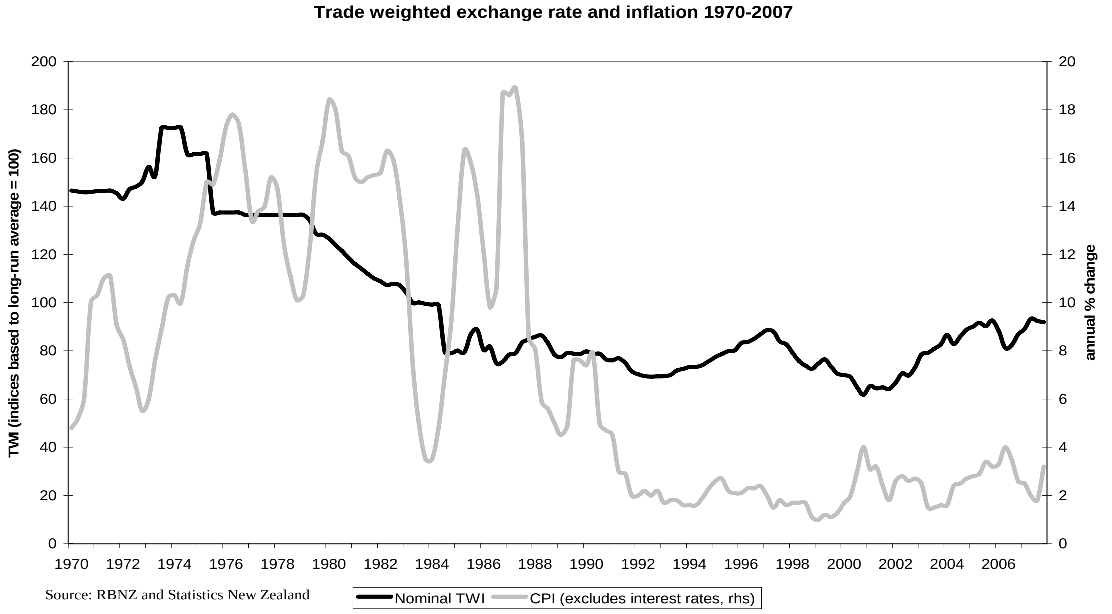
6 Svensson, Lars EO, Report to the Minister of Finance, *Independent Review of the Operation of Monetary Policy in New Zealand*, February 2001.

7 Submission MP/46A from Reserve Bank of New Zealand.

32 The following graph compares the exchange rate as measured by the trade weighted index of exchange rates and the consumers price index for the past 37 years.



33 In response to accumulating inflation pressures, the Reserve Bank increased the official cash rate from 5 percent in December 2003 to 8.25 percent in July 2007. Increases in the cash rate cumulatively produced a smaller moderation in activity, more slowly, than was predicted. Monetary policy had the expected effect, but took longer to act because of very unusual international circumstances—30- to 40-year highs in commodity and food prices, an international housing upturn, and an unusual period of very loose international liquidity. The slower impact of interest rate changes has increased the need for a firm monetary policy stance and, through the effect of higher interest rates, has pushed the exchange rate up, putting more pressure on the competitiveness of the export sector.

34 The essential elements of the Reserve Bank Act and successive policy targets agreements have been largely unchanged since 1989. New Zealand's monetary policy approach with central bank independence and inflation targeting was unique when first introduced in 1989, but is now standard among, small, open, developed economies, and is regarded by our advisers as "world best practice".[8] We are advised that more than 20 countries now use a similar approach to monetary policy. The target band of 1 to 3 percent is roughly in line with the range of inflation targets adopted internationally, and the tools used by other monetary authorities are similar to the official cash rate used by our Reserve Bank.

35 The improvement in economic performance over the last two decades reflects, at least in part, the effects of reforms to the monetary policy framework. In our view the framework provided by the Reserve Bank Act 1989 has been largely successful. We confirm the importance of maintaining price stability as a vital component of a healthy and

8 Because it is similar to that used by most other central banks. Even countries that do not have a formal inflation target, (for example, the United States and Japan) act, in practice, as if they did. The central banks that have a formal single target of price stability also give some weight to output.

well performing economy and agree that monetary policy remains the primary means for maintaining price stability.

36 Continuity is an important part of this framework, providing the public with confidence in the framework's commitment to low and stable inflation. In view of the broad success of the framework, we do not recommend any change to the framework. Our recommendations for change are not directed at the fundamental features of the framework.

3 Economic context—identifying the issues

Introduction

37 To understand monetary policy and the way the Reserve Bank's actions influence the economy we considered the various views of submitters on inflation–-what it is, what causes its, and how it can be measured. We then examined the way monetary policy is applied in response to inflationary pressures, to determine which of the main drivers of the economic cycle have given rise to the recent inflationary pressures, and investigated resource cost pressures that may not be cyclical. We inquired in detail into the reasons for these developments and their consequences for monetary policy.

Inflation

38 Inflation is the term used for the average rise in prices in the economy. Briefly, inflation results in a decline in the future value of money. The rise in average prices can be distinguished from rises in the price of particular goods, such as housing, oil, or milk. These changes, particularly in prices relative to average prices, provide signals to firms that they should increase or decrease production, or adapt in other ways such as increasing productivity, to maintain a viable business. Relative price changes are therefore an essential element of a market-based economy. When the prices of many goods rise together, it can be difficult for producers and consumers to interpret these signals and this may lead to poor decisions. Price stability helps ensure that observed price changes provide information about the underlying demand and supply situation. We considered the various explanations provided by submitters of the cause of inflation.

Price stability

39 Price stability was seen by most of the submitters as beneficial for the performance of the economy. They pointed out the principal benefits and costs and disadvantages of inflation. High inflation arbitrarily redistributes wealth and income, confuses price signals, and erodes the purchasing power of wages. Low inflation helps create a stable economic environment, which is conducive to growth and a stable exchange rate, and price stability protects savings, thus facilitating investment.

Measurement of inflation

40 There are various ways of measuring inflation. The one used in the Policy Targets Agreement is the All Groups Consumers Price Index (CPI) published by Statistics New Zealand. The percentage change of this index is commonly referred to as CPI inflation. The contents of the basket of goods used are specified by Statistics New Zealand, which periodically reviews and re-weights them, using data obtained from its annual household economic survey. This is necessary because the goods and services purchased by the average household change over time.

41 Some submitters expressed concern at the CPI treatment of housing. They commented that including housing in the CPI is unusual internationally (although we are

advised that Australia does so), and could lead to measured inflation in New Zealand being higher than elsewhere, and consequently to higher interest rates than elsewhere.

42 The CPI is based on an acquisitions framework, where expenditure weights in the index are determined by the value of goods and services purchased by households in the reference period, irrespective of whether the items were paid for or consumed in that period. Under this approach the costs of owner-occupied housing are based on the purchase and construction costs of new housing purchased in the reference period. This method is considered by the International Labour Organisation to be the most appropriate framework for an index, as it reflects the actual goods and services that have been transacted. There can, however, be significant differences between measured inflation using this framework and alternatives.

43 The 2007 United Kingdom House of Commons report says that housing is excluded from the CPI measures used in the UK and some European countries because the various countries had not agreed a common framework.[9] The Treasury Committee recommended that the UK Office of National Statistics work with their European counterparts to bring about a consensus as quickly as possible.

44 Another issue raised by submitters is whether the index should include non-market transactions and prices. Charges set by central or local government, for example, such as rates and education fees, are regarded as largely unresponsive to monetary policy.

45 The design and scope of the CPI are discussed in the 2004 Report of the Consumers Price Index Revision Advisory Committee. The report notes that excluding non-market prices would make the CPI basket less representative of the actual goods and services purchased by the vast majority of households. The report says that the index needs to be demonstrably a consumers' price index if it is to be credible, and that excluding significant components of household spending such as Government charges would compromise its credibility. The CPI Committee did not support such changes in the design and scope of the CPI, and considered that there was little demand for them. We support this view.

Inflation target

46 Most submitters agreed that inflation below 3 percent was consistent with price stability. The New Zealand Business Roundtable, however, told us that it did not consider inflation of around 2.5 to 3 percent to be consistent with this legislated requirement. The Business Roundtable pointed out that a 2.5 percent inflation rate over 10 years results in an increase in prices of nearly 30 percent.

47 We are advised that New Zealand's inflation target of "between 1 and 3 percent on average over the medium term" is similar to those in other countries, and that the goal of price stability has been promoted internationally by policies aimed at maintaining low and predictable inflation. Policymakers have not aimed for completely constant price levels, in the belief that very low rates of inflation also incur potentially important costs.

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9 House of Commons, Treasury Committee, Monetary Policy Committee of the Bank of England: ten years on, 2007.

48 First, the economy is subject to "downward nominal rigidities"; that is, prices and wages that do not normally fall even when market equilibrium might require it. However, with a small amount of inflation in the system, these prices and wages can fall in relative terms (by not rising with other prices) even if they cannot fall in absolute terms. This is an argument that small amounts of inflation may help to make price systems more flexible.

49 Secondly, there may be biases in the measurement of inflation that cause true inflation on average to be overstated by standard measures. We are advised that this can arise, for example, when an improvement in the quality of goods or services is not properly taken into account when measuring their price. To the extent that this happens, inflation would be overstated; and anti-inflation policy would need to make allowance for this by setting the target higher than zero. Thirdly, it is likely to be costly to reduce inflation, so some judgement needs to be made as to how far inflation reduction should be taken, weighing up the costs and benefits.

50 On the basis of the evidence we received, we concluded that the source of inflation is money and credit growth in excess of the supply of the goods and services available. Whether we have inflation in New Zealand or not, therefore, is dependent on the monetary policy stance of the Reserve Bank to control inflation, and whether the Reserve Bank's traditional tools are capable of responding to external, long-term pressures such as resource depletion, and to Government economic policies intended to address such pressures. Price stability remains a critical component of a healthy and vibrant economy. We consider that the design and scope of New Zealand's Consumers Price Index is an appropriate measure. We do not therefore support changing the scope of the CPI to exclude housing or any other components such as non-market transactions and prices.

Responding to inflation—role of monetary and fiscal policy

51 Monetary policy is one element of economic policy. The others mentioned by submitters as interacting with monetary policy include fiscal policy, that is, the Government's expenditure and taxation policies; product and labour market policies; regulations, including those that affect immigration and the supply of housing; policies for the better use of scarce natural resources and for environmental sinks, which drive inflation; and other regulatory legislation, such as the Resource Management Act 1991, which affects, investment decisions and costs.

52 Monetary policy affects mostly nominal economic variables such as the level of prices, wages and profits. In the long run, its impact on the real value of these variables, however, is minimal. While monetary policy can determine the dollar price of a basket of groceries, it does not affect how many hours must be worked to buy that basket. These real variables are determined primarily by factors other than monetary policy. These other factors include productivity and its determinants, such as the skills and education of the workforce; those factors that affect how much of their time individuals choose to spend working, such as preferences for leisure and incomes; and those that affect what goods and services can be produced such as natural resources and access to international markets.

53 The primary role of monetary policy is ensuring price stability, which is consistent with it also performing a countercyclical smoothing of economic activity in response to changes in overall demand. With monetary policy performing the stabilisation role, fiscal policy can focus on the medium- and long-term challenges to the economy. When

economy-wide supply is affected, monetary policy may be less able to stabilise both inflation and activity. This is discussed further in our section on natural resources.

Sources of inflationary pressures—economic developments

54 From March 2000 to December 2007, inflation increased by around 2.5 percent per year, which is consistent with the target range of 1 to 3 percent. This has occurred despite annual inflation sometimes exceeding 3 percent, and occasionally reaching 4 percent. In the year to December 2007 inflation grew at an annual rate of 3.2 percent, and is expected to accelerate further over 2008 before moderating and falling back within the target ban in 2009.

55 Submitters pointed out a number of shocks—unexpected events to which monetary policy has had to respond—that have affected the pace of economic activity and inflation in recent years: house prices, immigration, fiscal policy, commodity prices, global economic developments, and household borrowing. We examined each of these influences.

House prices

56 Many submitters specified the housing sector as one of the key drivers of inflation. In dollar terms house prices have doubled since 2002, and even after adjustment for inflation they have risen around 80 percent. This boom in real house prices is unprecedented in New Zealand's recent history; the 80 percent rise between March 2002 and March 2007 is about the same as the increase recorded over the preceding forty years from 1962. House price increases of similar magnitudes have also occurred in many other developed economies over the past 10 years or so.

57 The boom in real house prices has occurred in all regions of New Zealand and all types of property (urban, rural, commercial, and industrial), unlike the mid-1990s boom, which was largely based in Auckland. This has not, however, been associated with sharp increases in rents, which have risen at about the same rate as overall inflation.

58 We note the comments of a submitter, Professor Viv Hall, who believes that developments in the housing market affect the CPI indirectly; rather than the price of houses, per se, factors such as labour, materials, and rates feed inflation.

59 Other housing-related expenses in the CPI include insurance, real estate fees, and repairs and maintenance. The CPI also reflects changes in rent, and controls for changes in the composition and quality of rental accommodation.

60 In New Zealand cycles in consumption spending are closely correlated with the residential house-price cycle. This relationship reflects the effect of rising house prices on wealth, which enables people to fund more consumption either by borrowing against the higher-valued assets or by passive withdrawal of the increased equity when the house is sold. For example, the New Zealand Chambers of Commerce told us:

> Big increases in the value of houses make people more willing to borrow more and encourage people to go out and purchase. They feel more confident about their own wealth and are prepared to go out and buy some goods they perhaps wouldn't be buying if they felt that times were tougher.

61 We note that this has been encouraged by the active promotion by some banks and financial institutions of mortgage-funded spending.

Factors in rising house prices

62 Understanding the reasons for rising house prices is important for monetary policy. While house prices may move in response to changes in the fundamental determinants of demand and supply, such as changes in construction costs, the supply of land, demographics, and cultural factors, they may also move for speculative reasons—in the expectation that in the short term house prices will rise above their long-run fundamentals.

63 Submitters argued that the following factors have driven the recent growth in demand for housing:

- the surge in net immigration earlier in the decade
- growth in real incomes and employment
- a period of low interest rates
- the increasing availability of mortgage finance
- rising interest by investors in the housing market and expectations of capital gains, coupled with a perception that there is a tax advantage associated with debt-funding investments in housing.

64 The purchase of New Zealand real estate by non-residents is also considered to add to demand. The Reserve Bank estimates that about 5 percent of the housing stock is held by non-residents. The Council of Trade Unions believes that non-resident purchases exacerbate demand, but does not consider it to be a primary issue. On the supply side, we considered the comments of submitters about constraints on the availability of land, labour and materials, and rising compliance costs generated by regulation and administrative requirements.

65 On the basis of the evidence we considered, the housing situation can be summarised as follows:

- While the supply of new occupied dwellings has responded strongly to population growth, there are some signs of a shortage in Auckland, particularly Manukau.
- The increase in the new supply of occupied dwellings has come with large increases in the cost of constructing new dwellings since 2001, reflecting increases in section prices, labour costs, and the cost of materials.
- New dwellings represent only a relatively small share of house sales.

The three major regulatory factors that affect housing are

- the Resource Management Act 1991, which provides for the sustainable management of land
- the Building Act 2004, which requires building consent approval before building can commence
- development levies, to be paid under the Local Government Act 2002.

66 Some submitters were critical of the time it takes to process and gain resource consent, and argued that the associated holding costs have contributed to higher building costs. Further, the greater regulatory burden associated with the Building Act 2004 and greater rigour in the occupational licensing and building consent regimes had pushed up final costs. Council infrastructure levies are undoubtedly a sizable component of new housing construction costs, and we note that they appear to be rising. Purchasers of new houses expect a full range of services to come with the house, including sewerage, drainage, water, and electricity. We understand that territorial local authorities are charging developers increasingly for the provision of these services rather than funding them out of local authority rates or central Government funding from general taxation. These charges appear to be flowing through into new housing prices.

67 However, the infrastructure costs of growth must be paid for somewhere; if not incorporated into the prices of new homes, they would raise the level of local authority rates generally, which would also contribute to inflation. If new subdivisions do not bear their real infrastructure costs, the economic incentive would be to build in places where the infrastructure costs are higher.

68 The Parliamentary Commissioner for the Environment has commented on the large differences in land prices on either side of the metropolitan urban limit in Auckland, but advised us that freeing up land for development outside this limit “locks us into more oil dependency” and “the creation of car-dependent suburbs on the edge of cities goes generally in the wrong direction … We need to get better at building quality, dense housing in our cities.”

69 On the current state of the housing market the Reserve Bank told us that monetary policy is significantly affecting the housing sector in line with its forecasts; it regards this effect as appropriate, if rather slower to kick in than it has been in previous cycles. We also note the prediction of the ASB Bank that a period of “relatively mild adjustment” is likely, with a slight fall in prices followed by a flat period of little change.

70 While real house prices have risen significantly over the latest housing cycle, we are advised that this is in line with other OECD countries. The current housing cycle reflects the following factors:

- recent significant growth in income and employment
- historically, lower interest rates, in the first half of the decade, which have allowed households to borrow more
- the perceived low risk and tax advantages associated with investing in and lending for houses
- banks seeking market share and lending more aggressively
- a growing need for houses, driven by population growth and the long-term trend to smaller households
- higher building costs as a result of increases in the costs of labour and materials, and regulatory changes to ensure better quality houses
- higher consent and related infrastructure charges by local authorities

- controls designed to manage urban sprawl, which reduce the availability of land.

71 Many of the factors driving house prices are structural and beyond what can be reasonably controlled by monetary authorities or Government policy interventions in the short term.

72 We are advised that the latest data on house prices suggests that housing pressures are now falling, with moderating price increases and less housing construction activity. Housing is, however, an ongoing issue, particularly as housing cycles have been a persistent feature of the New Zealand economy.

73 Many factors, on both the demand and supply sides, have combined to push up the price of houses. The relative importance of each factor is not clear. Most of the evidence we heard about the housing market was anecdotal. While we welcome the slowing that is now evident in the growth in house prices, reflecting mostly demand-related factors, we recognise the wider economic implications should house price growth slow more abruptly, and perhaps decline significantly.

Housing supply

74 One driver of the housing cycle is the availability of land for development, and the costs associated with regulations governing housing development. The availability of relatively cheap new housing acts to limit housing price increases because, at the margin, new buyers of houses can choose between new and existing houses. We therefore do not want to see the supply side of the housing market contributing unnecessarily to the overall cost of housing. We do not consider that there is no place for regulating land supply or the quality of housing and associated infrastructure; but clearly these issues are important for the standard of living in this country, demonstrated in concern about urban sprawl and leaky housing problems.

75 We note that while allowing urban sprawl may release cheaper building lots on the outskirts of cities, the price of these lots will rise as soon as planning regulations allow them to be subdivided. In addition the associated high travel costs to residents, and high costs of water reticulation, sewerage and roading, and the general lack of public transport, may offset any gains in housing affordability.

76 We would like to see that an increase in the supply of good-quality homes achieved without compromising other urban development objectives, particularly if urban land-banking by developers is restricted. This is a significant challenge, however, and significant policy analysis would be required to streamline regulations to this end.

77 Notwithstanding this, we believe that to improve the efficiency of the regulatory processes related to the development and construction of housing the Government needs to implement a robust monitoring and evaluative regime for the housing market, in order to determine with certainty which factors combine to affect significantly the cost of housing.

Recommendations

We recommend to the Government that in conjunction with territorial local authorities, the Government consider streamlining regulations and planning laws regarding the provision of housing, and investigate the extent of urban land-banking of blocks of land for housing development—the aim being to reduce costs while maintaining standards to ensure the quality of housing and without compromising other urban development objectives.

We recommend to the Government that the Reserve Bank consider making the results of its monitoring and evaluation of the housing market more accessible.

Immigration

78 Many submitters suggest that the increase in immigrants to New Zealand from 2001 to 2003 has contributed to the increase in the demand for housing and in economic activity and inflation. The Reserve Bank explains:

> … after the 9/11 attacks migration flows to New Zealand reversed sharply. For several years New Zealand had been experiencing a modest net migration outflow. This reversed very quickly, and by 2003 there was a net annual inflow (of both permanent and long-term migrants and students) of in excess of 80,000 people. This represented an enormous economic stimulus. Even if all migrants went straight into the workforce—and many, students in particular, do not—all of them need to be housed immediately.

79 The bank acknowledges that this 2 percent "population shock" had an "immediately apparent" effect on the housing market. With hindsight the Reserve Bank recognises that it underestimated the significance of the "huge net migration inflow" and was "relatively slow to reverse the precautionary cuts of 2001". The ASB Bank agrees that immigration had a significant effect earlier in the housing cycle, as a fundamental driver for the boom of 2003/04, but doubts that it explains the strength of the market later in the cycle.

80 Having drawn a link between immigration, house prices, and the implications for monetary policy, some submitters suggested that we need to consider ways to moderate the volume of migration or its impacts. For example, the New Zealand Chambers of Commerce suggested a policy of encouraging a more even spread of migrants throughout the country. The Reserve Bank suggests that variations in new migrant approvals could be used as a supplementary tool, but notes that net migration flows are now quite small and the issue is not pressing. Other submitters are concerned that a reduction in net migration might actually fuel inflation in the longer term. For example, the New Zealand Exchange told us that restricting immigration would put upward pressure on wages and on inflation. The resulting rise in interest rates would mean that improving the "key drivers" of productivity, capital and the skills of the labour pool, would become "very, very difficult to do".

81 The Reserve Bank also acknowledges the beneficial effects of migrants, in that most of them help ease labour market pressures, but points out that initially, "in the first 12 to 18 months the demand effects typically dominate, especially in the housing market".

82 The Minister of Immigration sets the targets for migrant numbers annually through the New Zealand Residence Programme. We are advised that the short-term inflationary impacts of immigration have been recognised by the Government, and the number of migrants being sought under the programme in 2007/08 has been set in the 45,000 to 50,000 range. The range for the 12 months to 30 June 2007 was 47,000 to 52,000, with around 47,000 expected to meet the entry criteria.

83 Changes in immigration volumes present a challenge to the monetary policy framework and are a critical component in building New Zealand's long-term economic prosperity. Short-term changes in pursuit of economic stabilisation risk creating uncertainty `among prospective immigrants and shrinking the potential pool of those willing and able to meet our entry criteria. It is important therefore that the targets for the number of permanent migrants entering New Zealand are based on ensuring that New Zealand gets appropriately-skilled migrants relevant to the needs of the economy.

Recommendations

We recommend to the Government that the targets for the number of permanent migrants entering New Zealand each year continue to focus on New Zealand's need for appropriately-skilled migrants.

We recommend to the Government that recognition be made of the infrastructure requirements of increasing population, and that it ensure that neither immigration policy nor inadequate infrastructure act as constraints on non-inflationary growth.

Government charges and legislation

84 Some submitters, including the New Zealand Chambers of Commerce and the Asia Pacific Risk Management Group, cite the impact of central and local government charges on CPI inflation:

> [because]… the growing Government sector does not have competitive market-related disciplines that control price increases, other financial mechanisms and controls must be introduced to curtail the problematic "cost plus" price setting behaviour of the public sector.

85 The New Zealand Business Roundtable points to evidence that growth in councils' expenditure and charges are the "main explanation" for the higher costs of houses in New Zealand relative to Australia. Other submitters consider that recent legislation, such as the Building Act 2004 and Local Government Act 2002, and related regulatory requirements have contributed to increases in end-user costs and thus inflation. In the light of these claims, we inquired into the contributions that different sectors of the economy had made to overall inflation over the last 15 years.

86 The CPI sub-group "local government rates and charges" has increased faster than the overall index since 2002. From June 2002 to June 2007 the rates and charges sub-index increased by 29.4 percent, while the overall CPI increased by 13.3 percent. This increase was also faster than that in the 1994 to 1999 period, when local government rates and charges increased by around 19 percent. Increases in charges for other goods and services provided primarily by the public sector, such as postal charges, have, however, remained

subdued. The impact on overall CPI inflation of price rises for components of the sub-group depends on their weighting in the index. The rates and charges sub-group has a relatively small weighting, reflecting their small contribution to the average consumer's consumption bundle.

87 The home ownership sub-group of the CPI has contributed significantly to overall and non-tradables inflation. This is due partly to higher construction and maintenance costs resulting from the housing boom, which has increased demand for materials and has pushed up wages for builders in some areas. Increases in building compliance costs also show up in overall inflation through this sub-group.

88 While we note submitters' concern that the Building Act 2004 led some local authorities to increase their fees for inspections of building sites, the Building Act was introduced to stop the construction of more leaky homes; and we believe that as a result, the quality of construction is likely to have improved. Statistics New Zealand adjusted the increase in the home ownership sub-group to account for this in the September 2005 CPI release.

89 Recent increases in Government fees and charges have contributed to inflation. We therefore encourage both central and local Government agencies to ensure that the basis for rising charges and the related measures of performance are transparent, to maintain accountability.

Increases in household borrowing

90 While employment and incomes have grown strongly in recent years, household consumption has grown even more strongly, resulting in a steep decline in the household saving rate. From around zero in 2000, household saving has steadily fallen to around negative 10 percent of national disposable income in 2007. Over this period the household debt-to-disposable income ratio rose from 100 percent to about 160 percent. Because house prices doubled over this period, however, household net worth has also risen substantially.

91 Submitters argue that much of the increase in debt is based on good economic fundamentals: lower inflation, a more stable economic environment and lower interest rates than previously. Other submitters saw different factors at work:

- trading banks' policies that reward staff for extending customers' credit
- the increasing ease with which consumers can obtain retail credit
- advertising by the trading banks to encourage extra borrowing
- the Reserve Bank's prudential policies creating incentives to lend against property.

92 The Reserve Bank told us the effectiveness of monetary policy in New Zealand has been limited by "New Zealanders' intense desire to borrow and willingness to run up debt at higher nominal levels of interest rates than you would find in other countries." While the Reserve Bank could not fully explain this behaviour, it is quite certain that low average savings in New Zealand is one reason for its relatively high interest rates. The Reserve Bank believes that the Government's KiwiSaver scheme will help to increase savings, as will efforts to improve public financial literacy.

93 New Zealand householders' inclination to maintain relatively high debt reflects a number of factors, many of which are not well understood. We consider it is therefore important that the Government continue to focus on understanding households' saving and investment decisions.

Natural resource prices

94 Monetary policy works primarily through its effects on the demand side of the economy. The rate at which the economy can grow without creating inflationary pressures, however, depends primarily on supply capacity. Professor Hall acknowledged that some work has been done in this area, but told us that a more concentrated focus on the supply capacity of the economy was "pretty crucial" to helping monetary policy control inflation.

95 We note the comments of some submitters on potential capacity constraints in the supply of resources including water, oil, and gas, and environmental capacity to absorb wastes such as greenhouse gases and nitrates. This has consequences for food and commodity prices. The Reserve Bank believes that large unexpected changes in various major prices could have big implications for New Zealand, but that any such changes in natural resource prices could be accommodated within the existing monetary policy framework. Other submitters suggest that innovation will bring about more efficiency in the use of scarce resources.

96 We examined the impact of rising petrol prices on inflation between 2000 and 2007. Petrol prices have roughly doubled in that time, and the CPI was about 2 percentage points higher than it would have been if petrol prices were excluded from the index—the All Groups CPI measure increased by 22 percent, while the All Groups excluding petrol measure rose by around 20 percent. The small difference between these measures reflects the relatively small proportion of overall household spending represented by spending on petrol. Petrol currently has a weight of 5.4 percent of the index (up from 3 percent before the 2006 revision). The direct impact of a 20 percent rise in petrol prices today would add about 1 percentage point to inflation. We note that between 2000 and July 2008, the price of diesel rose by more than 150 percent, and that this has contributed significantly to other price rises in the economy such as food.

97 Oil, petrol, and other petroleum products are also inputs into the costs of production processes, such as agriculture and freight costs, and fuel costs are a significant component of other consumer prices. We understand that the size of these indirect effects is difficult to estimate, but they may account for about 50 percent of the direct price effect, so the total contribution of the direct and indirect CPI effects may be around 8 percent of the CPI. In other words, a 20 percent increase in petrol prices might lead to a total increase of around 1.5 percentage points in CPI inflation.

98 Petrol prices have increased by 20 percent in just three months (18 April regular petrol cost $1.83; at 8 July $2.19). Diesel prices (retail) have increased by 20 percent in less than two months (16 May, $1.60; 8 July, $1.92). World food prices, especially for grains, have increased markedly over the past two years, driven by oil prices and the availability of water, and New Zealand is not immune to these price rises especially for imported grains.

99 In the year ending June 2006 petrol prices rose by about 32 percent and contributed about 1 percentage point of the 4 percent increase recorded for that year (using the 3

percent CPI weighting). Regarding its implications for monetary policy, we distinguished between the short-term and medium-term responses of households and businesses to oil price changes. A rise in oil prices leads to an immediate fall in real incomes and means that households need to reduce their expenditure on other goods and services; or increase their borrowing (if total consumption is to be unchanged); or reduce their use of petrol and other oil-related products.

100 Ultimately, the resulting fall in purchasing power is likely to dampen economic activity. For example, Treasury estimates that the increase in petrol prices from around $1.28/litre to just under $1.70/litre between June 2005 and June 2006 effectively reduced households' disposable income by about $900 million, or approximately 1 percent. Changes in income of such magnitudes have previously been associated with a slowing in the growth rate of private consumption.

102 Oil price changes may also have long-term consequences for economic growth. For example, a rise in the price of oil may force users to substitute other energy sources. The less efficient these substitutes or the more limited their availability, the larger the resultant fall in output and real incomes. On the other hand, as investment in new energy-efficient technologies increases, the real income losses may be partly or fully reversed over time.

103 The role of a monetary policy focused on price stability is to ensure that the short-term rise in oil prices does not lead to more generalised rises in the prices of goods and services. This could happen if households and businesses attempt to increase their incomes to recoup the loss of real income associated with a rise in oil prices, for example by increasing wages and salaries and the prices of goods and services. In this event firmer monetary policy settings would probably be required, further dampening economic activity. However, if the price rise is not short-term, but ongoing and accelerating as much evidence suggests, policies other than the Reserve Bank's tools are needed to address it.

104 The distinction between changes in the price of particular goods and more generalised price changes is important as monetary policy is concerned with the latter. This means that, whatever the rate of price increases in petrol (or any other particular good) the CPI excluding that price, or holding it constant for the purposes of the calculation, can be expected to increase at a rate of 1 to 3 percent over time.

105 Monetary policy must remain vigilant to the possibility that inflation and inflationary expectations will rise as the supply of natural resources comes under increasing pressure. While the more efficient use of resources is likely, this would not necessarily reduce economy-wide dependence on or the economy's total use of resources.

4 Effectiveness of monetary policy and proposals for reform

Introduction

106 To determine whether the operation of monetary policy has been effective requires an understanding of what monetary policy can realistically be expected to achieve. While we have acknowledged the widespread consensus that the only appropriate goal for monetary policy in the long term is price stability, equally widespread is the view that this goal needs to be supported by additional objectives. We therefore considered it necessary to examine the way monetary policy works, and the channels through which it operates, to equip us to determine its effectiveness. Beyond changes to the primary objective of monetary policy, we considered suggestions for reform to the way that the inflation target is defined and the way decisions are made.

Operation of monetary policy

107 The official cash rate is the interest rate paid on demand deposits held by banks with the Reserve Bank (these deposits are otherwise known as settlement cash). Additional settlement cash can be borrowed overnight on demand from the Reserve Bank, by pledging appropriate securities, at an interest rate 50 basis points above the official cash rate.

108 The bank's borrowing and lending rates tend to provide a floor and a ceiling for overnight market interest rates. The overnight rate is of relatively little importance in its own right, and the Reserve Bank sets the cash rate mainly with a view to influencing (although not mechanically targeting) longer-term interest rates. Of these longer-term rates, 90-day bank bill rates are an important benchmark for pricing corporate lending, and interest rates on fixed-term interest-rate swaps are a major influence on the pricing of fixed-rate mortgages. These term wholesale interest rates are influenced quite directly by the current official cash rate and expectations of where the cash rate will be set in the future.

109 A change in monetary policy therefore means a change in the official cash rate, which is then passed through the whole structure of deposit and lending interest rates, and, with various lags, to production and spending in the economy, and finally through to prices and inflation in the economy. We are advised that prices and inflation are generally thought to lag behind such movements by up to two years, reflecting the time it takes for businesses and individuals to adjust their budgets.

110 In examining the different ways in which monetary policy affects the economy, we note that they are not purely mechanical in their operation. For example, although the official cash rate influences New Zealand's market interest rates, it is not the only factor doing so. Market interest rates, particularly for longer terms, are also affected by the interest rates prevailing offshore. Movements in overseas rates can lead to changes in short- and long-term interest rates even if the official cash rate has not changed.

Predictions therefore about the effects of a policy action in this area, like economic forecasts generally, are always subject to uncertainty. The task of policy is to make decisions on the basis of the best available information, recognising these uncertainties.

111 We considered several mechanisms through which these effects manifest, which we broadly grouped under five headings:

- saving and investment
- the exchange rate
- asset prices
- cash flow and credit
- inflation expectations.

Saving and investment

112 In practice, the cash rate has a very strong influence on other interest rates, and therefore helps to set short-term interest rates in the economy. It affects money-market rates and the key rates of banks and financial intermediaries.

113 Higher interest rates increase the cost of borrowing to finance expenditure. They increase the incentive to save, or to delay spending, and they reduce the net (after-interest) returns on investment. For a household, the biggest single investment decision is likely to be whether to buy a house. Although interest rates are not the only factor in this decision, a rise in mortgage rates will tend to have the effect of encouraging some households to delay the purchase of a house, or to reduce the amount that they can spend on one.

114 This sort of calculation is probably very familiar to most people—aspiring home-buyers have a limited capacity to meet interest payments and, when interest rates fall, the size of the loan they can afford increases and vice versa.

115 A rise in the duration of fixed-interest mortgages is a recent trend in the mortgage market. This has had the effect of delaying the impact of interest rate rises on households, and has subdued the short-term impact of interest rates on their spending behaviour. It does not, however, allow them to avoid the effects of monetary policy. The shorter the term of the fixed mortgage the greater the impact of any change in the official cash rate. Longer term, fixed-rate mortgages are immune from market interest rate changes until they are recognised.

116 For the business sector, some submitters commented on the direct effect of interest rates on the incentive to invest. The mechanism involved is their effect on the required rate of return on investment. When the cost of finance is high, fewer investment projects can be expected to generate sufficiently high rates of return to justify going ahead; whereas when interest rates are lower, more such projects will be undertaken. On this basis, we would expect aggregate business investment to be responsive to changes in the general level of interest rates. However, the operation of this kind of mechanism in practice is quite hard to detect because there are so many other important factors simultaneously driving investment.

117 Importantly, as a number of submitters pointed out, investment is driven by the business cycle. In the current environment, particularly with the shortages of labour evident across the economy, there is an emphasis on capital investment to meet demand. In addition strong demand increases the cash available for investment from profits. These factors are also influenced by monetary policy, and it is probably through these indirect channels that monetary policy has its most important effects on business investment.

The exchange rate

118 Other things being equal, a rise in New Zealand domestic interest rates puts upward pressure on the exchange rate by increasing the relative return on interest-bearing assets to international investors. Fluctuations in the exchange rate affect the economy by changing the relative prices of domestically- and foreign-produced goods and services. From a monetary policy management perspective, exchange rate fluctuations are important in two ways.

119 First, they directly affect prices. For example, an appreciation of the exchange rate makes imported goods cheaper, and, since imported goods make up a significant proportion of domestic spending, this will have an effect on the average price of goods purchased. The response at the retail level is, however, generally quite protracted, and the flow-on of exchange rate changes to retail prices appears to have become more subdued since the early 1990s. A notable exception is the price of petrol, which rapidly reflects exchange rate movements.

120 Secondly, exchange rate changes affect economic activity. By making imports cheaper and exports more expensive, an exchange rate appreciation will tend to reduce demand for both domestic import-competing goods and for exports. In aggregate, this will have a contractionary impact on the economy.

121 Exchange rates are influenced by many factors and currency markets can at times be volatile, so the immediate response to a change in one particular factor—such as monetary policy—is always hard to predict. Federated Farmers of New Zealand argued as follows:

> Although high interest rates have helped push up our currency relative to others, other factors also influence the exchange rate, and it is overly simplistic to say that high interest rates alone always result in a higher dollar. Other factors at play include the appetite for risk, general economic prospects, commodity prices, political stability, and the current account deficit. Markets can and do focus on different factors at different times, and often it seems events offshore have the biggest impact, as we've seen recently with the USA subprime market.

122 The point being made by Federated Farmers is one of tendency—higher interest rates will tend to strengthen the exchange rate—and that this is one of the mechanisms by which a tighter monetary policy works to restrain inflationary pressures.

123 We heard from many sectors including, forestry, farming, manufacturing labour, and commerce about the adverse effects of the high exchange rate on the competitiveness of the businesses they were involved in. The challenge for us was to determine how competitiveness could be best restored.

124 Many submitters agreed that while monetary policy was a factor and improvements were possible, on its own it would be of limited benefit. Dr Girol Karacaoglu talked to us about the need for efficient inflation control—that is, maintaining price stability without hurting the growth prospects of the economy—and said that the critical point is that monetary policy alone is not enough. Business New Zealand, among other submitters, expressed a similar view:

> The Reserve Bank Act needs mates … in terms of competition, markets, fiscal restraint, regulatory responsibility, and so on. If these things were being done fundamentally better than they are today, I think we would see much less pressure in the inflationary piece.

125 Some submitters distinguished between the absolute level of the exchange rate and its volatility, and considered volatility to be of more concern. For example, Steel and Tube Holdings Limited told us that it was difficult to manage the volatility, and they did not really care what the currency was worth as long as it was stable. Another submitter, Mr Selwyn Pellet, told us that "the manipulation of our exchange rate by carry-trade exposure and our domestic interest rate fluctuation tied to domestic inflation makes investment in the export sector an unreasonable risk." Similarly, Dr Robin Pope of the University of Bonn argued that it is very inefficient to invest in the import-competing and exporting sectors when the exchange rate can unpredictably double or halve. Other submitters considered that the tradeables sector bears a disproportionate share of the cost of reducing inflation, potentially leading to a loss of allocative efficiency and thus a fall in overall economic performance.

Fixed versus floating exchange rate

126 Many submitters argued that the monetary policy framework should pursue stability in the exchange rate. Dr Karacaoglu recommended that we consider the experience of Singapore, which has switched from an interest-rate-centred to an exchange-rate-centred policy, involving a managed float against the trade-weighted basket of its main trading partners' currencies. Other submitters considered that a fixed exchange rate would be desirable for New Zealand, to reduce the risk arising from the need to compensate investors for the uncertainty of exchange rate movements, and to reduce the risk of investment in the export sector.

127 Federated Farmers agreed that some of their members would probably support such arrangements. They pointed out that as a small open economy, New Zealand is buffeted about by international trends, and "to try and hold the exchange rate at a certain level is a bit like squeezing a sausage: the meat's going to pour out somewhere else and make a terrible mess". Professor Hall also expressed doubt about the wisdom of attempting to control this particular variable:

> Where you have external shocks, and some internal shocks, the adjustment has got to come out somewhere. And the economic literature is quite clear on this, that if you've got output, inflation, interest rates and exchange rates, if you have less volatility in one its going to come out somewhere else.

128 Another submitter, Wigram Capital Advisors Limited, told us how in Hong Kong a fixed exchange rate had transferred adjustment pressures to internal asset prices in Hong

Kong from 1997 to 2003; the price of maintaining the exchange rate was a fall in the Hong Kong property market of 65 percent. Wigram Capital also told us that the Singaporean monetary system is under "enormous stress" as a result of pressure from global capital flows.

129 The Reserve Bank told us that it had considered the methods used by Singapore, Chile, and some other countries to target exchange rates, but doubted that they could be made to work in New Zealand, the fundamental difference being that "their people have a strong preference to save." The Reserve Bank also argued that if such exchange rate controls were to be applied in New Zealand, resulting in interest rates 300 or 400 points below current rates, "our best judgement is that we would see a strong accumulation of inflation pressures." And it pointed out further disadvantages to a fixed exchange rate:

> While a fixed exchange rate might facilitate trade what it does on the other side is to take away our independence in terms of being able to run an independent monetary policy and it takes away the exchange rate as a buffer against shocks that are specific to New Zealand … if we are pegged to other currencies, then we're going to be having shocks in other countries transmitted back to New Zealand, because our currency is going to be riding with those other currencies. For example, if Australia is riding on a huge mineral boom and we weren't getting commodity price [rises] … we would really suffer.

130 The Reserve Bank also disputes some of the harm that the strong and volatile currency is perceived to have done:

> We should not underestimate how competent the export sector in New Zealand has been at dealing with this volatile exchange rate. Actually if you look at our export record, volumes have held up through this period, even in some cases where we would otherwise think that they would be hit … for exporters into countries like Australia using imports and exports in US dollars, for example, some of those have actually been in quite a good position.

131 The Bank of New Zealand similarly told us that the exchange rate had not in fact been greatly detrimental to export performance:

> New Zealand is primarily still an agricultural exporter. Volume responses for agriculture have far more to do with climatic conditions than interest rates or exchange rates. The returns have a lot to do with interest rates and exchange rates, but not the volume of production … on the more general manufacturing front, I think the bigger issue there has simply been a dominance of emerging markets in production.

Exchange rate intervention

132 The Reserve Bank exercises foreign exchange intervention by the purchase or sale of New Zealand dollars in exchange for foreign currencies, with the objective of influencing the exchange rate on the global foreign exchange market. In 2004 the Government gave the Reserve Bank the capacity to use foreign exchange intervention for this purpose, thus providing the bank with another monetary policy tool in addition to the official cash rate. This tool is designed to help lower the peaks and troughs of the exchange rate cycle, which is consistent with the Policy Targets Agreement's requirement that the Reserve Bank

maintain price stability whilst avoiding unnecessary instability in output, interest rates, and the exchange rate.

133 Some submitters were critical of the Reserve Bank's approach to intervention. The New Zealand Business Roundtable believes that steps should be taken to curtail foreign exchange market intervention. The New Zealand Exchange also believes that intervention should be prohibited because it is risky and undermines the Reserve Bank's credibility. On the other hand, Wigram Capital believes that the bank's foreign exchange intervention should be applauded and reinforced, arguing that the emergence of very large sovereign wealth funds tend to exacerbate exchange rate volatility, which can be reduced by intervention.

134 The Reserve Bank says its system is considered to be best practice, and assured us that its expectations of foreign exchange intervention are quite limited, as intervention can only work under limited circumstances.

135 While monetary policy was the focus of this inquiry, it does not operate in isolation from other economic influences. In considering explanations for the behaviour of the exchange rate, we noted the wide range of potential causes for the high level and volatility of the exchange rate, and found the evidence on the contribution of each of these factors to be inconclusive. While different approaches to monetary policy appeared to have significant implications for the exchange rate—particularly policies with a direct focus on stabilising the exchange rate, such as a fixed exchange rate—it was unclear whether they offer an enduring benefit to overall economic performance. In particular, as New Zealand's economic history demonstrates, a more stable exchange rate would not make exports more competitive if the trade-off was higher and more variable inflation, or more variation in the returns to exporters as a result of reducing the buffering role of the exchange rate.

Asset prices

136 Interest rate changes can affect asset values, which in turn affect people's wealth and therefore their spending decisions. In theory, higher interest rates can be expected to reduce the value of many assets by increasing the opportunity cost of holding them. A fall in asset prices, in turn, could be expected to dampen spending by reducing wealth, and also by reducing borrowing capacity to the extent that the assets concerned could be used as collateral for loans.

137 While the importance of these effects is uncertain, we accept that some asset prices do not respond immediately to changes in interest rates; they are influenced by too many other factors, such as changes in expectations and general business cycle conditions. The influence of asset prices on spending decisions also seems to be quite variable.

138 Some submitters were critical of the Reserve Bank's focus on house prices, and argued that its monetary policy statements had generated confusion as to the target of monetary policy. The Reserve Bank submitted that monetary policy does not set out to target movements in any particular assets, but has focused on the housing market because New Zealanders are focused on the housing market. The bank said that all it could do, and had done, was to provide warnings, to the effect that capital gains from housing investment are not guaranteed over a cycle or even a lifetime, and that it is unwise to "put all your eggs in one basket".

139 We note the comments of some submitters on the potential challenges to monetary policy of a rapid fall in house prices and the knock-on effects on output and inflation.

140 The New Zealand Exchange is concerned that the current framework is not flexible enough to take into account potentially spiralling effects of interest rate changes on long-term output. The NZX suggested that a better balance between price stability and output would help to mitigate this effect. It proposed that a "more opaque" approach, like that of the United States Federal Reserve Bank, which is explicitly required to take long-term output into account, would make the Reserve Bank's behaviour less predictable, and its interest rate strategy more flexible.

141 We are aware that the central banking community and other observers generally agree that asset prices should not be a target for monetary policy. It is still debated, however, whether policy should do more than this—whether it should respond more vigorously than is suggested by the estimated short-term effects of the asset price changes on the macro-economy through the standard channels such as wealth effects.

142 The case for further intervention rests on the belief that credit-financed asset price booms, when they reverse, are likely to have a highly contractionary effect on the economy. This effect can take longer than the usual one- to two-year forecasting horizon, so conventional forecasts may not capture these dynamics. In the longer term, however, it will probably be better for the economy if any boom is smaller, or stops sooner than expected. Policy which responds to a boom to a greater extent than that indicated by the short-term outlook may therefore be beneficial.

143 The opposing case does not deny the possibility that a boom will end painfully, but essentially argues that modest action will be ineffective in restraining it, and aggressive action risks bringing on the very recession that policy is meant to avoid. According to this view, policy should continue on the normal basis during a boom.

144 A narrow policy focus confined to the next one to two years could miss very important developments in the financial sector and asset markets, which often play out over longer horizons but which can have major economic implications.

145 We note the view of the Reserve Bank that the fallout from the bursting of very large asset price bubbles "warrants taking some risks". It stressed that such a situation is "rare indeed"; and intervention could at best moderate the fallout, at "considerable" risk. The Reserve Bank Governor explained that he interpreted his mandate as permitting such risk-taking in "rare circumstances"

> Normally, we would think in terms of the next three years. But … there will be exceptions. Given the potentially long-lived nature of asset price misalignments, it may occasionally be helpful to take a longer view of when risks might eventuate, how best to insure against them, and at what price.

146 The Reserve Bank does not consider that the recent increase in house prices in New Zealand constitutes a "bubble" so large that it warrants a one-off additional monetary policy response. Indeed, the bank submits that because of the rapid rise in the exchange rate in 2002 and 2003 and the bank's obligation, under section 4b of the Policy Targets

Agreement, to avoid unnecessary instability in output, it raised interest rates more slowly than it might otherwise have done.

Transparency of policy objectives

147 We note the view of many submitters that transparency on the part of a central bank increases the effectiveness of monetary policy and improves economic and financial performance in several ways. First, improving the public's understanding of the central bank's objectives and policy strategies reduces economic and financial uncertainty and thus allows businesses and households to make more informed decisions.

148 Secondly, if practitioners in financial markets understand better how policy is likely to respond to incoming information, asset prices and bond yields will tend to respond to economic data in ways that further the central bank's policy objectives. For example, if market participants understand that fresh information about the economy increases the likelihood of certain policy actions, then market interest rates will tend to move in a way that reinforces the expected actions, in effect supporting the goals of the central bank.

149 Thirdly, clarity about the central bank's policy objectives and strategy may help anchor the public's long-term inflation expectations, thus improving the efficacy of policy and the overall functioning of the economy. Finally, open discussion of the central bank's analysis and forecasts invites potentially valuable input and feedback from the public.

150 Monetary policy need not target asset prices, but it should be alert to the risks to economic performance arising from the building-up of and potentially rapid fall in those prices. It is of concern that some submitters found the Reserve Bank's communications confusing. We encourage the Reserve Bank to consider ways to improve its contribution to public understanding of its monetary policy roles and responsibilities.

Cash flow—money and credit

151 Another channel for the effects of monetary policy is money and credit. The standard description of this mechanism is that a tightening of monetary policy makes it more difficult for borrowers to obtain loans, and thus constrains their spending directly. It is important to distinguish this idea from the interest rate channel, which affects incentives to save, and from its effect on the amount of cash available for overall spending or cash flow. A rise in interest rates is therefore likely to reduce total household spending and a fall in rates will have the reverse effect. Business will experience a similar reduction in cash flow, which may lead to a decline in investment.

152 To the extent that there is a separate money and credit channel, it is considered to work by affecting the quantity of finance available. When the financial system was heavily regulated, this kind of quantity mechanism was very important in the operation of monetary policy. Interest rates charged by banks were regulated, and an important part of the mechanism by which monetary policy affected the economy was the rationing of loans. A tightening of policy would reduce the supply of funds to the banks and force them to reduce their lending. Although the price of a bank loan might not have changed much, a potential borrower was much less likely to be able to get a bank loan when financial conditions were tight.

153 In the system as it operates today, there is no such regulation-induced credit rationing, as intermediaries' interest rates are not regulated. It is possible, however, that some market-induced changes in credit supply still play a role in transmitting the effects of monetary policy changes to the economy. This is argued to result from the fact that lenders continually adjust their credit standards, making it harder or easier to obtain loans depending on their assessments of the risk that borrowers will default on loan payments. For example, we might expect credit standards to tighten somewhat in times when interest rates are rising, if higher interest rates are perceived as increasing the average risk of default.

154 While these effects are very hard to detect in practice, this does not mean that changes in the supply of credit are driving the economic cycle. To a large extent the explanation probably works in the other direction, through the effect of the business cycle on the demand for credit—when aggregate economic growth slows, borrowers have less need for finance, and so credit growth will also slow.

155 In particular episodes, however, the supply of credit may become an important driving force. A number of submitters argued that bank lending had expanded at such a pace that it was contributing to booming economic conditions and rising asset prices, most notably in housing and land. The Bank of New Zealand saw the growth in bank lending as "a demand-driven process", in which "people want to keep borrowing" to finance a "speculative boom" in housing. An alternative view is that banks have pursued aggressive lending policies designed to produce just this behaviour.

156 The risk is that this behaviour will go into reverse when the business cycle turns down and it becomes clear that asset prices have been over-inflated and debt levels too high. The Reserve Bank told us that it shared with the banks the concern that such lending was building up too much leverage in household balance sheets.

157 Submitters suggested a number of reasons why bank lending had continued to grow despite increases in the official cash rate. They noted unusual international factors, including strong global growth, ample global liquidity, and interest rate differentials, which jointly give rise to large capital inflows. Locally these conditions have provided incentives for mortgage holders to move to fixed rates, increasing the lag in policy effects.

158 In the light of this discussion, we inquired into the role of money and credit in the policy decision-making process. We were advised that there have been periods in some countries where the money aggregates were accorded a highly significant policy role, for example, in Australia and the United States in the late 1970s and early 1980s. Monetary policy aimed to keep the money supply, as far as possible, to an annual pre-announced growth rate. This policy framework reflected a view that the money supply had a reasonably stable relationship with the variables that policy sought to influence, particularly inflation and output. By controlling money supply growth, policy was expected to contribute to keeping these variables stable—the money supply in such a system is understood as an "intermediate target". We are advised that it is not an instrument of policy because it cannot be controlled, and it is not a policy objective in its own right; but it is something that is targeted because of a presumed close link to the ultimate objectives.

159 We were also advised that monetary targeting was abandoned because it was found that the monetary aggregates were becoming increasingly unstable and unrelated to the variables of ultimate concern. We understand that with no suitable intermediate target available, most countries have now moved to policy systems that focus directly on the ultimate objectives of policy, such as inflation and output growth.

160 Many of the international factors that have contributed to the current cycle are proving to be transitory. In the normal course of events the availability of credit does not seem to be a major part of the mechanism by which monetary policy actions are transmitted to the general economy. Improvements to the framework need to be focused on the next cycle, and we make some recommendations in this area later in our report.

161 None of this, however, means that money and credit are irrelevant to monetary policy. While they do not constitute an important part of the transmission process, and they are not policy targets or objectives in their own right, they have a potential role as information variables. Monetary policy decisions always have to be made on the basis of imperfect information about economic prospects, and the money and credit aggregates represent part of the information (along with an array of other economic indicators) that can help in making these assessments.

Inflation expectations

162 Monetary policy can affect the inflation process by affecting expectations of inflation. Cyclical demand pressures can be thought of as moving the inflation rate relative to where it is currently expected to be on the basis of the overall policy climate and historical inflation. Part of the role of policy is therefore to create a climate that is conducive to maintaining expectations of low inflation. To the extent that policy achieves this, it will make it easier to keep inflation low, and will help reduce the cost of bringing inflation down when it is necessary to do so. Professor Lars Svensson in his 2001 report explains the effect of inflation targets thus:

> Inflation expectations anchored on the target create a strong tendency for actual inflation to revert to the target and everything else equal, mean that monetary policy needs to be less active. Interest rates and output need to move less to counter unfavourable movements in inflation expectations. The corollary is that the exchange rate will also be more stable.

163 Internationally, policy-makers and economists have focused recently on ways to achieve this kind of favourable influence on expectations. Part of the solution usually proposed relates to the design of the policy system. A system that clearly states the inflation objective, with a clear commitment to achieving it, can help to focus the public's inflation expectations. It is equally important, however, that these public commitments be demonstrated in the actual conduct of policy to ensure their credibility.

164 We considered why inflation expectations have risen, and found that two main reasons were given. First, the Reserve Bank had not tightened monetary policy sufficiently and had allowed average inflation to rise. While the average over the past few years remained consistent with the 1 to 3 percent target, at around 2.7 percent it was significantly higher than the 2 percent average of the earlier period. The second reason was that upward movements in the mid-point of the target range had reinforced the perception that future

inflation would be higher. We note the comments of one submitter, Mr O'Donovan, that there have been three changes to the policy targets agreement over this time, all of them towards tolerating more inflation.

165 With the benefit of hindsight, it would have been desirable for the Reserve Bank to have acted more promptly than it did in the 2003/04 financial year in response to signs of emerging inflation pressures. Given the circumstances at the time, however, it is not clear whether the bank's actions were inconsistent with the requirement to minimise unnecessary variability in output, interest rates, and the exchange rate.

Proposals for reform

166 When we commenced this inquiry in May 2007, a major driver of inflation was a spiralling property market. According to the Reserve Bank's March 2007 Monetary Policy Statement, the situation was as follows:

> Strengthening domestic demand is being supported by a resurgence in the housing market and an expansionary fiscal policy. The acceleration in housing reflects firming net immigration, a recovery in confidence, a continuing rapid expansion of mortgage credit at very low margins, and strong growth in household incomes.

167 The increase in house prices created a wealth effect, leading New Zealanders to spend more on the back of inflating house prices. This was a major factor in the Reserve Bank's decision to tighten monetary policy.

168 Many submitters were concerned that the tools available to the Reserve Bank in this situation were ill-adapted to resolving the problem. Indeed some suggested that by increasing interest rates the bank was exacerbating the problem, by creating a large interest-rate differential with other developed countries.

169 Business and Economic Research Limited argued the effect in the following terms:

> Our present review of the experience 1989 to now is that, by using an interest rate rule alone, based on an objective for forecast inflation alone:
>
> 1. The Reserve Bank upon forecasting inflation above the range is required to lift New Zealand's relative interest rates above the average of international rates. This action can have the following unintended consequences:
>
> 2. It attracts foreign funds into NZ$ deposits, increasing New Zealand's domestic money supply.
>
> 3. With the deregulated financial sector, and competition in the mortgage market, this increased money supply is expected to enable an increase in house prices; and push money into sub-prime lending situations (even to offshore subsidiaries as with Bridgecorp and Nathan) thereby reducing the soundness of the financial sector.
>
> 4. The process of foreign funds flowing into New Zealand causes wide fluctuations in the NZ$ exchange rate thereby reducing the soundness of the tradable sector.

5. The house price increases reduce housing affordability generating associated social costs.

6. House price increases are associated with increases in household consumption. The Reserve Bank can interpret these consumption increases as threatening to increase forecast CPI inflation.

7. Under the Reserve Bank single interest rate rule it is required to increase New Zealand's relative interest rates.

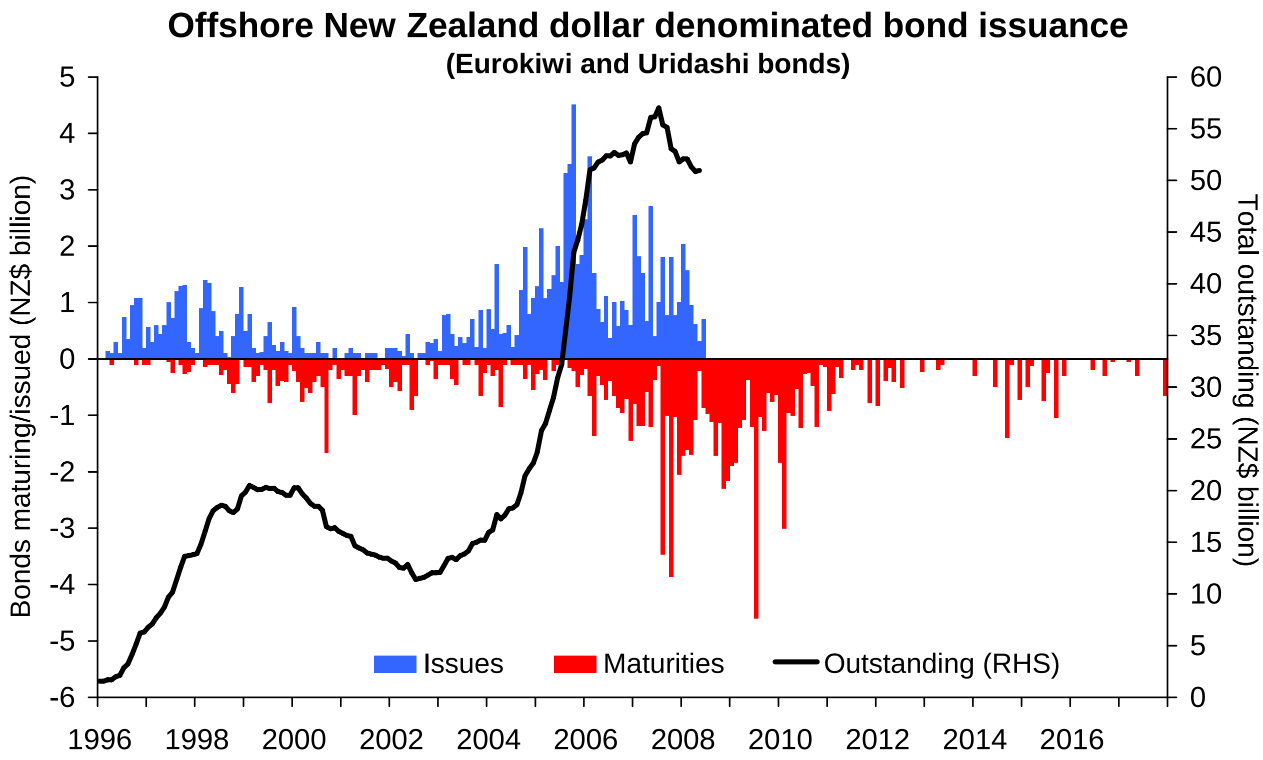
170 In summary, we were examining monetary policy in a context where serious economic commentators were suggesting that the monetary policy tools available to the Reserve Bank were at best ineffective and at worst increasing the very pressures they were aimed at solving.

171 The BERL arguments, however, contain a number of inaccuracies—the Reserve Bank does not use an "interest rate rule"; it is guided by the Policy Targets Agreement, which gives emphasis to discretion to pursue its inflation target without unnecessary instability in output, the exchange rate, and interest rates. There is also no requirement "to lift New Zealand's relative interest rates above the average of international rates"; whether it does so or not depends on economic conditions at home and abroad. Further, interest rate increases by the Reserve Bank alone do not increase or reduce the attractiveness of borrowing for property. Market interest rates, particularly for longer terms, are affected by the interest rates prevailing offshore.

172 Notwithstanding this, the important point here is that under normal market conditions a higher cost of borrowing will reduce borrowing and house prices. But in some exceptional circumstances, such as those prevailing over the last few years, other outcomes are possible in the short-term; there is no evidence to support the claim that one effect is to "push money into sub-prime lending situations" as it applies to residential mortgage lending in New Zealand vis-à-vis the United States.

173 Over the last 14 months this situation has changed markedly, for reasons outside the control of New Zealand's monetary or fiscal policy. The subprime mortgage crisis in the United States and the subsequent credit crunch has made an American recession possible. Global share markets have fallen considerably—the New Zealand Exchange being no exception. As a result cheap foreign capital has dried up.

174 The following graph suggests that the issuance of offshore New Zealand dollar bonds has fallen from its peak in 2005. We are advised that this is consistent with a reduction in the rate of credit growth over the last 12 months.



Source: Reserve Bank of New Zealand

175 However, inflation has stayed high. The global economic weakening has been accompanied by persistent inflation driven largely by global rises in food and oil prices (up 50 and 80 percent respectively in one year). Headline consumer price inflation rate in the United States reached 5 percent in June 2008; in China CPI inflation reached 8.5 percent in April 2008 but has since eased to 7.1 percent in June 2008. While inflation in New Zealand is high (4 percent in the year to June 2008), it is largely driven by factors outside our control. The Reserve Bank explained this in its Monetary Policy Statement of June 2008:

> The global economy is currently experiencing significant increases in oil and food prices. These price increases are occurring at the same time as activity is weakening in many economies in response to the global credit crisis and slowing housing markets. In New Zealand, this confluence of factors is producing a challenging environment of weak activity and high inflation.

176 The Bank goes on to note that

> In real terms, oil prices are now above the levels experienced in the 1970s. Furthermore, the inflation that occurred in dairy prices in late 2007 now appears to be occurring in other food groups, such as breads and cereals.

177 Although the global situation has changed significantly, our monetary policy response has been the same—the Reserve Bank has been compelled to keep interest rates higher than those in other OECD countries. We note, however, that the Reserve Bank reduced interest rates in July 2008, and that further cuts are expected.

178 We heard from some submitters that the increase in interest rates seemed to exacerbate rather than reduce house-price inflation because it attracted foreign investment to New Zealand, which found its way into the housing market, and fuelled rapid house-price increases. Now the problem is that increasing interest rates cannot reduce the effects of international prices.

179 In both instances, there has been upward pressure on the exchange rate. This in turn has put pressure on exporting businesses by reducing margins on sales overseas and making the prices of export goods less competitive so that sales contracts were lost. The high exchange rate has also put pressure on manufacturers supplying the domestic market by making imported goods cheaper.

180 We note that the exchange rate has been declining steadily since early 2008 (10 percent over the year), and peaked in mid-2007, and the Reserve Bank has not put up interest rates in this period.

181 We have spent considerable time and effort examining the operation of monetary policy in New Zealand and the various critiques of it. While we acknowledge that at times of strong inflation pressures, the costs of maintaining price stability are often borne disproportionately by the export sector, we remain committed to the idea of an independent Reserve Bank responsible for the operation of monetary policy, and that inflation should be the single goal for monetary policy.

Reform of inflation target and decision-making process

Policy Targets Agreement

182 Some submitters thought that a wider target range for inflation would enable the Reserve Bank to achieve its target at reduced cost to the export sector. Dr Ganesh Nana thought that being "slightly more relaxed on inflation [would] enable the economy, the export sector, investment in skills to be slightly more robust and slightly higher". A number of other submitters suggested that the policy targets agreement should include a requirement to consider explicitly the effects of policy on exports. The Reserve Bank Board reminded us that the Reserve Bank's role is very clearly defined in the 1989 Act and in the Policy Targets Agreement as targeting inflation, but in a way that does not lead to unnecessary volatility in the exchange rate.

183 Other submitters suggested that the target range should be narrower or that it should be defined as a point "so that there is no doubt about what you are targeting. That anchors expectations". Professor Hall, argued against any change "on the grounds of time consistency of policy". Similarly, Professor Svensson observed that "frequent adjustment of the PTA is likely to be detrimental to the stability and credibility of the monetary policy regime … credibility in the sense of inflation expectations anchored on the target is essential for stabilizing output, interest rates and the exchange rate".[10]

184 The Policy Target Agreement currently requires the Reserve Bank, in pursuing its price stability objective, to seek to avoid unnecessary instability in output, interest rates, and the exchange rate. While we acknowledge the central role of inflation expectations in

10 Svensson report (2001), p.44.

maintaining price stability, and are mindful of the costs of change without the promise of significant benefit, we did not see a strong case for change to the Policy Targets Agreement.

Single decision-maker

185 Under the Reserve Bank Act, the responsibility for monetary policy rests solely with the Governor of the Reserve Bank. In most other countries monetary policy decisions are the responsibility of a committee. Some submitters consider that decisions made by groups tend to be better than those made by individuals, at least at certain critical times. The current decision-making structure was also criticised on the grounds that it does not allow for a sufficiently broad range of input.

186 In his 2001 review, Professor Svensson concluded that significant risks were associated with the current arrangements. He saw these risks arising primarily from dependence upon the personal attributes of the governor, such as willingness to work with the Reserve Bank Board, and ability to withstand the pressures of the job. He also stressed, however, the importance of retaining accountability and coherence in decision-making and communication. He considered it preferable to retain the current arrangements rather than to appoint a committee with members who were not experts in monetary policy.

187 We note the comment of the Reserve Bank Board to the effect that it considers the current decision-making process to be a good one. We agree. They pointed out that such decisions, while they are taken by a single person, are informed by a wide variety of views from both internal and external advisers; and that accountability is monitored by an external board of independent directors.

5 Supplementary instruments

Introduction

188 For most of this decade, global interest rates have been lower than those in New Zealand, resulting in substantial upward pressure on the exchange rate. New Zealand has faced some very large shocks in recent years—in immigration, and house, oil and dairy prices—which pose real monetary policy challenges. Over this time the Reserve Bank has been setting the official cash rate in a highly unusual world environment—global interest rates have been low and Asian economies have generated large current-account surpluses that have been used to fund the capital needs of deficit countries like New Zealand. These strong capital inflows have put significant upward pressure on some exchange rates, including New Zealand's.

189 We noted earlier the view of many submitters that a more stable exchange rate would improve their ability to make long-term investment decisions. Many submitters comment on the interaction of monetary policy with the large capital inflows of recent years. These inflows of capital have enabled the trading banks to meet the demand for borrowing, particularly by home buyers, with direct effects on the prices of houses, and also less direct but broader effects on the overall demand for goods and services, and thus prices. The significant increase in borrowing by households over recent years has fuelled inflation pressures.

190 Submitters generally saw merit in the Government considering other instruments to complement interest rates in managing inflation, and put forward a range of policy instruments that they suggested could dampen these capital inflows and slow the pace of household borrowing. Most submitters who addressed this issue confined their comments to the 2006 Supplementary Stabilisation Instruments Report (SSI). However, because the report noted that various other tools or instruments operating in markets other than the housing market could have similar effects on cycles in demand and resulting pressures on the exchange rate and interest rates, submitters also proposed other possibilities, such as an interest-linked savings scheme.

191 We therefore considered whether there might be useful tools that could be deployed in a complementary role to manage inflation pressures. Possibilities included:

- prudential policy
- fiscal policy
- a mortgage interest levy and an interest-linked savings scheme
- a non-resident withholding tax and an approved issuer levy
- other taxes and costs on foreign exchange transactions
- variable Goods and Services Tax.

192 The focus of our inquiry was whether such tools might make it possible to rely less on the official cash rate and reduce some other pressures on the exchange rate. We also looked at how other countries had responded to similar challenges, and the importance of the quality of economic information to the implementation of monetary policy. Because of the significance of house price inflation to this inquiry, we discuss the taxation of housing in the next part of this report.

Prudential policy—capital adequacy tool

193 Existing capital requirements are linked only weakly to the risk on particular loans, and not at all to wider economic risks. We considered whether capital requirements that were better attuned to both these sorts of risk might be useful for influencing lending behaviour to help moderate inflation pressures.

194 Of the supplementary stabilisation instruments outlined in the 2006 SSI report, proposals for more regulation of capital requirements underpinning bank lending and measures to make access to credit more difficult for borrowers received the most support from submitters. Many considered that there was a strong case for measures to restrict lending by retailers or other credit providers to finance consumer purchases, and lending by banks to finance house purchases. A number of submitters favoured minimum deposit requirements or loan-to-value ratios.

195 The New Zealand Business Roundtable suggested that the capital requirements for mortgage lending are too low relative to requirements for other forms of lending, and that this encourages excessive mortgage lending by the banks. Their solution was to impose no controls and to leave it to banks to determine the appropriate capital backing. The Bank of New Zealand believes that there must be a division of prudential policy from monetary policy. While the BNZ believes it is appropriate for the Reserve Bank to ask banks to hold more capital if the risks of lending increase, they would oppose any increase in the required capital adequacy ratio as a mechanism to discourage bank lending. The BNZ believes that this would open up the potential for regular changes that might be completely contrary to prudential requirements.

196 The Reserve Bank considers changes in capital requirements to be an unsubtle approach, likely to prompt a huge expansion of the finance company sector, which is not subject to these controls, and disintermediation and arbitraging around banks. The bank suggested New Zealand households and corporates were likely to look for funds offshore to get around such regulations. It is also uncertain how the Australian parent banks would respond to such regulation of their New Zealand subsidiaries.

197 Notwithstanding this opposition, many other submitters expressed their support for further investigation of whether more regulatory controls over bank capital requirements, or discretionary loan-to-value ratio limits, would help moderate inflation pressures.

198 When the inquiry commenced, the readily available credit contributed to an increase in house process. More recently house prices have decreased as credit availability has retrenched. While the Reserve Bank may be reluctant to see its instruments used for macroeconomic purposes, the majority of us believe that the bank should be encouraged to take a broader view, as these issues are not only macroeconomic, but also prudential.

199 Current prudential policy in New Zealand acts in a pro-cyclical way: that is, when banks have higher profits, capital is easier to raise, the value of collateral backing for loans rises with assets-price inflation, and non-performing loans diminish in the good times. All these factors lead financial institutions (including banks) to support the expansionary phase of the cycle with more readily-available credit. The majority of us believe that there may be merit in persuading the prudential regulators that they have obligations to make their instrument counter-cyclical rather than pro-cyclical.

Recommendation

The majority of us recommend to the Government that, further to the advice tendered by our independent specialist adviser, the Government consider whether existing prudential legislation unduly restricts the Reserve Bank's capacity to respond to inflation through the use of its prudential tools, given the implications of the rapid expansion of credit for the risks in household sector balance sheets and for the inflation outlook. The National Party rejects any suggestion that the Reserve Bank could or should use its prudential supervision powers to achieve monetary policy objectives. In the context of a global credit crunch, the Reserve Bank has a critical role maintaining confidence in the financial system. Any change to the current objectives and method of prudential supervision would put New Zealand out of step with internationally accepted norms and could create costly confusion in an already stressed financial system.

Fiscal policy

Government spending

200 Increases in spending by central and local Government, especially in excess of Gross Domestic Product growth, were seen by most submitters to be adding to economy-wide demand. Specific areas of spending cited included superannuation and the accommodation supplement; and the effects of this spending on the declining supply of labour were also of concern. While some submitters specified areas of Government spending, such as Working for Families, and increased consumption spending, the Council of Trade Unions and the New Zealand Amalgamated Engineering, Printing and Manufacturing Union submitted that overall Government spending was not greatly affecting inflation, because some of the spending is directed toward infrastructure. One submitter, Mr Poletti, also argued that there was no relationship between the size of Government and inflation. Many other submitters held the opposite view relating to the size of Government.

201 While some submitters referred to the effects of fiscal policy on aggregate demand and inflation, very few attempted a quantitative analysis beyond rates of growth or shares of GDP. They could not therefore demonstrate the effects of fiscal policy relative to other factors influencing aggregate demand, or provide a profile of fiscal policy effects over time. Similarly, very few submitters attempted to reconcile the impact of increases in Government spending with increases in tax revenues and the trend of the fiscal surplus.

202 The Reserve Bank provided us with a comprehensive analysis of the impact of fiscal policy. The bank's initial analysis focuses on the direct impacts of fiscal policy in the context of the position of the economy in the business cycle:

> What makes the current fiscal stimulus unique is that it comes at a time when the economy's productive resources have been severely stretched for several years. To

> cope with additional government spending without adding to inflation, some other spending must be crowded out. Higher interest rates and a higher exchange rate are part of the mechanism for making that happen ... if the economy faces additional demand pressures from whatever source, when resources are already stretched, then monetary policy has to be tighter than otherwise if inflation is to be kept in check. Even measures that improve the economy's long-term growth potential can exacerbate excess demand pressures in the near-term—roading expenditure is perhaps a good example.

203 This comment reflects the point that fiscal policy is but one of the many factors affecting the economy. Further, the Reserve Bank submits that although the impact of discretionary fiscal policy on the business cycle can be substantial, it is complex and difficult to measure. The bank says that generally it is change in the operating balance, rather than its level, that influences demand pressure and inflation, and that the bank pays particular attention to net fiscal contraction or expansion. We note the evidence in the United Kingdom House of Commons report on the Monetary Policy Committee, where the Governor of the Bank of England expressed a similar view regarding fiscal policy: "What matters to us is not the rate of spending growth or taxes taken separately, but looking at them together."[11]

204 Changes in the operating balance are not, however, the best indicator of the impact of fiscal policy. The operating balance includes non-cash revaluations and business-cycle influences on taxes and expenditure (the so-called automatic fiscal stabilisers). The impact on aggregate demand also differs for revenue, expenditure, and transfer payments. Adjustments to remove revaluations, cyclical influences, and some limited differences in expenditures are made in the summary measure of fiscal impulse, which is regularly published by The Treasury.

205 There is no single indicator of the Government's impact on the economy just as there is no single indicator of the state of the Government's finances. It is no surprise, then, that different institutions can derive different estimates of fiscal impulse from the available data. To understand better how Government expenditure affects inflation in the economy, we examined the key channels by which this expenditure exerts an influence, including the following:

- Government expenditure on goods and services (Government consumption) is a component of aggregate expenditure.
- Government expenditure on new capital goods (Government investment) is also a component of aggregate expenditure.
- Government transfer payments go into household disposable income and enter aggregate expenditure via household consumption.
- Income tax creates a wedge between wages and household disposable income.

11 House of Commons, Treasury Committee, Monetary Policy Committee of the Bank of England: ten years on, 2007.

206 Although it is agreed that these flows feed into aggregate demand, there is no consensus on the impact of fiscal policy on the business cycle. In one view, an increase in spending or a reduction in taxes will induce "fiscal policy multipliers" so that the increase in economic activity is greater than the amount of the initial fiscal injection.

207 The majority of us found the evidence on whether fiscal policy has added significantly to inflationary pressures to be inconclusive. The National Party, on the other hand, concluded that the evidence found that fiscal policy has in the past added significantly to inflationary pressure.

208 Fiscal policy needs to balance a number of potentially competing purposes. It needs to try to maintain a predictable and smooth medium-term path. Given the concerns raised by submitters and the advice we received about the consequences of further interest-rate rises for the exchange rate, we believe a disciplined fiscal policy is appropriate.

Fiscal policy roles and objectives

209 Many submitters discussed the contribution of fiscal policy to aggregate demand and inflation, and how it might be set to take inflation effects into account, or play a more active role in stabilising output, inflation, and exchange rates. Several submitters noted the tension between public infrastructure spending and inflation. In general submitters were of the view that more infrastructure spending was desirable to promote productivity growth. Professor Hall asserted, "fiscal policy should be further countercyclical in the shorter-term and neutral thereafter." Whereas Westpac argued that fiscal policy should be "firmly focused on the medium term." Dr Karacaoglu stressed that while he proposed a managed exchange rate, it would need to be complemented by a better coordination of monetary, fiscal, labour market, and trade policy.

210 The stabilising role of fiscal policy cannot be easily separated from the complex issues regarding the impact of fiscal policy on the business cycle and inflation. We also recognise that fiscal policy has a range of objectives—economic, social, and environmental—and to understand better the tradeoffs required we examined the potential contribution of fiscal policy to economic stabilisation.

211 The UK House of Commons report on the Monetary Policy Committee of the Bank of England also covered the issue of monetary and fiscal policy coordination.[12] It was argued that fiscal and monetary policy should be compatible, and that the Bank of England should monitor fiscal policy, and issue a warning if it was concerned about its effects. There was a negative reaction, however, to the proposal of pursuing a more active counter-cyclical policy and giving the central bank control of certain fiscal policy instruments in order to target specific sectors of the economy. In addition to dispute about what causes the economy to move, there was concern about the delegation of fiscal powers away from Parliament.

12 House of Commons, Treasury Committee, Monetary Policy Committee of the Bank of England: ten years on, 2007.

International comparisons

212 We considered the fiscal frameworks of a sample of countries to understand better the weight placed on macroeconomic stability in setting fiscal policy and the rules and institutions employed. Internationally, there is a diverse range of fiscal frameworks, reflecting differences in the economic structures and fiscal positions of the various countries. Like that of New Zealand, the frameworks reviewed tended to focus primarily on achieving Governments' fiscal sustainability goals. Fiscal rules sought to ensure stable outcomes by allowing the operation of the automatic stabilisers, and requiring transparency.

213 We note that the emphasis particular countries placed on stability as an objective of fiscal policy depend on a number of factors; for example

- countries where monetary policy is weak consider fiscal policy very important for stability (Russia)
- countries in a monetary union see fiscal policy as important in responding to country-specific shocks (European Monetary Union countries)
- countries with a fixed exchange rate emphasise the importance of fiscal policy in controlling inflation to help maintain a given exchange rate (Denmark)
- countries with highly volatile revenue streams see an approach that manages cyclicality as important (Chile and Russia)
- countries that are satisfied they have reached a prudent level of debt have more ability to use fiscal policy to support stability (Chile and New Zealand).

214 Alternative approaches to setting short term intentions include targeting a cyclically adjusted balance; setting fixed annual expenditure limits; and making rules to allocate fiscal outturns that prove higher than expected. Stabilisation funds or independent fiscal institutions were also used by some countries to support their fiscal rules.

215 We note that, like New Zealand, several countries had the discretion to operate a more counter-cyclical policy than is possible by relying on automatic stabilisers. While some countries actively consider their fiscal stance, they do not generally follow rules requiring a particular response to the business cycle from fiscal policy.

216 An issue common to all countries is that fiscal outturns (actual revenue and expenditure) usually deviate from fiscal forecasts. Some countries have implemented rules to allocate surpluses that prove higher than anticipated. Countries that are still undergoing a process of fiscal consolidation (for example, Canada and France) have rules to allocate unexpectedly high outturns to paying off debt or building up assets. In some cases such rules are also seen to support macroeconomic stability. We are advised that this would be the case when the higher outturn arose from cyclical factors, and occurred at a time when the economy is operating beyond capacity.

217 Under the expenditure rules of the Netherlands and Sweden, unexpectedly high revenue outturns cannot be spent, and are used to reduce debt to support fiscal consolidation. The structural surplus rules in Chile and Russia also require unexpectedly high outturns to be saved. In Russia, however, once the stabilisation fund exceeds a certain

amount, there is no longer a requirement to follow the structural balance rule, suggesting that the focus is more on sustainability than stability. In Switzerland a notional account is created to deal with outturns exceeding expectations.

218 We note that some Governments use cash windfalls to set up funds for specific purposes, for example in some Canadian provinces and Australia.

219 A few of the countries reviewed use independent fiscal institutions to improve the quality of decision-making and the transparency of fiscal policy. For example, in Chile an independent expert committee estimates the copper price gap and the output gap. The committee is convened a few months prior to the Budget, and officials use an average of the committee's estimates in their forecasts. In Russia, a committee—a semi-autonomous adjunct to the ministry of finance—determines the long-run oil price. Expert bodies are also an important part of the Dutch system, where an independent body is closely involved in the budget process and election debate. In the United Kingdom, the National Audit Office audits changes in the key assumptions and conventions underpinning the fiscal projections, and the Treasury has a chair on the Monetary Policy Committee in order to facilitate the flow of information between the Government and the bank.

220 When it is setting fiscal policy, the Government needs to balance a number of policy objectives, including those sought through fiscal stabilisation. We acknowledge the view of some submitters that fiscal policy should place more weight on stabilising output, inflation, and the exchange rate. We consider, however, that monetary and fiscal policy in New Zealand are coordinated best by focussing each on medium-term objectives and making policy actions transparent. We believe the current fiscal framework is flexible enough to allow fiscal policy to provide more support to monetary policy, should this be considered appropriate.

221 While alternative approaches to fiscal management, such as rules to allocate unexpectedly high realised outturns or a stabilisation fund to manage changes in forward forecasts, give a greater stabilisation role to fiscal policy, we consider that considerable effort would be required to make these alternative approaches applicable in the New Zealand situation; and the gains from applying them in New Zealand are likely to be small and might not outweigh the costs. Furthermore, making decisions on the appropriate fiscal stance requires good information on the likely impacts of fiscal policy, and this is not readily available. We believe it should be.

Recommendations

We recommend to the Government that further analysis be undertaken of the interactions between fiscal, monetary, and general economic policy, given the impacts of fiscal policy on output, inflation, and the exchange rate.

We recommend to the Government that it maintain and enhance transparency as to the weight that it attaches to economic stability when setting fiscal policy.

Other measures

Mortgage interest levy and Interest Linked Savings Scheme (ILSS)

222 Some submitters provided detailed submissions on the option of a mortgage interest levy as proposed in the SSI report. While they suggested that it could be a useful instrument to slow investment in housing, and deserved further scrutiny, most submitters did not favour further work on this option. They raised the impact of such a levy on small-business owners, and also argued that it would adversely affect first-home buyers, and people who were using the equity in their homes to support their businesses. Another concern was with the potential for borrowers to avoid the levy by borrowing in New Zealand dollars from overseas lenders.

223 A mortgage interest levy had been considered by the Government as an additional demand-management instrument, to be used in exceptional circumstances to supplement the official cash rate when housing-market-related pressures in New Zealand were particularly intense and the local interest rate cycle was out of step with the international one. If effective such a scheme could be expected to dampen the peaks of the exchange rate cycle a little, allowing the official cash rate to be set lower than otherwise.

224 We were advised that it was provisionally estimated that for each 100 basis points (1 percent) of the mortgage interest levy, no more than 50 basis points of relief on the official cash rate would be provided. In other words, finance costs for those using a house as security would be increased, while finance costs for those using other security (or borrowing unsecured) would be reduced.

225 We examined closely an interest linked savings scheme. EROS Capital and a number of other submitters asked that we consider this scheme, which seeks to reduce volatility and uncertainty in the exchange rate by reducing the differential between interest returns available to offshore investors in New Zealand and other countries. Proponents of the scheme believe that it is necessary to put a wedge between what the foreign investor is earning and what the local borrower is paying. We also considered a related proposal for managing the revenue from such a surcharge.

226 An ILSS would replace the official cash rate with a levy on borrowing, using mainly fiscal measures to mimic the counter-inflationary effects of the official cash rate. The levy would apply in addition to a base rate of interest, which, rather than being determined by the Reserve Bank through the official cash rate, would be determined in the market. The official cash rate would be retained as a reserve instrument, but would be re-activated only in exceptional circumstances, and then confined to inter-bank settlements.

227 An ILSS levy would be applied to fixed- and floating-rate house, farm, and other property mortgages. It would also be applied to other forms of consumer borrowing, provided that it could be collected and administered cost-effectively. The Reserve Bank would have discretion also to levy business borrowing and other kinds of borrowing if necessary to combat inflationary pressures caused by such borrowing.

228 The rate of the ILSS levy would vary over the economic cycle, in effect replacing increases in the official cash rate above the base rate, which are referred to as the official cash rate surcharge. We understand that the ILSS levy would vary from zero during periods

of little or no inflation pressure, to whatever level was judged necessary by the Reserve Bank to constrain inflation pressures during expansionary periods. The levy could be applied at the same rate across all qualifying borrowings, or at differential rates—determined by the Reserve Bank—to target particular sources of inflationary pressure.

229 It was proposed that the proceeds from the levy would be transferred, either immediately, or on a deferred basis, to the borrower's KiwiSaver account, or to a stabilisation and growth fund.

230 The Reserve Bank would determine the placement of the levy's proceeds in the light of its macroeconomic (price-stability) objectives. The Reserve Bank would be involved with the management of ILSS-sourced funds invested in the stabilisation fund or in KiwiSaver accounts only to the extent of ordering the division between investments to be made in New Zealand, but not in conflict with the objectives of monetary policy. Thus, the Reserve Bank could direct that levy proceeds be invested either in foreign currency or New Zealand dollar investments, depending on whether the exchange rate was misaligned.

231 The Reserve Bank would also have discretion to allow the withdrawal of ILSS deposits in KiwiSaver accounts during recessionary periods, and by businesses in special circumstances, for example to offset climatic hardship or to fund productivity improvements. We understand this to mean that an ILSS could operate as a stimulatory as well as a restraining mechanism.

232 One submitter explained, one of the advantages of this scheme:

> Instead of the money flowing across the exchanges and disappearing—as far as we're concerned, at any rate—into the stratosphere, we have the option of using the money raised through the surcharge to reinvest in the New Zealand economy … what it does do is at least give an option, depending on what was decided to do with the surcharge, of returning it over a period, to those who've paid it—in other words a sort of compulsory savings scheme.

233 We are advised, however, that an ILSS poses similar enforceability and governance problems to those encountered by the mortgage interest levy, and that there are no precedents on which to judge the potential benefits and costs of either scheme.

234 We note the broad similarity between the ILSS and the proposal for a mortgage interest levy. Both proposals have a similar intent—to drive a wedge between interest returns to foreign borrowers and the interest costs paid by New Zealand borrowers. They also propose a similar mechanism—the regulation of mortgage interest payments by the Reserve Bank.

235 The differences between the schemes appear to be largely operational. An ILSS is proposed to largely replace the official cash rate, whereas the mortgage interest levy would be supplementary to the main official cash rate tool; and revenue collected by the ILSS would be allocated specifically to individual accounts or a central stabilisation fund. In the proposed mortgage interest levy scheme, although revenues raised are held in a fund, they are pooled, and withdrawn when the mortgage interest levy acts in a subsidy mode.

236 We also see similar difficulties in implementing this proposal and the mortgage interest levy, specifically creating appropriate governance and accountability structures, and high ongoing administrative and enforcement costs. The proposed ILSS appears to be the more complex of the two to administer.

237 Despite this additional complexity, we agree that a scheme along the lines of the ILSS would be more likely to moderate external capital inflows, and hence the exchange rate, than current monetary arrangements. Our analysis did not persuade us that the resultant benefit would outweigh the costs.

Non-resident withholding tax and approved issuer levy

238 New Zealand residents paying interest to foreign lenders are generally required to pay non-resident withholding tax (NRWT) of 15 percent or 10 percent, or, in the case of some specific borrowings, an approved issuer levy of 2 percent of the interest paid. The Reserve Bank and Westpac submitted that these measures were both ineffective. They expressed concern that offshore structures used by some borrowers to circumvent the withholding tax and issuer levy may inhibit the development of a deep domestic debt market. The Reserve Bank asked that consideration be given to making non-resident withholding tax and the approved issuer levy (AIL) applicable regardless of the use of the offshore structures.

239 We are advised that New Zealand levies NRWT of 15 percent on New Zealand-sourced interest paid to non-resident lenders. Most of our double tax agreements reduce the interest for NRWT to 10 percent; and if the borrowing is from a non-associated person, the interest may be subject to 2 percent AIL instead of NRWT. In total the Government earns around $280 million per year from AIL and NRWT—of which about $15 million is paid by The Treasury's Debt Management Office.

240 We are advised that some resident borrowers legally circumvent the NRWT and AIL levies by using a foreign branch of a New Zealand-based institution to undertake the borrowing, so the interest is technically not New Zealand-sourced. The Reserve Bank is concerned that this practice is impeding the development of a domestic debt market in New Zealand. Possible ways to prevent this would be to repeal the NRWT, so that there would be no incentive to use the structure, or to change the law so that an offshore borrowing structure would no longer circumvent NRWT.

241 Eliminating this loophole would mean that all borrowing from offshore would be subject to AIL or NRWT. We understand that reducing the return to the foreign lender for a given domestic interest rate should reduce the level of the New Zealand dollar associated with that interest rate. Some submitters argued that this is desirable, and suggested other mechanisms to achieve this effect, such as the mortgage interest levy and the interest-linked savings scheme. If such a tax differential were desired, the NRWT and AIL would probably be the simplest and most orthodox approach to achieving it, since they are long-standing features of the tax system. Imposing a tax penalty on borrowing from non-residents would, however, increase the domestic cost of capital.

242 While repealing the NRWT and AIL would simplify the tax system and reduce the efficiency costs incurred by borrowers using the offshore structure to circumvent the tax, it

would also reduce the cost of capital derived from borrowing from non-residents. There would, however, be a revenue cost and only a small margin of benefit for monetary policy.

243 We are advised that setting a maximum rate of interest for NRWT is a common feature of double tax agreements; and unilaterally repealing NRWT on interest would harm New Zealand's ability to bargain for reciprocal tax reductions from other countries. In December 2006 the Government issued a discussion document on a review of the international tax regime, including the level of NRWT to apply under double tax agreements. We note that a review of the NRWT and AIL is also on the Government's tax policy programme.

244 Setting the levels of NRWT and AIL involves complicated trade-offs between fiscal effects, the domestic cost of capital, and the relationship between the exchange rate and interest rates. New Zealand's ability to bargain for concessions from other countries under double tax agreements would also be affected.

245 Given the complexity of the trade-offs and the impact on the Government's bargaining position in international negotiations, we do not make any specific recommendations with regard to NRWT and the AIL, as we consider that the Government is best placed to take these issues into account in its review.

Other taxes and costs on foreign exchange transactions

246 Some submitters proposed that international capital inflows or foreign exchange transactions should be subject to additional taxes or costs, reducing their attractiveness and thus mitigating some pressures on the exchange rate. Such measures have been used in other countries, notably Chile, although we are aware that some, such as a Tobin Tax, remained theoretical possibilities rather than practical options.

247 One submitter observed that for a Tobin Tax to work it has to be implemented by all the countries in the world at the same time. The Reserve Bank has considered the performance of the instruments used in Chile, Singapore, and all the other obvious alternatives, but we note that it did not consider whether they could be made to work here.

248 We considered the experience of Chile, and the majority of us concluded that the regulation of capital inflows may have provided some short-term benefits, but that in the longer term, not only did it become increasingly difficult to ensure compliance, but the primary effect appeared to be to a change in the composition of capital inflows rather than any significant change in the volume.

249 The effect of impediments or costs to the flow of foreign exchange transactions, whether in the form of added transactions costs or reduced interest returns to foreign lenders, will tend to raise interest rates to all borrowers. Although this may have the benefit of helping to moderate inflows and reduce pressure on the exchange rate, it raises the interest firms must pay to finance investment, consequently affecting domestic business investment. Moreover, while some submitters considered the controls imposed in Chile to have been successful, the evidence provided to us is more equivocal.

250 Provision for a Tobin tax has been made in the legislation of Canada and Belgium. However, the fact that it has never been implemented means, because the international nature of the transactions, that no single country could enforce it.

251 New Zealand is very dependent on the free flow of international capital. Our exporters need to be able to convert currencies efficiently in order to bring profits home. There appear to be serious obstacles to implementing an enduring and efficient system of controls on capital movement; and, even if the controls could be enforced, we are concerned at the long-run effects on the cost of capital for businesses and households. The majority of us do not therefore support other taxes or costs being imposed on foreign exchange transactions.

252 The Green Party believes that a Tobin tax would primarily affect short-term speculative capital movements, and tend to reduce the benefit of currency speculation without seriously affecting the ability to hedge foreign exchange risk in international trade (because it would be at a very low rate). The Green Party believes it would be useful to join Belgium and Canada in expressing a willingness to be part of an international agreement to use a Tobin tax to stabilise international currency flows and provide a fund for international poverty relief and ecological repair, as was initially intended by its originator.

Variable Goods and Services Tax

253 We considered whether the ability to vary the rate of GST should be used as a means of supplementing the official cash rate. The general idea is that over time the average rate of GST would not be altered, but in periods of high demand and high inflationary pressure it could be raised to dampen consumer demand, and lowered in periods of weakening demand. Because it acts in much the same way as increases and decreases in the official cash rate, it could help supplement the effect of the cash rate in stabilising demand without putting additional pressure on the exchange rate. It was suggested that changes to GST be applied only to some items, such as imported items, and that it might be extended to interest payments.

254 The Reserve Bank suggested that a variable rate of GST would have its own difficulties and costs, particularly as a fiscal instrument. Changes would normally require parliamentary approval, or if this requirement were removed the process would require additional transparency and accountability arrangements. Low-income consumers would be affected immediately, and low-wage earners, who lack any formal indexation arrangements, might find adjustment problematic. Firms would incur additional costs making repeated price adjustments.

255 Professor Hall observed that the suggestion of countercyclical adjustments to GST was not new, and submitted that the technical and operational difficulty of implementing such a proposal would "significantly outweigh any potential benefits". He considered that there were two main issues: the difficulty of timing, given that the economy is subject to frequent unpredictable shocks; and where responsibility for such decisions should lie, especially in an MMP environment:

> … is there to be some sort of independent body, in which case who would it be? Can the Reserve Bank maintain its operational independence given the existence of that body, and who's in charge overall? Obviously the Minister of Finance.

256 This second issue arises because, as both Hall and the Reserve Bank point out, this instrument, like the mortgage interest levy, is not a monetary policy instrument; it does not involve changes in the issuance and pricing of the Reserve Bank's monetary liabilities, but is a fiscal or quasi-fiscal instrument. Consideration therefore needs to be given to the desirability of departing from the longstanding general principal that taxes should not be imposed without the explicit involvement of Parliament. On the other hand, if the Minister of Finance were to make the decisions on GST adjustments, this would pose a risk to the Reserve Bank's ability to operate an independent monetary policy.

257 GST applies at a flat rate of 12.5 percent on almost all goods and services with a few exceptions. The rate is unchanged since 1989, when it was increased from 10 percent. Only an Act of Parliament can change the rate, and we are advised that this is expected to occur infrequently.

258 We accept submitters' views that a broad-based tax on expenditures, such as the GST, could provide a useful additional tool to support monetary policy. We are concerned, however, that it would impose compliance and administrative costs on suppliers and retailers, who would have to change the rate of GST charged, possibly at short notice. We are also concerned that low- and fixed-income earners could find the impact particularly difficult to manage.

259 There may also be a number of technical issues that we have not explicitly addressed. In particular, because GST is imposed on intermediate goods at each stage of the production cycle, it could result in mismatches between rates of output tax and input credits. A single good could be produced with different rates of GST applying to its different components, and therefore the same goods at final sale would attract different effective rates of GST, and the GST system would no longer be neutral. It would also introduce more uncertainty into tax revenue forecasts.

260 In our view it would be difficult, if not impossible, for the Reserve Bank to time with precision a change that could not be implemented immediately. Not only would businesses need time to prepare and implement the change, but the impact on consumer spending might also be delayed. The degree of inflationary pressure at the time the measure became effective might differ from that predicted. Moreover consumers are likely to change their behaviour between the time a change is announced and the time it is implemented. This timing problem would be aggravated if, in keeping with our longstanding tradition of parliamentary involvement in the imposition of taxes, such changes were required to be imposed by the responsible portfolio Minister.

261 The proposal could also result in a perverse pro-cyclical effect. In times of high demand, consumers might accelerate consumption if they expected an increase in the rate of GST. Similarly, in times of low demand consumers could elect to defer consumption in the expectation of a reduction in GST. We do not therefore support a variable GST rate.

Economic statistics

262 The quality of economic information is vital to the implementation of monetary policy; as such decisions depend heavily on statistical information about the performance of the economy. We received only a few submissions on statistical issues, mostly from the

Reserve Bank and other submitters in the area of banking. The key points to emerge were as follows:

- Better data is needed on the purposes for which mortgage finance is being sought.
- A broader range of statistics is required to cover income-based measures of GDP, sectoral balance sheets and savings, and productivity.
- Statistics need to be more accurate and timely.
- The way the housing component of the CPI is constructed exacerbates the impact on inflation when house prices rise.[13]
- More resources need to be devoted to the collection of statistics because of their importance to the operation of monetary policy.

263 Good-quality statistics are undoubtedly important for the effective implementation of monetary policy, the formation of stakeholders' expectations, and the quality of Government policy interventions. While we appreciate that the quality of the statistics currently being produced is reasonably good and improvements are continually being made, we consider that more could be done to improve the quality, timeliness, and accuracy of statistical information. In particular, we consider that information covering income-based measures of Gross Domestic Product, along with household sector savings, balance-sheet, and income information, would provide helpful insights into the behaviours of households. Measurement of productivity for a wider and more detailed coverage of sectors not currently measured adequately would provide a useful basis for predicting long-term economic performance. The timeliness of statistical information could also be improved, particularly by providing monthly Consumers Price Index information.

264 The ability to deliver such improvements is a practical matter of Statistics New Zealand's capability, and the cost of the various options. We met Statistics New Zealand to discuss these matters.

265 We would also like to see mandated quarterly bank disclosures differentiate between the supply of mortgages to households for the provision of dwellings and to the business sector for commercial purposes. Distinguishing between loans to businesses for commercial purposes and to households for housing purposes is not part of the Reserve Bank's disclosure requirement for banks. Trading banks are required to identify exposures secured by residential mortgages, that is, the type of security, and not the purpose of the loan. We are advised that some loans in this category are used for business purposes, for example, by self-employed people operating small businesses, but the disclosure requirements in themselves do not require them to be identified. The Reserve Bank is to review the prudential disclosure requirements on banks and this is one of the areas to be investigated. We look forward to seeing the results of this review.

Recommendations

We recommend to the Government that Statistics New Zealand be empowered to utilise more effectively the fundamental economic information held by other Government

13 House prices are not directly included in the CPI—only construction costs and rents are included.

departments and entities, rather than imposing new compliance measures in the collection of information.

6 Taxation of housing

Introduction

266 The substantial increase in house prices is one of the contributors to inflation over the past six or so years, with demand pressures resulting from homeowners' increased wealth. A number of submitters have suggested that tax issues may have contributed to the housing boom. Others argue that taxation is not primarily a monetary policy issue, and should be considered from efficiency and equity perspectives.

267 Substantial house price inflation has been a worldwide phenomenon since about 2001, and countries with many different tax regimes have all had high-house-price inflation and volatility. We doubt therefore that tax regimes by themselves are the cause of house-price volatility; and we consider that changing the tax treatment, by itself, could not put an end to it. It is possible, however, that particular tax treatment could exacerbate the problem, although it is difficult to establish this empirically, given the other substantial variables in housing markets apart from their tax treatment. We considered this issue thoroughly, and outline below our discussion of this subject.

Tax on investment housing

268 We are aware of the debate as to whether the tax system favours investment in housing over other kinds of investment. Some submitters believe that there is no explicit tax preference, since pertinent aspects of the general tax regime, such as the non-taxation of capital gains, and the deduction for holding costs such as interest, apply to all investments. Others argued that the significant component of housing income is capital gain, and the general ability to borrow significantly to buy housing because real property is a preferred form of security, generating current tax deductions, may make housing tax preferable in practice. At the least there seems to be a general perception that investment housing is tax-favoured, and such a perception is likely to encourage investment in housing.

269 Owner-occupied housing that is not highly debt-financed is tax-preferred, as the imputed rent, which the owner consumes, is not taxed. We are advised that the average homeowner, however, does not generally appreciate this form of tax preference. While we accept that it may be "economically pure" to tax imputed rent, most countries around the world generally do not attempt to do so.

270 New Zealand is one of the few countries in the OECD that does not tax capital gains. As housing investments in recent years have appreciated significantly, the fact that we do not tax this gain may have contributed to the attractiveness of housing as an investment. This may have created a distortion by encouraging more investment into housing than would have been most efficient for the economy as a whole.

271 Many submitters support a capital gains tax or other measures to improve the neutrality of the tax system, arguing that it is distortionary to tax earned income, in the form of wages, salaries, and profits, but not income from capital gains, unless it can be proved that the investment was made for that purpose. Some also suggested that the ability

to offset housing tax losses against other income should be restricted in order to reduce the tax advantages of housing. A stamp duty was also considered as a means of reducing the attractiveness of investing in housing.

Capital gains tax

272 Taxing capital gains should, in the first instance, improve the efficiency and equity of the tax system, as they represent a form of income that is not currently taxed. In other words, it would extend the broad-based, low-rate framework to capture more economic income within the definition of taxable income. To make efficiency gains, the tax rates should be reduced while the base is broadened. This simple observation is not, however, the end of the analysis, as for practical reasons workable capital gains taxes have features that reduce their efficiency.

273 An efficient tax system would tax all income as it accrues. We are advised that it is not practical to do so with capital gains. The amount of capital gain is not generally known until the asset is sold, so some estimation would be required. Furthermore, the taxpayer may lack the cashflow to pay the tax on it as the capital gain accrues. For these reasons actual capital gains taxes generally tax the income upon its realisation, which imposes some efficiency costs.

274 When a tax is imposed on realisation, the tax impost is deferred, and the effective rate of tax is therefore lower than the tax rate on other income. We are advised that many countries also reduce the tax rate on capital gains explicitly relative to that on other income, so some distortion to investment decisions would still occur.

275 Another efficiency cost of a capital gains tax is the "lock-in" effect whereby a taxpayer may defer sales in order to defer the tax. Countries often complicate the tax system by adding "rollover relief", where some sales do not attract tax. In the case of sales of rental property, there may already be some degree of lock-in because of the impost of depreciation recapture when rental housing is sold.

276 A capital gains tax should not apply solely to investment housing, as this would create another distortion between investing in housing and investing in other assets. In principle, it should also apply to investments in shares and other assets. Applying a capital gains tax on share investments, however, raises other efficiency issues. We are careful with our imputation system to avoid double taxation of corporate earnings when they are distributed in dividends. If we imposed a capital gains tax on the sale of shares, this would create a double tax issue to the extent that the gain arose from the accumulated taxed earnings of the company.

277 The Tax Review 2001 Final Report proposed a way of taxing capital income without incurring lock-in. The "risk-free return method" (RFRM) would deem all capital investments to earn the same return, and tax would be imposed on that amount, regardless of the actual return. This should not distort investment decisions because the tax would be the same for any given amount invested in any type of asset. It could, however, violate the principle of horizontal equity because the tax could be different for different taxpayers earning the same amount of income. While a capital gains tax in theory is both efficient and equitable, an RFRM is efficient but not necessarily equitable. An RFRM would raise the cash flow issues associated with an accrued capital gains tax.

278 We also considered whether only "real" interest income should be taxed (the excess of nominal interest over the inflation rate) to reduce the disparity between investing in debt (where nominal income is taxed), and in real assets such as housing, as submitted by the Reserve Bank. The real asset may be appreciating in nominal terms at the inflation rate, which is not currently taxed. We consider that this would add complexity to the tax system, would not address tax disparities for assets that appreciate in excess of the inflation rate, and would raise issues about how to adjust for inflation for other types of investments.

279 The majority of us do not support a capital gains tax applying to investment housing, mainly because of the distortion that is likely to occur between investing in housing and investing in other assets.

280 The Green Party, however, believes that we have received enough evidence of the need for a capital gains tax to remove distortion from the investment market, and that work should now begin on developing such a tax on all investment income, with exemption for the primary family home. The Green Party does not believe there is any need to reduce the rate at which capital gains tax is levied, as some other countries do; we should aim for as level a playing field as possible across investment decisions.

281 The Green Party believes that while the housing investment bubble appears to be deflating this is not a reason to delay fair tax policy, and that if such a policy had been in place some of the recent inflationary pressure would have been eased. In fact, beginning now to phase in such a tax would make an easier transition, given that large capital gains are not imminent from most investments.

282 The Green Party believes that the risk of double taxation of capital gains from the sale of shares can be addressed in a similar way to the imputation arrangements of dividends paid from tax-paid profits.

283 The Green Party sees affordable home ownership as a social good, which assists family stability and the continuity of educational opportunities for children, and believes that any policy that increases the need to rent housing is poor social policy.

Loss ring-fencing

284 Investment in rental property funded by debt often produces current tax losses. This may be the case even where the investment is profitable because it accrues non-taxable capital gains. These current tax losses may be deducted by investors against their other income, and provide additional cash flow to fund the debt servicing. Most other types of investments do not produce current tax losses as often as rental housing investments, because rental housing investments may be highly-geared since housing is a preferred form of security, and the capital gain is not included in taxable income. A number of submitters have suggested restricting the ability to offset housing losses against other income in order to reduce this tax bias.

285 The general tax treatment in New Zealand is that all of a taxpayer's income and expenses are combined to arrive at a single taxable income figure. This means that net losses from one activity may offset net income from others. As rental property investments often produce current tax losses, this ability to offset the loss against other income and reduce tax, called "negative gearing", is often popularised as a benefit of investing in

housing. Westpac submitted that the increase in the top marginal individual tax rate to 39 percent in 2000 would have increased the value of rental property investments to investors in that tax bracket. A number of countries restrict the extent to which taxpayers can offset net rental losses against other income, either intentionally or as a consequence of a tax system where different investments are taxed separately.

286 New Zealand had some loss ring-fencing for rental property investments in the income years from 1984 through to 1990. Information provided by The Treasury using Inland Revenue tax data shows a significant increase in investment in loss-making rental properties from 1991. Before 1996, most rental property investments reported taxable profits, while now most rental property investments are in tax loss.

287 Data on house price changes from 1971 through to 2006 shows that prices have tended to be volatile during the period when loss ring-fencing was in place, as well as at other times. A limited effect on house price volatility could be explained by the fact that most New Zealand houses are owner-occupied, and loss ring-fencing would not directly affect this market.

288 A number of submitters opposed any move to loss ring-fencing, on the basis that it would be ineffective in reducing price volatility, would add a lot of complexity to the tax system, and would encourage avoidance. Loss ring-fencing would only affect highly-geared rental property investments; investors could also invest with substantial equity and thus avoid the loss limitation while still enjoying the benefit of non-taxed capital gains.

289 The Reserve Bank asked also whether another form of loss ring-fencing should be considered to address the potential gap between interest earned by an individual being taxed at 39 percent and the 30 percent at which it would be taxed when earned as an investment in a portfolio investment entity. We make no specific recommendation on this, but consider the Government should be aware of this potential tax arbitrage opportunity.

Stamp duties

290 Stamp duties are taxes that apply to particular kinds of transactions. For example, stamp duties can be applied to the sale of a house, calculated as a portion of the price of the house. Australian states raise revenues through stamp duties on real property transactions, whereas New Zealand does not. The Council of Trade Unions and the National Distribution Unit have submitted that stamp duties should be considered as a way of discouraging investment in housing.

291 Stamp duties incur the efficiency cost of creating "lock in", which we have discussed regarding capital gains taxes. The imposition of stamp duties discourages the sale or transfer of real property. They share this downside of a capital gains tax, but they do not have the efficiency benefits of a capital gains tax where the tax imposed is proportional to the capital gain income. Accordingly, we do not support imposing stamp duties on real property transfers.

Transitional issues

292 Increasing the tax on housing by either imposing a capital gains tax or ring-fencing tax losses raises similar transitional issues. In broad terms, increasing the tax on housing

should cause a one-off fall in house prices, or at least a reduction in the rate of appreciation for a transitional period. This could result in an unexpected loss to existing homeowners, while improving the affordability of the housing market for new entrants. Transitional relief could be afforded to existing homeowners, for example by "grandfathering" or phasing in the change, although these measures could also have efficiency consequences. Changing the tax treatment of housing investment in any way involves trade-offs between considering the position of existing stakeholders and possibly improving the efficiency of the tax system for the future.

293 Increasing the tax on investment housing also raises transitional issues for tenants. Higher tax would mean that landlords might demand a higher pre-tax rate of return through higher rents, or falling house prices, or a combination of the two. It is difficult to predict exactly what combination of these effects would occur. In the long run, increasing the tax on investment housing should result in fewer renters and more owner-occupiers of houses.

Owner-occupied housing

294 The Reserve Bank considers that the most important single feature of the tax system that clearly favours housing is the treatment of owner-occupied housing. This is because the owner-occupier is not taxed on the "imputed rental income" from living in their own house.

295 Suppose a couple has $300,000 to invest and is living in rental accommodation where they pay $21,000 per year in rent. They can buy a house of equivalent quality for $300,000, or can invest the $300,000 in a term deposit earning 7 percent interest ($21,000 per year). On a pre-tax basis, either investment is of equivalent value. If they invest in the term deposit, however, they must pay tax on the interest, which reduces the post-tax value to below $21,000. If they buy the house to live in, they save $21,000 per year in rent. This is a tax distortion, which favours investing in owner-occupied housing over alternative investments. We note that this bias applies only to the extent that equity is invested in housing. To the extent that a house is debt-financed there is no bias in favour of owner-occupation, and in fact there can be a bias towards the renter as the landlord can deduct interest.

296 Technically, using your own capital goods, for example by driving your own car, always generates imputed rental income. In practice, a house is the only asset that most people own that is large enough to be of material concern.

297 An economic efficiency analysis would suggest that living in your own home generates imputed rental income and, as part of a comprehensive income tax base, the imputed rental income should be taxed to minimise distortions in investment choices. Very few countries, however, attempt to tax imputed rental income. This is partly because the average homeowner does not understand the tax preference, and attempting to tax income that they are not aware they are earning unsurprisingly meets substantial public opposition.

298 Assuming we wanted to tax imputed rental income in order to reduce distortions among investments, how to do so raises significant practical issues. To do so accurately would require homeowners to declare income as if they were landlords, recognising the imputed rent as income (how to calculate the amount would have to be determined), and

making deductions for costs such as interest, depreciation, rates and maintenance. This would impose a significant compliance burden.

299 Simplified methods could be used. One method suggested in the Tax Review 2001 would be to apply an RFRM on the equity in housing. If an RFRM method of taxing investments is considered, then its application to owner-occupied housing could be considered as well. Another option would be to use a property tax as a proxy for an income tax on imputed rental income. For example, if rent is imputed at 5 percent of property value (the same rate as used for foreign share investments under the fair dividend rate method) and the income tax rate is 30 percent (the maximum tax rate on investment income under the portfolio investment entity regime), then a tax of 1.5 percent of property value could be levied. If, in addition, a deduction were allowed for mortgage interest expense, this could be a very rough proxy for a tax on imputed rental income.

300 Allowing a deduction for home mortgage interest would not be desirable in the current environment, as it would encourage further lending into the housing market. A new tax on imputed rental income could also cause hardship to people with fixed incomes and a lot of equity in housing, such as retired people. Additionally, transitional issues for current homeowners would be significant, with windfall gains for leveraged owners and windfall losses for unleveraged owners. There could be a chaotic effect on the housing market, with some properties rising in value and some falling. If some form of tax on owner-occupied housing is considered, these issues would have to be seriously considered.

301 The practical issues of imposing a pure tax on imputed rental income are significant. The majority of us do not therefore support its consideration at present. The Green Party disagrees, and considers that a capital gains tax would be a fairer outcome. The National Party recommends no change to existing law on the taxation of capital gains.

Recommendation

Notwithstanding the practical issues regarding a capital gains tax or a risk-free return method of taxing capital income, the majority of us recommend to the Government that the system for taxing all forms of income be investigated to ensure that it is neutral and not biased towards some forms of investment. The majority of us consider that it is desirable for the tax system to be neutral towards all forms of capital investment in a manner consistent with other policy objectives. The Green Party supports a capital gains tax on all investment income, other than the primary family home, as a way of improving the neutrality of the tax system. The National Party recommends no change to existing law on the taxation of capital gains.

7 Productivity performance

Introduction

302 We inquired into New Zealand's capacity for non-inflationary growth and the role of productivity in lifting this capacity. Our examination of this issue assumes that increasing the capacity for non-inflationary growth provides more headroom in the economy before monetary policy needs to be tightened during the upswing in the cycle.[14] We considered the concerns of submitters with New Zealand's productivity performance, and examined the problems and potential solutions. We looked at New Zealand's productivity performance, both in terms of recent trends and relative to other OECD countries, particularly Australia.

Productivity performance—comparisons

303 Cross-country productivity comparisons supported the view that New Zealand's productivity is lagging behind many OECD countries. In 2005 New Zealand was ranked only 22nd out of 30 OECD nations in terms of economy-wide productivity. Countries that New Zealand typically compares itself with are ranked much higher; for example, the United States was 7th, the United Kingdom was 12th, Australia was 13th, and Canada was 16th.

304 Relative productivity performance over time affects New Zealand's per capita gross domestic product ranking in the OECD. The gap in GDP per capita can be broken down into a gap in labour utilisation, or hours worked per capita, and a gap in GDP per hour worked, or labour productivity. In 2005 the gap between New Zealand's GDP per capita and that of the United States was around 40 percentage points, primarily because of the difference in labour productivity. Australia's GDP per capita gap with the United States was just below 20 percentage points, and also determined mainly by labour productivity.

Definition and measurement—productivity statistics

305 We considered various definitions of productivity and the difficulty of measuring productivity performance. Productivity is typically defined as a ratio of a volume measure of output to a volume measure of input. The simplest measure of labour productivity is output per worker. Output per worker will rise if workers produce more in the hours they work, or if they work longer hours. Labour productivity measured as output per hour takes account of variations in the number of hours worked per worker. Labour productivity can change as a result of additional capital input or a change in technology, with no change in the amount of actual labour input. Multifactor productivity measurement, that is, the percentage change in output less the contribution of changes in labour and capital, takes into account both labour and capital inputs.

14 This can be described as the potential growth rate of the economy. Briefly, in the inflation context, this is not growth in the sense of all resources being fully utilised. Rather, it is growth in output consistent with stable inflation. Historical measurement of potential growth can be carried out using various techniques, considering the contributions from drivers such as labour, capital, and productivity. Projections of potential growth can be built up from historical trends in growth in these three drivers.

306 The feasibility of gauging productivity varies across the economy. Measurement difficulties are generally greater in the service industries, including Government non-market activities, such as health, education, administration, and defence services, because they are provided free or at nominal charges. In the national accounting statistics, the output (value-added) of these activities is measured largely by inputs, such as employee remuneration. Using changes in inputs to measure changes in outputs assumes zero productivity growth.

307 We were advised by Statistics New Zealand that previous work on measuring productivity in the health system, albeit on a limited part of the system, had suggested low productivity growth, but that there were significant measurement issues. To reduce such uncertainty, Statistics New Zealand has sought to improve its official productivity data series by several means:

- expanding the measured sector to include more service industries, increasing this sector from about 63 percent of the economy to about 79 percent
- undertaking a study to determine if it is feasible to produce a labour productivity series adjusted for compositional or quality changes over time
- developing industry-level labour, capital, and multifactor productivity estimates for the industries in the measured sector
- determining if it is feasible to measure public-sector productivity in New Zealand. This study will review overseas methods and their applicability, and assess the current capacity to produce public-sector productivity figures. The study is expected to be published in June 2010.

308 Statistics New Zealand told us that its official productivity statistics employed international best practice and (on the currently-measured sector) were comparable with those produced in Australia. Further, it said that because of the substantial conceptual and statistical challenges of measuring output in the public sector, work in this area could not easily be accelerated. We consider that there would be value in Statistics New Zealand developing further its productivity data set. The department estimates the cost of developing a wider set of economic statistics to be around $40 million.

Recommendation

We recommend to the Government that it continue to support the development of Statistics New Zealand's official productivity data series, particularly in relation to the sectors that are not currently or adequately measured.

Productivity growth

309 We noted the following conclusions from Statistics New Zealand's official measured-sector productivity data:

- After a period of relatively strong productivity growth since the mid-1980s (labour productivity growth cycles averaging between 2.5 and 2.9 percent over the period), it has begun to taper off, averaging 1.1 percent since 2000.
- Multifactor productivity has declined in a similar pattern.

- Output growth has remained strong, averaging 3.3 percent since 2000. This reflects the strong contribution of increased resource utilisation over the period.
- The period since 2000 is an incomplete cycle and so the extent to which the recent slowdown represents a change in the productivity performance trend is unclear.

310 Various factors are likely to be contributing to the slowing of observed productivity growth. They include industry developments, employment growth, and changes in the quality of the workforce. For example, in recent years strong growth in domestic demand has boosted construction and service industries relative to industries such as manufacturing, where recorded productivity tends to be higher. Strong employment growth has brought many new entrants into the workforce, whose below-average productivity may have dampened overall labour productivity growth. We note that some submitters attributed the recent slowdown in productivity growth to changes in the regulatory and policy environment.

Productivity assessments

311 We clarified the differences between productivity assessments from the Reserve Bank and the trading banks. Westpac considers that there has been a decline in trend productivity growth, and provided the following list of potential contributors:

- growth dominated by the service sectors, which have generally lower measured productivity
- low unemployment with the marginal employee tending to drag down average productivity, and high labour market churn
- property being favoured at the expense of other investment
- higher taxes
- a rapidly growing Government sector crowding out private sector activity
- a trend toward re-regulation.

312 The ANZ Bank submitted that productivity growth has deteriorated and that this is not entirely cyclical. The bank highlighted a decline in the number of hours worked per full-time-equivalent person, and argued that business investment had not responded to capacity constraints. According to research undertaken by the ANZ, growth in regulation, by imposing costs on business, was causing inefficient resource allocation and increasing uncertainty, with a negative impact on investment.[15]

313 While it is plausible that growth in regulation could have the effects claimed by the ANZ study, some of us did not find the quantitative analysis in the study compelling. The study suggests a negative correlation between “uncertainty” and the capital stock. Uncertainty, however, does not necessarily result from regulations, and has many sources. In its analysis of the misallocation of resources, the study notes contrasting results in the different sectors and subsectors examined. Of the 12 subsectors, we note that only one has

15 ANZ Bank, *Quantitative impact of regulation on capital formation*, Research study, ANZ Policy Issues, December 2006.

a significant negative effect from the distortion variable, and in two others the negative effects are marginal.

314 The Reserve Bank submits that New Zealand's labour productivity is poor. The bank considers that there are serious difficulties measuring labour productivity over the whole economy. Although labour productivity growth in measured sectors has been fairly strong relative to Australia, capital accumulation has lagged behind Australia. The Reserve Bank also offers a number of possible reasons why the stock of capital is not growing faster in New Zealand, and believes that more work is needed to understand this and the potential role of policy in addressing it.

315 The Reserve Bank said that issues related to capital accumulation, and productivity policy more generally, are outside its area of expertise. The bank focuses on the interactions between export performance, productivity, exchange rates, and monetary policy.

316 We considered the views on labour productivity outlined in the Reserve Bank's submission and compared them with those set out in the paper by Aaron Drew (*Reserve Bank Bulletin*, March 2007), who finds that

- there is a large gap between labour productivity in New Zealand and that of higher-income OECD countries
- it is hard to explain why New Zealand's productivity growth has been so low, given its open capital markets, and the wide agreement that its macro and institutional settings should be conducive to, if anything, above-average productivity
- there are significant measurement issues, and in the international literature what determines labour productivity is also a contentious issue.

317 We concluded that while Drew considers more factors than the Reserve Bank's submission, their views are not inconsistent. Overall, Drew is relatively cautious in his conclusions about the factors influencing New Zealand's productivity performance, and particularly cautious about attributing its productivity performance to specific factors.

318 We have not attributed the recent downturn in productivity performance to any one explanatory factor. We consider that there are too many difficulties in explaining developments in observed productivity to allow a credible conclusion to be drawn. These challenges include difficulty in recognising trends, uncertainty about causal drivers (including policy), and the role of lags (from both growth-enhancing and growth-detracting policy).

319 Whatever the past performance and the reasons for it, we consider that there is undoubtedly a productivity challenge facing New Zealand. Our past strong growth has been primarily driven by increased resource utilisation, but we believe there are now clear limits to the continuation of this trend. Increasing productivity growth will need to play a bigger role in raising New Zealand's capacity for non-inflationary growth and raising incomes and living standards. Such growth would boost the welfare of New Zealanders both directly by raising incomes, and indirectly by providing resources for welfare-enhancing activities. We concluded that there is a clear imperative for the Government to

remain focused on improving New Zealand's productivity performance and to examine the challenges of raising productivity.

Recommendation

We recommend to the Government that high priority be placed on policy to raise New Zealand's productivity performance to the extent that this is consistent with the Government's other objectives. The weight given to these other objectives should also be considered in the light of any impacts they have on productivity.

Increasing productivity

320 Many submitters discussed policy changes that might have benefits for New Zealand's productivity performance. We heard a wide range of views on this, but they tended to fall under five broad themes:

- creating a business environment favourable to enterprise development (covering issues of regulation, competition, taxation, and workplace productivity)
- increasing incentives for investment
- stimulating innovation
- building New Zealand's skill base
- ensuring a sound macroeconomic and institutional environment.

Business environment

321 Submitters highlighted the importance of fostering a business environment that supports growth in enterprise, emphasising the influence of regulation, competition, taxation, and workplace performance.

322 We note that research by the ANZ suggested that the growth in regulation is having a detrimental effect on productivity, promoting the inefficient allocation of resources, creating uncertainty, and discouraging investment. Other submitters expressed similar views on the quantity and quality of regulation. For example, the New Zealand Institute of Chartered Accountants argued for improving the quality of regulation, the effects of regulation being cumulative: "Like rust, poor quality regulation is slow moving but, if not dealt with in time, is ultimately fatal to the proper workings of the machine."

323 The BNZ believes that it is imperative that policy makers consider the implications of all policy decisions on productivity. The BNZ suggests that anything that adds to business or personal costs without lifting output will detract from productivity. It submits that obvious areas for special attention are labour market law, business compliance costs, the Resource Management Act, environmental regulation, and Treaty of Waitangi issues. The ASB Bank also suggested it would be useful to explore possibilities for reducing red tape and increasing the flexibility of labour markets, and to revisit the Resource Management Act. The Business Roundtable raised a number of regulatory changes, which it believes have contributed to the recent slowdown in productivity growth, including the following:

- an increase in labour market regulation, such as the Holidays Act, and increases in the minimum wage

- cost-raising regulations in areas such as accident insurance, telecommunications, electricity, and banking
- cost increases arising from the Resource Management Act, changes to the Building Act, and council restrictions on land supply for housing
- a failure to press on with reforms in areas such as roading, water, and infrastructure to reap potential efficiency gains and cost reductions.

324 Federated Farmers of New Zealand expressed concern about employment legislation reducing flexibility, creeping regulation, and an unwillingness to undertake meaningful reform of legislation that imposes significant compliance costs. The federation considers that these factors have reduced the economy's capacity for non-inflationary growth.

325 The ANZ's suggestion of more oversight and scrutiny of regulation-making was echoed by other submitters. The Talleys Group believes that New Zealand should duplicate the Australian model and create a productivity commission, empowered to audit new and existing legislation to ensure that law changes are cost-efficient and will not constrain productivity. Talleys also suggest the introduction of sunset clauses in all new regulation, so that regulations would expire after five years, with regulation review focused on the actual effectiveness of regulations. Business New Zealand similarly argues that all proposals for regulation should include a cost-benefit analysis by an independent agency providing a service similar to that of the Australian Productivity Commission. The ASB believes that The Treasury should assess proposed Government policies for their implications for long-run growth outcomes, and conduct a cost-benefit analysis.

326 Other submitters proposed an institution with a focus on productivity and a wider role. The joint submission of the Council of Trade Unions and Business New Zealand recommended funding to support a stronger and more permanent institutional base for integrated initiatives on productivity. The CTU and Business New Zealand consider that improving productivity requires a joint process involving unions, business, and the Government.

327 The CTU and Business New Zealand described such joint processes undertaken in Denmark and Finland. Education and skills were a focus of the Danish work. They also cited the National Centre for Partnership Performance in Ireland as an example of an institution with a mandate to promote and facilitate workplace change and innovation through partnership. Their joint submission argues that New Zealand needs to consider establishing a significantly larger institutional and resource base for engagement on workplace change.

328 Many submitters regard competition as the fundamental driver of productivity. Westpac highlighted the utility and communication sectors as areas where the Government could seek to increase competition. Other submitters also argued the need to increase competition, especially in markets dominated by Government service providers. Business New Zealand considered that areas such as accident insurance and local government services such as waste collection and water supply should be opened up to competition. It submitted that central Government does not need to be a monopoly service provider to meet social and economic objectives. It is also noted that local government would be able to reduce the rating burden through savings from contracting out services.

329 We noted the concern raised by Asia Pacific Risk Management that a lack of market disciplines over price setting in the non-competitive sectors of the economy—the public sector and monopoly industries—was a cause of inflationary pressure.

330 Business New Zealand suggested that privatising all the central and local Government activities for which public-sector ownership is not essential would impose commercial discipline and minimise the risk of a cost-plus mentality. It noted that the sale of Government assets would also have other benefits, reducing Government debt, improving efficiency in general, and reducing political interference in the operation of businesses currently run as State enterprises.

331 Some submitters raised rates of taxation as an issue. The Business Roundtable believes that increases in tax have driven the ratio of taxation to GDP to around 43 percent, according to the OECD, putting New Zealand in the high-tax category and reducing incentives for productive activity. Federated Farmers also commented on the "rising tax burden", arguing that it is impeding productivity growth. The New Zealand Chambers of Commerce argued that investment and training are crucial drivers of productivity, and that tax cuts would provide valuable incentives to improve productivity. The New Zealand Institute of Chartered Accountants said that there is a need to broaden and simplify the tax system to reduce supply constraints and increase the efficiency of the economy. The institute argues that the tax system has become increasingly complicated and distortionary, to the detriment of private investment. They submit that fiscal drag has also reduced incentives to invest in productive capacity. The Talleys Group also suggested the establishment of economic policies or zones where investment is attracted by lower income tax, and suggested that provision for accelerated depreciation would be beneficial.

332 Some submitters also emphasised the importance of productivity in the workplace. The CTU commented that productivity is about continuous improvement, which requires many factors to come together. They argued that New Zealand cannot achieve high productivity without better performance at the workplace level. They cited research indicating that increasing unionisation, combined with high employee participation in the workplace, can improve productivity.

333 In their joint submission, the CTU and Business New Zealand comment that, as labour force participation and hours of work are already relatively high, the focus has to be on investment in the quality of labour (skills), the capital workers can use (technology), and workplace practices to effectively combine labour and capital. They call for investment in developing workplace practices. They also refer to the work of the Workplace Productivity Working Group in 2004 and the subsequent implementation of the group's recommendations.

334 While the CTU and Business New Zealand acknowledge the success of efforts to raise awareness of the importance of productivity, they suggest we are now at a critical juncture for engagement on productivity. They believe that New Zealand is not succeeding in various areas of need: widespread change in workplace practice, solid research on productivity, providing adequate resources for employer and union groups, reforming institutional design, and worker participation in productivity initiatives.

335 They suggest there is a need for better coordination of initiatives in areas such as workplace productivity and business capability partnerships, and point to the proliferation of separate pilot projects, suggesting the need for an umbrella institution or forum. They cite arrangements in Ireland as a model. The CTU and Business New Zealand also suggest a need for trusted networks such as business organisations to diffuse best practice, and for building participation in workforce development with a real focus on implementation.

Workplace productivity

336 We considered the various policies designed to improve workplace productivity, particularly the recommendations in the 2004 Workplace Productivity Challenge report. While a wide range of policies may potentially affect the productivity of New Zealand workplaces (for example, innovation policy, tax policy, and regulation) we note the focus on actions that can be taken at workplace level to increase productivity. Such actions tend to focus on raising awareness and building capability among employers and employees.

337 We believe that the key challenge in this area is ensuring coherence between initiatives and strategies for improving productivity, and see value in a coordinated approach. Changes in workplace practices need to be supported by new technologies, investment in capital, higher skills, and better human resource and organisational practices. We therefore support the recommendations of the Council of Trade Unions and Business New Zealand.

Recommendation

We recommend to the Government that it continue to cooperate with employers to improve workplace productivity and to create a stronger and more systematic approach to the development and delivery of productivity initiatives.

Regulation

338 While some submitters raised issues with particular pieces of regulation, we focused on the general issue of the quality of regulation and regulatory processes. We looked at regulatory quality in the context of New Zealand’s current regulatory environment. In particular, we considered the need for better review of proposed and existing regulation. We believe that such arrangements could be strengthened in New Zealand.

339 We note that New Zealand rates well on international comparative measures of regulatory quality. The World Bank and OECD measures of the ease of doing business and the quality of product market and competition regulation rate New Zealand highly relative to other OECD countries. While such indices are imperfect measures of regulatory quality, the majority of us concluded that, in general, New Zealand does not have a serious problem with the quality of regulation. The National Party does not agree with this view.

340 The *quantity* of regulation has increased over the past decade, however, increasing compliance costs for business. We therefore inquired into whether this has led to a general deterioration in the regulatory environment (and consequently lower productivity).

341 We are aware of anecdotal evidence on the costs of complying with various regulations, in areas such as building and occupational health and safety. However, we are

concerned that there is insufficient empirical evidence as to how changes in regulation have affected the quality of the regulatory environment.

342 We would expect compliance costs for business to increase with increases in regulation—regulatory impact statements generally show that additional administration or other compliance costs are expected to result from the introduction of proposed regulation.

343 The cumulative impact of regulation can be greater than the combined impact of individual regulations. For example, compliance costs for individual pieces of regulation may be small but might add up to an amount that meant a potential investment was not worthwhile—the additional cost being the forgone return from the investment. Regulations can also interact in ways that deliver outcomes that were not expected when considering their impact separately.

344 The impact of regulation can also lag behind immediate effects, and so may not show up for some years. This is especially likely in the case of impacts on incentives for investment and innovation. A regulation with higher compliance costs might incur lower costs in other areas. For example, a switch from outcomes-based to prescriptive regulation might generate additional compliance costs but also greater longer-term benefits by reducing uncertainty about compliance, thus increasing investment incentives.

345 Regulation is used to pursue economic, social, and environmental goals, from which the community derives benefit. We consider that the challenge is to ensure that any regulation delivers the maximum net benefit to society. This requires

- a genuine benefit to the community from the imposition of regulation
- the benefit to exceed the costs of regulating (both in direct administrative and compliance costs and indirect impacts on growth)
- an absence of more beneficial ways of meeting the objectives of the regulation.

346 There is invariably a context-specific trade-off between the benefits and costs of regulation, so a good system is needed for managing the stock and flow of regulation. We note that international opinion suggests that improving the quality of regulation requires two distinct but complementary review functions:

- ex-ante assessment of new regulation—ideally by a dedicated unit providing quality assurance on new regulatory proposals. In New Zealand, the Ministry of Economic Development's Regulatory Impact Analysis Unit carries out this function.
- ex-post reviews of existing regulation—systematic reviews of the "stock" of existing regulation, which can be broadened to examine other policies affecting incentives facing business such as industry policy.

347 This ex-post review function is not currently carried out systematically in New Zealand. Ad-hoc general reviews such as the Quality of Regulation Review have included various sector-specific regulations from time to time, but we consider such reviews may be less useful than regular targeted sectoral review programmes.

348 The ex-post review function is particularly important for understanding the cumulative and delayed effects of regulation and its unintended consequences. This requires a good understanding of both the relationship between regulation and drivers of productivity growth and the actual impact of regulation on sector and economic outcomes. We believe that taking a thematic or sectoral approach to such reviews is likely to be most effective.

Institutional arrangements

349 A number of submitters suggested that there was a need for improved ex-ante and ex-post reviews of proposed and existing regulation in New Zealand. Submitters considered that these arrangements should be strengthened and argued for an independent assessment of new regulatory proposals, as occurs in Australia.[16]

350 The ex-post evaluation of existing regulation is an important element of a high-performing regulatory management system. We agree with submitters that this is an area that could be strengthened in New Zealand. We see value in the Government exploring options for introducing more systematic reviews of the stock of existing regulation. These reviews would have greater value if a sectoral or thematic approach were taken to allow identification and assessment of any interdependencies between elements of the regulatory structure and the cumulative effect these are having on business. A sectoral approach would also allow the focus of the review to be broadened to examine other policy settings that are affecting sector-wide productivity. A targeted approach is also likely to be required to ensure a high quality review process.

351 Institutional arrangements will also need to be considered. The Australian approach has been to embed the ex-post review function in an independent agency (the Productivity Commission). This is likely to have advantages in terms of the quality of analysis, the transparency of the process and the acceptance of analysis by stakeholders. In the New Zealand context, resourcing such an agency to a level where it has a sufficient critical mass to be effective might be a challenge. We are advised that this was an issue when New Zealand established the Economic Development Commission in the 1980s. Other options which could be explored include some form of cooperative arrangement with the Australian Productivity Commission; establishing an independent unit within an existing department (along the lines of the Victorian Competition and Efficiency Commission); or applying additional resources to ex-post review within the existing departmental framework.

352 In relation to the ex-ante assessment of new regulatory proposals, changes were made in 2007 to improve the quality of the regulatory impact assessment process, moving the system to more of a "self-regulatory model"', allowing the Regulatory Impact Analysis Unit to focus its resources on more economically significant regulatory proposals. The report from the Regulations Review Committee on its inquiry into the Ongoing Requirement for Individual Regulations and their Impact recommended clearer guidance

16 While the review of new regulation was carried out in Australia by the independent Australian Productivity Commission, during the course of this inquiry it was transferred to the Department of Finance and Deregulation—a central agency department.

around exemptions from requirements to develop a regulatory impact statement and the auditing of proposals to claim such exemptions.

353 Submitters identified issues around the mandate and institutional home for reviewing new regulatory proposals that go beyond the 2007 changes and those of the Regulations Review Committee. Some of these issues may be addressed by the recent announcement of the Minister of Commerce that the Regulatory Impact Analysis Unit will be shifted to Treasury, closer to the centre of Government.

354 Given the importance of high quality regulation to productivity, we consider that it is imperative that this ex-ante "gatekeeping" function be as strong as possible. We see benefits from the Government reviewing how the recent changes to the regulatory impact assessment process are working in practice, whether they are delivering an effective gatekeeping function and whether there is scope for improving these further through a strengthened mandate for the Regulatory Impact Analysis Unit.

Recommendations

We recommend to the Government that options be explored for introducing a more systematic approach to reviewing the stock of existing regulation in New Zealand, including the cumulative effect on the productivity performance of a sector, and appropriate institutional arrangements, including a joint approach with Australia for conducting these reviews.

We recommend to the Government that the impact of the 2007 changes to the regulatory impact assessment process be reviewed, and options be explored for strengthening the ex-ante review function currently conducted by the Regulatory Impact Analysis Unit.

Competition

355 We see competition as affecting productivity in various ways:

- inducing producers to supply what consumers want at the lowest prices so that labour and capital resources are employed most efficiently
- providing incentives to improve managerial efforts to use capital and labour efficiently to avoid loss of market share or bankruptcy
- allowing new entrants with high productivity (possibly using new technology or techniques) to displace low-productivity firms that cannot compete
- stimulating innovation.

356 While relatively small markets may limit the number of firms competing in a particular market, we do not consider that there is a general problem with competition in New Zealand markets. We believe that there are relatively few regulatory barriers to entry and exit in markets—reflected in the good ratings New Zealand achieves on measures such as the ease of doing business, and on product market regulation and competition indices. Openness to trade and investment also helps foster competition in New Zealand markets.

357 We considered the requests of some submitters that more competition be introduced into markets for services currently provided by Government agencies. Submitters cited

examples such as accident insurance and water and wastewater service provision, and drew links to productivity and the inflationary effects of rising user charges.

358 The National Party supports the introduction of competition and choice to the ACC Work Account (covering employees and the self-employed at work). The National Party believes that this will result in safer workplaces and a more efficient and effective accident compensation system that benefits all New Zealanders.

Taxation

359 Income taxes affect productivity primarily in two ways:

- Income taxes on labour income may affect an individual's incentive to perform paid work.
- Income taxes on capital income can distort investment decisions and reduce the efficiency of aggregate investment in the economy.

360 Taxes affect growth by influencing participation, productivity, and investment decisions. We see much of these effects coming through the marginal tax rate. Average tax rates are also important, as they can affect decisions to participate in home or overseas labour markets, and companies' decisions on where to locate new investment.

361 We note that the OECD has reported that for 2006 New Zealand had the third-lowest tax wedge on the average wage in the OECD, and the second lowest tax wedge on a one-earner family with two children earning the average wage. For many moderate-income workers the tax wedge imposed by New Zealand may not be very distortionary compared with those imposed by other countries.

362 We note, however, that marginal income tax rates of up to 59 percent are now fairly common for people who receive Working for Families tax credits. We believe that high income tax rates on labour income are likely to discourage people from participating in paid work where they have a realistic option not to work; for example, people receiving benefits, or members of households where other members work, or people who can generate significant non-market income at home, most commonly by looking after their children. High income taxes could also affect whether people decide to work in New Zealand or another country. We are advised that where a person's benefit is being phased out marginal income tax rates can be 100 percent.

363 While high marginal tax rates are not desirable in themselves, we agree that there is no easy way to reduce them. We need to have taxes to pay for Government expenditure, and higher average tax rates on higher incomes can help income redistribution. By eliminating the benefit phase-out (and making the benefit a general entitlement), some high marginal tax rates at low-to-middle income levels could be reduced, but this would have an extremely high fiscal cost, necessarily increasing average tax rates. The marginal rate of abatement could also be reduced, but then the benefit would be abated over a larger income range, meaning fiscal cost increases; and more people would be affected by the abatement.

364 New Zealand has a mixture of abatement regimes for different programmes. For example, Working for Families has a moderate abatement rate of 20 percent, which is

intended to encourage parents to work, although it has the downside of a moderately high (53 or 59 percent) effective marginal tax rate extending over a large income range. Some benefits, such as the unemployment benefit and sickness benefit, have a sharper abatement rate (70 percent after a free amount of additional income); the domestic purposes benefit and invalids benefit allow a free amount, then are abated at 30 percent up to a certain amount, and then at 70 percent. We understand that these arrangements are intended as incentives for people on these benefits to move into full-time work (with an income beyond the abatement range), and for people on the domestic purposes benefit and invalids benefit to move into part-time work (hence the lower abatement rate for some income). The different abatement regimes involve balancing tradeoffs between containing fiscal costs, maintaining incentives to move into paid work, and minimising the number of people affected by the abatement.

365 Because of the link between taxes and growth we see growth benefits from tax reform to improve productivity performance, with a focus on reducing marginal tax rates. The tax system, however, is also designed to contribute to income redistribution, mostly via progressive tax rates. There are therefore potentially important trade-offs between the growth and redistribution goals of the tax system.

366 Taxes on investment income have an economic cost because by inserting a wedge between pre-tax income and post-tax income, they distort investment decisions. In other words, investors will choose investments with the highest post-tax income, whereas investments with the highest pre-tax income are the best for the economy as a whole.

367 New Zealand tries to minimise this cost by having a broad-base, low-rate tax system. The income tax base in New Zealand is fairly broad, but currently does not generally tax income received in the form of capital gains. Differences in the rates at which various forms of investment and labour income are taxed also lead to some deviation from neutrality. The broad base allows a large amount of revenue to be raised at the lowest possible rate. The tax base can never be perfectly neutral because it is defined in legal terms and will never reflect true economic income. This is why we agree that it is important to keep the rate as low as possible because the economic cost of investment inefficiency increases as the tax rate increases.

368 We note that the Government has recently lowered the taxation of investment income by reducing the company tax rate to 30 percent, and by reducing the tax rate on income from savings to 19.5 or 30 percent. This will reduce the impact of tax on some investment decisions and should improve the efficiency of investments in aggregate. We believe, however, that there are still inefficiencies in the tax regime. For example, an individual may invest in a portfolio investment entity at a 30 percent tax rate, while if they invest in their own business or a savings account; they suffer a 39 percent tax (after dividend distribution).

Increasing incentives for investment

369 Some submitters considered that New Zealand's relative "capital shallowness" (New Zealand workers tend to have less capital to work with than their equivalents in other countries such as Australia) means there is a need to stimulate business investment. In addition to the need to improve the general business environment for enterprise, submitters raised other issues directly affecting the incentives for investment. The Reserve

Bank considers that New Zealand's relatively high interest rates are one such issue. It suggests, however, that high interest rates seem to be explained by the saving and borrowing choices of households rather than by monetary policy.

370 The Canterbury Manufacturers' Association argues that the Government needs to seek policy settings that do not drive a wedge between local interest rates and those of other countries. The National Distribution Union also suggested that high interest rates increase capital costs and discourage the capital investment that would bring productivity gains. It believes that the Employment Contracts Act has reduced wages, causing a substitution of labour for capital. The union submitted that low wages encourage low productivity, so measures to increase wages, such as fostering collective bargaining or direct intervention, for example by raising the minimum wage, are required.

371 The Bank of New Zealand suggested it is necessary to understand New Zealand's investment performance, where investment has been directed, and why its returns have been relatively poor. We note the Manufacturers' Association's view that there is a bias in policy settings towards investment in land and buildings over productive investments and export growth. The association cites examples including the absence of tax balance (from taxation of capital gains), inadequate depreciation allowance on plant and buildings, favourable loss attribution rules on property, failure to enforce property trading rules, exchange rate volatility, and a CPI methodology weighted towards property and related costs. It notes that small companies in particular struggle with investment, exchange rate risk, and the development of export markets.

372 The view that there is a bias toward investing in property was also advanced by Wigram Capital Advisors. It said that, while recent changes to the investment tax regime have mitigated this effect, investing in property remains a tax-preferred activity. Other submitters did not agree that there was such a bias. The New Zealand Chambers of Commerce submitted there was no evidence that there is a bias in favour of rental properties over other forms of investment, and opposes any measures to bias the tax system against housing. A number of submitters argued for special measures such as accelerated depreciation, and economic zones to encourage productive investment in New Zealand. Other submitters asserted the need for investment in infrastructure to support productivity growth. Professor Hall submitted that New Zealand has suffered infrastructure-related constraints for some time. He believes these constraints can be addressed only slowly over a long period because of tight constraints on productive inputs. The Council of Trade Unions, Business New Zealand, and the New Zealand Chambers of Commerce also supported increasing investment in infrastructure. Westpac suggested that it would be useful to consider changes to the Resource Management Act to reduce obstacles to investment in critical infrastructure areas, particularly electricity generation and supply.

Recommendation

We recommend to the Government that it support non-distortionary measures (such as depreciation rules) to increase capital investment.

Stimulating innovation

373 We considered the importance of encouraging innovation to drive productivity performance. The Canterbury Manufacturers' Association argues that productivity is driven by innovation, and this drives growth. It notes that innovation involves reallocating resources in anticipation of a better return, and that it requires creativity, and involves risk and investment. The association points to the importance of exporting for future innovation and growth; it can provide bigger markets and therefore better returns on research and development than New Zealand's small domestic market.

374 The association also submitted that public policy in New Zealand does not support exporting. It considers that policy on research and development credits, first-year write-offs for productive plant, skill development incentives, and early-stage investment incentives should promote external stability rather than internal stability, and provide support for the productive sector. It submits that these coherent, mutually supportive policies would encourage more risk-taking and more innovation, resulting in higher productivity and growth.

375 The New Zealand Shareholders' Association emphasises the importance of research and development and education for building a world-class innovative society in New Zealand. It argues for more effective mechanisms regarding Crown research and development subsidies, and suggests

- replacing grants with a two-for-one tax deduction on research and development expenditure
- allowing tax losses to be sold, so that research costs could be turned into cash
- expanding venture capital funds to provide capital to start-ups arising out of successful research.

376 The association observes a lack of depth in New Zealand capital markets, which limits the ability of firms to exploit opportunities from research and development. The Shareholders' Association also recommends establishing a Crown fund to assist the enforcement of New Zealand patents. Westpac argued that the Government should focus on policies to increase market efficiency and innovation. It submits that the Government might usefully establish more generous depreciation rates to encourage investment, particularly in research and development.

New Zealand's skill base

377 Both Federated Farmers and Business New Zealand highlighted the essential role of human capital and managerial capability in improving productivity performance. Business New Zealand said that productivity improvement is now largely predicated on actions by knowledge workers and those at governance and managerial level.

378 Professor Hall believes that New Zealand's capacity for non-inflationary growth has been running up against labour- and infrastructure- related constraints for some time. He noted that while labour-related constraints can be eased gradually from the demand side, it is crucial that the supply-side aspects are attended to. These constraints can be influenced gradually by education, training and re-training policies, by skills-related immigration policies, and by other conditions and incentives affecting the efficiency and flexibility of

labour markets. Other submitters suggested that industry training organisations are struggling to keep up with demand, and need to ensure their resources are well targeted. The Engineering, Printing and Manufacturing Union also emphasised the importance of training and learning. It considers that we will "undersell and … undermine the next generation" if we fail to improve the uptake of training rapidly.

379 The EPMU considers that New Zealand's future manufacturing base should be at the very high-technology, capital-intensive end of manufacturing—the skilled end. It emphasised the importance of training and learning in preparation for more sophisticated technology. We note that the EPMU is keen to support genuine productivity improvements, but only on the basis that workers as well as investors must share in the resultant gains. The EPMU also regards reward and remuneration as important for retaining New Zealand's skill base. It noted that New Zealand was struggling to replace skills lost to emigration. Gough, Gough and Hamer also told us of their difficulties retaining skilled workers.

380 The ASB Bank also considers that education and trade training need to be better tailored to a changing economic environment. The Shareholders' Association expressed concern about fragmentation of the tertiary sector, and suggested reducing the number of tertiary institutions funded by the Crown, with an emphasis on quality. The association also suggested abolishing fees for New Zealand citizens (with foreign students paying the full amount), and provision of student allowances on a needs basis. The association submitted that on-the-job training should be encouraged by reducing the risk inherent in new appointments (by reviewing the Employment Relations Act) and by subsidising training organisations and apprenticeships.

381 Westpac considered education and health to be key policy areas for productivity growth. It suggested focusing education on basics such as numeracy and literacy, providing meaningful qualifications that provide a clear signal to employers, targeted training, and tertiary education focused on quality rather than quantity. It noted the need for health policy to ensure a healthy workforce.

382 Westpac also argued for better targeting of skilled migrants, and the recognition of trade and professional qualifications from a broader range of countries. It submits that this is necessary to break down "closed shop" industry associations. At the least, Westpac suggests that credits for foreign qualifications should be recognised, rather than requiring immigrants to retrain from scratch.

383 Business New Zealand in its joint submission with the Council of Trade Unions highlighted the importance of investing in skills. It noted that about two-thirds of the recommendations of Denmark's globalisation strategy report related to education and training.

384 The EPMU, the CTU, and Business New Zealand also discussed the importance of increasing managerial skills in New Zealand. The EPMU provided an example of an innovative approach to management at New Zealand Milk Products, which improved the reliability of the plant and allowed employees to earn more.

385 The New Zealand Exchange highlighted the importance of immigration for United States-led growth and suggested that New Zealand should be expanding its immigration targets to ease wage pressures and increase the supply of high-skilled technical labour. It argues against proposals to limit immigration to take the pressure off inflation, regarding such policies as contrary to efforts to increase productivity, for example by increasing broadband uptake. The NZX considered that such limits could restrict the supply of skilled workers, particularly in the 25 to 35-year-old demographic where many ideas for high-technology commercialisation opportunities emerge.

386 The accumulation of human capital is an important driver of productivity in its own right—a more capable workforce will generally be more productive—and it also has a key role in supporting innovation and the adoption of new technologies. Developing and building managerial skills in New Zealand will also be important for innovation and productivity growth. We agree with the submission from the EPMU that a sound base of training and learning is required to support the uptake of new technology in high-value, high-technology manufacturing.

387 Overall, we observe that New Zealand generally rates well on skills and the quality of the education system. Lifting the performance of under-achieving students, many from disadvantaged backgrounds, remains one of New Zealand's key challenges. Ensuring the relevance of qualifications to the needs of a changing economy will also be important.

388 As skill gaps emerge across the economy, we need to ensure that migration programmes are efficient and well targeted. We note the concerns raised in submissions about the need for an efficient mechanism for recognising foreign qualifications.

389 Many submissions only briefly considered skills as an issue for productivity performance. We received substantial submissions from the EPMU, the CTU, and Business New Zealand, which highlighted the importance of training and investing in skills, particularly to prepare for high-technology manufacturing. While there was agreement as to the importance of skills, there was only limited discussion of specific policy recommendations.

Macroeconomic and institutional environment

390 Some submitters emphasised the importance of a sound macroeconomic and institutional environment for productivity growth. Business New Zealand, for example, considered the following market features essential to improve productivity:

- secure and transparent property rights
- tax and expenditure policy that does not discourage investment
- flexible and responsible labour markets to facilitate resource shifts
- global connections through trade and immigration.

391 Business New Zealand highlighted the importance for productivity of competition, regulatory policy, infrastructure, human capital, and innovation. The New Zealand Business Roundtable emphasised the importance of sound institutions. It noted that while firms are obviously the vehicle for productivity in the business sector and management performance has a role to play, research indicates that institutions and policies are

predominantly responsible for productivity improvements and thus for differences in per capita incomes.

392 The ANZ Bank considered that the New Zealand economy has the broad macroeconomic conditions and framework necessary to perform well. It sees the challenge as getting the microeconomic framework right in many areas.

393 Tax and expenditure policy was raised by various submitters. The New Zealand Institute of Chartered Accountants argued that Government expenditure, through higher taxes, is crowding out private-sector investment. It submitted that the focus of increased spending has been on the redistribution of wealth rather than on investments to increase supply. Federated Farmers also called for expenditure and tax policy that fosters private-sector investment. Other submitters expressed concern about the quality of Government expenditure.

394 We note the comments of the Reserve Bank that the relative volatility of the exchange rate may have slowed the entry of firms into exporting and thus hampered productivity performance, although it noted that the evidence is far from conclusive. Other submitters also discussed with us the difficulties exporters are facing, particularly regarding the volatile exchange rate.

395 We consider that New Zealand's macroeconomic management and institutional framework is generally in good shape. Over the past decade and a half, New Zealand has seen a marked reduction in the variability of many macroeconomic factors such as economic growth, inflation, unemployment, interest rates, and key fiscal aggregates. Real and nominal interest rates are lower (although still higher than those in other OECD countries). The nominal exchange rate, which has continued to move through large cycles, is one exception to this general trend; and the current account deficit and high net external liabilities remain matters for concern.

Natural resources and productivity

396 The quality of the environment is vital for productivity. New Zealand has a significant natural resource base which is a substantial source of national income. As resources such as water in some areas become more scarce this will exert a drag on productivity and growth. Deterioration of the natural environment can also spill over and affect the productivity of other factors of production, for example by causing illness among workers, or the deterioration of physical assets.

397 Environmental issues are becoming increasingly important in relation to productivity—not least because New Zealand needs to manage both the impact of and the response to climate change. The key challenge is to manage these issues to achieve environmental objectives at least cost to economic growth. Efficient, market-based approaches to regulation are likely to be a key element of this response.

398 The natural environment can also deteriorate if it is used as a sink for by-products from production, such as nitrates and carbon dioxide. Such deterioration can affect productivity indirectly. The Parliamentary Commissioner for the Environment gave us a striking example of algal blooms in a Waikato lake leading to the death of beef cattle. Pollution can also reduce the recreational and social values of resources.

399 The Parliamentary Commissioner for the Environment highlighted the general lack of price signals to help the efficient allocation of natural resources and meet environmental aims. For example, she noted that atmosphere and water bodies have been used excessively as sinks for pollutants partly because there have been no prices signalling that their capacity to absorb waste has been diminishing. The commissioner also noted that the first come, first served, basis for allocating water under the Resource Management Act is inefficient, and that economic theory suggests that introducing a water price would encourage its efficient use.

400 New Zealand's management of its natural resources has important implications for productivity growth. These resources need to be managed in a way that allows environmental objectives to be met at least cost to economic growth. Efficient, market-based approaches to management are likely to be effective. We agree that while putting prices on the use of environmental resources may be inflationary in the short term, it can avoid much more serious economic impacts in the long term.

401 The Green Party considers that as natural resources such as oil, gas, water, land, fish, soil, minerals, and environmental sinks for wastes become scarce, the productivity of these resources become critical for our economy. The depletion of these resources drives higher prices in a structural rather than a cyclical manner. As the Parliamentary Commissioner for the Environment says in her advice, "increasing scarcity is inflationary". Most of us believe that this requires a fundamental rethink in our assessment of inflationary drivers, and of productivity.

402 Most of us note that inflationary pressures have in the past been seen as cyclical, and Reserve Bank tools are suitable for dealing with short-term pressures. Inflationary pressure from resource depletion is a permanent effect and recent struggles of the bank to control inflation are evidence that the official cash rate does not control rising prices caused by shortages of energy, water, land, and other resources or sinks.

403 Productivity has in the past focused on labour and capital. Resources have been regarded as part of capital, and capable of being substituted with it. Most of us consider that they now require dealing with separately.

404 Most of us note that substitution for scarce resources of others has in the past resolved issues of scarcity. This may still work for specific materials—plastics for metals for example. However energy, water, and land are primary resources that cannot be replaced with just another resource, and themselves drive price rises across the economy—oil, water, and land scarcity drive food price rises, scarcity of suitable land drives housing prices, oil drives price rises in everything that is grown, manufactured or transported, gas drives price rises in electricity which drive manufacturing costs.

405 The commissioner drew our attention to the two Ministry of Economic Development forecasts of oil prices in Energy Outlook 2006. The "mainstream" forecast has oil flat-lining at $60 per barrel of oil until at least 2030; this is less than half its current price. The "minority forecast" has it climbing to $120 then from around 2015 falling to $90. The commissioner noted first that the minority forecast has better predicted the price so far (although we note that reality has now considerably outstripped even that forecast); and then discusses the ministry's view that given time to make the necessary investments,

alternatives to oil will be developed for less than $90 per barrel. The commissioner expresses her view, as a scientist and an economist, that the decline predicted in the minority forecast is too optimistic.

406 Most of us believe that this suggests that if we wish to control inflation we must focus much more on using all resources more efficiently. The commissioner has suggested that better pricing of unpriced resources, such as water and carbon emissions, will assist. Most of us believe that this is essential but not sufficient. Relying solely on pricing will exclude from society those with less ability to pay.

407 Most of us consider that improving the productivity of urban land means intensifying urban development within the city limits. Improving the productivity of energy means much higher energy efficiency codes and standards. For oil, it means shifting transport modes as well as more efficient vehicles and more compact urban form.

408 The Green Party believes that as fisheries resources deplete and fish become harder to catch there is a strong economic driver to overfish, ensuring even less for the future. As the commissioner says, "the long term success of our fishing industry depends on setting the total allowable catch at a sustainable level and on adequate enforcement of the quota system." The Green Party believes that both of these are lacking in the present quota system.

Recommendations

We recommend to the Government that it specifically include policies to increase the efficiency with which the economy uses scarce natural resources such as oil, gas, fresh water, and the capacity of the environment to absorb wastes. These policies should include, but not be limited to, price signals.

We recommend to the Government that the Reserve Bank continue to highlight the distinction between cyclical and structural inflation drivers such as resource scarcity.

8 Conclusion

409 Monetary policy focuses on maintaining low inflation, helping to creating a stable environment conducive to economic growth. It is, however, only one contributing factor to economic performance. Other economic policies and a host of other influences have a bearing on whether the economy flourishes.

410 While monetary policy has largely succeeded in delivering low inflation despite challenges, the long-run economic performance remains less encouraging. GDP growth per capita has not been strong enough to close the gap with other OECD countries; the stock of capital equipment per worker remains low; and the country's export performance appears disappointing. It is also a concern that recent imbalances in the economy at present have manifest in a high exchange rate.

411 In this inquiry we examined the monetary policy framework established by the Reserve Bank Act 1989, and the effects of other economic policies on monetary policy, and on productivity. We make some key findings about New Zealand's monetary policy framework, which we consider are needed to maintain public confidence in the commitment of monetary policy to ongoing price stability. We believe it is important to recognise the value of continuity in the monetary policy framework to maintain that confidence.

412 We considered other instruments to complement interest rates in managing inflation, including those outlined in the 2006 joint Treasury and Reserve Bank report on supplementary stabilisation instruments, and an interest-linked savings scheme. While we agreed that an interest-linked savings scheme would be more likely to moderate external capital inflows and hence the exchange rate than current monetary arrangements our analysis did not persuade us that the resultant benefit would outweigh the costs.

413 Notwithstanding this, we make recommendations for improving our overall economic performance and believe that implementing these recommendations will help prepare our economic policies for the economic challenges that lie before us, and ensure that they continue to sustain New Zealand's economy. We consider that there is scope for the Government in the future to demonstrate more clearly how its actions support the monetary policy framework objective of price stability in pursuing its other policy objectives.

414 It is clear that increasing productivity, in particular, is critical to delivering non-inflationary economic growth. Such growth would boost the welfare of New Zealanders both directly, by raising incomes, and indirectly, by providing resources for other welfare-enhancing activities. We consider that, to the extent that it is consistent with the Government's other objectives, the Government should place a high priority on policy that supports the raising of New Zealand's productivity performance. The weight given to these other objectives should also be considered in the light of any impacts they may have on productivity. We agree with Westpac's assessment that national productivity growth stems

from a complex interaction of factors. This complexity was articulated by Federated Farmers:

> Improving productivity is not just the responsibility of government. The importance of individual decisions and behaviours of many thousands of businesses (many of them very small) and around two million employees must not be underestimated. However, government legislation and regulation and other the [sic] signals and incentives provided through its wider policies both directly and indirectly influence these decisions and behaviours.

415 There is no obvious "silver bullet" that will ensure a substantial increase in productivity growth. We found that lifting New Zealand's productivity performance will require us to get many different factors right.

Appendix A

Committee procedure

We called for public submissions on this inquiry. The closing date for submissions was 19 July 2007. We received 92 submissions from the organisations and individuals listed in Appendix B and heard 35 submissions orally. We heard all of the evidence in Wellington and submitters from other parts of New Zealand, Germany, and Australia were heard via video conference in Wellington.

The Treasury provided advice. Dr Stephen Grenville was appointed as an independent adviser and provided comments on submissions and the advice provided by Treasury. We also received advice from Mr Dean Parham from the Australian Productivity Commission. We thank the advisers for their assistance.

Committee members

Charles Chauvel (Chairperson)
Hon Bill English
Jeanette Fitzsimons
Craig Foss
Hon Mark Gosche
Hone Harawira
Rodney Hide
Moana Mackey
Dr the Hon Lockwood Smith (Deputy Chairperson)
Hon Paul Swain
Chris Tremain
Judy Turner
R Doug Woolerton

Appendix B

Evidence, advice, and references

List of submitters

Number	Name or organisation
MP/1, 1A	Wood Processors Association of New Zealand
MP/2	Mr Ivan Stanton
MP/3, 3A	Mr Christopher Worth
MP/4	Mr S Leonard-Taylor
MP/5	Sawmill Productivity Solutions
MP/6	Mr Gerald Hunt
MP/7	Foundation for Economic Growth Incorporated
MP/8	Mr Alan Armstrong
MP/9*	Dr Girol Karacaoglu
MP/10	Ms Jennifer Goldsack
MP/11, 11A	Mr Terry McFadgen
MP/12, 12A*	The New Zealand Shareholders' Association
MP/13, 13A*	Mr Stephen Poletti
MP/14, 14A to 14F*	EROS Capital Limited
MP/15*	Federated Farmers of New Zealand Incorporated
MP/16	Mr Ron Robert
MP/17	Mr Michael Andreasen
MP/18, 18A, 18B*	Business New Zealand
MP/19	Mr Ian Greaves
MP/20	Mr Peter Luiten
MP/21	Mr Fraser Aitken
MP/22	Mr James Cone
MP/23*	Talleys Fisheries Limited
MP/24	New Zealand Kiwifruit Growers Incorporated
MP/25	Mr David Butler
MP/26	Mr Andrew Fraser
MP/27, 27A, 27B*	New Zealand Manufacturers' and Exporters' Association
MP/28	Age Concern New Zealand Incorporated
MP/29*	Wood Council of New Zealand Incorporated
MP/30*	New Zealand Institute of Chartered Accountants
MP/31	Mr Anthony Morris
MP/32	Tuatara Management Limited
MP/33	Mr David Underwood
MP/34*	Bank of New Zealand

MP/35*	ASB Bank
MP/36*	Mr David Tripe and Ms Claire Matthews
MP/37	Democrats for Social Credit
MP/38	Mr John O'Malley
MP/39	Hongkong and Shanghai Banking Corporation Limited
MP/40	Mr Marty Verry
MP/41, 41A	Mr Ian Davey
MP/42	Mr Bryan Gould
MP/43, 43A	Marlborough Federated Farmers
MP/44*	New Zealand Business Roundtable
MP/45*	Reserve Bank of New Zealand Board
MP/46, 46A*	Reserve Bank of New Zealand
MP/47*	ANZ National Bank Limited
MP/48	Property Council of New Zealand Incorporated
MP/49	Mr Tony Hollis
MP/50	Mr Graeme Chisnall and Ms Lynn Janes
MP/51, 51A	Mr Tony Cranston
MP/52*	Professor Viv Hall
MP/53, 53A	Mr Alan McKay
MP/54	Mr Alan Stewart
MP/55*	Westpac New Zealand Limited
MP/56	Citi Australia and New Zealand
MP/57	Mr Warwick Jacques
MP/58	Mr W Gardner
MP/59	Direct Democracy Party of New Zealand
MP/60	Mr William Ferguson
MP/61	Insights Consultancy
MP/62	Mr John Walley
MP/63*	New Zealand Exchange Limited
MP/64*	Mr Selwyn Pellett
MP/65, 65A*	Asia-Pacific Risk Management Limited
MP/66	Mr Stephen Russell
MP/67	Mr Bernard Montgomerie
MP/68, 68A*	Wigram Capital Advisors Limited
MP/69*	New Zealand Chambers of Commerce and Industry
MP/70, 70A*	Business and Economic Research Limited
MP/71*	Mr Keith Rankin
MP/72	Fisher and Paykel Healthcare Limited
MP/73	Mr Luke Moriarty
MP/74	Mr Danny Freilich
MP/75	National Distribution Union
MP/76	Sustento Institute
MP/77	Arthur Murray
MP/78	Mr James Armour

MP/79*	New Zealand Council of Trade Unions (CTU)
MP/79A*	Joint submission of CTU and Business New Zealand
MP/80	Forest Owner Marketing Services Limited
MP/81	Mr Thomas Frank
MP/82	Mr Christopher Harris
MP/83	Mr David Webber
MP/84	Mr Tony Sullivan
MP/85	Mr Malcolm Bailey
MP/86*	National Council of Women of New Zealand
MP/87*	Dr Robin Pope
MP/88	Mr Robert Chrystall
MP/89	Registered Master Builders Federation
MP/90*	Steel and Tube Holdings Limited
MP/91*	New Zealand Amalgamated Engineering, Printing and Manufacturing Union
MP/92*	Gough Gough and Hamer Investments Limited

* Indicates oral submitter.

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Appendix C

Transcripts

Inquiry into the future monetary policy framework

Finance and Expenditure Committee

5 September 2007

Members
Dr the Hon Lockwood Smith (Acting Chairperson)
Chris Auchinvole
Charles Chauvel
Hon Bill English
Jeanette Fitzsimons
Craig Foss
Hon Mark Gosche
H V Ross Robertson
Hon Paul Swain
R Doug Woolerton

Witnesses

Mr Selwyn Pellett (Submission MP/64)

Smith: Welcome to FEC. You are opening our inquiry into the monetary policy framework. I won't take any more of your time. If you could just assume colleagues have read your submission and draw us to the most important features from your perspective.

Pellett: OK, that's probably quite an assumption given the number of submissions you've got, so I'll just quickly cut it off and read through what I consider to be the salient points. But, first of all, who am I? I am a serial entrepreneur. I've started a number of companies. I am 50 years old. I've worked in companies from zero revenue to $1 billion in revenue. The companies I'm currently involved in export around $50 million. We employ about 150 people in total. A hundred of those are in New Zealand and they earn in excess of two times the New Zealand average wage.

Why am I here? I believe that our current monetary and tax policies are severely impacting on the productivity and capability of New Zealand to generate wealth. I think that we could be the Swiss of the South Pacific if we chose to, delivering a high-wage, high-growth, high-tech economy.

What I will argue. Other submissions that I have read will argue what inflation is and how it should be measured, etc. Frankly, I don't care. I will argue that to not address the current problems that we have with tax and monetary policy will result in the shrinking of the productive and export sector, resulting in long-term balance of payments issues, continuing the unproductive investment in asset-based wealth creation, all resulting in increasing the divide between the haves and the have-nots to the detriment of New Zealand as a whole.

Simple observations. People make out economics to be a very complicated subject, but I think it's very simple. We all understand mum and dad have to go and earn wages and bring money into the home. That's very simple, and if you want to increase the spending power of the country, they have to earn more. Well, the exporters are the equivalent of mum and dad, and if we don't support exporters, we don't have an income.

What is missing in New Zealand is that psyche of understanding exporters are the equivalent of mum and dad. If we don't export, we don't earn. If we don't earn, we can't pay. If we can't pay, we start selling. If we do sell, what are we selling? We are selling our current position on the OECD, GDP per capita, and it's going the wrong way.

My belief. We have a biased and unstable investment environment—it's biased. I have so far invested in four New Zealand start-ups. My investments were from tax-paid money. The losses of these companies in the early years were not deductible against my PAYE. I had to sell down my own shareholding to fund growth. The investments have paid millions in tax to the New Zealand taxpayers and have created hundreds of jobs, which in turn pay tax at double the average New Zealand wage.

If I had invested the same capital in property I could have borrowed at cheaper rates with less risk of interest rate exposure because I could have taken out long-term interest cover, had operating losses reducing my PAYE, all of this increasing repatriated profits to foreign-owned banks with no gain to our economy. This is seriously biasing the wrong desired investment opportunities for New Zealanders. The bleeding of our foreign profits to foreign-owned entities is eroding our wealth-creating ability.

Unstable. We have an unstable investment environment. Business is hard enough, export risks are already a huge challenge, but the manipulation of our exchange rate by carry-trade exposure and our interest rate fluctuations tied to domestic inflation makes investment in the export sector an unreasonable risk. Fewer and fewer people are prepared to take that risk, and that is reflected in our poor productivity performance, despite the country's record participation rates.

So suggested solutions. These are supporting my submission, but not necessarily in the same order. Ring-fence the losses in property investments so they are no longer deductible against PAYE—that seems to be the most obvious thing that we could do. Why should I, as a taxpayer, encourage somebody else to invest in property? My tax as a result is higher, while 200,000 New Zealanders get their PAYE reduced by investing in property. It is a negative outcome for the country. Increase the compliance to current legislation and trading in property. The legislation already exists, but we're not forcing compliance to it. Progressively introduce stamp duty on all property transactions in alignment with Australia, exempting the first family home—you could grandfather certain clauses, etc. I realise that the majority of New Zealanders have their wealth tied up in housing and it is a negative to start impacting on what is essentially their retirement fund, but progressively it could be introduced and needs to be. Expand the tools available to the Reserve Bank to control inflation so it doesn't kill the export sector every time we have housing inflation.

My suggestions, and you can see in some of the pamphlets there. Varying the GST is restricting the unproductive sector. I may buy a plasma TV under certain conditions and I may not, but every time our housing inflation goes up we get hit as an export sector. Both the interest rates go up and the exchange rate goes up as a consequence if the interest rate goes up, and frankly you could kill the entire export sector. People say: "So what? It's market forces." Well, the "so what" is the people, the lives, and the lost business opportunities. When someone goes bust, very few people get up and do it again. So we lose that business for ever, progressively we're gutting the infrastructure of New Zealand to compete on an international market. Every business that leaves for whatever reason—whether they go bust or they choose to go offshore—is a negative in terms of our wealth creation as a country.

My request. All sides of the House must know by now that we need to, at a minimum, remove the bias towards housing and property investment, and I say "a bias" because it's clearly biased under tax legislation. This requires some form of capital gains tax or a restriction on the money supply, and frankly I wouldn't care if you could introduce the ability for banks to say you can only lend so much money to housing, and then you can lend whatever you like to other businesses and investments. Either way you would restrict housing inflation and not affect the export sector. In fact, if you restrict the amount of money going into housing, you will actually positively impact on all the other areas of the economy.

As a productive exporter, please help all exporters and the productive sector by addressing these issues. That's it.

Fitzsimons Thank you, Mr Pellett, for your submission. You talk about capital gains tax in a secondary housing market. Is there any reason why you wouldn't

	apply it across the board to all investment income? Like, private people investing in shares don't get taxed on capital gain either. Isn't that still a distortion?
Pellett	I think it is a distortion, but it's a positive one. I do the analogy: we're a rock in the middle of nowhere, competing with the world. If you allow asset-based wealth creation—which is, I buy a house and I sit on it—what good has it done to the country?
Fitzsimons	So you're looking not just to address a current bias, you're looking to create a different one in favour of productive investments?
Pellett	No. As I said, as a minimum, address the bias.
Fitzsimons	Right.
Pellett	That's the minimum. Ideally you will actually create a positive bias towards the positive aspects of investment, which is, savings is one of the ones that's already been done, which is great. We already have no capital gains tax on both sides, whether it's property or a business investment, so I can't argue that that's unfair. I can argue that one is negative to the country and one is very positive. In the example I gave, it's a reality. I buy a house for a half a million dollars and sell it for a million dollars. What jobs did I create?
Fitzsimons	Sure, I totally agree with you on that. You also mentioned ring-fencing of the losses. Would you agree that capital gains tax wouldn't be much use in an issue of ring-fencing of losses, because you can actually manipulate it at the moment in such way that there is no capital gains left to pay by the time you—
Pellett	Yes, I could support that.
Fitzsimons	Obviously, you're probably not suggesting a capital gains tax should be a complete revenue earner for the Government, and so you'd be looking at revenue neutrality for that, and some offset for tax?
Pellett	I'm not an expert in tax legislation, but I would propose, just for simplicity and so people understand it, following probably the Australian model, which is a stamp duty - based capital gains tax so that every transaction incurs a tax, which is revenue-based.
Fitzsimons	But where do you put the revenue? Do you reduce income taxes, do you reduce business tax?
Pellett	You reduce income taxes.
Fitzsimons	Income taxes?
Pellett	Yes, while increasing savings—if I was in Government.

Fitzsimons Sure, and if I could just turn to one other point. The other point that interested me that you make is the question of bank lending ratios, you can only lend so much for property investments, and you've got to estimate the rest for productive investments. Is that done anywhere, and what operating experience do you have of that?

Pellett I haven't seen it done anywhere, and I think it would be philosophically difficult to introduce into any country, but the concept—actually I think there is one example, which I'm not prepared to quote at the moment because I don't have it sorted, but I think there is one example of banks doing an informal relationship with a bank, where they would support what amounts to start-ups as a quid pro quo for reducing tax rates.

Swain We are all trying to attack the same problem and the point you've outlined, Selwyn, we accept about the importance of the productive sector. The issue though of that banking system that you've just outlined—is that easy to wrought, given that there's some very good people out there who are paid to try and work around these things?

Pellett I spend a lot of time in the real world, and the real world accepts that there are—you just pay costs, and a percentage of whatever you pay disappears in unproductive outcomes. When I look at all the legislation that could be introduced in New Zealand, always the argument is: "But someone really bright will find a way around it." I think we've got one of the best tax regimes in the world in terms of making sure no one can get through the net, but frankly it's strangling us. It's not actually creating the right outcomes. So in my opinion I would rather let 10 percent of people get through the net while we encourage the right behaviour and progressively squeeze that 10 percent, than do nothing, which is what seems to be before us today.

Woolerton My question fits neatly into Paul's supplementary, and that is we have tried over the last 20 years to have an unbiased tax system, and your submission is saying absolutely that we should have a biased tax system towards production and productive enterprise. Is that—

Pellett I'm saying you've got a biased tax system right now.

Woolerton We've got a biased tax system towards what?

Pellett Property. OK, so at the very minimum the outcome should be to remove that bias, so that's at least a level playing field then with other investments.

Woolerton And then, if possible, go on to—

Pellett I would. I mean it's standard investment. One creates jobs and incomes and keeps our kids here, and the other one encourages them to go to Australia or somewhere else in the world to earn a deposit for an over-inflated house.

Woolerton	I happen to agree with you.
Chauvel	I suppose, just following the questions about the distortionary effect of the tax system, you advocate re-gearing it so that higher risk industries, if you like, attract a lower tax rate and, therefore, presumably greater investment levels?
Pellett	That is done elsewhere in the world, where higher risk investments can receive a lower tax rate or a better investment return.
Chauvel	On the assumption that the higher the risk, the higher return for the nation?
Pellett	Somewhere in our history we got into this level playing field and everything's equal in market forces and all this rubbish. We happen to be a rock in the middle of nowhere. We have only got limited investment dollars and if we don't use them wisely—you know, we're a Third World country in 20 years' time. So we'd better get real about where we place our investment dollars.
Chauvel	And the answer that you'd give about the differential distortionary effects of giving those effective incentives would be the same that you gave to Mr Woolerton—that, look, there'll always be avoidance, but in the end, it's worth doing for the reasons you've set out?
Pellett	Yes.
Foss	Just one point. I think IRD are on record as saying they don't believe there is a tax advantage in property, as you outline in here, just for the record. A couple of things—with the capital gains you propose on, say, housing, many forecasters including the RB are predicting a stabilisation or at least a fall in house prices over the coming months. So should people get a tax credit? Should they get the other side of the capital gains tax if their house price falls?
Pellett	Well, they will, because when they sell it the stamp duty will be less.
Foss	But that's just the stamp duty, not the principal. So stamp duty's staying as a tax.
Pellett	I'm saying if you use stamp duty as the capital gains tax, it'll be self-levelling in that respect.
Foss	And you also suggest to tie our dollar to the Australian dollar, or perhaps—
Pellett	I don't seriously propose that.
Foss	It's in your submission.

Pellett	I know it is. When I went through the opportunities that were before us—and I think you read at the end of that I produced that submission in 1 hour. So I went through it very quickly looking at what I considered could be options before us, and at that stage the exchange rate was 80c and looking to go higher. I am sitting there thinking this is ludicrous, we are being manipulated by foreign forces, something has to change. That was an option; I don't think it is the right option, frankly.
Foss	Just finally, do you appreciate that's now 71c or something. Did you hold these same views when we were at 40c?
Pellett	In terms of housing? Yes, I did. I've been proposing capital gains tax on housing for 20 years, so this is not a new thought.
Foss	But the other bias towards the export sector—
Pellett	I've been campaigning for 9 years, which goes back prior to this about high-tech investments, so yes.
Foss	So at 40c—I suppose you just campaigned harder now, at 72c or whatever—
Pellett	One is a passive investment and doesn't generate jobs or futures for our kids; one does. Tell me what the difference is.
Foss	Right so that's the real approach here, isn't it? It's actually that tax on property/land as opposed to an always productive investment.
Pellett	It's also a psyche. I haven't looked back in history to see where this legislation came from—that we allow losses on property to be deducted against PAYE. But from the moment that was introduced, we had a bias towards investing in property, and the New Zealand psyche is you buy five houses. I have employees who, at 28, had five houses, and I am sitting there—that's the ridiculous—
Foss	Do you not think that's because of inflation—because they wanted to be up there financially because they were getting diluted out?
Pellett	Because it's built into our psyche that's how you create money.
Foss	Because we've had high inflation so people can touch those bricks and mortars to protect their investment.
Pellett	But again, it's part of our psyche, whereas if that same investment, all of those investment dollars over the years, were poured into, for example, our stock exchange, who invest it in and increase the value of our companies because there were competitive forces, which today there aren't, so all our companies get sold at low rates, our wealth creation goes offshore, and it's just a very big vicious cycle. So our companies are undervalued and we lose them.

Robertson	Why do you think successive Governments have shied away from capital gains?
Pellett	It's political suicide, which is why I'm here, because I wanted to say to both sides of the House you have to sort it out together. My opinion is both sides of the House are going to go down when the public finally wakes up to the fact that we're losing businesses because this issue has not been addressed. It will reflect very badly on the decision makers.
Gosche	Could you just explain your possible solution No. 5 about variable GST. How would that work?
Pellett	I understand there'll be a lot of compliance complexity around that. In simplistic terms, do I buy more food because I feel wealthy? The answer is no. Do I go and buy a new fridge because I feel wealthy? The answer is no. If I feel wealthy, do I go and buy a Ferrari or a Lamborghini or a new car or a plasma TV? The answer is yes. So logically there's a point at which there is a dollar figure that doesn't affect everybody's daily life, but there is another figure which says "Stop consumption". So pick a number—say it's $2,000—and say inflation's out of control, you make a capital purchase, or you make a purchase above $2,000, maybe the GST just suddenly went to 25 percent, because we're in an inflationary period. So it's not all goods; it's a dollar-targeted figure that doesn't affect everyone's grocery purchases at the supermarket, which means as a percentage of goods sold, how many would be affected—and I don't know the numbers, that's not my job, I'm just creating an opportunity. But it may only be 10 percent of all the goods sold in New Zealand. For example, it wouldn't affect petrol, it wouldn't affect groceries, it wouldn't affect buying a replacement refrigerator, but it will stop me buying a brand new car.

Professor Viv Hall (Submission MP/52)

Hall	Some of you know the background I bring to this, but, just very briefly for the benefit of others, I was a non - executive director of the Reserve Bank of New Zealand between 1992 and 2002, and that included the last period in the mid-90s when we were under considerable pressure with monetary policy. More widely, however, I have lived and worked in Sydney and Canberra from the early 1970s to the late 1980s, and I have followed the Reserve Bank of Australia's monetary policy during that period and since then. I've spent approximately 6 weeks in economics departments in the United States—in the Federal Reserve Bank of St Louis and the Federal Reserve Bank of Chicago—so I've observed the US system. Then in 2003 I had 3 months at the Hong Kong Institute for Monetary Research, which is a wholly owned subsidiary of the Hong Kong Monetary Authority, where I looked at governance arrangements and performance for Hong Kong, Singapore, Australia, and New Zealand. I've also kept a watching brief on the activities of the Bank of

England and the Bank of Canada. So I hope I bring a global, as opposed to a New Zealand-centric approach to that.

Just very briefly, key elements of my submission under three headings: (1) New Zealand's current monetary policy framework; (2) the operational challenges for that framework; and (3) what might provide greater help.

On New Zealand's current monetary policy framework, it's widely recognised internationally—perhaps not so much in New Zealand—that the basic framework is a fundamentally appropriate one and where you've got something that's basically OK, my view is that you don't try and fix something that's not broken.

What have been the operational challenges for monetary policy? More recently, these have been challenges which both the Reserve Bank of Australia and the Bank of Canada have also been facing as soft commodity economies. The operational challenges, in my view, have not been associated with an inadequate monetary policy framework, nor the lack of additional monetary policy instruments. Rather, they have been associated recently with a complex combination of pressures on our economy. In particular, we've seen those from the international environment in terms of oil prices. That's been supplemented by pressures from fiscal policy—from the demand side of fiscal policy more recently. We've also had the benefit of a very lengthy period of sustained economic growth, and that is great, but it also brings challenges in the sense that some of our productivity performance, therefore, slips as a result. Hence it's my view that those two latter aspects—fiscal policy and attention to policy affecting productivity—have been insufficiently supportive of monetary policy in the short term and the medium term in recent years.

What might provide greater help in a broad sense? First of all, then—fiscal policy could have been helping further from the demand side to lessen those pressures. There is evidence in the documents in the Budget Statements and so on in support of that. The pressures, if one takes one measure, the fiscal impulse measure over the current and the next 2 years, are equivalent to about 2.5 percentage points of GDP over the current and the next 2 years. Over the medium term, more concentrated focus on the supply side aspects of the economy. In other words, those which would lessen the supply side constraints to growth—in particular, infrastructure and skill. There has been work going on along those lines. There's been an accumulated backlog, but clearly further focused attention, which would impact on productivity growth, is pretty crucial, but you can only do that at a certain rate. So those two in a broader sense—fiscal policy and policy affecting productivity.

In a specific additional instrument sense—I have read the various reports recently. I haven't yet seen a sufficiently compelling case for an additional instrument that is other than temporary or doesn't have some adverse effects on other aspects of the economy. A couple of areas, which I've suggested on pages 3 and 4 of my submission, which weren't really considered in those reviews are the issue of more active counter-cyclical use of GST tax rates—there are pluses and minuses in that area, which we can go through if you want.

The second area is the issue you've just been talking about: the issue of capital gains at the same rate as all other income. My view is that while there are pluses and minuses for each of those, they should be considered in the context in which they are raised, both in the particular in the context of the efficiency and fairness of the tax system— this is how you should be looking at GST and capital gains. There might be some peripheral and temporary benefit to monetary policy, if one were to be able to operate those things at the right time, but by and large, fiscal policy has a pretty difficult job—changing things flexibly and at the right time. So I think—look at those in the context of the proper fiscal policy rather than kid yourselves that, in fact, they are going to be a significant help to monetary policy.

The third area under this, which I would not normally have raised in my submission, but seeing the governor of the bank and the Minister of Finance said that they might consider changing the policy targets agreement if there were to be some fundamental change come out of this committee, I thought I should say what I thought on that. My view is that on the grounds of time consistency of policy one shouldn't change the policy targets agreement again. It's been changed in an evolutionary sense over the years, but there are disadvantages of keeping on changing this. There are some relative weaknesses, in my view, in clause 4(b), and I can elaborate on those if you want me to. But, by and large, I don't think that weakness is sufficient to warrant changing the policy targets agreement.

The final thing is if you are considering making a material change to anything affecting the monetary policy framework it's my view that just as took place following the Svensson review of monetary policy, you should apply the principle of the maximum bipartisan or multipartisan support for changes. In other words, if it's not fundamentally broken don't try to fix it, but by all means keep looking for something that can be sustainably useful.

Smith — Professor Hall, thanks very much for that very wise presentation to us.

Swain — I think it's a good submission and you've kind of wandered around the traps that we've all been wandering around to try to come to grips with what we might do, or what we might recommend. Just on a personal basis I agree with your last point about the framework, but we will have debate and discussion about that. There are other things you mentioned here, which, as you say, have been tackled, which is the infrastructure issue, productivity and skills. I think your point here is that they are long-term sort of things—those that you can't do at once, there's no quick fixes. And then you're into the concept of the way in which property is treated.

If there was one thing that you would be recommending out of all that as a sort of a priority—given that your basic principle that we don't want to be fiddling with the monetary framework but we're looking at other things that surround it—what would that be? And, secondly, what is your view on the issue of the impact of housing, which is the big issue of the day, on monetary policy? So is there a possibility of carving out something around housing; either we've heard by way of a capital gains tax or a better compliance regime, or stamp duty we heard this morning, which got rid of sometime ago? So going to your questions—maybe that last one first, around the housing area—your thoughts on that. And, secondly, if there was one consistent thing that you wanted to recommend what would that be, which might help us if we think about what we might recommend?

Hall — You mean a consistent thing in terms of a new instrument or—

Swain — Yes, a new instrument, yes.

Hall — I think my view is clear on that, unless some rabbit comes out of the hat. I haven't seen an actual or potential new instrument that I could recommend. I think we just have to focus on doing better on the things that we already have.

On the housing stamp duty and so on issue, I think there are dangers in singling out housing on its own. Housing is one class of asset within the economy. It's cyclical. I've done some research on prices and cycles in housing and so on. These things do move pretty substantially over time. Sometimes they do go down in real terms. In fact, they certainly go down in real terms. Sometimes they go down in nominal terms. So the issue in the context of New Zealand's inflation is actually non-tradables inflation overall, of which the housing component clearly in an indirect sense contributes something. We don't put the price of houses, per se, in the CPI, it's the facts that go into the housing sector—labour, materials, and local rates and all these kinds of things. In other words, it's the non-tradables aspect of our economy overall that is doing that. So I wouldn't focus primarily and solely on housing. If you want to investigate ring-fencing, if you want to investigate capital gains tax, by all means do so. But do it in terms of looking at the tax system as a whole—in other words, housing relative to other forms of investment and so on.

Stamp duties and these other price-based instruments: I've looked at those and thought about it a bit, and also quickly looked at the Australian system with that. I note that in New South Wales, in particular, they have put stamp duty on and off and various other specific instruments on and off. By and large, the difficulty with doing it in Australia has been that investors would say: "Well, forget New South Wales, I'm going to put my money in Victoria.", and this kind of thing. So New Zealand has a bit of an advantage in that. Because it's a priced-based instrument I wouldn't rule it out entirely, but I guess you have to do it in the context of knowing that you are adding an extra price on a particular asset class relative to the other alternative asset classes. If there's too much money chasing too few assets or too few goods, well, that's not going to make the difference.

English Just with respect to housing—and you make the point it's been picked out as one asset class—wouldn't it, in a pure monetary policy sense, make just as much success to say: "Well, dairy prices are too high, so we're going to impose a penalty tax on dairy incomes, because clearly an extra 2 percent of GDP price shock is going to make monetary policy a bit more challenging."? Would it be just as logical? Is there any particular reason why—I'm trying to get a hang of why there's so much moral panic about housing because of its very indirect inflationary effect and none about dairy prices, which have a direct effect. I think it's just 2 percent of extra GDP turning up, or 1½, whatever it is?

Hall We're in the same ballpark on that—namely, you don't single out a particular product or asset for specific treatment. There is one difference, I suppose, in the sense that if the shock to the dairy industry comes from offshore, which is out of our control, the Reserve Bank can discount that—in other words, look through it temporarily. But I wouldn't use that as an argument for saying: "Hence you should put a tax on these things."

English It would sound ridiculous wouldn't it—

Hall Yes.

English —if the Minister of Finance said: "Well, I'm worried about the inflationary effect of dairy prices", because it's real, even if the bank governor only looks through it as a measurement activity. But it's real, so—

Hall Sure, I'm not advocating putting a stamp duty on houses, or singling out the housing sector. I've emphasised the fact that it's non-tradables inflation, which has been stuck at 4 percent since 2002, so it's broadly based in terms of too much money chasing too few goods and too few assets in that sense. Some have suggested that the Reserve Bank should therefore be primarily targeting non-tradables inflation component of CPI rather than the CPI overall. I've seen a fair bit of research on that, and, by and large, those models would suggest that, yes, you can get a bit of mileage out of that. Unfortunately that would go against the tenor of clause 4(b) of the PTA, of greater flexibility. I mean, if you're homing in on non-tradables inflation, and obviously that's of indirect assistance to the export sector, generally then, by and large, you're going in sooner and for a longer period of time and squeezing the economy more. Hence there'll be greater volatility on output and the exchange rate if you go in harder on non-tradables inflation. But that's an operational issue for the governor.

English Another argument that I'd expect we'll see a fair bit of in the submissions is that we should target the exchange rate instead of the inflation rate. The problem here is that exchange rate volatility so why not fix that. What's your comment on that aim?

Hall My first comment is that I read Dr Karacaoglu's submission suggesting we should look at the Singapore model. I think it's a very good submission and you should look at that aspect. I looked at these issues when I was in Hong Kong trying to understand both their governance arrangements and their performance, and there's no question that Singapore has performed very well. On Singapore they have a different governance arrangement for conducting monetary policy, their economy is very different, and their people are very different in terms of their attitude towards those things. Especially in the short run, and given that our central bank doesn't have a huge amount of experience in intervening in foreign exchange markets, the probability of being able to make a Singapore model work in the foreseeable future is virtually zip. There'd have to be fundamental changes, including to the parliamentary system, I guess, for decision making, to be able to do that.

English And would it be fair to say that whatever volatility you take out of the exchange rate it will appear elsewhere in the economy?

Hall Correct.

English I remember one episode in Singapore where everyone's pay was cut 10 percent as their way of handling external pressures.

Hall I think this does raise an important principle. Where you have external shocks, and some internal shocks, the adjustment has got to come out somewhere. And the economic literature is quite clear on this, that if you've got output inflation, interest rates and exchange rates, if you have less volatility in one it's going to come out somewhere else. Obviously we've seen significant volatility in our exchange rate. It's within the ballpark of comparable economies, but that doesn't make it any easier. The other thing, just to go back to your fixed-rate stuff, New Zealand has had fixed exchange rates in the past. It's attempted to run a crawling peg and so on, and that culminated in the economic and constitutional crisis of the mid-80s. Enough said, I think.

Woolerton Do you—and I'll just ask you the question—believe in a level of unemployment? We're talking about productivity and restraint with all our stuff, that's the first one—the changing of GST. Tell us a wee bit more about that, and there are some capital gains tax, and you just said it would need to be at the same rate as other income, and you did say that that was very complex, and I was wondering whether, to keep the chairman happy, if you could also give a slight over-view of the complete subject?

Hall — In the time we have available, I think no. And I would have to say to that—

Woolerton — Perhaps we'll leave that question off then.

Hall — Yes, sure. On the GST changes there have been several proposals put along those lines. I've already mentioned the fact that if one adjusts it upwards then that clearly penalises domestic buyers, and that's obviously a plus. If there were to be revenue coming and going, which affects the fiscal balance, then one would have to be very careful as to what happened to that revenue. For example, if you've got inflation problems then you don't go out and spend it straight away. You have to decide what to do about that. I think the two challenges are: can you get it right in terms of timing, given that we've regularly been subject to shocks, and in an MMP environment if that were to go through the parliamentary system, just as in the US—I mean it's very difficult to get the timing of fiscal policy right. So that raises the issue of the second one: is there to be some sort of independent body, in which case who would it be? Can the Reserve Bank maintain its operational independence given the existence of that body, and who's overall in charge? Obviously the Minister of Finance.

Chauvel — Why wouldn't it be just the Reserve Bank itself?

Hall — Well, that gets into issues of it's actually a fiscal policy item, and so would have to be something like the Reserve Bank or an independent body advising the Minister on it, and the Minister actually taking the decision—that would be my understanding. Is one willing to change up as well as down?

On the level of unemployment, that's not primarily a monetary policy framework issue. We have seen significant movements in New Zealand's unemployment since the mid-1980s. We had to squeeze the economic system from 17-odd percent inflation down, and unemployment went to 11 percent, and that kind of cost is one that we don't want to bear again by letting inflation get away. So it's inevitable that where there is inflation and disinflationary processes you will have changes in the workforce, changes in unemployment. Some of that is due to labour force participation voluntarily and so on. The interesting thing I think about the mid-1980s onwards was that in essence there was a lot of structural change in the workforce, so unemployment can be for short term. We've seen significant reductions in long duration unemployment, and our so-called natural rate of unemployment—namely, reflecting our institutional conditions, benefit conditions, skills—has come down a long, long way from what it was. The main thing is to have sufficient flexibility, if there is increased unemployment, for people to move into alternative jobs, alternative industries.

Smith: Colleagues, I going to have to I interrupt at this point. Professor Hall, many colleagues would like to question you further, and with your approval I'm going to ask if we could have you come back to us again. I've got a video linkage that was meant to be established at 11 o'clock. Many colleagues would like to question you further. I just think we won't have a chance of keeping up to timetable. If you're prepared to come back we would organise at a time that suited you, when the committee is meeting.

Hall: I'm happy to come back, subject to negotiating a satisfactory time.

Smith: There are many more questions and colleagues have found your submission very informative. Your experience is very appropriate for the inquiry, so if you are prepared to, we would like to have you back. Sorry to do this to you, but I can just see us getting further and further behind this morning.

Hall: Sure. I appreciate that.

Smith: Thank you so much.

Hall: Well, thanks for your questions.

Mr Keith Rankin (Submission MP/71)

Smith: Mr Keith Rankin, submission number 71. Keith, can you hear me okay?

Rankin: Yes, I can hear you.

Smith: Excellent. Keith, welcome to the Finance and Expenditure Committee. Sorry to hold you up a few minutes. We are obviously under real time pressure. If you could focus on the particular aspects of your presentation that you would like us to focus on, please do that and leave us a little time to question you. So fire away.

Rankin: Thank you, Lockwood. The main points in my presentation—I guess there are a number of them, but the first one is to make the distinction between inflationary pressure and inflation. Inflationary pressure itself does not necessarily lead to inflation, and it can actually have beneficial effects. For productivity to improve, inflationary pressures will often assist by creating the incentives that lead to improvements on the supply side of the economy that will alleviate long-running inflationary pressures. So pressures on their own are not necessarily a problem.

Second point is the distinction between acceptable and unacceptable inflation. The economics textbooks, they emphasise that inflation is a process, and so therefore unacceptable inflation is an ongoing process of price increases more than, say, 3 percent. So whenever prices exceed 3 percent for even a year or two does not necessarily make it a process. On account of that, the best way of treating an episode is not necessarily to apply a cure. Sometimes it is best to simply wait for that episode to self-correct.

The next thing I would like to note is just about the distinction between cost inflation and demand inflation, and the actions of the Reserve Bank quite distinctly add to the cost of the economy and the way that interest rates add to costs, some are more overt and some, if you like, are more covert. The cost impacts on a capitalist economy of high interest rates are significant. So what we are actually seeing with monetary policy is cost inflationary pressures opposed to attempts to reduce demand, which will hopefully reduce inflationary pressures, but it is a race between aggravating inflation by raising costs and relieving inflation by reducing demand. It seems to me that the benefits we get from doing that are often considerably outweighed by the costs of such a process.

Finally, in terms of effective monetary policy so far, I guess there are two more main things I will comment on. It certainly seems clear from the evidence that when we started to tighten—going back to 2002—that it has been completely ineffective in that non-tradable inflation has sat at about 4 percent for the whole time. So policy has clearly been ineffective. And even if we look right back to the 1980s, the only way we can judge the effectiveness of monetary policy is by having a clear counterfactual, which is what we believe would have happened had that policy not been applied.

The best way to derive such a counterfactual is by looking at other countries, where our inflation policies were not adopted. Examples in the 1990s would include Australia and the United States. They have similar inflation rates to us but without the types of policies that we applied. Likewise, in more recent years, other countries have had lower inflation than we have had while have not been tightening or raising interest rates the way that we have done. So if we had not raised interest rates as much as we had done, it is quite likely that our inflation would have been lower rather than higher.

The final comment to make relates to the exchange rate, and it appears that the balance of payments implications of raising interest rates and drawing a lot of money into the country as a result of those interest rates are simply not understood, and the impact on the country's balance of payments is far more serious than the benefits that we may get from having low inflation or deflation in the tradable sector of the economy.

English Can you just explain a bit more on the last point you made, where I think what you meant was that the effect of large capital inflows generated by high interest rates is worse than the effect of higher inflation, is that right?

Rankin Yes, yes, yes. We see that what has happened is this imbalance or bifurcation, where the inflation of the non-tradable sector becomes distinctly different from inflation in the tradable sector. So we have been seeing over the last year inflation rates of about minus 1 percent in the tradable sector and of about 4 percent in the non-tradable sector. What happens when we raise interest rates is that the tradable sector inflation goes down even more for a short while, but then when interest rates stay high and the exchange rate stays where it is for a while, even that tradable sector inflation comes back. So we actually find that for a short time, we do get some slight lowering of inflation because of the rising exchange rate. It does not last, but the problems that result from these capital inflows that necessitate us to have a current account deficit, what happens if we have autonomous capital inflows that are driven by high interest rates or driven by low interest rates overseas, we get much more money flowing into the country than we need even to service our current balance of payments deficit. That simply puts upward pressure on the exchange rate.

An inflow on the capital account of the balance of payments necessarily induces a deficit on the current account of the balance of payments, and that deficit is really adding to our—indebtedness as a nation—really adds to the amount of our GDP that is claimed by foreign investors.

English So you talk in your submission about a generally relaxed stance of inflationary pressure?

Rankin Yes.

English And a market-driven approach to setting interest rates?

Rankin Yes.

English If you take the current bit of the cycle that everyone is worried about, how would it look under a regime of a more relaxed stance on inflationary pressure—you know, in hindsight, what would it look like?

Rankin What normally happens is the business cycle has its own impact on interest rates. As we have a business cycle expansion, interest rates tend to rise, and in a contraction, they tend to fall. What monetary policy seems to do is to aggravate that effect by pushing interest rates higher in a business cycle expansion than they would otherwise be. My argument is that the normal ebbs and flows of interest rates in the business cycle are sufficient to allocate credit, to manage the market for credit and so on. So, in other words, interest rates would have risen through the expansion but not as much as they have risen as a result of the activities of the Reserve Bank.

English What do you think the inflation track would have been?

Rankin I think the inflation track would have been roughly around the 2 percent mark, but with the difference between tradable and non-tradable much less. So, in other words, tradable would have been higher but non-tradable would have probably been in the 2 to 3 percent mark, I believe, had we not been pushing interest rates up to higher than they would otherwise have been. The necessity to have a high return on capital, the cost and impact of these unnecessarily high interest rates has caused non-tradable inflation to be higher than it otherwise would have been.

Swain I think everybody is sort of on the same page in terms of interest rates, exchange rates, and balance of payments issues. I think that is probably why we are here, actually, fundamentally. The problem with counterfactuals, of course, is that it is a comparative thing—you are looking at what might have happened and, of course, we will never know that. So the question really is that in many of those other countries, there will be some other fundamentals as well that are different: savings regime, productivity arrangements, etc. I am just wondering whether what you are saying is, I think, from what I have read, being more relaxed as inflation starts to move and not come in and jump on the brake.

Rankin Yes.

Swain I suppose the two questions are: how long do you wait before you actually do really start to sweat; and, secondly, are there some fundamentals that need to be in behind to support that ability to wait?

Rankin How long you wait depends. Once you have identified that any inflation that exists has been a process, that means that it is something that needs a cure, because it is an ongoing process, then it is a problem. If it is simply an episode, like if you get a cold or something; if it has clearly not gone away after a couple of months or so then you need to treat it. But these things normally go away after a certain amount of time, if it is just an episode. But once it is clearly a process, policy has a role to play.

Our monetary policy, we are not even waiting for the inflation to happen. We are anticipating inflation and actually treating the problem before it happens, but most of the monetary policy theory relates to how you deal with a process that is well under way and appears to have generated expectations, and those expectations are what are fuelling the process. We do not have any of that inflationary process at the moment, so we are making a problem for ourselves that we do not really have at the moment. But by adding to costs in the economy, by making it harder for businesses to invest, we are creating an inflexibility on the supply side of the economy, which means that an inflationary process is actually more likely rather than less likely.

About counterfactuals, all policy implies some kind of counterfactual—it is not always what is specified—to assess whether policy is working or not. Everybody in that debate must have some counterfactual as a reference to what would have otherwise happened. The implied counterfactual here is that inflation would have been tracking 5, 6, or 7 percent were it not for the policies that we have introduced. My suggestion is that inflation would have been tracking more like 2 to 3 percent without any great problems had we not intervened to the extent we had in monetary policy since 2002, and especially since 2004.

Swain Actually, on the fundamentals, I mean, there are other things hovering around it—productivity, savings regimes, etc. Have you got a quick comment on that or not?

Rankin Well, the productivity we need to have flexibility for the supply side to respond, and indeed inflationary pressures is part of what makes it possible. If we have low wages and high interest rates, we are very unlikely to get productivity gains. We want to have incentive to substitute from labour to capital. High interest rates, relatively low wages simply doesn't cut it.

Fitzsimons Good morning, Keith. Are you concerned that the way in which banks are aggressively pushing credit on to consumers at the moment is contributing to both the exchange rate and the balance of payments deficit—I think particularly credit card limits and also the way that house price inflation is being used to encourage homeowners to up their loans to the maximum in order to pay for the overseas holiday and the new boat and car? Is that connected with your view of the disparity between the effect the bank has had on the non-tradable sector and the tradable sector, and could you elaborate on that connection?

Rankin Okay, well, in terms of what the banks are doing by raising their funds overseas, by issuing the Uridashi and Euro-Kiwi bonds and so on, they are drawing in this autonomous capital inflow. Of course, they were seeing significant opportunities to profit, because interest rates are low overseas in some countries, they are very high here. By supporting that very big interest rate differential—and we were one end of the spectrum; Japan and Asian countries are at the other—we are just creating absolute heaven for the speculators , because these are unexploited profit opportunities, which normally close, but they are not being allowed to close, because our monetary policy is like a price floor—it is creating a price control that prevents the market from doing what the market will normally do.

Now, having got that funding into New Zealand, the banks then have got to decide how to profit from it by who they are going to lend to.

Clearly, with the high exchange rates, anyone in the tradable sector, which is manufacturers, service exporters, and all exporters are not going to be the flavour of the month for banks to lend to, because they are clearly struggling under the high exchange rate. So the banks are going to be much more interested in lending anywhere in the non-tradable sector, which is booming, and especially lending with collateral. It is a lot less risky for them to lend to anyone who holds collateral, and it is in the areas like shares or lending on property that is clearly the most attractive. So the interest rate differential is bringing the money into the country. It is apparently less risky to lend where there is collateral and where prices seem to be rising, which is in housing.

That is a huge imbalance, so it means that we have an inflow of money instead of a reduction in the money supply, and it means that there is a huge flow of resources in New Zealand going from the tradable sector to the non-tradable sector. If we are going to trade our way out of difficulties as a nation, that is the exact opposite of what we need.

Foss

Just a quick one—those Japanese investors, of course, they are not lending against New Zealand collateral; they are lending against the security and collateral of the World Bank or someone like that. But isn't it fair to say that actually without the 100-plus billion that has been let into New Zealand, without that, our interest rates would actually be a lot higher in the 2, 3, four year— Who else would be leaving New Zealand those funds?

Rankin

The money is coming into the country, attracted to high interest rates. If high interest rates were high for some other reason, then that money would be coming in, because it is low in Japan or China or wherever and it is high here. So whatever the reason for the high interest rates, that differential creates an unexploited profit opportunity, which will draw that capital here. Now, they are just lending to the banks through the bank bond issues. It is the banks, of course, who are then making their decisions about what to do with all that funding, and they are select— they are lending to the dairy sector, sure, but much of the manufacturing and other exporters are not investing at the moment, basically because they are contracting. So what the foreign investors are doing is simply taking advantage of the interest-rate differential, and good on them in a way—that is what the price signals are telling them to do.

Whatever the reason for interest rates being higher here will attract that money here, but normally when profit opportunities are being exploited, they close, that differential will narrow. But the Reserve Bank, by holding that differential, through its tight monetary policies is preventing the price differences in different countries from narrowing, creating a process by which money keeps coming into the country, and there is no obvious end to that process.

Smith: Gentlemen, we are going to bring this to a close. Keith, I would just like to ask you quickly one question. In relation to your argument about a more relaxed approach to monetary policy and the counterfactuals you mentioned, if you go back to the 1970s and early 1980s—and I am old enough to remember those times pretty well—when there wasn't an independent monetary policy regime in place, what went wrong there that resulted in such massive levels of inflation? Just very quickly.

Rankin: I mean, it is a long question, and you would need quite a long look at the whole thing and changes. A lot of the inflationary pressures in the 1970s and 1980s were international, and monetary policy systems in New Zealand changed. But we do see some parallels with what has been happening here in the last year or so with 1986 and 1987 and the way, after the exchange rate was floated, monetary policy allowed interest rates to be much higher than they otherwise would have been, drawing a lot of money into the country, and that was invested in commercial property and shares, and we saw what happened in the bust after that.

In the 1988 to 1992 period, we actually needed some more active monetary policy because, as we saw in the States in the late 1980s and also in the States after 9/11, there was a role for monetary policy when there was a real crisis, and I would argue from 1988 to 1992, New Zealand was in its second-worst economic crisis of the twentieth century—the worst, of course, being the Great Depression. So it is a bit like crying wolf. If we keep applying monetary policy all the time, every couple of months or so, then we lose our ability to apply it when we really need it, when we have a real crisis.

Smith: Thanks very much, Keith, for those answers. Thanks for your time you have given us this morning.

Rankin: Thanks very much.

Mr David Tripe (Submission MP/36)

Smith: Now we are on to David Tripe, submission 36. David, if you could join us. Sorry to keep you waiting. If you could focus on the parts of your submission that you would like us to pay most attention to.

Tripe: Okay, well, if I make a 1-minute introductory comment. The key points are that the terms of reference for this committee identify some problems with the New Zealand economy. Our suggestion is that these problems with the New Zealand economy are not necessarily those that are most significant. We also need to look at the balance of payments, current account deficit—and I prefer to start with that, rather than looking at the level of overseas debt—because one of the consequences for the balance of payments, current account deficit we have is that we need to draw in that amount of capital every year, and some of it is absorbed by the banking system. It does not all have to be absorbed by the banking system. Some of it ends up getting absorbed by foreigners buying New Zealand businesses. That is the alternative, but basically one or the other of those two has got to happen.

Our view is that monetary policy is probably generally OK, although it may, at times, have been a little bit slow in its response. Particularly over the last 3 or 4 years, we have probably seen some reluctance overall to raise rates as quickly as they should have been. It is somewhat encouraging this year to see that the Reserve Bank has decided that some of the previous concerns about the consequences of raising rates should be disregarded. It should get on and raise rates and try and get rid of the inflationary pressures out of the New Zealand economy. That was very quick.

Swain — Well, thanks, David. I thought it was a very good submission. I stayed with it most of the way. It is always a good test. I mean, there are lots of things in here, and maybe when we have formulated more questions we might engage with you further. I felt that there were some quite interesting points in here, which I had not quite thought of until I read your submission.

I think it is in paragraph 22, or around about there, you say that there are some issues around, for example, figures around total house lending and it is not broken down, I think, is the point you are making in this submission, and you are saying that might be quite useful—we have not got it, Obviously the housing thing, there are kind of two arguments to debate—why would you pick on housing and why not something else, but other people are saying housing is part of the reason why we are in the problem. So my question was if we had the additional information that you are suggesting it might be useful to have, what could we do about that even if we had that information?

Tripe — It would give us a clearer idea of the extent to which some of the borrowing on housing is being used for investment and investment in various categories. We would find out what was being invested in purchase of second properties, and that may be nice to know but not necessarily of great economic significance. What is of more economic significance is the extent to which housing finance is being used to fund small business. There is a lot of argument from time to time as to the extent to which the banks are assisting or not assisting small business. In essence, it is actually very hard to find any information which actually says with any certainty that the banks are not helping small business. It would be useful to actually know what the aggregate flows of funds were to small business, and, to that end, it would be useful to have a more extensive breakdown of what is happening with housing finance.

Swain — Would that be hard to disaggregate?

Tripe Well, it is going to depend on the quality of banks' databases individually. Some banks will be able to clearly identify what their customers borrow for and the extent to which that is used to finance small business, to finance investment properties. Others will perhaps be more in a situation where they have been lending without such concentration on some of the detail, or it may be simply the case that they know the detail but the banks' database does not have any basis for actually recording that information.

Auchinvole Some of it would be indiscernible too. In my own small business, when I was operating that before I got here, my house was my asset, which guaranteed my cash flow and credit opportunities. It was not really recorded as showing that.

Tripe There certainly will be some lack of clarity around the margins of the data. At this stage, I tend to work on a ballpark figure, but probably of that $150 billion-odd of housing lending there is probably $40 billion to $45 billion of small business lending. There is probably $40 billion to $45 billion of lending for investment purposes, and the balance, which would be around $60 billion to $70 billion is probably lending to people who are actually struggling to buy a home. Now, if we are actually going focus on the ratios of disposable income to levels of housing debt, that is actually a much more significant and relevant figure than this data set we have got otherwise, which is really like a bowl of soup that we are trying to cut into portions.

Foss I wonder if you could go back to a couple of points in your submission MP/5. Just talking about actually the current account not being quite the bogey that it is perceived to be. It is more of a reflection on, as I read this, confidence at the domestic in the private sector in the economy. Can you expand on that? Also the bit at the start there, where you said: "Actually, it is either borrowing of capital from overseas or selling of New Zealand assets to overseas holders.", because you use those in the same breath.

Tripe Yes, well, to some extent, we do have a bit of a chicken and egg problem, because we have got several things occurring simultaneously. There is a very large balance of payments deficit—that is very large by international standards—which New Zealand can probably get away with only because it is such a small country, therefore it falls off the radar a little bit. One of the consequences of that balance of payments deficit, of course, is that that has got to be funded, and, as we know, that is funded by capital inflows. Those capital inflows have got to find a home somewhere in some New Zealand assets. So that is taking things in—

Smith Could you just explain that, David? When you say it has got to be funded, I mean, there is nobody out there with a big stick, saying that you must put capital investment in New Zealand. It is funded by definition, as I understand, by the way we define a current account

	balance. The way it is defined, it is funded. If not enough capital flowed in, what would happen? Our exchange rate would simply—
Tripe	Certainly, if we looked at the current situation and we tried to stop the net inflow of capital, it would require a massive adjustment in the exchange rate. We would be likely to look like instead of having an exchange rate of 70 cents US, we may have an exchange rate of 35 cents US. Instead of having petrol $1.60 a litre, we may have petrol at $3 a litre.
Smith	So that is the risk around the current-account deficit is the potential impact on the exchange rate?
Tripe	We actually need those capital inflows. Well, one way of looking at it is to say that we have got the current-account deficit because we have got the capital inflows. The other way of looking at it is to say that we have got the capital inflows because we have got the current-account deficit. The two of them are linked to each other inexorably.
Smith	Inexorably indeed, but I still— This is an area that I —You heard me refer to Keith Rankin as Derek Rankin. I heard him present the other day. He said the current-account deficit these days is irrelevant to the floating exchange rate. Now, he handles a lot of international financial investment.
Tripe	There is certainly a perspective on that. There is what is known as the Lawson doctrine, which says that the current-account deficit, where you have not got huge amounts of net government borrowing—and that was probably the contrast with the situation in the 1970s, where we did have significant government borrowing. In the current environment, we do not have huge amounts of government borrowing, so it is therefore arguable that the current-account deficit reflects personal savings and investment decisions, and it is really a matter therefore that we are collectively choosing to spend that much more than we are earning by way of income. So the way of looking at it then is to say that we have got this current-account deficit because we are spending internationally $12 billion to $13 billion more than we are earning.
Woolerton	And supplementary to that—is it then important that that money is streamed into productive enterprise rather than houses?
Tripe	Well, it would generally be regarded as preferable if I was sitting in a bank doing some lending, and I was looking at lending to somebody, I would be much more encouraged if they were going to use the funds that were lent to them to increase their income-earning capacity in the future by doing some investing in some productive assets. As we say, some of this housing lending may in fact be going to that, but we do not have the data on the small-business lending. So if we look at New Zealand as a whole, that question can be raised about whether we are

spending on unproductive housing or whatever else, but some of the information is less than totally clear and certain as to exactly what is happening to some of those flows of funds.

Foss But intuitively, it is very rational for someone to borrow against their house to fund their business, because it is a cheaper price of capital, so they are actually making a very rational and smart decision using those funds that have come from outside of the auditing.

Tripe Exactly, and there is no criticism of that.

Swain With all due to your profession, David, you were indicating before that the Reserve Bank, for a period anyway, didn't intervene soon enough, and you sat and listened to Keith saying that they intervened too soon, and thereby setting a floor, and I am sure there is a third option—

Woolerton You're not contradicting—

Swain No, no, no. I'm saying that somewhere there is a third option out here, somewhere. So, I just wonder—you were here, I think, when Keith was submitting—

Tripe I didn't hear particularly Keith—I heard some of it, yes.

Swain Well, basically, he was saying that the Reserve Bank just sets a kind of floor. Everyone knows that it is going to intervene. Interest rates are up, and exchange rates. And we are back in the same old current account problem. So, how do you counter the argument that the Reserve Bank has intervened too soon and that we operate on a perceived and rejected inflation rate rather than an actual one, whereas you are saying we should have actually jumped in a bit sooner, particularly back in the early 2000.

Tripe There is an argument, which I think is wrong, that interest rates are high only because the Reserve Bank pushes things up. Now, we actually saw signs of the actual disconnect and what might be a harbinger of the future a couple of weeks ago, when we saw market interest rates take off way ahead of the level of the interest rates being set by the Reserve Bank. That disconnect was a reflection of the high risk of the New Zealand economy. When you look at a country that is running a balance of payment deficit which is now a mere 8.5 percent of GDP, exceeded by very few countries in the world, you actually start to think there might actually be some risk to the exchange rate. One of the consequences, because there is so much funding coming through into the banking system from non-residents, if the non-residents get uncomfortable with their exposure to New Zealand they can either seek to exit urgently—as they did on August 17th or whenever it was—and at the same time that can push up interest rates dramatically. It may be that 3 months down the track the OCR will be completely irrelevant, because the perceived risk of New Zealand will be having such an overwhelming effect on driving interest rates that in essence the Reserve Bank won't be able to do much about that at all.

Fitzsimons	It's got two parts. First, doesn't it essentially come down to an argument about where price stability is more or less important than exchange rates stability? There seem to be some saying that one is more important so you sacrifice the other, and others saying the reverse.
Tripe	If we don't have price stability there is no way we will have exchange rate stability. So price stability needs to be the foundation upon that, because that gives some certainty. Price stability in terms of low inflation provides much better signals for the economy and economic development than having high inflation. If we don't have price stability we engender a whole raft of other problems in the economy. We get again what happened in the 70s and early 80s to some extent, where the only way you could actually make money was investing in property, and you have to be privileged to borrow it, and you are actually investing in real assets because those were the only ones you could be certain of the value of. One of the consequences of that is that you actually transfer wealth from the poor to the rich.
Fitzsimons	But are we actually in the situation now where the easiest way to make money is to invest in property? What's changed? Is it that everybody can borrow to do it because the banks are pushing the money at them, but nevertheless it's still draining that money from the productive sector of the economy. Now, do you agree with Keith Rankin that the distinction between inflation in the tradable sector and the non-tradable sector matters?
Tripe	Oh, it certainly does, and in the current environment, when we actually look at what's happening, there is quite high inflation in the non-tradable sector. That means that when the exchange rate falls, inflation will boost significantly. The Reserve Bank's efforts to strangle some of inflation in the non-tradable sector have not yet had as much effect as they would have liked. So, from that perspective, what we actually need is not lower interest rates but higher interest rates.
Fitzsimons	But Keith Rankin is arguing that, actually, income productive (??) in the non-tradable sector in that they have driven the property market and borrowing and that whole cycle.
Tripe	I don't think that high interest rates drive inflation. If you were a property investor and interest rates rose, it would be a pretty strange economic signal, pretty strange behaviour that actually encouraged you to actually buy more property. The message that it is actually going to tell you is that owning property in this environment with borrowed money is not as attractive as it was previously. The general response to that is to reduce exposure, reduce investment in that area, not to increase it.

Fitzsimons So why is it going the other way?

Tripe Because there are other factors promoting property development, and one of the factors, of course, is that when you actually look at it, if I engage in completely rational behaviour in the current environment I would be doing more investing in property. I remember being at a meeting of finance academics in Dunedin about 18 months ago, and we talked about the situation and had a bit of a laugh and said that the sensible thing to do if you follow the signals being given by the New Zealand economy would be to stop work and invest in property. But if the whole economy did that, where would we be. I do think there are some encouraging signs this year in the Reserve Bank's actions, that they realise they've been going softly, softly on inflation and that hoping that house price rises would slow doesn't actually work. Their more vigorous activity this year is much more likely to generate a housing price slowdown and cause some reconsideration of other investment opportunities.

Business and Economic Research Limited (Submission MP/70)
Mr Kel Sanderson and Dr Ganesh Nana

Smith Gentlemen, good morning and welcome. If you could draw our attention to the key parts of your submission and leave us a little time to question you that would be great.

Sanderson Thank you very much, Mr Chair and committee. I would just like to introduce by saying that we put in a fundamental submission, which Ganesh will go through the key points of. As a result of some of the changes in the economy in the last 2 or 3 weeks, and other work we have done, we have prepared a supplementary submission, which I sent to you overnight. I sent it through yesterday, actually.

Smith I see some blank faces. If you could give a copy to our officials, they'll get it copied for us.

Sanderson I'll give 20 copies to you.

Smith That's great. They will just take them and hand them out. That would be great.

Sanderson So I'll hand over to Ganesh.

Nana I'll take just a couple of minutes to go through our main submission and then leave Kel to talk about the supplementary. In terms of the key points on our main submission, summarised in bullet points on page 3 of our submission, summarising those even further—down to about four points—I'd say essentially that control is to reinforce; controlling inflation is not the only economic policy objective. That seems to have arisen because it it's our only legislated target, it seems to be interpreted that it's the only objective. We need to remember that there are other economic policy objectives we should keep in mind.

In choosing inflation control, if we do choose inflation control over other objectives we are potentially trading off progress towards those other objectives. Our submission is that those trade-off choices that we make, whichever way we go, those trade-offs should be measured explicitly and transparently for all others to see. In other words, there are benefits and there are costs to inflation control. It's not all one way. It's not always: "Yay, we've controlled inflation, we've reached our goal!". There are costs in reaching that goal. So there are benefits of inflation control. There are costs of inflation control. These should be assessed before deciding to pursue one objective over the other. So what we are after is, yes, inflation control is good, but there may be, or there are in a lot of instances, costs in pursuing inflation control, so we should assess those benefits and those costs transparently, measure them, and report on those transparently so we can see the basis of the decisions that we enter into.

Sanderson Right. And two of the main functions of the Reserve Bank, as defined by the bank—the first is promoting the maintenance of a sound and efficient financial system, and the second is operating monetary policy to maintain price stability. We contend that the present lack of soundness in the financial system is, to some extent, one of those costs of the operation of our price stability objective of monetary policy, relying solely on an interest rate rule. Our reasoning, at a broad level, is that the appropriate levels of both interest rates and the growth in money supply are essential to maintaining a sound financial sector.

In the supplementary submission we give a review of the experience from 1990 to today, showing that by using an interest rate rule alone—which is what we are operating on—based on the objective of forecast inflation alone, the Reserve Bank, when it forecasts inflation above the range, is required to lift New Zealand's relative interest rates above the average of international rates. Our analysis of the experience since 1989 shows that when the Reserve Bank takes this action, it can have the following unintended circumstances. You will have heard this from a lot of the submitters, no doubt. It attracts foreign funds into New Zealand deposits and that increases New Zealand's domestic money supply. The Reserve Bank itself pointed out in their submission on affordability of housing that, with the deregulated financial sector and competition in the mortgage market, increased money supply will be expected to enable an increase in house prices.

A second effect of the increased money supply will be to push money into less than—well, what could be called for shorthand—sub-prime lending situations. A greater increase in money supply does see the lending institutions looking for additional homes for that extra money. That thereby reduces the soundness of the financial sector.

The third unintended consequence will be that just the process of those funds flowing into New Zealand causes wide fluctuations in the NZ dollar exchange rate, thereby reducing soundness in the tradable sector. A further effect is that the house price increases reduce housing affordability, generating associated social costs, and the house price increases are then associated, and can be shown to be associated, closely with household consumption. So with the house price increases comes an increase in the household consumption. At that point, the RBNZ can interpret these consumption increases as threatening to increase forecast inflation. So under their single interest rate rule, it is required again to increase New Zealand's relative interest rates.

So you can see the cycle. I note it says: "Return to (1) above", because this cycle can continue for a period until the market finds unacceptable one aspect or some aspects of the New Zealand monetary situation—for example, the over-inflated exchange rate or current account deficit, and withhold funds. At that point, of course, the dollar tends to fall and the effectiveness of any Reserve Bank action is lost. Clearly, we have seen examples of this—1996-97 was a key point where, no matter how high the Reserve Bank drove the interest rates, the exchange rate kept going down and the money supply dropped. So that was a breakpoint. There's a possibility from our assessment that we are somewhere close to another similar breakpoint.

Just to say that most of these relationships—and we show them graphically or diagrammatically over the page—are borne out by all types of international findings. I would just like to leave you with two quick quotes. The first was advice given towards the end of the 1990s by John Taylor about the robustness and efficiency of monetary policy rules as guidelines for interest rate setting by the new European central bank. This was the thinking at 1998. It is useful for central banks to keep track of monetary changes and perhaps monitor policy rules for the money supply or the monetary basis, even when they are using interest rates rules as a guideline. So it is saying, think about supply as well as the price of money. Secondly, Rob Lucas from the Chicago School of Monetary Economics said: "Central bankers and even some monetary economists talk knowledgably of using high interest rates to control inflation, but I know of no evidence from even one economy linking these variables in a useful way." He went on to say: "The simple correlation between inflation and money growth … "—in 110 countries that they had analysed—"… is 0.95." In others words it is very high correlation between money supply and inflation. But he, a monetary economist, said that he did not find a meaningful relationship between high interest rates and inflation.

English — Given the unusual circumstances of this last cycle— it has been unique—what should have happened?

Sanderson — What should have happened?

English	Yes, if you just look back over 4 or 5 years, back to 2002, what should have happened with this?
Sanderson	If we're going back to 2002—if we're going a little bit further back, there was a problem there in 1996-97 where we had a monetary conditions index that hooked the exchange rate in with the interest rate, and the bank was aiming to keep that at a certain level. So when the market lost confidence in New Zealand and the exchange rate drove down, that automatically drove the interest rates up. There is some good learned assessment of that by, for example, the chief economist of the Bank of England, using that as an example of just the wrong intervention and the wrong use of the MCI. At that point, as we were coming up then to the Asian crisis, the Reserve Bank should have been reducing interest rates. We were running into a problem and we should have been reducing. In the more recent—2002 to the present—
Nana	Well, go back to our core submission. The problem with the latest periods, and indeed from about 2000 onwards, is we still remain fixated on inflation. That's the target. If we set economic policy based on that one target, we'll almost succeed on that one target, but we are ignoring or putting to one side the consequences on the other economic policy objectives that we so rightly should be pursuing, whether that be the current account deficit, whether that be the export sector, our foreign exchange earnings, whether that be employment, or whether that be investment in infrastructure—all of those other things that I would put together in some sort of measure of potential output, GDP output potential. That then lifts the horizon to something a lot more long term, rather than the short-term indicators of inflation over the next year or so. So if you ask me what should have happened over the past 5 or 6 years, a lot more relaxed attitude towards inflation. Yes, the inflation police have to be out there. But what really are the costs of inflation and the difference between it being 3 percent and 3.5, or even between 2.8 and 3.2? What are the real costs of those on the economic potential of New Zealand, looking 5, 6, 10 years out versus being slightly more relaxed on inflation to enable the economy, the export sector, investment in skills to be slightly more robust and slightly higher? Yes, we might have to live with slightly more inflation over the short term, but hopefully that would enable us to be counterbalanced with the benefits over the longer term. So, yes, over the last 5, 6, 7 years, I would have encouraged a lot lesser vigilance on the inflation front. That would mean a lower interest rate scenario, yes.
Sanderson	I think I will just come in and say also that I think one of the things over the last 4 or 5 years is that we have had strong economic growth, strong expansion of the labour market, strong increasing consumption, and that there is some confusion in the thinking and, in fact, in some of the

writing from the Reserve Bank, which confuses high consumption or increases in consumption with inflation. I think the world as a whole is experiencing and enjoying a period of low inflation quite largely in the big picture driven by the lower costs of manufactured goods coming out of China and, increasingly, India and so on. So we can have increasing real consumption without it becoming a threat to our increasing inflation.

Woolerton So we've been fighting an historical bogeyman?

Sanderson I've believe we've been fighting two—a historical bogeymen and a phantom in the future—because we're running it on forecast inflation rather than actual inflation.

Chauvel You say that the secondary costs of the focus on inflation control should be made explicit. How easy would that be? Would there be huge debate about how you measure those costs across a number of different consequences or do you think it would be relatively straightforward?

Sanderson I'd say the first thing is that it would have the salutary effect of requiring people to sit down and document just what the costs and the benefits are, to understand the whole process a lot better than I believe we understand it today.

Nana We seem to be under the impression that inflation is low and we've won. We haven't drawn the dots. The next question or the next sentence we'll no doubt be asking why haven't we got a skilled workforce in New Zealand? Why haven't we risen up the GDP per capita ladder? Or whatever other. Why have we got a current account deficit? We haven't joined the dots between that objective and that objective, and I think to bring that to the forefront and say, yes, inflation control is important but let's tie it into some other economic policy objectives as well, so we don't continually go down this one narrow track.

Robertson Dr Nana and Mr Sanderson, in your main submission, in the summary you refer in the first bullet point of No. 2 to the use of monetary policy tool, so I take it that you are thinking of other things. You also go on to say in the second point that the primary goal of economy policy is to enable and encourage the efficient expansion of the capacity of productive resources. My question therefore is, do we as a nation do enough to increase productivity? Secondly, what do you understand by the term "productivity"' And, thirdly, what could we do, recognising that productivity is the only way to increase our standard of living?

Nana And I would add that productivity is the only long-term weapon against inflation that will work. Are we doing enough to encourage productivity? The short answer is no, because we've got this fixation with inflation. That is what is undercutting a lot of our efforts in terms of increasing productivity. We're doing things on one hand, in terms of encouraging skills and perhaps investing in new machinery and in new equipment, but then on the other hand, we've got an interest rate policy that puts a cap on our growth. So you've got businesses saying: "OK. Is it worth investing and taking on new staff and putting investment in to them to get them upskilled, etc., etc., and investing in this new machinery when what's the outlook for growth, what's the outlook for increasing improving income and increasing profitability? Well I know that's always going to be capped, because the moment growth rears its ugly head it's going to be stomped on by some interest rate policy."

So the skills and productivity thing is all long term and it's good. But it gets undercut in the short term by our fixation with inflation, which keeps growth at a tied-in level.

Robertson What do you understand by the term "productivity", because there's a misconception amongst many people about what the term means? What do you understand productivity to mean?

Nana What do I understand productivity to mean? Productivity is how well we work. How well we work with the equipment that we've got in our economy, with our resource base and the skills that we've got. How well we put all of those things together to produce goods and services that New Zealanders and the rest of the world want.

Robertson What about better utilisation, though, not just of labour but land—

Nana Yes, the resource base.

Robertson —capital and machinery.

Nana Yes.

Sanderson I was going to say that it's the number of units of output we get for any given number of units of resource or input, and they are land—and I'm an agricultural-based guy, so that's pretty important—and labour and capital. But the interest rate and the wage rate thing, as Keith was saying, is very much the one that indicates whether you're going to put on more low-cost labour or invest in more capital.

Robertson So we what could we do, then, as a nation State to improve our perceptions and do something about real productivity growth in this country, in your opinion?

Nana In my opinion it's around investment in infrastructure. New Zealand has got a miserable record in terms of how much of our annual income each year we put into reinvesting in new machinery, equipment, infrastructure, roads, hospitals, schools—call it what you like.

Chauvel Broadband.

Nana Yes, broadband. Investment is the key. What Keith was saying—that link between low wage rate and high interest rate—those are the prices of those two things. We're encouraging businesses and the economy to shift to labour—employ more labour and neglect the investment in the machinery and equipment on the capital side. So we need that rebalanced. That means a rebalance of interest rates and wage rates. We need a lower interest rate horizon and we need higher wage rates. That will encourage skilled labour being employed, in conjunction with new equipment and the most up-to-date technology. That's how we get productivity. It's those two things together—labour and capital together. Not either.

Fitzsimons I'd like to pick up on this conversation about productivity and capacity and ask you about an area that nobody has raised in their submissions to us or at the table so far. It's not an area that's usually considered in conjunction with monetary policy. But to start from the basics, you're saying that inflation is driven by a shortage of productive resources relative to demand. We usually think of those productive resources as being labour and capital investment and capital plant and we've just added land, which often gets left out, but it is no doubt a part of it. Would you agree that fresh water and oil and gas act in the same way if they are scarce as a shortage of capacity in limiting and therefore leading to inflation?

Sanderson Certainly, at the basic level, I guess, with economics when we talk of land we tend to mean the natural resources. Equally, just homing in on the water, as such, I think that it's very apparent now that capacity in a number of our regions—and you think of dairying in the South Island, vineyards in the Hawke's Bay and so on—they are clearly coming to the end of the capacity of water. So from that point of view, as an agricultural economist, I would expect to see the price of water coming in to start rationing that to its best use. I'm not sure if I'm answering the question, Jeanette.

Fitzsimons You're recognising that that is a factor.

Nana Can I just add that, yes, that is potentially inflationary but I guess it just reinforces my point that if you're going to knock that inflationary process on the head you've got to do some investment to ensure that that water—the water quality and all the systems associated with water or energy—is kept up to date or maintained or reinforced somehow. Otherwise, they will be inflationary, yes.

Fitzsimons We've also got limits coming on the world availability of oil—at least oil of the sort that we're used to using, the cheap oil. New Zealand's gas resources have peaked and are declining. We know that it's unlikely to change that figure. So we have some resource constraints there. Would you agree that productivity can apply not just to our capital plant and our labour but that the productivity with which we use energy resources and water resources may be crucial to that?

Sanderson Absolutely. In fact, you will see over the period of, I think, the first half of the 1990s we did fairly significantly increase our productivity based on energy.

Fitzsimons Another environmental service, apart from the resources, is the capacity to absorb wastes, which we generally take for granted. We have now reached and overshot the limits of the natural environment to accept greenhouse gas wastes from being fossil fuels. Would you agree that that is also a capacity constraint on the economy?

Nana It's a potential constraint if we don't invest to get around it somehow. That's all—that's part of the economic system. If there's a potential constraint coming, if the market signals are allowed to work there will be incentives to create some other substitutes or process to get around the system. But if that market mechanism is not allowed to work, then it will be an effective constraint, yes.

Fitzsimons We can actually fairly easily target policy and increasing labour availability or substituting for labour, and increasing capital plant and substituting for capital plant. But there are actually some physical reasons why we cannot substitute for something like water or actually substitute for the capacity of the atmosphere to accept waste. So would you accept that there may be some limits there that we cannot just work our way round all that easily?

Sanderson I think that's a very global question. I think Ganesh's answers are right—that is, the market is allowed to work in these situations, then you'll get resources shifting from one use to another and innovation being brought in to increase the productivity. But I think relating monetary policy to global warming in a direct way is a bit beyond our—

Robertson It's a long bow.

Sanderson It's a long bow, even for heroic applied economists.

Fitzsimons What I'm trying to relate it to is if there are capacity and productivity constraints on the economy, which means that the harder you run the more constraints you run up against, that some of those are going to be impossible to completely get rid of and expensive to find a way around. Therefore, we are dealing with a different kind of world in the future.

Nana It's always a different world in the future, and economic constraints are nothing new for economists. There are always constraints. The most productive economies find ways—whether it's next year or in 20 years' time—around those constraints.

Gosche — Given that your organisation's initial opposition to the eventual form of the Act—I was looking at the first page of your written submission—my question is do you see a need to change the Act now to take away the single focus or is it the way in which the Reserve Bank operates? I mean, can it be done under the Act as it is now, or does it need a change?

Nana — Ideally, I'd have a legislative target that had something else as well as inflation, because the legislation is perpetuating the idea of one single target. But whether that's the only avenue open I don't know. It could be done through appropriate singles and incentives to the Reserve Bank and other arms of Government to ensure that they are following more than one economic policy objective.

Gosche — So the Government's got currently productivity programmes running and a whole load of other things that you've pointed the finger at—skills training, apprentices, etc. So—

Nana — Sure, but somehow they've got to be lifted. Those targets or the ranking of those, in terms of the inflation target, somehow—either formally or informally—have to be lifted.

Gosche — And do you think it can be done under the current agreement in the Act?

Nana — It's around attitudes and behaviour.

Sanderson — It may be around definitions, as well. Price stability could be related to all of the important prices in the economy, which not only are the CPI but the interest rate and exchange rate.

New Zealand Shareholders' Association (Submission MP/12)
Mr Bruce Sheppard, Chairman

Sheppard — I'll take my paper as read, so I won't relitigate what I consider to be the causes of inflation, which is excess household consumption, fuelled by free credit, although shortly I suspect that credit won't be quite so freely available with the finance company meltdowns. Perhaps the robustness of the finance company lendings over the last 10 years has done the Reserve Bank's work for them with a very large bang.

Dr Cullen is on public record as stating that he believes the assumption that we can have a growth economy while controlling inflation, which was the assumption behind existing monetary policy, is in some way contestable. I would like to re-examine the submissions that I've given you, in the context of growth and the sustainability of growth. When we are talking about growth, I guess we need to define what growth we're talking about. Are we talking about GDP? Are we talking national income per capita? Are we talking about real national income per capita? What are we talking about?

I presume that since we care about the people who live in our country we are talking about disposable national income for the people who live here, in real terms. I guess what that means is national income per capita adjusted for inflation in some way, and there is a decent international measure for that, which is the OECD league tables. They define our national income per capita in US dollars and compare us with everyone else. I guess you don't have to be a rocket scientist to work out that if over 10 years your New Zealand dollar goes from 40c to 80c, you've had a compound rate of gross income per capita increase, in US dollar terms, of 8 percent per annum. We can then fool ourselves into believing that we've actually got some real growth in our disposable income per capita against an international benchmark. However, it comes back to how sustainable that US dollar is and what our New Zealand dollars actually buy us in real terms in the shopfront.

Chauvel Which is why you have purchasing power parity measuring?

Sheppard Yes. But if you eliminate the exchange rate adjustment to our US dollar notional growth in income you may well find that our growth is somewhat illusory. I suspect that if you look at productivity you may find that productivity improvements among our labour and capital deployment over the last decade have been somewhat pedestrian.

Another item that the select committee asked submitters to comment on was growth and productivity. I'm going to answer some of your questions, Jeanette, about productivity and environmental constraints.

Productivity, at the end of the day, comes back to the efficiency of labour and the use by labour of the resources that are given to it. Labour's productivity is, in effect, driven by two key subsets of events: one is attitude and the other is the toolbox. The toolbox is the resources that are made available to them to do the job of work that they're asked to do, and their attitude is how they actually want to respond to the task in front of them.

If you'd like to have another look at my thought piece that was attached to my submission, I'd like to draw your attention to some comments that I've made on attitude. New Zealanders have a very poor attitude to consumption. They have for a generation consumed more than they've earned, consistently, and rocketed their way into a mountainload of debt. But they also actually have a fairly poor attitude to being productive. Let me give you but one example of this from my own workplace. As you know, I'm an accountant, so I tend to employ intelligent, middle-class professionals. We have an elaborate productivity incentive plan in our workplace. This particular individual, who was a solo mother with a student loan, decided that she wouldn't for 2 months of the year do much work at all, because the extra incentives that she was going to earn through completing her tasks of work were more than consumed by way of reduction in ancillary benefits and increases in student loans. So when

I said to her: "Why don't you bill that extra $20,000?", she said: "I'll bill it in April when it doesn't affect my student loan."

What we've actually got, based on the society that we have built over the last 40 years, is a nation of people who believe that their future can be provided by others. We've created a nation of people who do not accept personal responsibility for their own futures, and we've developed a dependency society that is going to be really hard to break. That's the No. 1 non-monetary issue that we have to contend with. But in the workplace it makes it really hard to motivate people to perform and be productive when the safety net, which it no longer is, has become an entitlement and a way of life for them, in terms of the way they think.

The next point is what is the incentive to work to earn more? How do you spend more if you earn it? If you save it how safe are your savings? Do you put your savings into finance companies and watch them disappear? Do you put your savings into forestry and have the Crown steal your carbon credits? There are all sorts of issues here as to why people don't aspire to earn more.

There are a whole bunch of fiscal issues that need to be dealt with. Now, let's talk about the tools. The only way the toolbox improves is through investment, and investment occurs in a rational economic world only if it makes a return that is in excess of the risk-free rate of return that can be derived by doing nothing. Obviously, the easiest measure for the risk-free rate of return on any particular investment is bank or Government interest rates. So the higher interest rates are, the harder a particular investment has to work to justify it occurring in the first place. So when a business sits down and decides am I going to make an investment—I'll give you, Jeanette, two examples, because there are two. One is in waste disposal and one is in increasing water capacity. You might say that water has a finite capacity; well, it doesn't. Plants absorb water at different rates, and the softer the water the less water they need for a given output. So if you had a piece of technology that would enable you to soften water and improve the utilisation by plants of water you can expand the supply of water. Right?

Fitzsimons: That's an efficiency argument that—

Sheppard: Of course. However, in order to do that you have to make a decision about whether you want to make an investment, and in making that decision you have a look at the risk-free rate of return and you have a look at the volatility and risks around your investment. Volatile exchange rates increase risk. So, eventually, you get to the point that it's not economic to deploy that technology in New Zealand, because our interest rate regime is too high and our exchange rates too volatile. It is safer to deploy that capacity in a different country. That's what practically happens. So the volatile exchange rate is having a direct effect on productivity, because it is making the risk and cost of investing higher, which is holding back our toolbox. Therefore, our workers are not given world-class tools with which to improve their productivity, and if they care about that they move to other countries that have lower interest rate structures and lower risk structures to deploy their skills with a decent toolbox and skill migrates. We, as a nation, cannot develop our productive capacity without redressing those two fundamentals.

Ask yourself this: why is New Zealand, as a sovereign risk, as risky as Indonesia? When did we last have a revolution? When did we last shoot political leaders? Maybe we should do it soon, to justify the risk premium we're paying. The reality is that New Zealand is not a risky country, yet we are paying the risk premium of Third World countries. And you wonder why there is no investment.

Now going back to the closing remarks in my submission, there is no fundamental problem with the structure of the Reserve Bank Act. In fact, in my earlier thought piece I described it, along with the Fiscal Responsibility Act, as one of the more enlightened actions of our Government in my short life. By taking monetary policy away from the control of politicians, you have ensured that the money supply is not manipulated for political purposes. That is a laudable objective that cannot be undone.

The issue is really this: section 8 of the Reserve Bank Act defines the purpose of the Act and it needs to be widened. We are one of the few OECD countries that actually solely focus monetary policy on inflation. There are far broader economic issues that need to be dealt with. There needs to be the issue of national income, growth, price stability, trading arrangements stability. All three prices that are influenced by interest rate policy, which is inflation and the exchange rate, need to be taken as a basket and need to be measured against the holistic view of what is good for our economy. In the last 10 years we have considerably moved on—it's more than that; it's nearly 15 years since the Reserve Bank Act came to pass. It was designed for its time. In 1991 we had been through 20 years of stagflation. The economy had suffered as a result. The savings of the middle class had been confiscated through fiscal drag and erosion of buying power, inflation was a bogeyman. Now what have we got? In real terms, relative to our trading partners, we've got declining productivity, we've got skill migration, and we're slipping down the wealth tables. Maybe we don't care about that. Maybe, Jeanette, it doesn't matter. But the reality is that it does. The only way you pay to have a perfect environment is with cash you don't need to spend to pay your grocery bill. So we do need to care about slipping down the league tables.

Are we going to change? The reality is that it isn't going to change any time soon, unless we redress capital formation in New Zealand, New Zealand ownership of productive assets, which will occur only if we stop spending and start saving, and the deployment of those savings in an efficient way. There is one other consequence of high interest rates. If you're a mum and pop, sitting at home, and you're offered 9 percent interest or the opportunity of an equity investment, which are you going to take? If you're offered 3 percent interest or the opportunity of an equity investment, which might you take? And do you really think debt security investments grow our economy, or do you really think equity investing grows our economy? Which do you think creates jobs and opportunities?

Swain — As usual, Bruce, very interesting and entertaining, which was helpful in this place. You're talking about, you are kind of starting to talk a bit about multi-targets. It's kind questioning Christianity, almost—going back to the founding fathers of the document, or the act right at the start. The argument that we're all grappling with is not just this thing, what are the other things that sit around all this, but the statement always has been, among the founding fathers of all this, that if you have multi-targets you hit none. Whereas if you have a simple one you are likely to hit that. What's your response to that?

Sheppard — If you have a simple target, yes, you'll hit it, but you'll hit it with a really big bullet and there'll be collateral damage. If you're prepared to accept the collateral damage, you can have a simple target. Yes, you shoot the inflation bogeyman, and the cost of that will be various balloons within the economy that eventually pop. You'll end up accentuating boom and bust cycles and you end up destroying the productive sector over time. Yes, that's the collateral damage and you can accept that with a simple target. You could actually leave it as a simple target and simply widen the band. You could say: "OK. 0 to 2 percent isn't an appropriate band anymore. The economy can cope with a wider band." So in effect you reduce the size of the target you're trying to shoot and you could possibly achieve the same outcome. The alternative to actually considering exchange rates, interest rates, and inflation as a bag of events that you try to consider, you simply widen the band and say: "0 to 5 percent is OK." But preferable not double digits. That's a bit worrying. So then you're back to arguing quantum.

Swain — Yes, quantum, which is why in the end there was a band, and it was set at that.

Dr Robin Pope (Submission MP/87)

Pope — It is a great pleasure and an honour to talk to your committee. I am very pleased to hear that you are considering changing the system. I look forward to being able to contribute to this from the work that we've been doing for 10 years under a Nobel Laureate at Bonn University, Reinhard Selten, with experimental results that can control the sum of the effects that are hard to see in a normal environment, using a new theory that includes all the risk effects compared with normal economic theories that I have developed, called SKAT—the stages of knowledge ahead theory—for how we should choose under risk and uncertainty.

Smith Thank you. If you could quickly draw our attention to the key issues in your submission and then we'll have a chance to ask you some questions.

Pope My submission is in two parts. The first part is the desirability of having the exchange rate stable. If one has the exchange rate stable, you avoid risk premia, and New Zealand is suffering, for instance, compared with Singapore and Japan, which have stable, predictable exchange-rate policies. They have policies in which their interest rates are of the order of one-eighth of New Zealand's. This is a big burden for the country and it arises because those lending money have to bear the burden of an exchange rate change in one way or another, either directly or if the loan is not in Kiwi dollars, because of the risk of default of the people in New Zealand if they suddenly have to pay back a lot of money. So that is one big problem.

In some ways an even bigger problem is the tiny size of the open economy in New Zealand. It should have, when it is such a small community, big import competing and a big export sector. But it is very inefficient for people to invest in this when the exchange rate can unpredictably double or halve.

Let me give you an example. Tourism is very important. You have such a very beautiful country, so people could decide they could start investing, building hotels for the tourists to be in, when the exchange rate is very low. Then, by the time they're built—and buildings, after all, last and are occupied for 50 years—they find that the exchange rate has gone very high. But tourism is an industry where the demand is very, very sensitive to the exchange rate. So you find that you have far fewer tourists than expected, and you have them half occupied. This happens for all your other export industries.

It is the reverse way round, to some extent, for the import competing ones. It will be a great blessing. You will get far more efficiency, far fewer white elephants, if you can keep the exchange rates stable. It is perfectly feasible to do. I was informed by my father—my parents have immigrated to your beautiful country, Betty and Norman Roberts, as has my younger sister, Lynn Roberts, who is an environmental consultant there—that there was anxiety in the press that if you try to keep your exchange rate stable, this is not possible, you will have runs on the currency like the UK experienced in 1992. But this is false. In New Zealand—and in fact the UK has changed its system—the central bank controls the interest rate. They've got that crisis because the central bank did not. The UK Treasury did. If you want to keep a stable exchange rate, one of the important instruments is, of course, for the central bank to be able to alter its interest rate to do this. In your country you have all the rules and the laws already.

Our experimental results show that even better than keeping the exchange rate stable, when there are many different currencies, the best one can do is a trade-weighted, capital-weighted basket of exchange rates. Yet even better than this, although it won't perfectly reflect your trade weights, we found is to form a currency union. With a currency union, there is, of course, no uncertainty with the investors that the exchange rate for those ones is going to stay stable. When we say this is better we look at it in terms of the macroeconomic determinates that the Government wishes to keep in mind. One is international competitiveness. This is done far better with a currency union or a fixed exchange rate, we've found. We've found it is also better for all the other macro objectives that jointly in our experiments the central bank and government were trying to keep. These were keeping inflation low, keeping the interest rate at an ideal level, the exchange rate as predicted, not having over-employment, and not having under-employment.

It is a great shame for New Zealand that it stands out from all the other developed countries in how it has grown over the post - Bretton Woods era. All the others have grown at approximately the same rate. New Zealand is much, much slower. I put it to you that one reason is that it has one of the biggest—indeed arguably the biggest—fluctuating exchange rates.

Let me mention just briefly—I don't wish to make the introduction so long that there's no time for questions—the other issue of monetary policy that cannot primarily be done by the central bank. Inflation, in the short run, all studies show, is cost-push. One should not put the whole burden on the central bank. There is no evidence that for monetary policy. You do better if your own central bank works on this instead of having a fixed exchange rate, and you have then roughly the inflation rate of your partners also.

In managing, though, asset bubbles—these are always a feature of a capitalist economy. The US has had two terrible ones in the last 20 years and New Zealand is at risk at the moment. This causes much environmental damage in the over building, and I have proposed that you want to go slow on rezoning for this and you want a progressive capital gains tax. I've made suggestions in my submission that this is democratic and very difficult to bring in. We need to both make sure that we do not have parliamentarians who are against it because of the big tax that they would pay, and we need vivid personal accounts of the damage to people and to the environment to explain the story so that people do not think it's unfair and realised it for the unimproved value of land. This is not personal skill. This is what the community itself has interested done. It has increased its population and so forth.

Now, I hope with that introduction I've opened the way for you to ask me some questions.

Chauvel — Thanks, Dr Pope. What's the downside of the trade-weighted basket of economies we've heard you speak about?

Pope	We do it only on the trade-weighted. You don't put enough emphasis on capital flows. Economists generally don't put enough emphasis on these. Capital is also very important and it may be that for doing the capital flows we do not have good statistics on the real lenders. But a lot of this is done indirectly at the moment through the US dollar. Therefore, I would propose that additional weight be given to it, in particular. The Euro is becoming more important, the pound will be used also a little for doing the capital flows. So I would propose that not all the weight goes on the trade basket, but you should also put some weight on the capital flows, because this is also going to affect your result and conclusion.
Chauvel	OK, so you have a trade and a capital-weighted basket that you measure the dollar's value against. What's the downside of doing that as opposed to the system we have at the moment?
Pope	I would want to say there are no downsides. It is popular, for instance, to say that you should not do this because you want to be able to change your exchange rate when you have too much unemployment – that you want to depreciate - but our findings show that this is not the case, that this is based on very simple models. New Zealand has, I might say, never followed that policy anyway. Many other countries have. The models are too simple. They think there are gains for curing unemployment that, in fact, generally, do not exist when you study the matter more carefully. The other claim that has been believed in New Zealand—and this is also shown by the results to be false—is the belief that you will get lower inflation and that this is key to having a good economy. But, as I mentioned before, why this proves to be wrong is it's based on thinking that only money matters for inflation. Of course money matters, but so do many other cost-push factors. In the period of under 2 years these are the prime impact on inflation. This is why you will find that the central banks that have not pursued fighting inflation first have overall performed very well on inflation. I also mention that without empirical evidence, in the early period New Zealand chose a very low inflation rate—lower than that found in most econometric studies for per capita income growth. You need some inflation. It is bad to have too little. I'm in Japan just now, teaching in a class of faculty, doctoral, and masters students. One of the key issues coming up for Japan—the very first one mentioned by one of my participants in the class, who is right here listening—is the problem for Japan to grow when the inflation rate is too low. There are many difficulties. You want to a keep a little bit of inflation. It is very bad to have too much, but you don't want too little. You're going to get probably about the right amount if you use a trade-weighted basket, because you're going to have a mix of other countries and what they're doing on it. But when you have inflation too low, then you have problems that firms did not feel confident that their output prices are going to be high enough to repay loans. This is very unfortunate. You're

going to get the efficiency of some prices being able to stay steady when they become less desired as products, relative to other prices. You need a little bit of inflation that creates a little bit of variation in individual price inflation. This is an upside.

English — Why do you assume that fixing the exchange rate to a financial or a trade basket is going to make it significantly more stable? If we look at the exchange rates of who would be in that basket, they are slightly less volatile than ours but not significantly less. We'd just end up with someone else's volatility instead of our own.

Pope — It is perfectly true that the ideal—and I would support this, and we have Nobel Laureates such as Robert Mundell arguing for this—is to have a single world currency. This is the second best. What it will mean is that for exporting to one country you get, as you say, more volatility than perfectly stable. But because you're keeping the total basket steady, exporting to other countries will be in the opposite direction. So a firm that is diversified perfectly across this basket will have no change in this, overall, but, of course, you should not have all firms completely diversified. It will mean, however, that you get a balance in the economy. Some will be benefiting from which way the exchange rate moves with windfall gains, others will be losing, but you will be, on average, doing the best you can in the unstable world that was brought into existence by mistakes and misconceptions, most importantly, of Milton Friedman, who influenced Nixon and had, by and large, a mistaken element. He did not understand the asset role in the exchange rates and he had also a misconception of how money works, even in a closed economy.

So it won't be perfect; you are right. The other exchange rates, on average, are more stable, by the way—not all of them. Of course, poor Indonesia had far worse trouble with the exchange rate than New Zealand has had. But, on average, they actually are more stable and you will get some balancing out of windfall gains and losses, which you do not get at the moment when you have it moving so much relative to the basket, violently relative to the basket.

English — Just one more question. Let's say you did it, and you do end up with a more stable exchange rate, your economy, particularly a small open economy, still best to adjust to the shocks—we're just a cork bobbing on a global ocean—where do those adjustments show up if they don't show up in the exchange rate? Where do they work themselves out?

Pope — When they don't show up in the exchange rate, you will still get some, of course. If China, for instance, has a crash because of its property market boom in Shanghai, this will affect all countries, including New Zealand, and you will suffer. But you have one less element in the complexity of the whole system. We demonstrate this in our experiments in the laboratory. The shocks came through various factors, including Government fiscal policy, which can be a terrible shock factor. What we found is that how you adjust—we found this in the laboratory experiments, and you can also look at this. It is difficult to see in the field data, because so much else is changing. If your entrepreneurs do not have to simultaneously deal with a shock in demand or supply and worrying about the exchange rate—what is happening to it, how has it changed now, how will it change in the future?—their world is much less complex and they can therefore, with this key relative price more stable, make better decisions and you have less damage, better adjustment than you would without.

Transcripts

Inquiry into the future monetary policy framework

Finance and Expenditure Committee

12 September 2007

Members

Shane Jones (Chairperson)
Hon Bill English
Craig Foss
Hon Mark Gosche
Darren Hughes
H V Ross Robertson
Dr the Hon Lockwood Smith (Deputy Chairperson)
Hon Paul Swain
Chris Tremain
R Doug Woolerton

Witnesses

Federated Farmers of New Zealand Incorporated (Submission MP/15)
Mr Don Nicolson, Vice President and Mr Nick Clark, Manager, General Policy

Jones — Federated Farmers—Don, Nick Clark—welcome. We will just allow our friends, the media, to get set up. For all people assembled I would like to formally acknowledge the presence of Dr Stephen Grenville. He is a specialist adviser to the Finance and Expenditure Committee. Welcome, Dr Grenville, who is based in Australia with a vast experience in monetary policy and performance of Reserve Banks, etc. We've got half an hour or more, so over to you gentlemen.

Nicolson — Thank you very much, Mr Chairman and members of your committee. Thank you for giving us the opportunity to speak to our submission today. It is a topical subject and vital to the best interests of New Zealand exporters that we have this discussion.

First of all, the high currency has focused considerable attention on the workings of monetary policy, the use of interest rates to control inflation, and a number of people have been calling for changes to monetary policy. At the outset I think it's important to say, or to recognise, that although high interest rates have helped push up our currency relative to others, other factors also influence the exchange rate, and it is overly simplistic to say that high interest rates alone always result in a higher dollar. Other factors that play include the appetite for risk, general economic prospects, commodity prices, political stability, and the current account deficit. Markets can focus, or do focus, on different factors at different times, and often it seems events offshore have the biggest impact, as we've seen recently with the USA subprime market.

Federated Farmers submit there have been problems with the implementation of monetary policy, and our submission to this inquiry has been critical of the Reserve Bank in its forecasting, its communications, and its unwillingness to deal with inflationary pressures earlier in the decade. These factors have ultimately resulted in higher interest rates for longer. Although we have concerns with implementation we are strong supporters of the existing framework set out in the Reserve Bank of New Zealand Act. In our view the Reserve Bank must retain its operational independence, and it must remain focused on controlling inflation.

We also believe that the OCR is currently the best available tool for the Reserve Bank to use to control inflation. Most Western countries use a cash rate system to target inflation, and they do so effectively. An independent review of monetary policy held in 2001 found that New Zealand's monetary policy framework and the OCR tool are consistent with best international practice. So it's been the use of the OCR tool that has been the problem, and this was particularly so in 2003-04 when interest rates were cut and held at low rates despite it following a period of rapid growth in the money supply and during a period when inflationary pressures were building.

Some think the Reserve Bank has not considered the interests of exporters and have suggested that the Reserve Bank Act needs to be amended to make it consider factors other than inflation. We disagree. We believe that the Reserve Bank attempted to accommodate the interests of exporters in 2003-04 when interest rates were, in hindsight, too low.

Talk about changing the Reserve Bank or ditching the OCR is being used by some as a smokescreen to divert attention to the real issues around productivity and competitiveness. We are therefore very pleased that the inquiry's terms of reference poses important questions such as the interaction of monetary policy with other elements of economic policy, how to improve New Zealand's capacity for non-inflationary growth, and the role of productivity in the economy. In our view it is simple. Productivity and competitiveness are keys to enabling the economy to grow faster without generating economic imbalances and inflationary pressures. This requires all Government policy to be aligned with the goal to improve productivity and competitiveness, but, as we have observed in our submission, this has not always been the case, and our productivity performance in recent years has deteriorated. We contend that if the Government gets its economic policy settings in order then the Reserve Bank will be able to concentrate its efforts on controlling inflation, and it will have a much easier job in doing so.

So we urge this committee to reinforce this message, and not let itself be diverted into tinkering with the monetary policy framework or ditching the OCR tool, neither of which will do anything to address the real issues facing the New Zealand economy. Thank you, Mr Chairman.

English — I want to ask you about a view that's been expressed here a few times—a bit more introduction doesn't matter. You represent a sector whose success is based entirely on international competitiveness, and if you can't compete internationally you can't survive. So what about this view that says that 4 or 5 percent inflation doesn't matter too much if it means we can have lower interest rates. I'm not trying to justify the logic of it. It's an argument been put to us: we can have lower interest rates if we have higher inflation. It seems a contradiction but in any case why do we, and how do the farmers see inflation? Do they think it matters that much?

Nicolson — Oh I'd say we do, and I'm going to divert to Nick to answer.

Clark — A lot of the comments that came back to us when we put out the draft submission basically said inflation is the enemy and it needs to be kept in check. I've seen a bit of work that's been done by some academics that suggests that inflation over 3 percent definitely has a negative impact on the growth in the medium and longer term, and we would certainly agree. We've noticed that farm expense costs for farmers had been increasing higher than 3 percent over the past few years, and that's had an impact on the margins that farmers have been able to get, and it's had a particularly negative impact on sheep and beef, in particular, who haven't had the commodity price windfall that some of the other farming sectors have had.

English — So do you agree or disagree with the view that the Reserve Bank should take up a more relaxed attitude, and the whole framework should take a more relaxed attitude to inflation?

Clark — We would disagree with that.

English — You mentioned in your submission non-tradable inflation. I know from chatting with my constituents that non-tradable inflation bothered them a fair bit. What do you think the answer is there? We've had non-tradable inflation running, domestic cost inflation for farms running at 4 percent for 3 or 4 years. Doesn't that tell us that the policy doesn't work?

Clark — Not necessarily. The use of an interest rate - cash rate based system, and the current operational independence of the Reserve Bank, and the policy targets agreement which says 1 to 3 percent over the medium term—that's all fine. I think the issue is, as you rightly say, that non-tradable inflation has been persistently over about 4 percent for the last 4 years. The tradable inflation has been bouncing around, but generally has dragged overall inflation under 3 percent. We think that the current interest rate based system is the best way to deal with domestic inflation, but the interest rate needs to be at an appropriate level where it can influence the domestic economy more effectively.

English — Just one other question. A number of submissioners are arguing that fluctuating exchange rates are a problem for investment and the export sector, and therefore the monetary policy framework should target exchange rate stability. Now is that an argument that your membership would sympathise with and do all things possible to do that?

Clark — I think it's something, the idea of it, that would probably have a bit of support from some of our members. But the reality is that we're a small open economy. We're buffeted about by international events and by trends, and to try to hold the exchange rate at a certain level is a bit like trying to squeeze a sausage; the meat's going to pour out somewhere else and make a terrible mess, and that's what we try to do when we try to have a fixed or managed exchange rate.

English — In theory, at least, if you target the exchange rate then other markets need to be more flexible, as I understand it, so do you think, for instance, the labour market is flexible enough that if the exchange rate is stabilised and there's some external shock, for instance, the meat industry might take a 10 percent pay cut if that's what's required to restore competitiveness, and are the other markets flexible enough?

Clark — I think that's an interesting comment. I think what's more to the point is if these markets are flexible enough, if the regulatory framework is right, and if all the various policy tools are working in the right direction, it might have an impact on the volatility of an exchange rate at the margins, but perhaps more important it would actually businesses to cope with a more volatile exchange rate than they currently can if they—

Jones — OK, Doug.

Woolerton — Just supplementaries, just three questions. First, do you believe inflation is happening in farm circles now, whether it's fertiliser or anything else; (b) are you happy with that; (c) do you think anything can be done about that; and (d) do you believe any other sectors should do anything about that?

Nicolson — Certainly inflation is an issue in farming sectors right now. Farm input costs that are fair and freely traded are something that we can't perhaps do much about. The input costs that are imposed—effectively monopoly costs are the ones that concern us the most. I think New Zealand prides itself on having an open economy. I know, for instance, fertiliser costs right now are one. Superphosphate costs have risen immensely—

Woolerton — It's not a monopoly though is it?

Nicolson No it's not. So I'm saying we can cope with that. We will cope with that. That's something we've always had to do since the 1980s, and I think that's been the good part of the New Zealand farming psyche, that we are able to compete on an open playing field for our inputs that are made out of the marketplace. It is the imposed costs that are a problem.

Woolerton And an example of that would be what?

Nicolson Oh, we've got an RMA overview where we've highlighted the costs of the RMA on business, we've got ACC costs, you could argue that electricity sector costs are a huge burden on us, even though—

Woolerton And do you think they've gone up more than fertilisers?

Nicolson Well, fertiliser is an interesting one, Mr Woolerton, because obviously there are other countries in the world looking at sourcing product for the growth of their economy, and New Zealand has to compete with that. Same as fuel.

Swain There are heaps of questions I have but I'll limit them to just two, one around productivity, which is a big interest of this committee, and the second issue is around the relationship with the fiscal policy, and monetary policy, because as you say we widened the terms of reference to take these terms into account. The first one around productivity: there's been a kind of a reasonably loose argument that's been put here by a couple of people that if you were a bit more relaxed about inflation, and therefore didn't stamp on it and drive up interest rates, which is the way to do it, then that would be a signal to people, because the interest rates were relatively lower, to reinvest in new plant and equipment to try and deal with the inflation problem and therefore that would be the best way of trying to deal with productivity. Now it doesn't sound like you agree with that general approach, because you're still wanting to have the basic framework around inflation. That's what I read in your report. So the other comments we get, we get a lot of platitudes about productivity—you know, it's bloody hard to do, and as a former Minister of Labour, it's bloody hard to actually do anything even though everyone thinks it's good to do—so could you give us two or three things that immediately could be done, do you think? I mean, aside from immigration, skills training, which are a couple of obvious ones that spring to mind, what other things could we do collectively to improve productivity, given that you say, and I agree with you, that unless you've got non-inflationary productivity improvements you're always going to be behind the eight ball?

Clark I don't think there are any silver bullets that you could implement overnight that would suddenly change the picture and improve productivity at the stroke of a pen, for example. I think this is all about medium to long term stuff—getting the wider policy parameters right. I think a lot of what the Government has done in terms of these areas—

	skills training for example, and investment in transport infrastructure—will have a positive impact down the track in terms of productivity. But there are other things that have been done, as we have mentioned in our submission, which we feel have been negative to productivity, and perhaps those could be re-looked at in future.
Swain	Just on the fiscal thing, in your submission you talk about Government expenditure increasing over time, and other people have said that we are not alone here. You've identified increases, for example in New Zealand superannuation? I will just take a couple, which are super and the accommodation supplement, which is presumably increased to try to keep up with the housing. If you don't do that, then people can't live in houses, and that is kind of not a good thing, otherwise, they live on the street. The second thing is, there is not a great deal you can do about people retiring. So I am just wondering, if you were going to try and do something about this increase in Government spending, which areas would you cut?
Clark	Well, you could say "cut", but you could also say that Government spending grows at a slower rate than it has currently been growing. I think we have observed that Government spending has increased from about $40 billion 7 or 8 years ago to about $67 billion this year. That is a pretty—
Swain	A lot more people get hip operations nowadays.
Clark	I am not going to debate that.
Swain	I understand the global point you're making, but it is always hard to focus people's minds down as to, you know, 40 to 60. When they are in the 20s, what do you slow? What do you cut, or what do you slow? So what spending do you slow, and what is the impact of it socially—they are the big issues. I just wonder whether you have got any off the top of your head comments about that?
Nicholson	No, I don't have, but it is intriguing to note that for all the increased employment opportunity we have in this country, we still have a growing social spend on, for instance, welfare. Why is that? It doesn't seem logical to us. For instance, again go to the accommodation supplement you talk about. Surely that underpins the housing market, one of the very drivers of the demand for cash. I mean, focusing money into that area, that you are talking about would have people on the street, surely underpins the property market, with privilege.
Swain	Well, you could ask landlords to take less rent, you see, but I don't think they would do that.
Nicholson	Well, that is a point I would make to you—that the privilege is misguided. It is going into the hands of the landlords, perhaps. Perhaps.

Jones	If they're not on fixed interest, going to the bank. OK, Lockwood, you guys finish up.
Smith	Thanks, gentlemen. To me one of the fascinating things about your submission is that despite the fact that the farming sector has perhaps been hurt as much as any by high exchange rates, you are not arguing that we shouldn't fiddle with the monetary policy framework to try to target it. You are arguing that we should focus on the fundamentals, and I think that's quite interesting, coming from your sector. With respect to productivity and this whole fiscal question you have just been addressing, I am interested in your reaction to this. Dr Cullen tends to argue that the Government's fiscal policy is supporting monetary policy because he is running an operating surplus. Therefore he is taking money out of the economy, he argues, and therefore fiscal policy is supporting monetary policy. You seem to have a different view, because you have focused rather more on the cash balance or the operating surplus, you are focusing more on the rate of increase of Government spending. Would you care to enlarge on that? Do you agree with Dr Cullen that just because he is running an operating surplus, fiscal policy is supportive of monetary policy?
Clark	It is certainly good that the Government is operating operating surpluses. That is far better than, say, going into deficit. But you do have to look at the wider picture and see whether the growth in spending has had a fiscal impulse, regardless of whether there has been an operating surplus or deficit. And it is forecast to continue doing so for the next couple of years. Certainly having a surplus is good, but it is not necessarily sufficient.
Tremain	I just wanted to ask about—I am particularly interested in productivity, particularly comparing the productivity of the farming community to the productivity of the general economy, because it is my understanding that although we have had a 0.4 percent, you think, productivity improvement across the economy, the farming community has had a significantly higher year on year productivity improvement. Am I correct in saying that?
Nicholson	Very much so.
Tremain	So what do you think it is about the farming community that enables that part of the economy to have multi-factor improved productivity year on year, as opposed to the general economy not being able to achieve that, and the general economy's position being one of the key reasons that we have ongoing inflation?
Clark	Well, I think first of all Don is correct that the performance of the agricultural and primary industries in general has been outdoing the rest of the economy. That is quite true, and there are probably all sorts of reasons why that could be. It may be that practices behind the farm gate

have been pretty innovative over the years, and that goes back for 80, 90, or 100 years—all sorts of advances in on-farm practices have helped grow that sector very well. And I think also—

Tremain Has it been through increased investment in capital? The point I am making is, how come the farming community has been able to invest and increase its capital, grow productivity, despite high interest rates, while the rest of the economy has not been able to mimic that?

Clark This might be a slightly controversial thing to say, but the farming sector lost a lot of its support back in the 1980s and was forced pretty much to do it for itself, and it has responded very well to that.

Smith What would your view be if we focus on the monetary policy framework per se in this inquiry and don't address some of these fundamental issues that you argue are driving productivity, such as infrastructure, the extent to which the Government sector is crowding out the private sector, regulation, and this kind of thing? Do you believe we will achieve anything at all if we just focus on monetary policy without actually addressing these fundamental issues that do affect productivity?

Clark The answer would be no; it is as simple as that.

Foss We've got the Reserve Bank monetary policy statement tomorrow, and in the last statement dairy farming, in particular, featured in it and in some commentary. All those circumstances; i.e., the payout is higher, the dollar is lower, etc are again in place. I really enjoyed your submission here, but you've just told us that you have one of the most productive sectors in the economy, yet here we are talking about whether farming has problems with monetary policy or not. The message here is that this is a bit of a sideshow, and in fact there are a lot more core issues, such as the question that Chris was just asking there. Dairy have had productivity gains, performed very well in getting the returns, but now you find yourselves the whipping boy when the Reserve Bank governor hikes rates.

Jones Well, the dairy farmers do.

Foss The dairy sector, yes.

Jones Not many sheep farmers.

Nicholson Well, the sheep farmers are struggling, and no doubt about it, but the dairy boys haven't banked their money yet. I mean, it will be next year. They have certainly had productivity increases. They are captive. We can't take our business elsewhere. I can assure you that many of us would like to take our business elsewhere; we can't. So we have to be innovative inside our farm gate and make those productivity gains for survival's sake. It is as simple as that; it is survival's sake that drives these people.

Foss Would you expect to be featured in tomorrow's statement—at least, the dairy part of your industry? When the Reserve Bank governor speaks about monetary policy issues tomorrow, do you think you will feature again?

Nicholson I am not sure he will make it a feature, because last time he dampened down his discussion on it as opposed to expansionary fiscal policy. The Reserve Bank governor has said, in every monetary policy statement I can remember, that he is concerned about the level of Government spending making it harder for him to do his job.

Swain Just on the regulation. Everyone flicks across the standards—the RMA always appears—and then we move on. Would you agree that that in some areas the RMA implementation works better than in other areas, and would you, therefore, then agree that what people get concerned about primarily is the implementation of it rather than the Act itself—whether or not to change the Act—and in the end they say actually the Act is not too bad; it is the implementation?

Nicholson The federation has never promoted the repeal of the RMA—never promoted that. We are saying that there needs to be some better discussion around compensation where the public generally wishes to have its right of say over private property. That's basically the driver for our need for reform. The cost structures that are imposed in the central or local government areas around the RMA are also of concern, because of course there has been a, what, 15-year roll-out of this Act, and it has been at huge cost.

Jones The RMA? OK gentlemen, thank you very much for a very thorough submission.

Mr Stephen Poletti (Submission MP/13)

Poletti Hi, I'm Steve Poletti from the University of Auckland, in the economics department. I would like to thank the committee for having me here to present my submission. I have printed some stuff off, which you should have in front of you, so you should be able to follow what I'm saying—written as well as oral.

The first thing I think I would like to focus on is what is the aim of monetary policy. I would suggest that we really need to situate it in the context of providing a macroeconomic environment that is conducive to improving standards of living in the country, but without compromising economic and environmental sustainability. I argue that the current policy settings are not doing this.

So let's look at what economic sustainability is, and there's already a Cabinet paper on this, from 2000. In it they state quite clearly, and I think this is really important, that we want economic growth that is not interrupted by rising inflation, growing unemployment, emerging balance of payments imbalances, and increases in inequalities in distribution of income and wealth.

So judged against this rubric, how do the Reserve Bank of New Zealand Act and current monetary policy fare? First of all, on inflation growth, the Act, the monetary policy, is delivering low inflation, so we have to give it a tick. Low unemployment. We do have very low unemployment at the moment, so you can give the Reserve Bank monetary policy settings a tick, but I would argue that one of the reasons we've got low unemployment is because of low wages. I will come back to that later. In my view, that's not a good thing. Have we got a stable exchange rate? No. Clearly not. Do we have persistent balance of payment imbalances? Clearly, we do.

Productivity growth in New Zealand has been shocking over the last few years. I would argue, and I will argue, that the Reserve Bank of New Zealand Act has a lot to do with that. Overseas debt is spiralling out of control in this country, and inequality of income wealth is increasing steadily.

So let's look at it and ask why this current policy is not working, when it's judged against that wider matrix. So the first thing is that the narrow focus of the Reserve Bank of New Zealand Act on inflation and price stability is, in my view, misguided. The other misguided thing about the Act is that we've chosen one instrument, the interest rate, to control inflation. The interest rate is a very important price, as an economist. It is the price of capital. If you're interested in productivity growth, what would be the thing you would not do? You wouldn't put the price of capital up. You wouldn't keep it up. You wouldn't keep it high.

Because we've got a very tight band on inflation—we've persistently had interest rates higher than the rest of the world—we've had a wedge. So we're trying to maintain a wedge between our interest rates and the interest rates in the rest of the world. In a world with now such huge capital flows, this is just not sustainable and it won't continue, I can tell you that. New Zealand has now the eighth most traded currency in the world, and we're nowhere the eighth biggest economy in the world. So with our attempts at focusing on high interest rates, we're getting these huge speculative flows coming into the country, destabilising the exchange rate, resulting in huge amounts of money washing into the country, which is correlated with the balance of payments problems that we have, and then this money is recycled into the housing market and consumption. It's just silliness, in my view.

So I will say that high interest rates are basically curing the patient by killing the patient. Persistently high interest rates discourage product investment. Also, wage rates in New Zealand are low, and they seem to be persistently low compared with, say, Australia. Real wage increases in

New Zealand have been running at about half of those in Australia. So we've basically got the price of capital is very high, the price of labour is very low, so what does that mean? It means no productivity growth. You would rather hire someone else, hire a few workers at a low wage, rather than buy a machine.

Just to give a concrete example. In my other life I'm a vineyard owner. I sat around with some other people who own vineyards and we were discussing this new leaf-plucking machine. One of the guys who worked in Switzerland said: "Well, in Switzerland, the interest rate is 4 percent, wages are really high, it's a no-brainer. You go out and buy that machine." In New Zealand, interest rates are 10 percent and you can hire people at 13 bucks an hour or something. We went through the numbers. In Switzerland, you would buy that machine. In New Zealand, you wouldn't buy that machine. So you don't get productivity growth in New Zealand, because we've got such a distortion compared with other countries between the price of capital and the price of labour. So that's the first point I would like to make.

The other corollary of that is that the focusing on interest rates alone in a tight inflation band has resulted in excessive volatility in the exchange rate and a very high exchange rate. The OECD believes that this is a major reason for our low productivity growth. So I would say that the deliberations of this committee are very important, because if we get it right we can start to get productivity growth back in the economy.

The other point I would like to make is that if you set your parameters up so you are getting low productivity growth, then of course that leads to inflation in the long run, because the economy has constraints on it, and you can't get around it by increasing productivity. So it's a sort of vicious circle really that we're in at the moment.

But it's worse than that, because, as we've seen, if we have interest rates you get huge capital inflows. The banks then have access to a lot of funds from overseas. They can then relax their lending criteria, recycle that back into the housing market, and make it easy for people to borrow money. The amount of money that people borrow now for housing has gone up dramatically over the last 3 years. It's doubled. It's all come from overseas, or most of it has come from overseas.

The corollary of that is once people have seen the capital gains from houses, they sell the house, they withdraw equity from it, someone else buys it with borrowed money, and so you are seeing, effectively, money coming from overseas, going straight into consumption and it's not sustainable. You can't borrow to consume. Almost none of the money that is coming in from overseas is being used for productive investment that is going to help us pay back the money that we've borrowed, or lead to increased exports or whatever.

So this cycle can't continue, and it won't. It will eventually unravel. But it's caused a lot of damage in the meantime. So the conclusion here is that in a world with a huge spectrum of capital flows, targeting only inflation, and very tightly, and using the interest rate as your sole tool, is just madness.

I would like to turn now to talk about the second tier of the framework that I think the Reserve Bank of New Zealand Act should encompass, and that is environmental sustainability. In that same Cabinet paper on sustainable development, they talk about environmental sustainability as being a key factor in any kind of economic growth. This is a quote from the Cabinet paper: "It is development providing for human needs that does not impair the quantity or quality of non-renewable resources or the health of ecosystems." I would submit that environmental sustainability needs to be a constraint under which our economic policy operates under. So if we can find ways of growing, in clever ways, that may not mean the environment is further degrading, that's great. But it should be a constraint. It should be something that we all accept, that this is the way the economy has to work.

Now, there's a natural fit here with monetary policy. In general, more growth means more environmental degradation and everything else staying the same. It doesn't have to be, but in general if we don't impose that constraint explicitly, more growth will lead to more environmental degradation. So you have the possibility of the Reserve Bank of New Zealand Act actually explicitly including environmental sustainability as part of its targets. If that criterion isn't being met—in other words, if the economy isn't growing sustainability—then in my view the Reserve Bank of New Zealand Act should be able to slow the growth down or reduce it by using the standard monetary policy tools.

I would say that in fact we've absolutely got a fantastic opportunity here for New Zealand. We've got debate about food miles in Europe. That's only going to increase in the future. We've got a great opportunity to front-foot that kind of stuff and put environmental sustainability right at the heart of our economic policy in the Reserve Bank of New Zealand Act. Just as an example, we could start with an explicit carbon dioxide target, which is included in the Reserve Bank policy targets. If carbon dioxide consumption goes up, or production goes up beyond that, the Reserve Bank of New Zealand Act could step in and dampen demand and hedge growth.

I think this would absolutely reframe the debate amongst policymakers and amongst the public. If the choice was between shutting down one of the Huntley power generators or the Reserve Bank using its tools to dampen demand so that we get very little growth, I think it would be very clear what the decision would be. So I think it would completely transform the environment. I mean, everyone wants to be sustainable but when it comes down to making hard choices, I think we're often reluctant to do that, and this, I think, would concentrate policymakers' minds.

Jones — It's certainly concentrated our minds, anyway. Steve, do you want to wrap it up now? I can sense a number of questions coming.

Poletti — So basically I have talked a bit about submission goals. Basically I just want to say that we need to have a range, so the Reserve Bank of New Zealand Act needs to specify a range of different targets, the exchange rate, balance of payments, inflation, and environmental sustainability. Also, we need to have a range of tools, and this I think is a key point. I just want to spend a minute, if I may, on this.

The interest rate is good. As I have pointed out, we don't want to just rely on it. We don't want to run a high interest rate policy. So there are a number of other tools that we could introduce and give to the Reserve Bank. A capital adequacy ratio is something I hope other people will have talked about, where the banks can effectively control the amount of the credit that's available. A fiscal measure I think is also something we should really think seriously about. I have suggested here that KiwiSaver could be a good example of this. The Reserve Bank posts the interest rate and the KiwiSaver rate, so if demand is high, people basically who are in the KiwiSaver scheme, which is a voluntary scheme, would have to put more of their money into the savings, employers would have to contribute more, and that would dampen demand.

Over the economic cycle, we could arrange it so that the net amount of savings they put in over a cycle is the same, but it would be staggered. So in periods of low demand people would be saving less, employers would be contributing less, and vice versa if you have a period of high demand. So I think that could be very usefully looked at.

A capital gains tax I think is very important for the housing market, and possibly any other asset bubbles when they arise. I think it's important to remove the investment breaks for housing. But in general we're going to be faced with different situations in the future, and I would suggest that there needs to be a simple, robust mechanism to allow for the development of new tools as new situations arise. So maybe a yearly review of the Reserve Bank with a parliamentary committee, for example, where we could look at those things.

OK, that's it. I would just like to thank the committee for receiving this submission.

Foss — Your choice of closing down Huntly or dampening down growth, say, for example at about 1.5 percent, the choice is obvious. Could you just tell us what the obvious choice is?

Poletti — Well, the cost of—

Foss	Close Huntly, or dampen it down from 1.5 percent to zero percent.
Poletti	Well, the actual costs of closing Huntly, in terms of prices of electricity, or something, is actually very small compared with changing the growth rate from, say, 1 percent to zero percent.
Foss	But what's the choice? You said there's an obvious choice.
Poletti	OK, so if we want to reduce carbon dioxide emissions, one way you can do it is to reduce economic growth across the board. There's a strong correlation between energy use and GDP. Or we could be smart and shut down Huntly and generate electricity using geothermal, or wind, or whatever, which would have a cost but that cost would be a lot less than changing the growth rate in 1 percent of GDP, effectively. So if we wanted to reduce carbon dioxide emissions that would be the way to do it.
Jones	OK, well, moving on from Huntly.
Fitzsimons	Thank you. It's an interesting submission. I think it's the first time I have heard anybody try to link environmental sustainability with monetary policy. What you're actually saying, then, is that the environment sets some bottom lines for the economy?
Poletti	Well, absolutely. I think it's something we have to take very seriously. It has to be a constraint on our economic growth. Carbon dioxide emissions, where you have to grow in a way—the world has to grow in a way—that does not pump too many carbon dioxide particles or molecules up into the atmosphere, otherwise at some point we'll pay the cost. The cost will be much greater than if we took action now. To me it's clear.
Jones	A no-brainer.
Poletti	Yeah.
Fitzsimons	We're used to hearing that inflation is caused by a lack of capacity for the economy to grow, and that is usually seen in terms of labour capacity or capital plant capacity. Would you agree that lack of capacity in the atmosphere to absorb carbon, lack of capacity in the world's oil wells to supply increasing oil demand, lack of capacity in the aquifers and rivers of Canterbury to supply constantly growing demand for dairying are equally inflationary pressures?
Poletti	Well, I mean, yeah. If you run up against any resource constraint—I mean, labour is an example—but environmental constraints as well, it will push the price up. Of course.
Fitzsimons	And that will have inflationary effects right throughout?

Poletti: Yeah, that would have inflationary effects through the economy. The other thing is that I guess the longer you leave doing something about it, then the worse it will be in general.

Jones: A final point, Jeanette?

Fitzsimons: Yes, can I ask you, you have recommended a capital gains tax and ring-fencing, as a lot of submitters have actually done. That happens in a number of other countries. Do you have any experience of how that has affected—you could take Australia, for example, or any other country where you know that that tool is used—the economy generally, inflation rates, or the mix of investment?

Poletti: It's always very hard to know what the counter-effect is, what would happen if you didn't have that policy in place. I think I would say that in Australia the lending of banks on residential housing is, I think, 35 percent of lending. In New Zealand it's 50 percent. So we're heavily skewed to lending on residential houses in New Zealand, and I would suggest that part of that reason is the distortion of our tax system, and it is a distortion not to have a capital gains tax. It's a tax break for people basically to invest in housing. We don't really need that kind of investment. I think we've got too much investment in housing. We need productive investment.

Woolerton: My question is surrounding the issues when people talk about inflation, and they say the present Reserve Bank monetary policy settings are very good at keeping inflation under control, and that just before you asked Federated Farmers and they said that inflation is huge on farms right now, yet they are still happy with the Act as it is. My question is, as some other submitters have said, do you believe that the present Act is old-fashioned; it's trying to attack an issue that's no longer there, and ignoring issues that are seriously there?

Poletti: I do believe it's old-fashioned. I think when it was put in place the capital flows were much less. They were much less, by orders of magnitude. It's a different world now. We won't be able to continue this policy, whatever the committee decides. In a few years' time we'll have to change anyway.

Tremain: I'm just really interested in pursuing your concept of having multiple targets for the Reserve Bank of New Zealand Act. Do you think that by having multiple targets we end up running the risk of not actually achieving any of them?

Poletti: You are never going to achieve them all exactly. I would point out that we're pretty extreme in our Act of only having the one target. Australia, the UK, the US, all of them, have multiple targets explicit in their Act. I guess the point I would make is that if you have multiple targets you have to have multiple instruments. You're not going to achieve everything exactly, but you will do better. It's better to have a bit of inflation and less exchange rate variability, in my view.

Smith I am interested in your analysis that it doesn't look at different segments of the economy particularly if you take an overall view of it all. I am wondering whether you have a view that if you take the tradable sector of the economy, of course the farming sector you represented earlier is very much a part of that, and inflation in that sector is very low, and farming sector productivity improvement has been very high, despite for some years it was dampened. Productivity growth was about 4 percent a year, which is extraordinarily high. On the other hand, you have got the Government sector of the economy, which is now all levels of Government approaching 50 percent—say 44 percent—of total GDP and is now basically the Government sector of the economy, at one level or another. Obviously, inflation in that sector is extraordinarily high, and productivity, while it is not measured, doesn't appear to be very impressive at all. Do you have any view of that huge gap between the tradable sector and the non-tradable sector—which is the public sector?

Poletti I don't think the size of the Government has got any relationship to inflation. I mean, if you look at Sweden, for example, it has got a huge Government. It is much bigger than New Zealand's. Inflation is not a problem there. I guess I don't really understand the question. Are you saying that there is a relationship between the size of the Government and inflation?

Smith Simply, if productivity improvement is quite important to achieving—and I think you accept that productivity improvement is quite important; you put quite an argument about the importance of higher wages and cheaper capital, suggesting that productivity improvement is quite important. If you have got almost half the economy with no productivity improvement at all, in fact, maybe zero, negative, productivity performance, and take the health sector—billions more have gone into it, and no more elective surgery is being performed. There is no more output, but billions extra are going in. What's your view of how that is going to affect the improvement in productivity in the economy?

Poletti Again, if that's true, then that's a problem. But it's not an intrinsic problem to Government operations. I think the most productive country in the world is Norway, which has got one of the biggest Government sectors. The only reason GDP per person in Norway isn't bigger than the US is because they have a lot more holidays. But their productivity is much higher than the US. I guess what I would say is that we look at countries like Norway and see why their public sector is productive, if it is much more productive than New Zealand, and implement measures to follow what they do.

Smith Obviously, competition is not something you see as terribly important in all this?

Poletti No.

Fitzsimons You refer to a Tobin tax—an international tax on financial flows—and that New Zealand should advocate for that internationally. That's an idea that's been around for a very long time, and it has its advocates. But can you tell us what support you would expect there to be if New Zealand took that position internationally? What other countries might potentially support us, and if it's a long way away from achievement, what could we do that might have similar effects in the meantime?

Poletti The Tobin tax, I don't know if people are familiar with it. It's just a tax on short-term carry trades, basically. The problem with it is it has to be implemented by all the countries in the world at the same time, basically, because it's very easy—

Jones Was it Chile that introduced the notion like that?

Poletti Now that's a good point. Chile introduced some capital control measures with effects that are similar to a Tobin tax. I think that's something that the committee should really seriously look at. They were successful, as well. They have basically avoided the Mexico peso crisis, so they have managed to limit the capital inflows into Chile. You didn't get that huge asset bubble, and then the collapse of the exchange rate. So that's something I really think would be important to look at. In terms of the international Tobin tax, I think Canada has passed legislation advocating that. Belgium has passed a law that says they will implement a Tobin tax if the rest of the euro zone implements one. So I think it's something that we should be actively promoting and encouraging. We can't do it on our own, but we could look at something like what happens in Chile.

Jones We might get a bit more information from our officials about the Chilean experience.

Poletti Yeah, I think it's very important—

Jones Thank you very much, Stephen.

New Zealand Institute of Chartered Accountants (Submission MP/30)
Mr David Pickens, Director and Mr Craig Macalister, Tax Director

Jones David, welcome, and Craig needs no introduction whatsoever. We've got your submission, so walk us through it and we'll open it up for questions.

Pickens Thank you. We certainly appreciate the opportunity to come down and speak to the committee on this topic. We do think it's an important one. I think the key point we would like to make at the outset is that we are strong supporters of the current framework for controlling monetary policy. I think, referring to a speech heard some 20 years ago from Treasury about the importance of monetary policy, we accept it is the field gun in the fight against inflation. But, that said, we also think that there are other complementary measures that can usefully be put in place as well.

In terms of the Reserve Bank of New Zealand Act itself, we do see some risk with amending the Act and amending the agreement between the Minister of Finance and the Governor of the Reserve Bank to pursue multiple objectives. There are a number of risks with that, including knowing when you've achieved your objectives; the signals that it provides to the market. For example, if you change your objectives, then that will signal, even if those objectives are consistent with what the Reserve Bank is doing with growth in employment. The risk is that it will signal a weakening in the Government's resolve to keep inflation under control, and given the important role that inflationary expectations play, that can be counter-productive in terms of increasing the costs of retaining control of inflation.

In terms of complementary measures, we certainly appreciate that there are two sides to the equation when it comes to inflation. There is the demand side, which the Reserve Bank very much focuses on, but there is also the supply side. So in terms of complementary measures, the sorts of things that we would advocate include a regulatory responsibility bill that will look at the quality of the regulations that have been passed by Government, and what impact that is having on productivity, and the wider economic objectives of the Government.

There are also other issues around, for example, the taxation system. We have certainly advocated for a number of years now a lower, flatter scheme of taxation in New Zealand. New Zealand has been moving away from that, and we think that's impacting on productivity and supply side issues, as well. Craig Macalister, the director of tax, can provide a very brief overview of the issues around the proposed ring-fencing of rentals.

Macalister The institute was aware that the ring-fencing of rental losses was an issue that this committee was looking at. The position of the institute would be that we would oppose that, and we really go back to basic tax policy fundamentals in opposing that, and it's simply that you shouldn't be using your tax system for any objective other than the raising and collecting of revenue.

We've had examples of this in the past. We have had rental loss ring-fencing before. All it does is introduce a myriad of unintended outcomes, economic distortions, and consequently imposes a whole lot of dead weight costs on the economy that weren't there before it. It's not a particularly good mechanism to use to try and do something other than collect tax.. So it would be a very poor policy outcome, I would have thought, in the current tax setting of our operating—.

Jones	Craig, can I just ask you a question on factual accuracy. When did this arrive in the tax system?
Macalister	When did the previous rental loss ring-fencing—
Jones	Yes.
Macalister	That was 1980—it got repealed in the very early 1990s, and it was in the mid to late 1980s that it was introduced, I think.
Jones	And do you have a sense as to how it modified behaviour? What happened prior to that?
Macalister	Well, that was a policy response to a different issue altogether, and that was the days when we had very, very high personal marginal tax rates that were up over 60c in the dollar, and you had your problem with your Queen Street Farmers using losses to shelter their income and reduce their marginal tax rate. So that was a particular response to that. But interestingly, at least that was a sort of tax response to a tax issue; it was not a response to another economic issue that is going round the marketplace that is non-tax-related.
Pickens	Also on that, we footnote a reference to some of the work that has been done by the Reserve Bank, which shows that internationally it has not had the impact on inflation that—
Jones	We have had that.
Macalister	I guess I drew the analogy with the Kawarau Dam and the dam over the outflow from Lake Wakatipu as a very good example of where you would end up if you wanted to cap rental losses and that is— That was a scheme designed in the early 1900s to lower the gates on the dam and stop the water flow, and then the gold minors could rush in and mine the Kawarau River, and everybody would make a lot of money. And when the day came, and they lowered the gates, and they thought the water flow from the river would stop, it didn't. It just carried on flowing, pretty much as before. It only went down a little bit, and I think that is exactly the same response you will get by capping rental losses; people will just find ways around it. Yes, it will have an impact at the margins, but, you know, rental losses are comprised principally of depreciation and interest, and you can shift interest to all sorts of assets in any which way, shape, or form you want to, so there are going to be scams designed to get around it. Then the Government is going to have to respond with policy responses to stop the schemes designed to get around the schemes that they are getting around and, again, before you know it, you just end up with a turgid mess, and it is just better not going there, in our research.
Jones	And more accountants, perhaps.

Macalister Well, absolutely, I mean, that is the irony of it all, of course, when we actually are arguing that accountants—

Jones Yes, well I think your point is well made. Paul, I think a point of clarification—

Swain I just have a question, really. I mean, you have a go, obviously, at looking at some of the implications around doing something around the housing area, and you raise problems. Every time you try something or think about something there's a problem with that and I accept that. I mean, this is not easy. If it was we would all be doing it, presumably. And so, then we kind of wander into the two old bogeys, really, which are government spending—an easy thing to kind of flick away—and regulation.

On the regulation side, I will just ask the questions where I can. International surveys show that New Zealand is still one of the easiest countries in the world to do business, so I would be interested to know, for example, could you give us one that the regulation or responsibility of the Act, or whatever it is, is going to fix, one, that you would get rid of, tonight, today, tomorrow, which would see this huge surge in productivity growth. I will just leave that hanging.

But around the Government spending one, the issue is always trying to identify which bits are causing the problem. You identify a positive one, which is roading, and then you raise what looks like bad ones, which are childcare subsidies, which have always been part of that internationally. It's been to try to improve productivity, actually. Health expenditure, which is about, you know, a population demanding higher health expenditure; student loans, to try and get people out of that debt cycle so they can put a bit of money away, either into a house or put some money for their superannuation.

So I am wondering which one of those is the worst, that you'd do something about—that you would cut, get rid of, chuck over the edge, because no one ever is prepared to say: "Oh well, you should stop spending on health, you should stop paying old people. It's an outrage, and if you did that, we would all be better off."

Pickens I think there are a lot of responses to that. I think, one, just going back to touch on New Zealand's, compared to the other countries', compliance costs in terms of business, it is certainly acknowledged that New Zealand probably has a lighter touch in most of the areas, compared to the countries we compare ourselves with and we compete—

Macalister Overlaying that, though, you have got to look at the size of New Zealand business compared to—well, we regard, many businesses in New Zealand are very small to medium-sized enterprises. When you compare

	it to overseas, they call a business of 500 staff small. We call that large. And compliance costs surveys show that the smaller the business, the more disproportionately they bear the burden of compliance costs, so it does not surprise me that we get these relativities of size—
Swain	One counter argument that I have read is that actually the smaller the business the lower the compliance cost—they just do not bother.
Macalister	That is right, there is an aspect to that, it is true.
Pickens	But the other issue around that, too, is that it is important to look at the trend, and the trend that we are concerned about is that New Zealand is rapidly giving up its comparative advantage in this area. We do see it as a comparative advantage, but we also see that, the way we are heading, we are surrendering that advantage. So in that sense, we would like to see a system in place to make sure that we do properly weight that light-handed regime. In terms of the expenditure, again, there are a number of responses to that, as well. I think one of them is around how we provide those services. Are we really looking across the whole range of options we have available to us to make sure that we are providing those services and that assistance as effectively as we can? Are we willing to consider, for example, public-private partnership to improve effectiveness and efficiency, or is that something that is off the table?
Jones	So then more marketisation?
Pickens	Looking at the incentives and the weight on the providers to make sure that we are getting the best value for money that we can. I think the other response, too, is that we are pragmatic. We realise that people are not going to be putting issues on the table at this stage for big cuts across government, but, at the same time, it would be nice if we could see curbs on new expenditure, and making sure that that new expenditure really is of high priority. So that's normally where we'd focus, rather than necessarily trying to put big cuts across existing government.
Swain	Could you just give one quick example before you do that?
Jones	So, put the Super age up—is that what you have in mind?
Swain	People are pens poised over here, you see!
Jones	You don't want to put the Super age up and reduce the minimum wage?
Pickens	What has been happening is that the economy's been growing very, very rapidly over the last 7 or 8 years, incredibly so, but, as a proportion of that growth, more of it is going to Government than previously. But the political problem, of course—it is not a problem, I think it's about 29 percent or 33 percent of GDP—is that in a strong, growing economy,

	we are devoting more of that to Government, and it is very hard to politically then take that away. The risk, of course, is that when we go into a downturn—and, of course, New Zealand, at some stage, will go into a downturn—that is when those hard decisions will end up being made, and the cost is going to be much greater for us, because—
Swain	Which is why you run surpluses. But, anyway, that is a whole other matter. Sorry.
Woolerton	My question is, not only in this issue we have before us but in another issue on shares, overseas treatment of overseas shares, almost without exception people were saying that we should have a capital gains tax, and then there were discussions about that, and I just wanted your oral views of capital gains tax.
Macalister	The hairy old chestnut.
Woolerton	No, well everybody else has mentioned it, and I just thought you are the boys to ask your views on it.
Macalister	It is a very interesting one internally within the institute, because, obviously, we have a lot of quite high-powered tax practitioners involved in the institute, and it is the one key thing that we cannot agree on. But having said that, I can answer the question this way, in saying that the institute's key policy plank in tax policy is the broader the base and the lower the rate. I think capital gains—the decision around capital gains tax—it is not the decision do you or don't you have it, it is the policy parameters that you put around it. For example, if you decided—and I think the previous submitter was saying—look, this is a whole lot of untaxed income, and that creates distortions and disproportionate investment in those assets that are untaxed. But housing is just not the only one, I could give you an example of a—
Woolerton	No, I did not just say housing, either.
Macalister	OK, so if you decide to tax it, you then might decide, OK, then we lower the tax rates across the board proportionately by the amount of expected revenue we intend to get, and I think the broadening of the base, and the lowering of the tax is a gain. That is good for the economy, because that removes more distortions out of the decision-making process. So I think, if you put the right framework around it, I think a capital gains tax is possibly potentially something that could be considered.
Woolerton	Could be viable, shall we say?
Macalister	Yes, but if you were just to dump it on the economy with the current policy framework setting, then you'd have to say, no, it's probably not a wise idea.
Woolerton	I understand that.

English	Just in respect of that, maybe there is an argument that the monetary policy framework wasn't designed to deal with asset—discussion as to how much that mattered to inflation, but even if you have capital gains tax, like any of these tax measures, and ring-fencing off money, wouldn't it be correct that they'd have a one-off effect? It might change the base value of the asset, but it doesn't change the dynamics of the market, unless you alter the tax. Is that right?
Macalister	The economic advice we get is that a capital gains tax almost becomes like a stamp duty and then it just becomes a transaction cost, gets incorporated into the price of everything you buy and sell, and we all move on as we did before.
English	So why do you think so many people tout either ring-fencing losses or capital gains taxes as ways of suppressing value when the prices go up and down—
Macalister	Superficially, at a prima facie, it's obviously a way— I mean, people react to tax. If you tax something, there's a reaction and sort of a dampening effect in that. But possibly that's more psychological than real.
English	But even if it's real, you can only bring them tax once. Unless you can correlate the tax rate to rising values, you can't stop an asset price changing.
Macalister	Oh, absolutely. You've only got to look across the Tasman. They've had problems with housing bubbles as well over there.
English	So why do so many smart people believe that these kinds of tax changes would get rid of changes in house prices? Why do they believe that?
Pickens	In 2 years' time we may see the same sort of argument with regard to dairy farmers. I mean, the dairy farmers could be the ones pushing inflation in 2 years' time that other people look to blame. But I agree with what you're saying.
English	Well, they are now—I mean, why don't we bring out a milk tax? In fact, it would have a more direct impact on the short-term inflation problem than a capital gains tax.
Macalister	We would say from a policy perspective that possibly you'd look at it in the sense that you've got some untaxed income, possibly should you tax it? But you'd want to set your policy settings then across the board.
Jones	It's a broader question, isn't it?
Macalister	Yes.
Smith	Gentlemen, first could I congratulate you on what I thought was an extraordinarily high-quality submission. You sat through the previous

submission, and we've got to weigh up the evidence put to us. I saw you guys sitting through the previous submission and obviously you're not going to be too critical or you're not going to comment too much on another submitter's submission. But let's say for argument's sake that the recommendations in the previous submission were adopted by the committee and recommended to the House, and the Government thought that's great and it was adopted by the Government, what do you think would be the outcome of that kind of policy description? So you're not commenting on the submission; I'm asking you to comment on possible outcomes of that kind of policy description.

Pickens The type of approach we heard, and I think we did address it in a submission of it as well—I think monetary policy is there to deal with prices, and that's its first and foremost purpose. I think putting the multiple objectives in the Reserve Bank of New Zealand Act will certainly muddy the waters. I think it will reduce accountability, it could reduce the effectiveness of achieving the price stability objective, and I'm not sure that it's the best objective for achieving, for example, a clean, green environment either. So we're not sure that it's really going to contribute on all of those objectives, no.

Smith I note that you've argued that, in fact, if we're to have much impact, we've got to focus on the supply side of the economy rather than just on monetary policy, and you've run through a number of matters that while the fiscal responsibility Act's helped, it has not had any impact on the rate of increase of Government spending. You talk about the process by which regulations develop and the quality around that and possibly a regulatory responsibility bill, broadening some—taxes, and you're talking about planning legislation, RMA, Building Act—that kind of thing. Is it fair to say that what your point is arguing is that there's no magic bullet to productivity, that productivity can be influenced by this whole range of supply side policies that are very much within the control of the Government? Is that fair?

Pickens Absolutely, I think that's fair. And I think we've put the dynamic spin on that as well, over time. Our concern is that we potentially have policy settings and they're going to get worse for productivity, and make the effective implementation of monetary policy more difficult. So that's our concern.

Smith And on the increased Government spending—I know certain members have been asking what we could cut, but examples of Government choosing to increase spending where, in fact, the arguments may or may not have been that strong economically but may have actually been more political, might be decisions that become extraordinarily hard to change once they're in place. It might be such things as decisions to make student loans interest free rather than reduce taxes collected—and remember there's always a cost to collecting tax—to hand out a whole lot more money to middle New Zealand through a Working for Families policy—almost $1 billion, say—instead of reducing. Are those the kinds of areas where increasing the Government spending is not actually going to—

Jones Now let's see how judicious the accountants are.

Woolerton And as a supplementary, do you see encouraging people to go to university as productive or unproductive?

Pickens One thing we'd expect to see with the university one—I mean, it's standard practice within Government to have post-implementation review, and what we'd like to see with the university one is just how effective has it been at promoting access to universities. Has it really achieved its objective? If it hasn't, then remove it.

Jones OK, right—Craig.

Smith Hang on, they're still answering the question.

Jones Oh, he's not going to answer that question.

Smith He just did—I mean, that was a very interesting answer, but the question is, has that increased spending increased improved access to universities? That was the point he made.

Jones The existence of a student loan, or the removal of the interest component?

Pickens The removal of the interest, I think, was the question that you were fixing on.

Jones Too early to tell.

Pickens OK?

Foss Point 26 in your submission—it's the first time I've seen it, actually, in any of the submissions. There's a danger in all of this inquiry that the grass is greener, and many very considered submitters are now saying: "Hey, it's actually not really broke, and it's worthy to have a look at it, but there's nothing broken." But I look at your point there, and you put up for consideration that the last time some of the framework was changed, the PTA was widened to 1 to 3 percent, but also I'd like you to expand on the possible questions—you talk about this possibly reducing the credibility of the Reserve Bank. How does that potentially affect monetary policy—or what is the effect of it now?

Pickens I don't know if you've heard yet from some of the economists with the registered banks, but I've certainly picked up some those sorts of sentiments from them. The issue there is that—a key driver of inflation is what people think inflation's going to be in the future, and if they see

	that in response to the pressure during a tightening in monetary policy the Government is going to change the framework and make it easier, if you like, at that stage, then those expectations are going to be for higher levels of price levels. They'll change their behaviour accordingly, and therefore look to the Reserve Bank to actually control that. They have to go further, higher interest rates than they otherwise would, and the real impact on the economy over the short to medium term is bigger than it otherwise would be.
Foss	So the effect of that is greater uncertainty and, therefore, a higher risk premium?
Pickens	Yes.
Tremain	Just quite a specific question around the supply side, in terms of controlling inflation, and the policies that any Government has in place with regard to helping to control it, particularly in regard to the supply in terms of investing in capital. I mean, you do make the point in your submission about fiscal drag,—working, to invest in public capacity. Do you think we've got depreciating life—on taxation, and also any other policies that other Governments may have in regards to current investment in capital? Because I certainly think there seems to be a low, or a lack of investment in capital assets in this country in comparison to other nations that we compete with. Where are we missing out there?
Pickens	Yeah, at a high level I think we've had in New Zealand a situation where, because our labour markets are relatively not constrained by a lot of legislation, that when it's come to expanding businesses, people have been prepared to take on labour. I think we've got to the point where we're getting to the end of that—the ability of businesses to do that without pushing up the price of labour quite considerably—and I think we're in that sort of phase now. So I think the price of labour will go up, which is great for them, but I think what's also going to happen is you'll see an increase in the level of investment around business.
Tremain	So you think the market will take care of it without any other policies getting into play?
Pickens	It will, yeah. And the broad context I'd put around that too, when we're looking at what the Government is doing, is that we're concerned that the Government is moving away from the lower, the flatter, type of tax structures, to a more complicated regime, which again is counter to that type of investment as well.
Fitzsimons	Thank you for your submission. You make the interesting statement that the only purpose of tax would be to raise revenue and that it's dangerous to try and use the tax system to change behaviour. You would presumably then be opposed to things like tax incentives for research and development—and we have a number of those in the economy. So

the Institute of Chartered Accountants of New Zealand doesn't support that?

Macalister We didn't.

Jones No, they didn't like it.

Fitzsimons Going on, then, do you think that in addition to raising revenue, one of the aims of tax systems ought to be to maintain as level a playing field as possible across different behaviours and different kinds of investments, and not to be distortionary?

Macalister Absolutely.

Fitzsimons Would you agree, then, that it is distortionary that I can ring-fence my losses on a healthy investment, but I can't ring-fence against my salary my losses on an investment in the sharemarket?

Macalister No, I don't think I'd agree with that statement. Taxation on rentals, per se, is no different to any other source of income we derive. You can borrow money to buy shares, you can claim a tax reduction for that interest, the same way you can borrow money to buy a property and claim that against your rentals. So they're both tax, pretty generically in that sense.

Fitzsimons But the LAQCs are specifically for property investments and not for other kinds of investments?

Macalister No, you can use some limited attributing qualifying companies for anything you like, when really they're just a bit of a hybrid between—it gives somebody the benefit of having a company structure but the treatment like a partnership to pass losses through it. When you look at it pre the LAQC days, for somebody going into a business there was normally a business cycle. You might not anticipate profits straight away, so you'd have to set yourself up in a partnership. So you take your losses and then when the business starts to become profitable, you then migrate that into a company structure. So all an LAQC does is give you that from day 1. But, yes, they have been used for tax avoidance schemes and a whole lot of things that you might not regard as appropriate, but that's not the LAQC vehicle itself; that's the problem.

Jones OK, time for your final one.

Fitzsimons You said that capital gains tax could be acceptable or feasible in the context of your across-the-board settings. Did you mean by that that a tax like a capital gains across the board rather than only on some investments and not others, as we have at the moment, provided that is offset by the lowering of the general rate of taxation, then the general mix would be appropriate? Is that what you meant by that?

Macalister	That's right.
Fitzsimons	That you don't want new taxes dumped on top, but that if it is offset and other taxation then could end up with a fairer system?
Macalister	Yes. I mean, it is all about then that would possibly take some of the tax-driven decision-making out of the system while still raising the same sort of amount of revenue. Obviously, there are issues around administrative costs and the like. It would be a more expensive system to administer, but that's broadly where we're coming from.
Fitzsimons	But not more expensive than constantly trying to decide what your intentions were when you bought a house, which is what the tax department has at the moment. You can take that right out.
Macalister	Yeah. The taxation of property, that's one part of it—
Jones	OK. No, we've had enough about tax. We're going to wind up. Final question from Mr Gosche, and that's it.
Gosche	On page 10 you've put up alternatives to rental property tax, which are things we have quite a few people asking for at the moment—freeing up of land, reviewing the Resource Management Act. How realistic is that? I was at a public meeting in Auckland last night where the prospective mayors and councillors were told fairly plainly what their future would be if they allow 10-storey developments in a certain part of Auckland. Another council is struggling at the moment with development down by Cleveland, where all the locals are up in arms and fighting it every inch of the way. I think the same council is dealing with trying to have the MUL go towards the airport. So, I mean, it is an easy one to put up, but when you actually look at the realistic prospect of it happening, is it just something to throw into the mix?
Pickens	I think you're absolutely right that it is a very easy one to put up, and we're certainly not experts on the political dynamics and the decision making around councils either, so if it's not politically possible, it's not politically possible.
Gosche	Well, it's not only the politics of it. We've got suburbs in Auckland that spread for miles, and then there's an enormous cost for providing them with the infrastructure that everybody expects. So there are some reasons why you don't just allow cities like Auckland to sprawl and sprawl and sprawl. I mean, the motorway currently being built to the north has a lot of people worried in terms of where the next residential development further north would be, so it's no easier—[*interference on tape*]
Jones	OK, on that note, that's an alien message that you've had your time. Thank you very much.

New Zealand Chambers of Commerce Incorporated (Submission MP/69)
Mr Charles Finny, Chief Executive and Mr Jeremy Harding, Policy Manager

Jones First, Charles, I apologise for the slight delay but the accountants were a bit more protracted that we would have expected, so over to you.

Finny Thank you very much. Can I introduce my colleague Jeremy Harding who is with me today and, in fact, he did most of the work on the submission, and thank you for forcing me to read it again this morning, because I thought it was a very good submission that Jeremy had put together. Don't apologise at all for the protracted session that preceded us because it was very interesting, very relevant, and we agreed with pretty much everything we were hearing from the previous submitters.

This is a really important issue and we are delighted to be submitting on it. Basically, we support the existing monetary policy framework and we do not believe changes would be in the long-term interests of the New Zealand economy. However, we are delighted to have this opportunity to propose some policy measures that we believe would enhance the effectiveness of monetary policy and thereby take pressure off interest rates and the exchange rate.

This submission was, of course, prepared before some of the corrections that have occurred to the value of the New Zealand dollar occurred and before some of the very interesting information that is coming out on the state of the housing market had come out, and there is more interesting material to emerge, having talked to a few people in the industry this morning and over the weekend.

Jones We've got Dr Bollard here tomorrow, Charles.

Finny So we do feel vindicated in taking this position, given recent developments, and we look forward to the inquiry next year about what we do about sub-prime and about problems in the collapse of the housing market.

Basically, our submission explains why we support the existing monetary policy framework. We do believe that low inflation and price stability is crucial for the competitiveness of the New Zealand economy, and long term and medium term is the best way to maintain low interest rates and exchange rates.

Basically, we see the current inflationary pressures and also the high level of interest rates not as a sign that our monetary policy has failed but a sign that we have poor policy. Basically, the high interest rates are a warning signal being sent. The reason for this is that the bank is having to lean against policy settings, which all—until recently, anyway—have been pushing in the wrong direction, contributing to higher prices, and we see and cite a number of examples, including increasing Government expenditure, and growth in Government expenditure, which is exceeding growth in the overall economy. We also point to increasing labour costs and local government charges as examples of this problem.

Really, we think monetary policy needs support from other pillars of Government policy to be effective and it's not getting it at present. And we also want to emphasise that strong economic growth and inflation do not necessarily go hand in hand. There is too much focus on slowing demand and not enough attention given to the supply side of the economy. In that regard, I agreed absolutely with the comments that were made by the previous submitters. We really do need to increase capacity so that economic growth is non-inflationary.

Now, there have been a number of ideas that have been floated. We, in our submission, cite suggestions of biasing tax system against housing, mortgage interest levies, variable GST. We disagree with them and explain the reasons in our submission. We think that a couple of them are impractical and we really think that biasing the tax system would not be the way to go.

We, instead, propose a 10-point programme of action and this is explained in detail in our submission. Point one is slowing the growth in Government expenditure and should anyone want to ask me questions about examples, I have a few of where we could slow growth or trim Government expenditure. We need to enhance the competitive environment, and can I emphasise the important role that competition plays in maintaining downward pressure on prices.

We do not believe actually that migrants are the problem, but it is possible that if all migrants were to arrive at the same time and try and locate in the same place, there might be a short-term negative effect and so we do suggest the possibility of a policy that encourages a more even spread throughout the country.

We suggest that we do some work looking at capital adequacy ratios. We believe we do have a savings problem in New Zealand and we do need to improve the savings culture. We have supported, in general terms, KiwiSaver but there are other things that need to be done in that regard. We are strong supporters of an increase in investment in infrastructure. We have a very serious infrastructure deficit. The current Government has done a lot to help ease that deficit in very recent years and we are very supportive of those moves and want it to continue and expand. I guess the point to make there is infrastructure investment, particularly if it is well considered and well targeted, is quality Government expenditure. Our concern lies in low-quality Government expenditure. And, of course, the poor infrastructure has exacerbated problems over capacity constraints in the economy.

We've given you some ideas on increasing the responsiveness of the supply of land and housing. We really think we need to increase work on improving productivity. We agree absolutely with what the previous submitter said—that we have been growing our economy on the back of increased labour market utilisation, not on the basis of investment in capital, and we haven't been doing enough to upskill our workforce to use new technology.

We are very concerned about the rise in local government rates and we think that action should be taken in this area. One theme you will hear constantly from us is that we need to review the number of local governments in New Zealand and rationalise and achieve efficiency and productivity gains overnight through that action.

If we are to tinker with the existing framework, we would suggest rewriting the policy targets agreement to focus solely on price stability. If you do want to make any changes, we would recommend a look again at the targets and we would prefer a 0 to 2 percent range rather than the relaxation that occurred a few years ago. We think that has been part of the problem as well. So thank you very much for the opportunity to submit and we would be happy to answer any questions.

Swain Thanks, Charles. I thought by and large it's a complicated business and the summary of your 10 points was quite helpful. I mean we could spend hours on each one of them. They cover a lot of things that people have said but not summarised. Just quickly on the immigration one—you realise there are points, additional points, for people who settle outside Auckland? That was designed to try and get that spread of migrants out of the bottleneck in Auckland. The improving productivity—I'll just ask a question.

You say there is a need for investment and training and structure and stuff like that. Of course, someone's "Government investment" in these things is someone else's "crowding out the private sector", so I just kind of raise that generally. I agree with the point you are making but there's been some debate about high quality - low quality. I would be interested, in a minute, for you to give me an example of low-quality spending, because you mentioned that. But I think the guts of it really is that it's coming down to essentially two camps over the time we've had here. One is—look the framework basically is OK, and you are in that camp. You are actually saying is should be a little bit tighter and because you focus on inflation and that's what monetary policy can do. The other group is saying if you do that, we've got the interest rates - exchange rate regime. It's basically a solution to an old problem back in the 1980s and that with high-capital flows now this is actually telling off our productive sector and therefore we need to be more relaxed and have a broader range of targets. Have you got a response to that broader range of targets—the Australian model is the one that's generally raised? The current situation that we're in is dealing with a problem that was before and now we need something more modern, more appropriate, for the 21st century, given the change in, particularly, capital flows.

Finny	We wouldn't support that and if we were to be talking in a year's time I suspect the evidence would be all pointing our way. I'll let Jeremy respond in detail, but I would note that this isn't the first time a select committee has been considering this issue, every 10 years or so, when balances occur in the economy, bubbles rise, and people look for simple solutions. But we think that existing policy settings are fundamentally sound.
Harding	Only to add that the increase in the target has raised people's inflationary expectations and that's been one of the reasons for higher inflation and the need for high interest rates and exchange rates in response.
Robertson	Having looked through the previous submission, they make the case for supply side options. One of the things they say is that there are two ways to encourage greater aggregate supply. One is to increase investment and the other is better use of investment funds. So my question to you—because you have raised the issue of productivity in your submission—is what do you understand by the term "productivity"? That's the first question. The second one is what we might do to improve productivity. And the third one is what can we do as a nation State to promote better utilisation of all resources and not just labour, as so many people seem to concentrate on at the exclusion of other resources that may be improved? Three questions.
Harding	I think the first point to make is that at the moment the best way to achieve low inflationary economic growth is to remove some of the capacity restraints that we have at the moment, and improving productivity is going to be one way of doing that.
Robertson	What do you mean? I'm asking you what, as a term, do you understand by the term "productivity"?
Harding	Simply level of output per level of input.
Robertson	Wider? Are you just talking about labour and investment? Is there anything else we might use as resources—things like land and machinery?
Finny	That's certainly an issue when it comes to the rural economy. You can't measure productivity in the rural economy without looking at the technology used, and I have to say we have enormous growth in productivity in certain parts of agriculture, particularly dairy. It's world standard and it's particularly frightening that we can achieve that in some sectors of the economy but overall our statistics are so abysmal. Basically, if you want quick fixes, more investment, more investment in key infrastructure, removing capacity constraints there, roading, rail, and broadband. We need to look at the tax regime and we need to reduce the tax burden. There is an efficiency gain, productivity gain, to be achieved by upskilling the workforce and I think that the previous questioner

maybe was thinking that I was suggesting that that's Government's role. It's everyone's role, and employers have a very strong role in ensuring that their workplaces are learning environments.

Robertson You haven't answered my third one yet. What can we do as a nation State to promote the better utilisation of productivity—that is, all resources? What could we do?

Finny Exactly what we just said—tax cuts and increased investment, and create a regime which is going to be very investment-friendly. That investment isn't just going to come from within our own shores.

Foss You probably heard me speaking about this in the previous submission, as well. I just want to touch on, again, the last time politicians got their sticky fingers on monetary policy. You quote here that when it was changed from 0 to 2 fixed to 1 to 3 expectations over the medium term, I see that as actually being a floor—under-inflation expectations at 3 percent, not a cap at 3 percent, is what we had. So I'd like you to comment on that. But also, you actually just supplied the evidence here in that the effect of that was, sure, lower interest rates in 2003-04 but actually this merely fuelled the property and credit boom in accommodating the sustained rise in inflationary expectations. So, basically, short-term political gain, medium-term harm for the nation State.

Finny I think you've answered the question.

Smith Congratulations on a very comprehensive submission. I guess a bit of an out-of-the-square question, but your submission is quite similar to the Institute of Chartered Accountants. Business New Zealand is following you. Their submission is remarkably similar—

Finny They're always copying us.

Smith —Federated Farmers preceded you this morning. Their submission was very similar. So you've got much of the productive sector of the economy, be it the primary sector—the wider business sector, including manufacturing and services—and I guess the accountants see much of the productive sector in terms of the economic cycle. You are all pointing out that in fact there is no magic here, there's no silver bullet, productivity is the result of determined Government policies that impact very significantly on productivity. Why do you think that message is not being heard, because it's not as if it's the first time you've been saying this?

If I can even take it one step further, we've got all sorts of proposals around housing. We've hard people talking about ring-fencing, investment housing, that kind of thing. Price levels normally relate to supply and demand, and all of you people in the productive sector are actually pointing out that we've got a problem with the supply of housing. It's not been in demand; that's why the price is going up. Why do you think your messages are not being heard?

Finny — I think that there is an undue focus on housing—point one—and people are distracted into that territory. But I think that there is quite clearly a responsibility there for Government to look at the extent of and quality of expenditure, and that is perhaps a message that some find uncomfortable. But if there is to be a silver bullet it's more in that territory than some of the sort of voodoo solutions out there to change monetary policy.

Smith — You offered to give some examples. No Government member has taken you up on that of perhaps spending increases that have been justified.

Finny — I do get annoyed when I hear: "Oh, you can't cut Government expenditure because it means essential services are going to be cut.", etc. There are examples that come across my desk every day. The overspend on the helicopters—it was a pretty large some of money, pretty much equal to the funding deficit we have right now over Transmission Gully. There was a billion dollars spent by Government last year on IT. Surely, you can take some action in that area. No one's going to notice and it's actually going to help us here in Wellington where we've got a huge shortage of expertise in the private sector in the IT area, because all the expertise has been sucked up into Government. So that's a quality and quantity issue.

Woolerton — Just a very quick one on housing. How do you view the situation in America, where it is starting to turn into an oversupply of houses, arguably? But, certainly, it is having an impact worldwide. How do you view that? Do you think ours is no big issue here?

Finny — I just say watch this space. The US isn't the only economy with a sub-prime problem.

Woolerton — And what do you think we'll see?

Finny — Well, we're already seeing that correction. Just wait for the statistics to keep coming out. Prices are holding but volumes of sales are moving downward quite significantly, and prices will follow.

Jones — Correction on the way. OK, thank you very much, Charles. Oh, you had a question?

English — A number of submissions have said: "Look, let's relax a bit about inflation, because the costs of keeping above it are too high and in this context we'd value 3 or 4 percent on trade and inflation for 3 or 4 years. We're right at the top of the band." So do you agree with that view—that if we relaxed a bit about inflation a little bit more, then we'd have fewer other problems?

Finny — No, I do not agree with that view. I have spent most of my working life trying to deal with the problems that were created by that type of economy, and I do not want to go back. I do want to see New Zealand advance up the OECD growth ladder, and that is no way to get there. The long-term effects of a relaxation of policy in this area will be the long-term impact of these types of imbalances we're seeing right now in the economy. So it'll be exactly the reverse of what we should be doing.

Fitzsimons — Can you explain why the price of capital is so much more important to you than the price of the dollar, or the size of the current account index? You're saying it must be the pre-eminent role. Why is it so much more important than those other key factors?

Finny — Well, again, in a year's time I think I'll have a lot of evidence there to explain the reason. But we are already seeing some really major movements in the dollar, back to levels that we would see as being realistic in value. We actually would expect to see, before too long—I'm not saying in the next announcement, but before too long—the Reserve Bank is going to have to react to a number of trends and there are some really worrying signs out there, so I expect to see an easing of the OCR in due course.

The problem is not going to actually be the high exchange rate for very long. It was very uncomfortable for a number of our members, but we have coped. It has been very difficult. We are delighted that it has come back to the extent it has, and we look forward to it over the next few weeks coming back by another 10 percent against the US dollar and by even more against the yen. So we are concerned, there is no lack of concern, but by sticking to the existing polices, we are actually going to get to where we want to go, and it's happening right now. We're in that process.

Fitzsimons — You've given me some predictions, but not fundamental reasons, as to why inflation is more important. What about the current account deficit? When do you expect that to start reducing?

Finny — The current account deficit is, in part, a reflection of our poor savings record. I wouldn't dispute that at all. It has been exacerbated by the high exchange rate, so as the exchange rate comes back to more realistic levels—levels that are supported by the fundamentals—then you have the opportunity to see an export-led recovery occur, and I would anticipate that that will occur and we will see a much improved current account deficit at that point in time.

Fitzsimons — And the last question: Is our poor savings record influenced by the extreme ease of borrowing against high house prices, taking equity out of houses and spending it on consumption?

Finny	Oh, without doubt. Big increases in the value of houses make people more willing to borrow more and encourage people to go out and purchase. They feel more confident about their own wealth and are prepared to go out and buy some goods they perhaps wouldn’t be buying if they felt that times were tougher.
Fitzsimons	You don’t believe that that’s something that should be targeted by policy?
Finny	Not by this policy.
Fitzsimons	Or any policy?
Finny	Again, it would come back into synch—stick to the current policy, we will move ahead as an economy.
Jones	OK, right. Thanks, Charles.

Business New Zealand (Submission MP/18)
Mr Phil O’Reilly, Chief Executive and Mr John Pask, Economist

Jones	Phil, welcome. If I am to quote Charles, you could be a plagiarist, but welcome anyway. Welcome back, Phil, and John, the economist. You may recall, Phil, that 2 or 3 weeks ago we were strongly anticipating your arrival, because there’s a huge level of interest amongst our committee in terms of productivity and the connection between productivity—or our failure in productivity—and the problems, perhaps, that the monetary policy framework is experiencing in relation to price stability. So we look forward to hearing what you’ve got to stay about that.
O’Reilly	Thank you, Mr Chairman. We appreciate the time this morning and it is always a real pleasure to follow the Wellington Chamber, and, of course, to proceed the unions. It is always nice to be in front of at least one of the social partners for a change. We support the select committee, and, in doing so—to your point, Mr Chairman—we recognise that you had intimated to me informally that you would have some questions about productivity. We are going to have a joint session with the CTU in a few minutes’ time to tickle that out a bit more. With your permission we have given members of the select committee copies of a publication we put out a little while ago on productivity to give you our thoughts, in an organised fashion, on productivity. We are happy to talk about that in more detail when that comes up for conversation in a few minutes’ time. I suppose I should start, for those of you who are a little longer in the tooth, with another select committee that I recall looked rather like this one, and it was when Auckland was having a big drought many years ago, you’ll recall—10 years or more ago, when people weren’t washing their cars and all that sort of stuff. A select committee got together because there was a major emergency about water in Auckland, and we were talking about piping it from the Waikato, and huge investments and

so on—all good stuff. I recall that by the time the select committee got around to looking at that and taking hearings in Auckland, they couldn't hear the submitters for the sound of the rain on the roof, which is to the point about the speed by which politicians and politics can act, and therefore the kind of issues and interests that I think should primarily concern the political process. To some extent—not to a complete extent, but to some extent—the same thing has happened and is happening here.

I recall when this select committee was set up, the dollar was threatening US80c, and in fact went past US80c for a day or two. It is now below US70c and that is by no means out of the woods. Many of our exporting members would love it to be lower than that, still. But what that demonstrated is that the market moved much faster than the political process ever could. So my recommendation and suggestion to you is that, primarily, in your deliberations here, you do not do anything in a precipitous fashion—that you do things that are going to be valuable for New Zealand in the medium to long term. I think that is the best way in which politics and politicians can influence the process of growth in New Zealand and the growth of productivity in New Zealand.

In terms of this select committee process, we think it is important that the public has had an opportunity to have their say and have some open debate on the issues. I think it is certainly a very valuable idea to air the issues so that it doesn't just become a piece of rhetoric—the official cash rate and the Reserve Bank of New Zealand Act and so on—but they become real issues that people understand. We tried to contribute to that some months ago through the publication of our booklet *OCR: The sharpest tool in the box?*, which was sent to you and many others, and the purpose of that, really, was to look at some of the proposals that were being put forward, because I know your email in-boxes are full of people putting forward proposals saying: "If you did it this way, it'd be better.", and so are mine. So we thought: "Well, let's actually expose some of those, let's have a look at some of those, because some of them might be valuable, some of them might not be." And that was really the point of this publication—to take some of the more commonly held views about these things and give them some analysis, with a view of making the public debate more informed.

What we found is what you've already heard from my colleagues in the accountancy profession and my colleagues in the chamber: that there are no silver bullets. But there are some practical things that can be done to take some of the pressure off inflation, and, hence, interest rates. Those are in our submission to you, which is really the booklet. Among other things, those are things like making sure that markets are competitive, making sure that the regulatory burden is not too oppressive, and making sure that Government expenditure is constrained. Those are obvious things that we would say. They have been said before us, but we say them again. For example, issues surrounding land availability and housing supply clearly warrant further consideration, and I know a number of you have had some questions to previous submitters about that. That's the nature of the debate, but, clearly, issues around housing supply deserve another look—for example, in terms of making sure that we get housing prices that are fit for the market. Another example is that more information to the general public and overseas investors is required. Clearly, financial literacy is not particularly good, given the results of the AC Nielsen survey that we quote in our submission.

Overall, although there are some things you can do—and we certainly recommend that you think about them in the medium and long term, and you can start today, if you'd like—we would warn you, or, if you like, give you some thoughts that we would recommend against making fundamental changes to the structure of the Reserve Bank of New Zealand Act, because in our view there is some potential for some adverse consequences. New Zealand's monetary regime, and to some extent its fiscal policy regime, is the envy of many other countries. As you all know, the Reserve Bank of New Zealand Act provides for independence from intervention, ensuring transparency in monetary policy settings. We think undermining the objective of monetary policy by focusing on multiple objectives for the Reserve Bank would create confusion and reduce business confidence in the Reserve Bank as an important economic institution in New Zealand.

As I said, a number of indicators have shown that the pressure on resources, and particularly housing, have already lessoned over recent months. That is not only as a result of increases in the OCR feeding through into interest rates facing households eventually but also, of course, a slowdown in net migration. Obviously, the potential for importable tradables inflation remains a possibility, particularly if the New Zealand dollar drops further suddenly, and that will need to be taken into account as well. I think you need to be mindful of the fact that, as I said to you before at the start, sometimes the weather beats you, in this case the markets have kind of beaten you, to some extent. Markets will generally be faster than Governments at correcting, of course. Government intervention is not without potentially significant costs. The drop in the New Zealand dollar of around 15 percent against our major trading partners on a TWI basis is a case in point. Certainly, the horse has well and truly bolted, in terms of the current business cycle and the dollar and what you might be able to do about it.

So, really, we'd recommend that you focus on—to your point, Mr Chairman—the very issues that you have indicated to me that you want to focus on, which are those issues around productivity, the things that only Government can do and Government can do best. Those will tend to be the medium and longer-term issues—the settings, if you like, of the economy—by which the players can then go and play the business game in.

I have with me today my colleague John Pask. He is the economist at Business NZ and far better at understanding these matters than me. I am only a history scholar, Mr Chairman. So with your support I may direct some of your questions to him, if I may. Thanks for your time. I'm happy to answer any questions.

Jones — Competition policy. How important do you think competition policy is to achieving these productivity outcomes? Have we gone off the boil in relation to competition policy in New Zealand?

O'Reilly — Competition policy is absolutely vital to achieving productivity aims. John can give you some examples of where it's right and where it's wrong.

Pask — I guess the fundamental issue here is seriously looking at areas where there needs to be, potentially, monopolies, or, in the case that a lot of services could be opened up to competition and still meet the objectives of Government providing a safety net. There are a number of areas in local government—for example, do they need to be suppliers of water and waste, or those sort of things? The provisions of those services can be contestable. You've got your ACC scheme, all those sort of things need to be looked at on their merits. Do we actually need monopolies in these situations or can it be opened up to competition—not only in terms of provision of services but also in terms of price instructions. What is it worth? You've got to look at each individual based on its merit, and each individual case probably doesn't contribute a lot, but all those combined have an accumulating effect.

Jones — You may have already done it, guys, but is there an area where you think that competition policy changes ought to be started from? Would it be in the utilities sector?

Pask — Well, I think if you look at a number of areas, energy is an obvious area, do we need three large SOEs, could they be privatised over time? Would we send better price signals or those sorts of things? So I think you can look at those areas as a start, certainly.

English — Can I ask you the same question I asked the last people. The main criticism that comes through submissions about the current framework is that we're not relaxed enough about inflation. We get a bit wound up about it and overdo it, and that's what counts for particularly the volatility of the exchange rate. So is that a view you agree with?

Pask — No, absolutely not. I mean, if you look at the policy targets agreement, it allows the Reserve Bank to look at price stability over the medium term. Obviously, it uses the target of 1 percent to 3 percent. So there is already reasonable flexibility in there. There is already a requirement in the policy targets agreement for the Governor to consider issues such as exchange rates, what are the impacts of those, to try and not create unnecessary pressure when they're implementing monetary policy. So they are already in there. The danger, I think, when you get into reducing or taking a much more flexible approach is it creates uncertainty in the market. It is the same as actually having multiple objectives for the Reserve Bank. For example, if it had employment intentions, economic growth, sometimes they may be in conflict with inflationary pressures. What sort of emphasis do you put on one as opposed to the other? So you end up with a greater degree of uncertainty and the old saying, you know, how much inflation is good, you just end up with more and more and more over time. So I think it is reasonably important that you have a rigorous framework as we have got in place currently.

O'Reilly And I'd add to that, Bill, by making this point. The Reserve Bank's key role should be inflation. That doesn't suggest that other players don't have other responsibilities. So one of the points that we often make publicly, and it's a quote from someone in the dim distant past, and that's that the Reserve Bank Act needs mates, and so there's a complex interplay of factors here, and that's really what we're saying in terms of competition, markets, fiscal restraint, regulatory responsibility, and so on. If these things were being done fundamentally better than they are today, I think we'd see much less pressure in the inflationary piece. That would be out thought about that in the context of what John has said.

English One argument that I've heard with respect of contrast with New Zealand and Australia Reserve Banks is that New Zealanders have much more capacity in constraining the economy than Australia. We've been in a tighter corner with a very tight labour market, for instance, compared to a somewhat tight one in Australia. In looking back, one can argue about whether the Reserve Bank did the right thing at the time. Do you think the framework has delivered reasonable outcomes for most people through this growth phase or not?

O'Reilly Let me have a go at it and then John can talk about it too. I'm not sure that I necessarily agree with you that the Australian situation is not now quite constrained. The Australian unemployment rate now is hovering around the 4 percent mark, as I recall, or even the high 3's, so it's not a million miles away from us. So there's already very tight constraint there. I think the big difference between the Australian situation and our own is the fact that the Australian economy is fundamentally more productive than our own, and is, therefore, not quite so capacity-constrained. I mean, it's a different nature of an economy, of course; they dig a bigger hole and send it to China if they're in trouble. So there's some differences in the nature of their economy.

There are some interesting differences between Australia and New Zealand around the edges. For example, the Australian Reserve Bank governor very rarely makes a public comment outside of his interest rate comments. He doesn't try and talk things down or talk things up to quite the same extent that our Reserve Bank governor does. So there's some interesting differences around the edges, and I think some of those are bought out in the publication. But I'm not sure that the Australian economy is so different to ours that it warrants that difference in approach. John may have some other comments.

Pask — Yeah, I guess that the sheer size issue is always going to be an issue of economies and scale. I mean Australia being bigger, it's easier to move and you've got a bigger population and all those sort of factors. I think your point about the—one of the things we raised in our publication of whether the Reserve Bank, by incremental changes in interest rates over time, it's a bit like death by a thousand cuts: it takes a while to actually have its effect. I guess people, in terms of having fixed-rate mortgages, didn't really take that into consideration. So, I mean, without criticising the Reserve Bank, I think everyone's experts in hindsight. But perhaps actually taking perhaps around a 2.5 percent approach to movements in interest rates, less the number of changes, but more significant changes when they actually do it, to actually send people signals. I mean, it was an amazing reading that AC Nielsen stuff. Ninety-five percent of mortgage holders basically said, you know, increasing in the OCR by 0.5 percentage points would have no impact on behaviour. That to me—from an economist—is quite bizarre, to say the least.

English — OK, one last question. We're sitting here listening to submissions, and what's interesting is that the submissioners who represent the external sectors who have been most affected by a volatile exchange rate, seem to favour the currant framework, or not want to change it. And submissioners who represent the domestic sector, which appears to be very well served by the framework, with rising real incomes and a relatively flat interest rate until quite recently. You seem to want to change it. Can you explain that to me? I mean, why is the external business sector willing to take the punishment and not ask for anything much different, but the domestic sector, as we've had a pretty good run, actually, under this sort of framework, seems to think there's something wrong with it?

O'Reilly — Bill, I don't know. John might have a view, but certainly—

English — Why are you willing to accept that a framework that has generated significant shifts in the exchange rate, which make business investment a bit harder?

O'Reilly — I think the point I make, Bill, is that we're not saying: "Do nothing." In other words, we're saying this element of the framework is fit for purpose—largely; as you can see we've made some suggestions for change—but fundamentally it's a major element of the New Zealand economy that creates confidence and trust for an offshore investment, and creates a trusted framework for New Zealand business more generally to go about its work. So no surprise I would think, that even if you're taking some pain from it, you would say, be very, very careful, indeed, about changing it. But that's not to say: "Do nothing." As you'll see, the Reserve Bank Act needs mates, and it's that, in our submission, which is causing is causing exporters and other businesses difficulty. So regulatory frameworks, overtaxation, competition issues; if you sort those out, then the Reserve Bank Act becomes very much more relevant and reasonable in terms of its impact, we think. So overall, if you were to build productivity in the New Zealand economy through the various issues we're talking about, changes in the OCR would be much less impact-ful, which we suspect. So it's really a case about saying: "Leave that alone,"—largely—"but there's a whole bunch else you can do.", and only Government can really do over here, which would make that much less painful for exporters.

Swain This is going to be, obviously, a wide approach to any discussion, but I after just the observation about Australia with less flexible labour relations, higher general incomes, and there's people around here who would rail against that, but we will talk about that a bit later when we come to comparative relationships between Australia and New Zealand. I suppose the fundamental issue—putting aside the corrections which you have just outlined, and I basically agree with that—is that the issue on the one hand is that obviously with the single focus on single targeting—which is why some of us are interested in thinking about it. The single target has been around for 20 years; it was at another time. We're in the 21st century. Other economies have had a broader look at issues such as exchange rate, current account, etc. Some of us are nervous about: "Oh my God, if you do, the high priests of monetary policy will tell you: 'Look at those multiple targets. You don't have any of them.' ", but the worry essentially is that whenever you start to get some growth, it's going to be squeezed off, which ultimately then impacts on the export sector, notwithstanding the argument about relationship, interest rates, or exchange rates.

So the question really is, isn't it time for us to have a think about whether, in fact, a multiple series of targets might be interesting for us to consider? You've already thought about that, and just to summarise, I would ask why you don't think that's the right approach?

O'Reilly John can answer that question, Paul, but as an aside I am looking forward to a new discussion which suggests that work choices in Australia is less flexible than the Employment Relations Act here in New Zealand. I must say that'll be a good conversation.

Pask Just briefly, I guess, on page 4 of our submission we talk about the Reserve Bank has already been required—and I'll read it out here—to basically "avoid unnecessary volatility in output, interest rates and the exchange rate", so to consider those issues where they are actually setting monetary policy, but their sole focus—their major focus—is on inflation. So it's a wee bit, perhaps, wrong to say that they're focused solely on inflation without any consideration whatsoever to these other things. But if you gave these other points where there's employment objections, economic growth, and so on like that all the same status, in some cases they could be in conflict with each other. How do you actually put emphasis on one as opposed to the other? It does create that potential for uncertainty.

Swain	Some other countries try that though don't they? By and large you'd say that their overall economic performance has been better than ours—for a whole pile of reasons, I acknowledge.

Pask	Yeah, I mean in our earlier Reserve Bank policy in the early 1970s-80s and all that sort of stuff, you had multiple objectives and just ended up going to extreme cases. So I think you need a very sound framework that's clear. I mean, I guess to the point, there's big debates about increasing the target from 0 to 2, to 1 to 3. I don't have strong views on that personally, but I guess that sort of issue has raised a number of concerns. I guess it's what I'd consider a relatively minor change like that has created a great degree of debate. So if we're actually going to add a whole lot of other things into the mix as well, it could cause more problems.

Woolerton	Yeah, I'd your views on an issue that is current—that is, when Fonterra was set up, and before that the Dairy Board and all the rest of it, just about everybody said it's the wrong model, it's a co-operative model, it's old-fashioned, it's rubbish, it doesn't send the right signals, and that it wouldn't be successful. Yet it has been far more successful than most other exporting businesses. My question is simply, why do you think that is?

Pask	Well, I think you've got to look at, say, the latest international commodity prices have peaked, there's a very high demand in terms of world growth—that's what drives commodity prices. The droughts in Australia last year—them getting rid of capital stock and so on there. So at the end of the day prices are not going to be determined by your particular model, but driven by, ultimately, supply and demand factors.

Woolerton	But it's always been more successful than meat and wool and all of the rest. It always has—not just now; always.

Pask	Well, I think you have to look at the change in commodity price. I mean you had the wool boom way back in the 1950s and things change over time as to what are—

Woolerton	That was that much.

O'Reilly	I might have a bit of a go at that, Doug. There is a bit of a difference, I think, between selling things like meat and wool product and dairy product and selling elaborately transformed manufactures, for example. I think that has led to some of those capital structure issues. So for example, milk powder that comes from an Otago dairy farm is largely the same as milk powder that comes from a Waikato dairy farm. The owners of those places have traditionally been cooperative in the sense that they co-invested in plant like freezing works and dairy factories and so on. So that was a very fit-for-purpose structure at the time, because they had a lot of capital and they were capable of doing that. It doesn't surprise me at all that Fonterra's continued to be successful because, of course, the big key to Fonterra's success was scale. They've built themselves scale, and that's the issue. What's interesting to me though—and I don't think Business New Zealand took a view on that at the time—but at the end of the day the owners of any business should work out the capital structure.

Woolerton I wasn't accusing, I was—

O'Reilly Yeah, I understand, Doug. But what is interesting though is as Fonterra looks to expand offshore into new markets, just as recently as in today's business pages of the *Dom* they're looking at different capital structures in order to enable them to do that, which is just a demonstration that as enterprises grow and as they change, then different kind of capital structures will be relevant to them.

The point I'd make to you is I think that if we look at what's going to take New Zealand forward, we're not going to be able to double our exports of dairy in the next 10 years—or if we can, that'll have some interesting consequences in climate change and all the rest. The big opportunities for New Zealand are not only to draw better value out of those things, but to build new industries based on things like manufacturing and services that we might not even have thought of today. When it comes to that I think the job of politicians like yourselves is to really build the framework by which we can potentially have 100 Nokia's. That's what I think you should be thinking about. I come back, when I think to that, about things like competitiveness in markets, restrained Government spending, and regulatory networks and frameworks, as well as all of the other capability building stuff that Trade and Enterprise does, which I think is fantastic. But it's those kinds of things that I think you can do well.

I think you change some of those big ticket levers in the economy only with a great deal of care, because they can have all kinds of unintended deleterious consequences down the back of the stage. So that would be my point.

Woolerton But that was my point. We did think that we were on the track to developing Nokia's but we're not. We still have a most successful dairy company, so we're no further ahead, really.

O'Reilly Well, I think we're substantially further ahead, Doug, in the sense that we now have scale, and you're now starting to see Fonterra do a couple of things which are very interesting. One is expand. They are investing New

Zealand capital offshore, which lots of New Zealand companies don't do very well, so that's a great thing. Secondly, they and partner companies and others involved in the New Zealand dairy industry are starting to develop some quite interesting new manufacturing and services industries based on, for example, pharmaceuticals from milk. These are interesting things, and there's no question in my mind that New Zealand is still a big farm. The things that we will do well will tend to be things that are based on that or are very closely aligned to it. That doesn't mean that we won't get a Weta Workshops; we will, because of the expertise of people. So that goes back to my point that you still need, I think, overall frameworks that encourage innovation as opposed to worrying too much about short-term solutions.

Smith Very quickly again, congratulations, Phil, on the quality of your work. If I could take you to your document on productivity you've got the heading "Improve Productivity". You've got a 10-point list on how to improve productivity. I'd just like to run you through those quickly, and you stop me where my interpretation of what you've got here you think is wrong. Some of these, I think, the Government recognises they're important and progress is being made on them, and others I think you'd probably agree that no progress is being made.

I'd like to start at the bottom of your list, because perhaps it's more positive: R and D is recognised as an important issue. Tax incentive: debate about whether that's the best way to go, but still recognise that it's an important issue. Innovation; the Government recognises that's important. Obviously, regulatory environment is hugely important whether it stifles innovation, but at least it's recognised as important. Global connectedness through trade and immigration: there's multi-partisan support now, I think for trade and the positiveness outcomes in immigration. Education skills: OK, how successful all policy is debatable, but at least it's recognised; it's hugely important.

Flexible and responsive labour markets: OK, if anything maybe we've taken a step backwards, maybe not. But certainly you point out, I think, that we've got sectoral negotiations across the country very negative for improving productivity. So that's one we've got to be mindful of, obviously. Infrastructure: I think that's recognised. The Government's making progress but obviously not fast enough. We're not meeting infrastructural demands fast enough. I think most people would recognise that. Expenditure and tax policy: another area of real controversy. I think it'd be fair to say we've gone backward in that regard, that'd be fair to say I think, in the last decade. Regulatory policy: I think you would argue we're going backwards there, too. There's not enough focus on the quality of regulation. Secure and transparent property rights: you see it's been a strong point for New Zealand in the past, and I think you're pointing out there are now resource property right issues that are actually becoming quite important to productivity.

Finally, competition: despite the Auckland University economics department thinking it's unimportant, you highlight it as being very important. It would be fair to say, if anything, we're not making progress on competition we may even be losing ground in services in particular things like education. Private sector involvement in education is tending to get squashed. The private sector delivery of prison services has been killed. Is that a fair summation—that on some of these things there's positive movement, but some of them, in fact, we're going backwards? And we've got to address those if we're to deal to productivity?

O'Reilly That's right, exactly, and I am happy to talk about that in the second session. Well send you some more detail, Lockwood. But the good thing is that—to your very point—there are some issues here where we've got some serious concerns and others where we think some good moves are being made. Overall, I think—and some members of the select committee may quietly or publicly agree with this—one of the big issues I think that we need to get on with in New Zealand is execution—getting on and doing it.

I was recently in Denmark, in fact, with Ross Wilson, who is going to submit next. One of the things—and I think I can speak on Ross's behalf; not that he'll agree with what I'm about to say in terms of what that means to me—but in terms of our experience in Denmark it was palpable that in Denmark there was loud public agreement about some clear targets, some KPIs, some accountabilities, and people got on with it—not just Government people but private sector people got on with it—in making Denmark a great place to be. As a result, of course, Denmark's the No. 1 place that the *Economist* tells you to invest your money over the next 5 years. So to me that's one of the big gaps. It's not just talking about it, but getting on with it. As well as that, of course, there are some serious issues that we have with some of these things being done at all.

The last point I made about this list is, this list should not surprise anybody. This list is just good economic management, and there's no silver bullets in all of this. So I'm happy to talk about that in more detail later on.

Jones Thank you very much.

New Zealand Council of Trade Unions (Submission MP/79)
Mr Ross Wilson, President and Mr Peter Conway, Policy Director

Jones Mr Peter Conway and Ross, welcome.

Wilson Thank you for the opportunity to make this submission on behalf of the 40 unions representing the more than 350,000 workers that we represent. The first point, I suppose, is that we certainly recognise the damage that can be caused by high inflation. The purchasing power of wages is easily eroded by rapidly rising consumer prices, and we've seen that in the past. But the issue, I think, for us is more that at low levels of inflation, the cost of extracting the last bit of inflation out of the economy can outweigh the benefits. There's a general perception that, at the very least, the official cash rate is a blunt tool that cannot on its own address inflationary pressures, and to the extent that it can, it causes widespread collateral damage to the export sector via exchange rates. Eighty-five percent of the current account deficit is from the income investment part of the current account. This decomposes into profits accruing to foreign investors, and overseas funding of bank lending to flow through into household mortgages. Although the exchange rate naturally is impacted by the relative strength or weakness of other currencies, there is an additional margin that is due to the currency speculation based on high interest rates.

In addition, there's a major concern that property speculators are encouraging house price inflation and the resulting interest rate increases are affecting employment security and the survival of firms in the manufacturing export sector. Even if the recent spate of hikes in the OCR along with other influences on demand manage to cool the housing market it is not desirable to see a repeat performance of what we have witnessed in the last 5 years, with house prices far outstripping wage and salary increases, and making it harder and harder for first-home buyers.

So we've been here before. We've suggested a number of measures that can improve the operation of monetary policy. In particular, we emphasise the need for sweeping measures to address house price inflation. It's not time, obviously, to fully discuss fully all the issues, but I do briefly want to touch on productivity—and you've indicated, Shane, that that's a primary focus of your interest. The CTU recognises that many cyclical and structural problems in the economy can be addressed in the context of rising productivity. Paul Krugman said in 1992: "Productivity isn't everything, but in the long run it is almost everything. A country's ability to raise its standard of living over time depends almost entirely on its ability to raise its output per worker." So we've got no quarrel with that. In fact, we're acutely aware that union involvement in productivity can be quite controversial within our own constituency for a number of reasons. The evidence of real benefits for workers can be hard to detect. Union engagement on productivity can affect the way that unions operate. Worker experiences of productivity initiatives, certainly historically, have often been negative, and employers are sometimes ambivalent about union involvement. There's a whole range of stuff.

But, disturbingly, it's hard to detect a relationship based on New Zealand data between lifts in labour productivity and an improvement in real wages. But the CTU also knows that if we are to lay firm foundations for the high-wage, high-skill economy that we have advocated for many,

many years, then continuous improvements in labour productivity will play a vital part.

And there is a connection with monetary policy. This is partly because we should recognise that if productivity is rising, it is that much easier to lift wages and profits with low inflation. But it is also relevant because high interest rates add to the cost of capital and, therefore, encourages employers to rely on low-cost labour. It magnifies the problems we already have with low capital per worker. In addition, it worsens the exchange rate, making it harder for New Zealand firms to export. In this sense the operation of monetary policy is undermining productivity improvements.

Just turning to a little bit more detail in relation to our proposals, firstly to amend the Reserve Bank Act and reword the policy targets agreement. We note that the Reserve Bank of Australia has to consider quite full employment in the economic prosperity and welfare of the people of Australia. The US Federal Reserve Board has price stability, maximum employment, and moderate long-term interest rates objectives. The Bank of England has to support the Government's economic objectives, including those of growth and employment. We would like to see the PTA wording strengthened by specific references to the impact of a high exchange rate on export performance and employment. Our preference is for such a statement to be embedded in the Act, rather than the PTA.

Given that monetary policy decisions to the board of the Reserve Bank of New Zealand, the current policy decision-making process doesn't allow for a very broad range of input. That again is significantly different from the situation in Australia, the US, and the UK.

Enforcing current tax rules in relation to housing. Again, this a point we made in relation to the housing issue. The CTU hopes that the Budget announcement that Inland Revenue is to expand its audit activity to ensure property speculators pay a fair share of tax will be enforced.

Capital gains tax. A recent editorial in the *Dominion Post*—and we don't agree with many of them—said that the situation requires politicians brave enough to impose a capital gains tax on homes other than the family home. They said that while such a move would not be popular, how many jobs have to go and how many times does the economy have the life choked out of it before politicians face up to the fact that New Zealand cannot afford to indulge property investors at the expense of those who create jobs and generate overseas earnings. The need for additional calls to control housing speculation is not a new issue. Don Brash said in April 1998 in a Reserve Bank publication, "the absence of a capital gains tax, and the over-taxation of many types of productive investment … together mean that inflation creates a strong bias in favour of real estate investment". We know all that.

We’ve also discussed the possibility of variable stamp duties. Another suggestion we’ve made is to remove the ability to offset expenses in rental properties—again, a point we made in relation to the housing issues when we came before you.

A variable mortgage levy to apply in some circumstances—and the Treasury and Reserve Bank discussion of supplementary measures included that suggestion that the mortgage levy that could be imposed is an effective tax. One of the concerns this raises is the impact on lower-income borrowers, and so one possibility is for such a levy to apply to mortgages on property that was purchased at above the median price or as an investment property.

The CTU has also supported a number of supply side initiatives in respect of housing: shared equity, increased State housing stock, addressing zoning issues, more high-density development, and acquisition of land-banked property. We’ve suggested other measures also in respect of housing, such as developer levies, higher levels of trade training and construction, higher levels of restriction on foreign purchase of property in New Zealand, targeted housing assistance, improved accommodation supplement policies, subsidised home lending, and enhancements to the KiwiSaver benefits for the first-home buyers.

We’ve also, in our submission, proposed implementing greater controls on bank lending practices. There also needs to be an investigation of the lending practices of banks, specifically the pay systems and disciplinary processes that incentivise staff to maximise consumer lending. We also note that KiwiSaver will, over time, have a positive effect by boosting savings. We are aware of submissions made in support of an interest-linked savings scheme and believe that these proposals deserve full consideration by the committee.

So in conclusion the CTU urges the committee to make some clear recommendations on future monetary policy. For us a lot is at stake. In particular, we hope that a solution can be found to the problem caused by overwhelming house price inflation. In an MMP environment we are looking for a practical way forward. It’s likely that any solution will have a downside, but this would be considered alongside the damage being done now. Thousands more New Zealanders every year are being priced out of decent housing, manufacturers are laying off workers due to the twin effect of interest and exchange rates, and a long-run cycle where the currency appears to settle even at the bottom of the cycle at a higher level each time. Controlling inflation needs to remain a key imperative. Workers don’t want to see the value of their pay packet eroded by high and persistent inflation, but the damage being done to the economy when interest rates rise significantly to dampen house price inflation is too high a price. Another tool and a more appropriate approach in our view is needed.

Jones Ka pai. Well, we've got 5 or 10 minutes for members for specific questions on this submission, and then we go into a joint session where both Phil and Ross and Peter will be present.

Swain You heard my question before about—and we'll get into productivity in a minute and ask some questions about that, but the issue of the two camps, essentially, on monetary policy: the ones that say: "Don't touch it now. It's all working well.", and those who say: "No, we need to have some adjustment with the other countries.", which is what, I think, you're suggesting. The problem, of course, is the issue that at some stage you're likely to get some tension between those objectives, particularly at what point you allow inflation to run and the impact that that might have on exchange rates, exports, and jobs. So what's your response to the multi-target, don't-hit-any-of-them argument?

Conway Fundamentally, what we are saying is that the OCR itself should not carry the whole burden of, in particular, addressing house price inflation. So we're a bit more focused on that, although we have submitted about having multiple targets. But we put that in the wording rather than any alteration of the band. So I think the band being there gives a pretty firm steer that you're still talking about, over the medium term, 1 to 3 percent, but we would like to see there be more consideration of the effect on the export sector by the exchange rate. So that rather than just say: "Well, sorry but it's out of our hands.", there's a greater onus to discuss that, to consider the effects of it, to look at whether you could delay an OCR increase through the cycle, etc. That would just put more onus on them, but we haven't suggested widening the band or that there's specific, for instance, employment figures that would have to be considered.

Swain One of the arguments that one submitter's made is that part of the reason why we're getting into a series of OCR increases over the last little while was because the Reserve Bank was looking at things a bit wider and not acting soon enough, and so there's criticism back the other way that if they'd acted sooner, we wouldn't be going through this issue now with high interest rates. So you would disagree with that, or would you share that view? The issue, I suppose, is at what point do you act? That's always going to be a problem, no matter what the target is.

Conway Yeah, we would disagree with that—that you failed to increase soon enough—but I accept that many economists do say that. I think we have to respect that somebody in the system is making a judgment call under current legislation in the PTA. The point we are making is that when you're dealing with such persistent house price inflation and you haven't got other tools at your disposal, you're asking for the problem that we're seeing.

Jones Potentially wrecking the productive sector in the process.

Robertson Peter, in relation to the submission under 7.2 you make a point there—and I will come to that in a minute. We all recognise that improved performance is the only way to increase our standard of living, and under 7.2 in the second part you said: "But the CTU also believes that we cannot have high productivity without enhanced performance at a workplace level." If that means that there is an expectation that there will be an increase in performance at the workplace level by the worker, what initiatives, if any, are in place to ensure that the workforce shares in any gains in increased productivity?

Wilson Well, essentially, there is nothing. I was a bit surprised to hear Phil say, in response to Lockwood's comments, that sector strategies are a constraint or an irrelevancy, because actually I think we would argue that wages should be very much in the sector strategy, and so should improving productivity. If you look at what we refer to there in 7.2 as being the necessary prerequisites to improvements in productivity, it is not just workers working harder—I think we would all acknowledge in New Zealand that we work very long hours, and people work very hard—it is actually that investment in skills. It's about modern infrastructure, it's about all of those things that we refer to in the context of the seven drivers as far as workplace productivity is concerned. So we think that there is an opportunity at this time to actually have a constructive debate, when unemployment levels are low, around productivity, but we have to do it in a way that is actually going to lift skills, lift the value of the products and services that we are producing, and lift the income that we derive from it. We think, therefore, that wage bargaining, collective bargaining arrangements of some sort need to accompany that, to ensure that there is a continuing incentive for workers to actually see productivity as something positive, because, as I said, historical experience has been very negative.

Conway Just to add to that, we, if we were asked the question about pay, we would say lifting pay involves distributional measures around collective bargaining, minimum wage, etc., but also lifting productivity. Where there's a risk at the moment is that with a lot more investment going into skills and into infrastructure, it is still at a workplace level that these things come together. So there are limits to what a Government programme can do about lifting best practice in the workplace, which is why we spend so much time with Business New Zealand and other employer organisations talking through seven workplace drivers and things like that. As Ross said, there is an opportunity now with much lower unemployment, because we would not want to see productivity lift by unemployment going up. Technically you can do that, but there is now an opportunity to lift capital per worker, which most economists would say, including the OECD, is the single biggest factor holding back our level of labour productivity.

Robertson One final question to both of you. What can we, therefore, do to promote or market the concept of productivity amongst the general population here in New Zealand in order for them to recognise that the only way for us to increase our standard of living is to do that?

Wilson Well, I think we should do what we have been doing. Over the last 2 or 3 years we have, I think, lifted the awareness of the importance of productivity by having a quite public discussion about that. I absolutely agree with Phil's comment that the key to it is the implementation, the execution of what we call the seven drivers—getting that change in New Zealand workplaces, and the infrastructure around it—to ensure that we do get the productivity. There is also the sort of process that Phil referred to in Denmark, where they had a very public national process of—meeting the challenges of globalisation was what they called it. I think it was a process that was very engaging for everybody; it was a very high-profile process. They came up with more than 300 recommendations, many of which related to investing in education and skills, and improving performance in those areas. But it was interesting that that discussion, that national debate, resulted in a survey showing that 71 percent of Danes see globalisation as an opportunity rather than a threat, compared with 45 percent in the rest of the EU countries. So that sort of public debate—and we have been saying that, too, that we do need a public debate, a national strategy, and a stronger consensus between capital and labour about how that is achieved.

Robertson Have you got any information you could share with the committee on that?

Wilson Yes, sure.

English I am a bit surprised at how much you focus on housing. I would be interested in your comments and explanations as to why you think it's so important. But more importantly, this framework works pretty well for your members. They've have had real wage increases, the wealth of their assets, the value of their assets has gone up quite a bit—might argue too much, but that's not an argument—here. If anything, the one problem has been that credit has been so cheap, as indicated by the fact that your members along with every other New Zealander have substantially increased their stock of debt as a proportion of income required to service it. So I am just wondering what—and you haven't mentioned that problem at all, which, of course, you'd have to argue that interest rates were too low through this growth period, not too high, if you thought the stock of debt—that they had access to too much easy credit. By and large, inflation's been around 3 percent, despite the biggest housing increase we have had in modern times, despite massive increase in household—. Real wages have risen. We haven't actually—growth's choking a bit now, but you'd expect that after 6 or 7 or 8 years of 3 percent-plus growth. What is the problem again? What are your members upset about monetary policy?

Wilson — Well I suppose we are populists, but we are not just concerned with current members who own houses. We actually have a longer-term view of the economy.

English — Yes, but has it not worked for them in some way? I will put the proposition: the only thing that's been wrong with it is that interest rates have been too low, and so they've gone out and borrowed too much, and now there's going to be a consumption crunch.

Conway — I don't think it's so much that interest rates have been too low. I think the issue has been that there has been such rapid house price inflation that it has been an insider/outsider situation. So for those who have not had to stretch, and for those who are in the housing market and have seen the capital value of that house rise, we would much rather see workers' consumption on the basis of rising real wages and higher productivity than cashing in on the basis of house price inflation and spending on holidays or consumer items or whatever on the basis of that, when there is a risk that that bubble could burst, etc. So the two issues, I think, are, first of all, the Reserve Bank governor often quotes house price inflation as a major factor and the reason he puts it up; secondly, the equity effects and the rapid increase. It's been very, very significant increases. People are talking about it slowing, but we're still talking about between 10 and 13 percent annual increase being a relatively mild increase. They talk about wage increases above 3 percent being a good increase. So, tale of two markets; it is a very different tale.

English — So in that sense your problem—I'm not disagreeing with you—is that the housing market per se, and a lot of your submission concentrates on what mechanisms might be put in place to achieve what you see as income growth, being productivity and wages rather than—or spending productivity and wages, rather than house inflation. I am just trying to work out the extent to which your views about the monetary policy framework are related to your problems about housing. Could we take from your submission that the problem with the housing market—as I said, that's the proposition that you have got there—if we put that to one side as something that could or should be fixed on its own merit, what do you then have to say about the monetary policy framework?

Conway — Well, we have said that there should be some change in the Act in terms of the targets, or, if you like, the objectives. We have not suggested widening the bands, so I guess that is an indication that we are relatively relaxed about that. We have said the decision-making process should be changed to not just be one person.

Jones — Internally, within the bank?

Conway — Yes. So I think what we would say is that we're not trying to—Peter Harris before us, etc—the CTU has been a long-standing critic of the operation of monetary policy, primarily because of its effect on the tradable sector. We have made relatively mild comments, very much in line with some of the things that the Svensson report came up with about that. We have tended to focus more on what we see the contemporary problem as being, which is the fact that it is not the right tool to control housing, particularly given what we have seen in the last 5 or 6 years.

English Yes, OK. So if I can just make sure that I understand the bits of thinking. One is that a view about the nuances of the monetary policy framework, which is quite arguable, what is in the Act and who makes the decision. Another chunk is your housing market, and you raise quite serious issues about affordability—. Then another chunk is your productivity argument. You've got particular views about how that can be achieved rather than questioning whether it is a really—issue. You believe it is, and you've got your views about how to use opportunity to achieve productivity. Is that the three parts of it?

Wilson Yes.

Conway Yes.

Fitzsimons You mention, as a problem, the degree of foreign ownership of the rental housing market, and you suggest that something be done to tighten up on that. Do you have any information you can share with us about the extent of that foreign investment in housing property, and the degree of significance that it has? I mean, presumably your argument there is that it vastly increases the amount of money available that is chasing a fixed number of houses in New Zealand, and it is a good investment opportunity because there is no capital gains tax, and that therefore that explains the prices. I was wondering if you have any information about the extent of the problem and also what the—.

Conway On the first part, no we do not have any particular information. We notice on page 58 of the Reserve Bank's submission that they said there is partial information available. They estimated about 5 percent of housing stock is held by non-residents—that is on page 58 of their submission. In terms of what to do about it, we have just asked the committee to look at that question. Given that it is 5 percent of the housing market, we see it as exacerbating, rather than a primary issue. But there could be some greater tightening up of the rules that operate in that area. I have also found that if, for instance, some of the issues such as the ring-fencing, and things like that were addressed, and capital gains, that would also tend to put some pressure on them as well.

Jones OK, right.

Joint discussion with Business New Zealand and New Zealand Council of Trade Unions

Jones — Stay there guys, or however you want to do this, and bring Phil and John up. Now I've got about 20 minutes for this session, committee members, and I need to encourage you to compose your questions very lucidly and deliver them in a succinct fashion, because at 10 to 1 we are going to hear from our special adviser from Aussie, and we are going to clear the room at that point. So in the spirit of succinctness, we will hear from Mr Swain.

Swain — Actually, both of you have kind of joined forces and worked on the broad productivity challenge. I am interested to know how you think it's going and is there one thing that seems to be potentially missing that needs to be considered from, say, central government?

Wilson — Money and time.

O'Reilly — That's right. Spend more.

Wilson — Well, the first phase was definitely an exploratory phase when we produced the productivity challenge report and identified the seven drivers. There's been, I think, quite an effective education process so that we're now talking about productivity to the extent that we weren't, and in the last year or so we have been developing potential models for implementation, because as Pete said earlier on, the Government can't do it. We can't do it on our own either. It actually does require a joint process, and I think that's one of things that impressed us from Denmark, for example, and Finland the year before. They actually do take a very focused approach to what it is they are trying to do, and the key to it is implementation, and that's the most difficult bit.

So what we are trying to do at the moment is to identify some projects, some models that relate to existing work. For example, our sector work around food and beverage manufacturing, the forest sectors, that we can actually inject these initiatives into, and then, at the bottom end, just plain upskilling from basic literacy and numeracy skills up through to high school levels. I just make the point that in that Danish report about two-thirds of the recommendations did relate to education and training.

Jones — And in capital.

Wilson — Hmm.

O'Reilly — Paul, I guess it's valuable for me to commence my response to you by making the point that I was just saying to John: "Have we ever done this before?", and he couldn't recall a time. So it's kind of valuable for the select committee to dwell on that for a second. Here we have business and the trade unions sitting in front of you. I don't recall sitting with my colleague Ross and Peter at a table like this before, although I spend an unhealthy amount of time with them. So I think that's a valuable thought. What it goes to is a very important point, Paul—and I know you were Minister at the time this whole thing started off, and I think—

Jones Oh!

O'Reilly —which is why he's asked the question, Mr Chairman, of course—what I think it does, though, is show the value, not just of Government action but of Government action with relevant private sector organisations to actually drive it out, because there are things the Government do best and there are things that other players do best. So to your point, as you know, the productivity piece actually started out of a conversation that went on in the private sector between Business NZ and the CTU. It was later on that the Government got engaged, and it is a very good thing they did. And to Ross' point I think we have been very successful at coming up with seven key drivers of productivity in the workplace. We have gone out and publicised that and it's now a much bigger part of not only of the political debate but also the business debate than it was 2 or 3 years ago. That's a very good thing, and it's a very positive thing that we are having that debate in a positive way, and that we are engaging unions and employers and businesses in that debate.

We are currently trying to think about what we do, as the next stage, because we have now done the publicity thing very well. We're now saying: "Well, what does this turn into?", and really the other thing that occurs to me is that the economic transformation agenda wasn't really around at the time we had these conversations, either. So one of the things that we're trying to do is work out where this fits in the wider ETA framework if we're to be fit for purpose as far as the Government is concerned.

If I was to do one thing—if I was sitting in your chair and had the power to pull some fiscal levers—to Ross' point, the one thing I'd do is to invest in skills; if you were to say one thing. To go back to Denmark, my counterpart organisation in Denmark, when we asked that person what was it that creates Denmark's competitive advantage, he said: "Training, training, and training." So that was his answer. Now, to invest in skills is a huge issue. To Ross' point, you can invest a huge amount in literacy, numeracy, right through to management capability at the top end, or even higher level science skills. So we need to have that conversation about whether—but if I was to do one thing, I'd do that, because it's the key thing that Government can do best, and it sets New Zealand up for a bright future in 20 years' time.

Robertson Phil, on this productivity perspectives, you make the point that low productivity brings low wages. I agree on that. But then there is an assumption—because you go on to say that the main reason why 20,000 New Zealanders leave New Zealand to go to Australia—that productivity is higher in Australia. I've got to say I'm not convinced of that, and having spent 20 years in performance within industry before coming to this place, I've had a look at the manufacturing basis here in New Zealand and Australia for best practice. I think that we actually rate above many industries in Australia, especially with our workplace performance, which is very, very good.

So that brings me to the whole issue of land, capital, and machinery. Working on the point that Ross made before about Denmark, how committed are both the business association and—to Ross—the trade union association in looking at this whole thing and working together to promote or to market this whole concept of walking towards best practice across New Zealand? And the point I ask – and I'd like to ask you both that – and the point I asked Ross: what initiatives will the employers' association take to recognise the point that if there is improved workplace performance on the part of the worker, what initiatives will you put in place to ensure that the worker also shares in the gains of increased performance?

O'Reilly Ross, to the first point you make, I point you to table 2 in the booklet, which is the OECD stats on productivity. So, objectively, Australia's productivity has been higher than ours, year on year, for many, many years—for some years now.

Robertson Manufacturing basis?

O'Reilly That's the overall economy, because those workers are not just moving to manufacturing jobs; they're moving to services jobs and all the rest. I think you made a good point, and I notice it too. I see workplaces in both Australia and New Zealand all the time, and world-class New Zealand workplaces are at least the equal of Australian workplaces. There's no question about that. The point is we are not doing it overall across our economy.

To your point also, that is not necessarily that New Zealand workers are less skilled than Australian workers necessarily, although in some cases that will be the case. It's to do with issues like capital intensities, to do with issues like the structure of their economy and scale, and so on. So all of these things play out. But, nevertheless, the fact of the matter is that the reason why Australian wages primarily are somewhat higher than they are in New Zealand is because of productivity—in other words, they're more affordable. Because I've got a bigger machine or I've got more skilled workers, I can therefore afford to pay them more. So that would be my answer to you: yes, I see elements of the New Zealand workplace and the New Zealand economy that are world class that'd beat anything in Australia. But overall, we clearly are not doing as well. and that's not because we don't have skills, or we don't have good management-worker relationships, or anything like that. It is to do with structural issues in the economy including, for example, the propensity to invest capital.

To answer your second point about what are we going to do to ensure that workers get a fair share from productivity gains, fundamentally we would argue—this is where we do have a point of difference between the CTU and us—that sector strategies are very relevant for certain things and not relevant for others. Sector strategies over 20, 30, 40, 50 years, probably, have been perfect in some industries, anyway, in some sectors, for developing skills. That's why unions and employers have sat around in industry training organisations and their predecessors for many, many years. One of the points I often make is if I'm sitting in a meeting with a Minister talking about workforce skills and I leave the meeting, I'll be happy to leave my proxy with Ross Wilson because I am sure he's going to say almost the same thing that I would have said. That's not surprising. That's been going on for 20 years—a large range of consensus between labour and capital about the nature of skills development and its importance. Those things work out well in industry because those skills, of course, are transferable and joint investment works there.

Less relevant in issues like wage bargaining, and the reason simply is this: my productivity gain is not yours. If I've just invested in a new piece of machinery and I have more skilled workers and you don't, that means the wages outcomes for our two businesses will necessarily be different. Otherwise, I'd cause significant competitive damage to the employer that's not in that situation. So we will simply argue that the best place to create wage bargaining is on an enterprise level, for the fundamental reason that wages need to be linked to the overall firm capability and productivity, as opposed to industry-led.

Having said all of that, I think what we would agree on is that the overall New Zealand solution to this is to build skills once again, because a skilled worker is much more likely to be a winner in a productive economy than an unskilled worker—and we can all agree on that. How that plays out will be a different song, but the fundamentals I think we can agree on—that is: build skills, you will employ employability, and you will build a better wage structure.

Robertson — And if the input-output ratio is improved as a result of the workers' performance—not necessarily new machinery—then what?

O'Reilly — That, once again, plays out on an enterprise basis. That's very difficult to do out on an industry-wide basis.

Jones — You're basically saying: "Confine that to each firm and enterprise.", aren't you? As opposed to the sector?

O'Reilly — That's right, and the point here, Mr Chairman, is this is an ongoing debate between employers and unions for a long time. Unions will say that national or sectoral bargaining is a good idea for a bunch of reasons, and we will say that enterprise bargaining, or sub-enterprise bargaining, is relevant for a whole bunch of other reasons. So there's nothing new in this debate.

Jones OK, Mr English.

Wilson Just very briefly—we have a point of difference.

Conway On the counterfactual with Australia, when the figures came out this year on last year, in terms of labour productivity at 0.7 percent, which was much worse than the lift in Australia, everyone said it's terrible. Then it came out the year before at 2.6 percent, which was ahead of Australia, and everybody said we're doing great. The reality is we're not doing great, because we're 30 percent level below Australia, and in the 1980s we were on the same level. So this has taken a long time to develop, so we are trying—as in many other areas—get our way out of a hole and we are in catch-up mode. That's the general thing. And even if you take mining out, it still doesn't change things that much. So on that one, perhaps Ross can respond.

Wilson Just very briefly on the other issue. First of all, in response to your question, we are committed to working in the productivity area, because actually we do fundamentally believe that it is crucial, so we have to continue this work, whatever happens.

I pick up Phil's point—yes, we agree that there are many firms that are best practice. So part of this is actually about having about a process, logically, from our view, within industries where that best practice is shared. That is very logically done, particularly with industries with an export focus.

As far as wages are concerned, we don't think that workers are actually going to be motivated for very long around the productivity agenda unless we can demonstrate that there are some benefits from it—that's one point. But the second point is that we see wages as actually being an integral part of industry development and economic development. So addressing the issue of how wages might improve as a result of strategies that improve productivity is a very important signal, in effect, to the workers and unions in that sector—not necessarily just put in the context of collective bargaining. So we don't see industrial relations as just a political issue you develop around; we see the wages issue within industry development as a very integral part of it. We should be able to develop some framework around skills, and the relationship between skills, improvements in productivity, and wages, as part of that process.

English Just one question. You guys have been talking about this issue of skills for a while. How different is the approach of business and unions from the bureaucracy in which you are working?

O'Reilly Two thoughts there, Bill. First point is there's a lot that the CTU and Business NZ agree on, and when that happens we celebrate it—hence the productivity reference group work and the workplace productivity agenda. There's an awful lot that we don't agree on too, and we are very clear about that, as you've just seen, and if Peter Conway was to talk to you about the productivity publication, he'd agree with some points and not with others. So that's the first point. So the point I'm making is that our relationship with Government officials will sometimes be different, depending on what we are talking about.

Where I think the big opportunity is, is for more of the Government and more of the officials inside the Government, if you like, to recognise the power and the value of private-public sector partnership and engagement on issues like this that are big issues for New Zealand. So I think the traditional model of the bureaucracy—whereby they took submissions just like this and went away and beavered away at it somewhere on Bowen Street or on The Terrace, and then came out with some draft proposals and submitted again, and went away again—some of those models still work fine for various purposes, but when it comes to something like this, it's not quite that simple. The power and value, I think, of ongoing public-private sector partnership is probably under-rated inside Government, and from my perspective—even though there are many things I will disagree with when it comes to my colleagues in the labour movement—what I will always argue is that they should be in the room to contribute.

Wilson I suppose it's the issue between policy and implementation. The Government officials are very good and very sophisticated at developing policy and we've had some very good discussions around these issues. But actually the implementation's got to occur out there, and so it's just keeping very much in focus that what we are trying to do is strategies that actually move outside Wellington, rather than are confined to a discussion.

Conway The only thing I'd add to that is that social partners are quite complex organisations. So we have lobby organisations and many other things, and representation organisations, but we are also service-based organisations, particularly the employer networks around service-based, in terms of what could be done there to change workplace practices and really, if you like, harness things like the tax treatment of research and development, and the investment in skills, better use of broadband—that's the sort of thing that we're really trying to move to.

In the union movement we are also focusing in on what we do with affiliates, what affiliates do with their delegates, and how they work with members, so that we've got a better understanding. Have we seen marvellous results yet? The answer would have to be no. But we're pretty convinced that we're on the right track in terms of what we've been doing around the seven drivers and diagnostic tools. We accept that implementation is always the hardest part and we've got a lot of it ahead of us.

Fitzsimons One thing that has been coming through in OECD reports and IEA reports for decades now is that New Zealand's energy productivity is very poor compared with other countries. As rising oil prices and decreased availability of accessible oil and carbon prices on all fossil fuels are likely to make that a driver of inflation as well, I'd actually like a comment from each of you on where you think we can go on that.

Now, what I have found, looking into it in the job I have at the moment, is that there's a tremendous shortage of skilled people at both the management level and the worker level in terms of understanding how to improve energy productivity in a business. There's a real reluctance to invest in more energy-efficient plant if it takes longer than a year and a half to pay for itself, even if it has a positive NPV and a long lifetime. How can we turn this around, and what can each of you do about it? Because I believe that energy crises are going to be a driver of inflation of the future.

Pask I must admit I'm not an energy expert here. I guess one of the big drivers is really the issue of relative prices—the price of energy in New Zealand as opposed to overseas—and the other inputs into the production process. So I'd just leave it at that.

O'Reilly I think it's a very useful question. The NGA process—the negotiated greenhouse agreement process—that took place during the carbon tax debate demonstrated, to me anyway; although I don't know about the productivity number, I'll go away and check that out—but certainly we're highly energy efficient, and that is what the NGA process pointed out. It was that we're at world-class levels of energy efficiency.

Fitzsimons But that only looked at a few firms, that process.

O'Reilly Sure, but from my knowledge of industry I think you could take it that that will play out quite a lot amongst the big energy users. But the point that you make's a valuable one despite that, which is the point—that it'd be a good idea if we could invest more in capital, plant, and equipment that was new and highly energy efficient and highly energy productive, and certainly drive some activity in that way. That, to me, is a story about investment capability. That's a story about ensuring that New Zealand companies have the capability to invest. It comes back to many of the things that I talked about: secure property rights, a regulatory regime that encourages that, skills development in our economy which enables that as well.

So I think companies largely, particularly large energy-using companies, will definitely be up for a conversation about the productivity of their plant and equipment, and by the way their total enterprise—taking an energy frame—no question about that. The question is how you get there. I think what you do is, you don't—for me anyway, I don't think you think about energy as being any different from the other kind of inputs to John's point that you might have in an enterprise. What you want is a highly efficient and productive enterprise, and that would tend to include capital plant. If you can get that right, one of the points I often make to politicians—sounds like you make it, too—is a new piece of equipment will almost certainly be better for the environment than an old piece of equipment. So one of the drivers should be: how do we get many more new pieces of equipment into our economy than old equipment?

Jones OK, Peter.

Conway Well, can I absolutely agree with that last point. I think there's definitely a connection between modernisation, capital per worker, and improving the quality of capital. And when you think of multi-factor productivity, which is how effectively labour and capital work together, then the quality of your technology around that is important.

The second point I'd make is that, just as aiming for high productivity doesn't sit on its own—for instance, we should all be concerned about levels of unemployment—then it doesn't sit on its own, meaning there is no limits to what GDP can do, because if it's always just about increasing output and we're not looking at issues of sustainability, we're going to get that wrong, as well. Therefore, there is a much greater emphasis, I think, that needs to be put on our joint work together about the linkage between productive workplace practices and sustainable workplace practices.

Smith Gentlemen, a couple of things you've said really made me want to ask about them. You have been working on this productivity in the workplace—the seven drivers of productivity you mentioned—for some time. Productivity measurements during this time have continued to nosedive, and they are now getting down to very serious levels. Our productivity growth, as I understand it, is about zero now, having been up close to 2 percent during much of the 1990s and the early part of the last 8 years. Does that suggest to you in any way at all that, in fact, there are other issues that are not being addressed—and since you guys are trying to make a difference out in the workplace, in fact, the party that is not making enough difference is the Government?

Before you respond to that, let me come to the point you made, Phil, a while back, about how one of our problems in New Zealand is getting on and doing anything. Productivity is often improved when a business that has got the productivity seeks to invest and take over from a business that is not able to improve its productivity—I mean, that's the way the world works. Yet in New Zealand here you try to set up a business somewhere, and you talk, Phil, about getting on and doing something, but it's bloody well impossible. I happen to live in part of the country—my constituency is where a lot of development is supposedly happening—but you try to actually set up a business of any kind, and it just takes endless time. So what's your reaction to that?

You guys are trying hard to improve productivity in the workplace. We are not seeing results yet, and admittedly I accept there's a time frame issue here, but is it right that in fact, before we will see any results, the Government has to accept that it's got—around competition policy, regulation, size of Government—all those sorts of areas.

O'Reilly — There might be some differences between us on this matter, Lockwood. I agree with you completely. In other words, what I would say is that the workplace productivity reference group work has been extraordinarily valuable because it has enabled business and workers to talk about issues relating to productivity in a very positive way, and I think it has the potential to make some very useful gains in workplaces in terms of workplace culture, skills acquisition, and so on. It hasn't been executed as well as we would've liked, but that's a matter for the future, and we're just talking, as we speak, back in the bureaucracy about how we might achieve that outcome. So it's good that that's going on.

But, of course, I think it would be a very serious thing to say the whole of New Zealand's productivity is based on the work of the workplace productivity reference group. Of course it's not. This is a useful mechanism and a useful conversation to have, and hopefully it will make some positive change. But fundamentally, as we set out in our publication, there are many, many other things that need to be done structurally in the economy with regard to regulation policy, competition policy, ownership rights, all sorts of R and D, and so on. Productivity is a thing that's impacted by hundreds of Government policies. They all need to be aligned to that point. We would argue—I am sure the CTU won't agree quietly with this—that many of them are not, some of them are, but many of them are not. And until you align some of those things you really won't get the turbo charging of productivity that we need.

Conway — We are second, according to the World Bank, in ease of doing business, but I would agree substantially with what Phil has said.

Smith — Come to my electorate, and try and invent something.

Conway — We will come and try to lift the wages in your electorate.

Smith — The most powerful regulatory authority in my area is Transit New Zealand. I had $2 billion of investment. It couldn't happen, because Transit New Zealand would not allow it to link up to State Highway 1—it would not allow it. It has absolute authority. There's millions and millions of investment that can't happen because Transit New Zealand is—

Swain — It should be funding some of that. That's the problem we've got in Hamilton.

Smith It's not about funding. Transit New Zealand says: "You are not going to"—it doesn't matter who—"join up to our highway."

Conway Can I just finish answering? I'll be brief. I do very much agree that—we are not saying we are the only show in town; it's been about workplace level productivity and about the networks that we operate within. We absolutely accept that investment in infrastructure, and broader training and education expenditure, and those sorts of things are very big investments. Where I think we are getting to now is that we are probably collectively saying to Government that the scale of effort in this area of workplace productivity is probably too low compared with other economies, countries that our social partners have gone to look at. The integration could be better across a wide range of initiatives—I mean, is promoting exports, or lifting the performance in the manufacturing sector, that much different from productivity, etc.? Also, there could be much more done in terms of recognising the role of our networks and diffusion of best practice.

Gosche Obviously, the committee's looking to make a report about what could be done, and the productivity area I think might be one of the easier ones, actually, given the range of views. You've done a lot of talking and you've produced reports, and obviously the next thing is, how do you get on and create some action? That's going to involve Government. Take one out of the air—skills—and if we look at Modern Apprenticeships, which have been, I think, a pretty successful policy, but they've got lots of constraints. Are you geared up—the two partners—to work with Government and say: "Well, how do we actually pick that one up and improve upon it?", or: "How do we pick up the one of workplace literacy and improve upon it?", so that it actually leads to a Government response that is more than just words?

Wilson Yeah, well actually that is about maximising the value of the investment, because you can make a big investment in skills, but actually it is the application of it in the workplace—the way the work is done, whether there's sufficient training around new technology and ways of work that are introduced. That really is what we're focusing on. We have to take that debate into the workplace as well, because we actually have to get people—and a lot of people still don't—although we talk a lot about productivity a lot in Wellington and we've elevated the debate, there is still a lot of persuasion to be done at workplace level about this issue. We want to pick that up.

The literacy and numeracy process—we've got a learning rep process that has been working very well in the UK that we are promoting, and Business NZ is supporting, because we think that it's a very cost-effective way of getting a few people in each workplace to actually be the champions of lifelong learning and skills, and being the contact point with training institutions and actually having some knowledge about how you go about getting additional skills and training and being the advocate for it.

O'Reilly Mark, I think the capability of the private sector through both of the social partners and elsewhere is fit for purpose and capable of contributing—in a nutshell, that's the answer to your question. What's necessary though, I think, is some real efficiency from Government about the way in which they inter-react with us, and then a very efficient relationship about advice around deployment.

Let me give you the literacy and numeracy issue as a starter. Literacy and numeracy in New Zealand is a real issue. It's an issue in all of the countries of the old Commonwealth. So what do we do about that? Well, there are some things that you can do, but you'll waste a lot of money in pilot testing and God knows what, when in fact all you need to do is to go and chat to people like me and Ross and our networks. You'll find out pretty quickly the first, second, and third thing that you do. To the Government's credit they've done a lot of that, and good for them. So I use a positive frame to answer the question, but I think we are capable of offering the right advice, to Peter's point. We've got all of the networks in place, and we know lots of folk. I think it's about the certainty and the efficiency and the trust in the relationship between Government and the bureaucracy and the social partners, in order to make that happen.

Gosche Through you, Mr Chair, I wouldn't mind asking both organisations just to give us a little paper about how you might—I mean, you've got workplace procedure, you've got Modern Apprenticeships, and that sort of thing. They're not doing too bad, but then problem X—that might be you both sitting there, confronted with: "How do we deal with that one?". I just think it would be useful for the committee to hear back from both of you together, just to say how we put in place a better mechanism to actually deal with problem X that is holding us back in terms of productivity. If we found a couple of good examples that could be expanded, that is a simple matter of expanding them, but what is the mechanism to attack the one we don't know about?

Jones OK, thanks guys for coming along. Thank you very much, Phil and Ross, and we note the historical significance of you both sitting together in front of this illustrious committee.

Transcripts

Inquiry into the future monetary policy framework

Finance and Expenditure Committee

19 September 2007

Members

Shane Jones (Chairperson)
Charles Chauvel
Hon Bill English
Jeanette Fitzsimons
Craig Foss
Hon Mark Gosche
Dr the Hon Lockwood Smith (Deputy Chairperson)
Hon Paul Swain
Chris Tremain
Judy Turner
R Doug Woolerton

Witnesses

Reserve Bank of New Zealand Board of Directors (Submission MP/45)
Mr Arthur Grimes, Chairman and Ms Alison Paterson, Deputy Chair

Jones The first submitters are Arthur and Alison—welcome. We are slightly behind time but we have a reasonable amount of time. We have your submission. There is a great deal of interest in it. Perhaps you would like to introduce yourselves briefly and speak to your submission, but leave enough time for questions, which are definitely in our midst. Over to you, Arthur.

Grimes Thank you. [*Introductions*] As you know, the board of directors of the Reserve Bank is appointed ultimately by the Minister. Our role is to keep under constant review the performance of the Reserve Bank and of the governor in discharging all its functions, including monetary policy. This submission has been made by the directors of the bank.

I will just make some opening comments, and then I will leave it to questions. So that you know how the board operates with the bank, and especially in terms of monetary policy, after every monetary policy announcement the board gets to see all the internal documents that have been generated within the bank leading up to the monetary policy announcement. We see the advice of the OCR—the official cash rate advisory committee, including the two outside advisers that sit on the committee. And we see all those documents after the announcement of the interest rate announcement. We don't see them before. We're not involved in the actual decision. Our role is to review and to monitor the performance of the bank.

We also see reports that are generated by visiting academics and central bankers, who sometimes sit in on the whole forecasting and policy process. That happens about twice a year, where people are invited to come in and sit through the entire process. Those reports, I think we could say, are almost invariably highly complimentary about the process that the Reserve Bank staff follow, and occasionally suggest minor tweaks or additions to that process, but are very, very supportive of the process that is followed within the bank.

Last year the board was very supportive of the bank and Treasury holding the Macroeconomic Policy Forum. That forum, which was internally called the "Blue Skies Forum", trying to think about ways of expanding our knowledge of monetary policy and processes, included a number of external participants. They included Stephen Grenville, who is here today, the former deputy governor of the Reserve Bank of Australia; Professor Willem Buiter, probably one of the world's leading experts on monetary policy, based at the London School of Economics; Klaus Schmidt-Hebbel from the Central Bank of Chile; Sebastian Edwards, a very high-profile professor at UCLA, in Los Angles; plus Val Koromzay from the OECD, and Steve Dunaway from the IMF.

I should say that those people were chosen, in particular Buiter and Edwards, the academics, because they are not shrinking violets. They are people who are exceedingly frank in their views and are quite often slightly out of the mainstream. Despite that, it was very clear from their comments that they were strongly of the view, in terms of monetary policy, that "if it ain't broke, don't fix it". In fact, Willem Buiter, who, as I say, is almost invariably on the fringe, his paper was titled *Count Your Blessings One by One*—in other words, this system is probably the strongest system that you could imagine and that you could hope to have.

A minority of the speakers there did suggest investigating some of the alternative instruments that the bank and Treasury have been looking at in their *Supplementary Stabilisation Instruments* paper, and as a board we have consistently supported investigating those instruments. We don't support any particular instrument. We have a very open mind as to their merits, but we support the process of actually searching out to see whether there is something that can act as an adjunct to the current process to assist monetary policy, essentially to affect domestic interest rates without affecting capital flows and hence the exchange rate. So we've been very supportive of the process. We note that each of those instruments has its fishhooks, which is why they are not in use elsewhere, I suspect. They have pros and cons, and they have to be weighed up very, very carefully. We don't want the cons to outweigh the pros.

We have also, in relation to the instruments side, supported the bank's judicious use of exchange rate intervention. It is something that went through the board very, very carefully, and that's been modelled along the lines of the Reserve Bank of Australia's processes over the last two decades, which have generally been very successful. So we've been supportive of that process.

Overall, as we say in the submission, the board considers that the current legislative framework that the Reserve Bank operates under, and for monetary policy, is sound. The current PTA is flexible, and appropriately so. The bank has set its monetary policy in line with its obligations under the PTA and with the Act, but we also note that the economy has imbalances. It is certainly worthwhile seeking broader economic responses to those imbalances, and also to search out whether there are additional instruments that can be used to mitigate some of the effects of those imbalances.

The final comment I wish to make relates to a consistent view that the board has had since the Act was prepared in the late 1980s, and also after the Svensson review some years ago, that the current decision-making process for monetary policy is a good one. The single decision maker, we believe, informed by the views of both internal and external advisers, is that it is a sensible one. It allows accountability. At the same time it is informed by a wide variety of views, and it is monitored by an external board of independent directors. We think that that process is actually a very good process and one that we do not favour changing.

Paterson I would only add that the board itself is comprised of no shrinking violets, too, so that the governor and his team are well tested. We need to be content that we have sufficient information—and Arthur has outlined that—and that we test against best practice both internally and externally, and you have that detail as well.

Jones Thank you for those introductory remarks.

Fitzsimons Good morning. When the board and, I understand, Treasury and the bank met with the group of world experts recently, and they gave you a big tick for monetary policy settings, did they express a view on what broader economic measures might be useful in the New Zealand context to support monetary policy?

Grimes They discussed a number of alternatives. As I say, in some cases, they basically said to leave everything unchanged. In others there was some support for investigating an exchange rate intervention in the way the bank has subsequently adopted. The other area, I think, that was probably a focus, was savings policy. There was a feeling amongst a

	number of them that the imbalances in New Zealand are to do with the savings/investment imbalances—really, the savings side; they are not investment problems—need addressing. So I think that was probably the area that they highlighted most of all.
Fitzsimons	They didn't comment particularly on the housing market and housing inflation, and taxation policies, and so forth?
Grimes	My recollection is that wasn't the focus of their comments. Because they are from the international arena, they are probably not too aware of the specifics on the New Zealand housing market, for instance.
Fitzsimons	I understand you're an expert on land availability for housing.
Grimes	Personally, yes. That's not specifically as a board member, but yes.
Fitzsimons	The bank's submission refers to the problem of regulatory constraints on land supplied for housing, and some of them suggested that that means we should relax the urban limits and allow housing to spread further out, with the consequence of higher infrastructure costs, and so forth. Others have been more concerned with land banking by developers—keeping land which has been released for housing by the council out of the market to push up prices. Do you have a view or does the board have a view, or are they different, on which of those two needs to be addressed most?
Grimes	I should make it clear the board does not have a view on that. It's an issue that we have discussed at some length. We have people involved who have some expertise from a number of angles on that, and we have supported the bank's view that these are issues that really need to be looked at. There are some major regulatory constraints there that need to be addressed, but as a board we haven't taken a view as to how best to address those regulatory constraints. But we do note that they are there and that they do need to be addressed.
Fitzsimons	So you're not particularly promoting relaxing urban limits.
Grimes	That's not a view that the board of the bank has taken.
Jones	That's a relief.
Fitzsimons	The rest of my questions, I think, are perhaps better directed at the governor.
English	There's a little book written by the former Australian governor, the guy who's just retired—
Grimes	Ian MacFarlane.

English Ian MacFarlane; that's him. I think it was him who suggested that inflation actually comes through more now in asset prices—OK, inflationary effects. That's how they show up, and he sort of says: "Well, we're not quite sure how to handle that." Is that an issue that the board has thought about at all?

Grimes The experience that we have found over the years is that it shows up in different ways at different parts of the cycle, and in different cycles, in fact. If I were to drop down from Mars today and say how inflation shows up, it would show up in commodity prices: oil, wheat, dairy, whatever. So I think these things do change over time, and one of the things that's in the current policy targets agreement is that the bank shall monitor a range of price indices, and that is there for a reason. The reason is that at different times inflation shows up in different ways. I think the bank—again in the materials that we see as a board, we see that the bank has actually tried to draw information from a wide range of price indices, including asset price indices as well as other price indices.

English OK. So you don't think there's been any particular shift in the way that inflation is manifest.

Grimes Personally I would see no systematic shift in that way.

English OK. I just want to ask you about the issue of credibility around monetary policy. Its credibility is pretty important. I wondered what the board's view has been of the strategy of the bank going around saying monetary policy doesn't work, when it's the bank's responsibility to execute monetary policy, and that saying it doesn't work undermines the credibility of what they do; then, as soon as it starts working, stop saying it doesn't work. It's all looked a bit confusing, and is that in fact one of the reasons we're having this inquiry—because the bank itself has said that monetary policy doesn't work?

Now, your job is to look at the performance of the bank and the governor, and it appears that the performance has met the targets, generally, in the sense that inflation is at the top of the band but it's been mostly within the band in a set of circumstances where the economy is being really quite constrained—significantly more so than Australia, probably, in our own way. So how do those two things add up? You're sitting there with a performance assessment that says: "Yes, the governor is basically within the parameters.", at the same time as the bank itself is saying: "No, this doesn't work.", and we end up having an inquiry.

Grimes OK. I think you'd find it very, very difficult to actually find those words in what the bank has said. I think you'd find that that is an interpretation of what the bank has said. One of the things that we do when we look at every monetary policy statement, is we look at both its performance in terms of whether it has achieved its objectives, and then we look prospectively at whether it's likely to achieve its objectives it's setting out. We also look at the communications, for the reason you've talked about. Credibility is hugely important for central bankers.

I think what the bank has said is that in the past cycle monetary policy has been less effective through its OCR instrument than it had in previous cycles because of the shift to fixed mortgage rates and the mortgage price war. I don't think it's ever said that it's not effective. But the point you raise, which I think people always have to be careful about, is that communications is extraordinarily important in monetary policy. Open-mouth operations are as important as open-market operations. I think the bank has been aware of that criticism that you raise. I think it's not a criticism that is actually factually based, if you like. I don't think they've ever expressed the issue in that way, but they've made it clearer since that criticism was first raised that monetary policy clearly does work and always has worked.

English — So what do you think it is, given that the parameters are being met, what do you think are the factors that have given rise to sufficient political concern, at a time when monetary policy is under real pressure, that politicians have thrown a spanner in the works, so to speak, by saying: "Let's have an inquiry into whether it's working.", just at the time when it absolutely needs to be seen to be working. "Let's throw it all up in the air and see if something comes down."

Paterson — I wonder if I could add a bit to what Arthur said about your last question, Bill. I've been on the bank board for 13 years, and the improvement in quality of information that comes to the board, etc. has improved immensely in that time. It's always been my observation that the bank is an organisation that strives for perfection—100 percent perfection. What, I think, they try to think about is: "Can we do this better?". Arthur has said that the OCR has become less effective. The bank has really been saying: "Are there supplementary instruments? Can we improve the way we are conducting monetary policy?". If you remember, New Zealand was a world leader. It is now a conventional approach. It's fair to say that the thinking has always been lateral on the topic.

Grimes — If I could just come to the latest question, when I was sitting with this committee at the time the Act was being drafted in the late 1980s, one of the things that came through there, in the discussion, was a discussion about what happens when there's an imbalance in the economy and the Reserve Bank has to tighten monetary policy to control inflation. The answer quite clearly was it has to control inflation and it makes that imbalance manifest. Both sides of the House at that stage, all the members of the committee, said that, yes that was absolutely correct. If the imbalance is there it should be brought out into the open and monetary policy should continue to target inflation.

I think what we have in the economy, as we've noted in our submission, is that there are some imbalances in the economy at the moment, and that has become manifest through the high exchange rate, for instance, and that is appropriate. That makes it absolutely clear that is the imbalances are out there, and I think it is because those imbalances are now manifest that the issues that you raise have come to the surface.

Jones Thanks, Arthur.

Swain I think if you summarise most people who come here, they say that the basic issue of still trying to attack inflation is fundamentally right—which most people agree with—but there is this concern about the relationship between interest rates and the exchange rate and the impact then on long-term growth. And you've mentioned that before. When you look at the last statement you do see quite a clear relationship between interest rates and exchange rates, except for the last bit, which has probably got to do with finance and various other bits and pieces. So everyone's trying to come up with that bit that says: "Well, how do we do this without having that negative impact on growth?". You're suggesting a few things in your submission, and I just wondered if I could tease it out a bit more. We have talked about land supply, which Jeanette's already raised. You've got the issue of ring-fencing, and various people will get their way around that. Other people have said there's no basic advantage in the tax system for real estate, private property, than there is for anything else. You talk about migration. You don't mention capital gains tax, and I would be interested in why not, because a lot of people have mentioned that.

Migration, you're saying, could be used more as a tool. The difficulty there, of course, is that that is also dependent on some shocks outside, as well. If we have a 9/11 thing, then suddenly people stop travelling. Then again, if you've got a salary difference between New Zealand and Australia, a lot of our tradespeople are going to go there, and you're going to suck people in. It's quite a hard thing to manipulate. Finally, you talk about the statistics and maybe upgrading them. So I suppose the question is, in all of those things is there any priority list there? If you were recommending one of them, what would it be?

Grimes I'd recommend that the bank and the officials look at it. I make it very clear that Alison and I are here as directors of the Reserve Bank board, not as the Reserve Bank. I think that's really important. Our role is to make sure that the bank and others are looking at these issues. I'm very, very happy that the bank has been really going through these issues very fundamentally with the Supplementary Stabilisation Instruments paper, with the Macroeconomic Policy Forum. As a board I don't think it's our role to come up with a view on which of those is preferable, but we do think that they absolutely have to be looked at.

Jones	Yes. I think your submission was that it doesn't get specific on interventions. It does highlight the fact that there's obviously a sense in the board that there's scope for inquiry and maybe not necessarily just this inquiry but other explorations. That point is well made.
Woolerton	My question is around areas of exporting versus importing and that sort of thing. The only type of incentive we seem to put out in New Zealand is the incentive of the exchange rate and that sort of thing. So my question is, do you see a place for the bank in looking at helping people in this country to export? By that I mean not helping them to export; giving them the message that we favour an exporting economy, which obviously we are, and sometimes in times of a high dollar and that sort of thing, that gets lost. That's what I was asking for your comments on.
Grimes	The bank's role is very clearly defined, I think, in the Act and in the policy targets agreement, and within the policy targets agreement clearly it has to target inflation but it also has to try to implement that in a way that doesn't lead to unnecessary volatility in the exchange rate—coming back to the exchange rate portion of what you say. It doesn't really have another responsibility directly to assist exports or to any other sector other than that, except it does have a role within the Act in that that it can give advice and have discussions with bodies or people whose actions may assist monetary policy. So in that sense there's a broader sort of economic role, which the bank is allowed to play within the Act, where it can discuss these matters, for instance, with Treasury officials or others.
Woolerton	And you make comment on housing and you make comment on the availability of land and that sort of thing.
Grimes	Yes, because these things can affect the implementation of monetary policy. So I think it's a proper role for the bank to look at some of these issues and to think about their implications but not to act directly on them. Its role is to discuss that with other people, to say: "This is where you might want to consider."
English	I do want to get to the bottom of this statement—that you believe the New Zealand economy may benefit from additional policy instruments. So here we have the board of the bank saying there could be some additional policy instruments, it doesn't know what those are, has a list that could be reviewed, from what I can see has no developed point of view about how any of them might work, ranging from variable GST through to mortgage interest levies. Isn't the board helping create an environment of uncertainty? Have you got something to say about alternative instruments or not? This discussion has been going on for 12 months. Nothing has come of any of it, from any part of officialdom. Consumers out there are now facing the bite of high interest rates. It seems to me they are being let down by an official structure that wants to worry and wring its hands but is producing nothing that effectively

guides politicians or the public on what would work better. It seems to me that if you haven't got something to say, then you're better not to keep saying you might.

Grimes — My view on this is that it is not for the board to come up with what a particular instrument should be. That is the role of the officials. Our role is to monitor and to keep under review what they are doing in that respect.

Paterson — And challenge.

Grimes — Certainly to challenge. I mean, if they came up with some ideas that we didn't think were sound, for whatever reason, we would challenge those. If they missed out on possibilities that we thought were possibilities, it is our role to challenge and to think about those. Is it unproductive or counter-productive, as you say, to suggest that we should look at these things? No, I don't think it is. I've always believed in transparency—transparency in monetary policy, transparency in implementation. In fact, it's a requirement of the Act that the bank has to discuss policies that may potentially be implemented in the future, in its Monetary Policy Statement.

English — So where is this discussion going?

Grimes — If I can give you an example over two time periods. One is on the exchange rate intervention side. When the Act was written in the late 1980s, there was a school of thought that said the Act should not allow any ability whatsoever for the bank to intervene in the exchange rate. I think that, fortunately, the view prevailed that no, this should be left as a possibility. And it was in the Act as a possibility. The bank, for 20 years or so—possibly 15 years—decided not to use this. Earlier, as from last year essentially, it decided that this may be something that is a useful adjunct to the existing monetary policy system, and it went through the correct processes within the board, within the bank, etc. to say: "Is this a useful adjunct?". It was decided that yes it was, and that has been used. So that is one example.

I think it's best to actually put these things out in the open. There are two reasons for that. One is that one can get good comment back on it. Let's say there was consideration of a mortgage interest levy, for an example, which may or may not be a good idea. But unless you get the views from people involved in that, you're actually formulating policy in a vacuum. And, secondly, if you were trying to do it internally and it got out that you were doing this secretly, I think that's actually very poor for the bank's credibility. So I support their openness in looking at these issues.

English — So when are we going to know whether the board thinks these options have been looked at and either need further development because we do need them as extra tools, because monetary policy isn't as effective as it was; or it says: "No, we've finished that discussion."? I mean, it's just wandering on endlessly, isn't it?

Paterson I don't know that it is. I think that really what the board is saying is that as a board they support the governor and his team with regard to the initiatives that he's suggesting. If we disagreed we would be required within the boardroom to do something about it. So I guess that that statement just indicates that we do support the direction of the bank.

Jones I just wonder, though, Alison, picking up on what Bill is saying, it is one thing to have a quality of transparency and openness but, I guess, us as members of the committee, Arthur, when we see the board is talking about the investigation of structural policy to assist a transition to a more balanced economy, it's sort of like a never-ending journey, isn't it.

Grimes Always. It is a never-ending journey. Who would ever think that we could have policy right and that was it? If we thought that, we'd be failing to spot new problems.

Jones And the balance that I guess the committee has to bear in mind is ongoing work as opposed to providing a level of certainty for the markets and the citizens that rely on the quality and the credibility of the advice and decisions coming out of your institution.

Grimes Yes, there is a balance there. Absolutely. And I think at times you extend the boundaries. You say: "We're really pushing the boundaries at the moment looking for new things because there are imbalances and problems out there, and we're seeing if there is something we can look at." At other times you'd just be quiet and you wouldn't push those boundaries. I think it just depends on the issues that are being faced.

Paterson And Mr Chairman, can I just add to that that in governance terms if you had a board acting independently, forming its own view, and advertising that, without the responsibility under the legislation, you would have a dysfunctional board.

English This committee's got to find its way through this issue, right? You would expect it to look to the board of the Reserve Bank for some sense, some weighted view, of how significant the shortcomings of the monetary policy framework are. Because we're only having an inquiry because people think there are shortcomings—right? And I am having trouble getting a handle on what that view is; whether you think the shortcomings are sufficiently serious that a group, like of politicians, whose role it is with legislation, should seriously be looking at whether other tools are necessary or whether you think they're not that serious but you don't mind continuing to speculate. So if we're looking to the board, who are the governance of the bank, for some guidance, then what is that guidance? It is pretty hard to tell from the range of public statements that have been made.

Jones OK Arthur, you need to offer a definitive view because time's moved on and we have to now hear very shortly from your employee.

Grimes Absolutely. I think the important thing for us is to support that employee, to be honest, unless we thought the employee was doing a poor job. And we think the employee has been doing a very good job.

Tremain So do we need more supplementary instruments or not?

Grimes It's not a question of whether we need more supplementary instruments or not; it's a question of what the pros and cons of them are. That's really, really important. The message I would probably like to leave with you is to avoid tinkering unless you're pretty sure—almost certain, in fact—that tinkering is going to benefit.

Jones Thanks, Arthur. Right, Paul, and then we have to have Dr Bollard.

Swain I suppose the point I was driving at before was that the various policy issues or instruments that have been suggested by the governor, obviously have been talked about at the board. Alison, you say that the board, if it disagreed with any of those, would say so internally with the board. I suppose the point that I was trying to make was: why is it not possible for the board to have a view on the broader policy issues and leave it to the governor? I understand the difference between the two, but the frustration a bit is that we know this discussion is going on, and it would be helpful in terms of the policy debate to hear some more definitive view from the board as to which ones of those things may be helpful in terms of the wider issue that everyone is coming to tell us about.

Grimes Well, it's one organisation. The board's role is to keep under constant review what the bank does; it's not to have a separate view. That is quite clear in the legislation, and I think it's really important that we are there as a testing role, as test bed for the staff and for the governor, but we're not there to present another view. Otherwise, as Alison said, the governance relationships within the bank become quite dysfunctional. We have expertise but it's not our role to come out with a public view on that.

Paterson I think what I'd say to you is that what the bank puts forward has been thoroughly debated, challenged, in the boardroom.

Swain I've taken that point.

Jones OK, thank you very much.

Reserve Bank of New Zealand (Submission MP/46)
Dr Alan Bollard, Governor, Mr Grant Spencer, Deputy Governor, and Mr Michael Reddell, Special Advisor, Economics

Jones — Welcome Alan and team. At the risk of showing my ignorance, it might be a good idea if you introduced your colleagues again to us, and then over to you for a brief opener and I'll go round the table.

Bollard — Thank you. Good morning Chairman, good morning members. [*Introductions*]

Chairman, in our view monetary policy has been working. I was quite surprised to hear Mr English apparently quote us as saying the opposite. We've certainly never said that. What we have said, of course, is that monetary policy has been through a time when it's taken longer to act, and of course one of the points about jawboning through that process has been to allow people who are thinking about purchases—for example, houses—to think about what might happen over the next couple of years. I am sure some of them have done that and are now thanking us for that advice as we go through a tightening housing market.

It's been working in a very unusual international period. It's a period when the New Zealand economy and the world economy have been through 30 to 40-year highs in oil prices, in commodity prices, in food prices, in an international housing cycle, and where we've had a most unusual period of very loose international liquidity. Through that period we have achieved price stability. In the last decade we've had CPI averaging around—just roughly—2.5 percent. Has that been at the cost of growth for New Zealand? Well, the broad figures wouldn't suggest that at all because we are currently going through the longest period of uninterrupted growth that we think New Zealand has ever seen. We have roughly had something like 3 percent growth a year since 1998.

Has that been particularly at the cost of certain sections of the community? Well, in broad terms, unemployment has halved during that period and that would suggest not. But is this good enough? Well no. We think there's two very significant things here that we hope you'll be examining. One of them is the productivity story. We've got a very good employment story; we don't have a very good productivity story. You have written that into your terms of reference. We would be very interested in what you have to say about it.

Secondly, the exchange rate. The exchange rate has been a difficult part of the whole process for us and others right through this period. It's, of course, been a period of international financial conditions when a number of countries have recorded reasonable growth stability, reasonable price stability, reasonable Government fiscal stability, but increasing exchange rate instability. And that's led a number of countries—us included—to go through periods of misaligned exchange rates and volatile exchange rates. Now we've looked at that in a huge amount of detail; we don't have a simple answer for you. We've gone through the submissions. We don't see a simple answer there, either. We do conclude that it is reasonable to think there could be limitations on the degree of independence that a small, open economy has in running its monetary policy. I think that's a very reasonable conclusion out of that.

The story on our exchange rate, of course, is very similar to Australia and has been with other economies, as well. Of course, we would also urge that the committee should not underestimate how competent the export sector in New Zealand has been at dealing with this volatile exchange rate, and that comes through in some of the data around the export sector's performance through this period.

When we look out at New Zealand's monetary policy compared to other monetary policies in small open economies, the whole irony is that the standard for modern, small open economy monetary policy is the New Zealand model. There are now over 20 countries focusing on inflation targeting. They tend to be around a band that varies, but our policy targets agreement band of 1 to 3 percent on average over the medium term is roughly in the middle of that sort of experience.

The tools they use are roughly what we're using—the official cash rate. The objective they have got is broadly speaking inflation targeting. There's different ways of writing that; there's different ways of thinking about it. It does need to be put in a bigger context; most central banks try and do that in some way. But they would generally agree it's hard to broaden out into other objectives.

Of course, in the Reserve Bank we'd love to see other broader objectives for New Zealand being advanced. We don't think that we can do them in a primary way through monetary policy. Monetary policy is limited and a lot of what we've been trying to say in our submission is we can't do certain things. We don't try and do certain things because we're doing monetary policy and that's it and we're doing it via price stability, which, of course, has got a bigger role in terms of helping stabilising cycles and allowing the background environment that allows business and households to get on and do the best they can and do the best for New Zealand.

We have found ourselves limited by one feature that has been a bit different in New Zealand and that has been New Zealanders' intense desire to borrow and willingness to run up debt at higher nominal levels of interest rates than you would find in other countries, and that's an interesting socio-economic phenomenon in New Zealand. We're also, to some extent, limited by, of course, the fiscal background and the tax structure background in New Zealand if it impacts on people's desire to spend or save and how they might spend, particularly around housing.

We note a lot of other interesting submissions. We don't see easy answers in them. Of course, the committee is very aware there is huge literature on this internationally—just a huge one. There's a vast amount been written; the international community now knows a lot about monetary policy and I'm sure you'll be having recourse to that scientific material as well as some of the latest submissions as you go through this.

Our recommendations are there in our submission for you. Generally they are along the lines of increasing flexibility to allow markets to work, doing what can be done to reduce things leading to bigger business cycles, and compensating where we think there's tax distortions that do impact on monetary policy. But we know that tax policy and other policy development is very complex, and that's why we've been quite restrained as to how we've talked about it and how far we think we can advise you on some of this.

We do think that you'll be there looking at the role of monetary policy, not today but in future cycles. Actually we think that we're through this cycle, or getting through this cycle, as we look at how housing is currently going, the impact monetary policy and interest rates are having now, and where international cycles are going at the minute. We urge you to look at how monetary policy can best work in a neutral sort of environment with assisted policies elsewhere for future cycles. Thank you.

Fitzsimons — Thank you. You are using very restrained language in your recommendations but nevertheless it's pretty clear that you're advocating a consideration of broadening the tax regime on investments so that it's even-handed across all types of investment with a capital gains tax and ring-fencing the losses in housing that goes with that. It is interesting that a large number of submissions to the committee have recommended the same thing. I am wondering if you could tell us a little bit about whether you've done any work in the bank on the experience of other countries. We are unusual in not having a capital gains tax on property investments and across-the-board investments. What has been the experience where they have? I have talked to people who have lived under the Australian regime and say it's fine, and people who've lived under the US regime and say it's horrible. What have been the impacts of various capital gains tax regimes in other countries in stabilising prices, or stabilising exchange rates, or any other economic goal?

Reddell — I think we have done quite a lot of work trying to look at other countries' experiences. One of the reasons why, as the Governor said, we've been deliberately cautious in how far we've gone in our recommendations is precisely because it's difficult to get clear-cut answers. If we look around at the experience of the last 10 years, so many countries have experienced relatively large housing cycles. That includes Australia, who have our same approach to offsetting rental losses but also have a capital gains tax. It includes the UK with an inflation index capital gains tax and a whole variety of European countries, all of whom have different systems.

I guess our approach is to say it looks as though some of these things could make a helpful difference at the margin but we don't believe that they're going to change the essential character of the economy or take away from the fact that we will see housing cycles in future here as we do in other countries.

Fitzsimons Is there anything about the design of capital gains taxes overseas that makes them more or less successful in achieving the objectives that we're looking at?

Reddell We haven't looked at them in that sort of systematic detail. I guess a theoretical approach would say you'd want to look at a capital gains tax on accrued valuation gains; no one has implemented a system along those lines, for good practical reasons. The very fact that people have found themselves unable to do something like that means that you only ever collect a capital gains tax at the point the house is sold, which encourages people to hold on to the asset for a prolonged period of time and to look for ways to offset gains there against other losses. We haven't done that sort of level of detail. That is why we're effectively saying: "This is something you'd need to talk to the Inland Revenue Department about as well, and people with a better understanding of the details of cross-country tax regimes."

Fitzsimons My second area of question is: you refer to resource pressures, you acknowledge that the driver of inflation—too much demand changing into too little capacity goes beyond just labour and capital and also includes oil and land. You refer to a very unusual international period that we've been in. I want to ask you a "what if?" question. What if the rising prices of land, oil, water, grain, and carbon are actually not temporary or cyclical but actually reflect the approach of oil plateauing and starting to decline, reflect limits to water availability in Canterbury, which is an absolute limit eventually, reflect the fact that the physical land area isn't elastic, and the need to reduce carbon emissions fast, creating a constantly rising carbon price, if that were to be the case, would the current monetary policy we use be adequate to control inflation, and what would be the output for the banks' of the world?

Bollard If that were to be the case, then you are going to find forecasters all around the world changing their settings, and you are going to find economists all around the world going through quite big turbulent times as they readjust to different major prices. In that sort of situation then that would be big news for the New Zealand economy. We would have gains and losses, we'd go through a period when we would have to adjust. Of course part of the problem would be knowing that it was a permanent move not a temporary move. As for monetary policy, I don't see anything particularly in that that would impact the framework of monetary policy. As for the settings, well that depends on what's there at the particular time. But structural changes like that can be accommodated within the existing monetary policy framework.

Fitzsimons So the fact that all those key inputs to the economy were going up in price, you could still control inflation?

Bollard Yes. Well, I mean, we've got an option there. What I was talking about in terms of being an unusual period has been more along the lines of some temporary big increases, with some bubble behaviour in that fed on by very, very liquid funds in world markets. How would we adjust to something like that? Look, it just depends on how see the price changes at the particular times. We're all the time looking, on average, over the medium term. If we get a short-term spike in something, the policy targets agreement says "focus on the medium term" and that's what we do. It doesn't say "look through spikes", but it does say "just keep that medium-term focus". So we would keep doing that. But if it's going through a turbulent period, then yes, it's harder to interpret.

Fitzsimons Your forecasts have tended to be more accurate than a number of others. What happens to them as you move out—1 year, 2 years, 5 years, 10 years?

Bollard We are quite proud of our shorter term forecasts because we have been through a period when they said there's inflation pressure around and there's growth pressure around. Of course, there's a big market for forecasts out there but the typical forecast said: "No, there's not an inflation problem." They were wrong, we were right. We went through 2004-05 pushing up rates. We got a lot of criticism, some of it around this table, from people saying: "Why on earth are you leading us up into the highest rates in the OECD—or near highest?". We were right to do that.

Fitzsimons Now they're saying you should have done it sooner.

Bollard We are certainly getting some of that now. But what would we be like on medium-term forecasts? Well, frankly we are not forecasting medium long term. There isn't a lot of predictive power beyond, say, 3 years out in our forecasts. So there'll be big errors in our forecasts. We're doing short-term forecasts.

Jones Any further points, Jeanette?

Fitzsimons Just the last one confirming that you wouldn't really be looking as far ahead as the IPA's statement that within 5 years we're looking at an oil crunch?

Bollard — No, we're not. Of course, we've got to keep looking at those sort of authorities' work and keep the medium-term background focused. It won't figure in our short-term stuff generally, but it's got to be there in our minds as to what path we're on.

Smith — Dr Bollard, today you are telling us that New Zealand's got a pretty good story to tell. You said the one bit where we don't have a very good story was in productivity. As I've searched your submission for what you might have to say about productivity, you do have a supporting paper. A5 focuses on productivity, investment, exports, etc., and monetary policy. What I am curious about there is, given that you say that is one of the big issues, why your analysis almost studiously avoids the glaring issue. It's almost as if you don't want to upset—I mean, you've got no political masters, so I don't know why you've chosen to ignore the huge productivity change that's happened in New Zealand. That's the difference between the 1990s and 2000 to now. Instead of that, your analysis is conveniently from the mid-1980s to mid-1990s, the mid-1990s to now, and focused on capital accumulation, and you observe that we're a bit behind, that, in fact, our capital accumulation's gone up a bit in the mid-1990s to now, and we're a bit behind Australia and the OECD but, if anything, we're looking better than we were from 1985 to the mid-1990s.

Another submitter who's making a submission to us today doesn't seem to be so constrained by not wanting to upset politicians and has pointed out the huge—more than a 50 percent drop—in labour productivity growth between the 1990s and 2000 and now. In fact they say that it's dropped from 2.6 percent annual growth to 1.2, and that if since 2000 that 1.2 percent annual growth in labour productivity had been 0.2 percentage units higher, they tell us the economy—the supply side, the capacity of the economy—would be raised, the output gap, there would be negative interest rates, would be at least 50 base points lower and the New Zealand dollar may well be south of US70c. Just 0.2 percentage units higher. In other words, instead of it being 1.2 percent growth since 2000, 1.4 percent growth instead, since 2000. Not back up where it was in the 1990s, but just 0.2 percent units higher.

So my first question is, why have you studiously avoided that glaring drop in labour productivity, when you acknowledge productivity is such an important issue?

Bollard — We haven't. We brought up the whole question. I've just said that one of the issues that we are concerned about is productivity. You're quite right, we're completely independent on this. Of course, we're interested in medium term features on productivity. We have to say that because the data is so poor in any country on productivity.

The main feature we've seen around the markets over the last 10 years has been this very big increase in employment. Typically that does push down productivity, partly because there's more people in there and less capital, partly because as unemployment gets really low, employers report that they're bringing on people who are less skilled and are less able to have a productive contribution.

We think some of that is going to be addressed by the investment that's been around. We've had reasonable levels of investment over the last few years, partly—again—as a result of the stability in the growth track. But that's yet to show through. Partly that's that employers have to learn how new capital, new machinery is going to be best worked and keep training and upskilling workforces.

Smith — Do you seriously expect us to believe, Dr Bollard, that just that reduction in unemployment could account for more than a 50 percent reduction in productivity growth?

Bollard — We haven't put numbers on this, but if you look historically, in most countries where you see a very big increase in employment you see a short-term fall-off in productivity. It's the sort of thing that basically happens because as more people come into the workforce, you can get more work from them. The challenge for the economy is to ensure that they're harnessed properly and lead to a better ongoing trend in productivity growth.

Smith — So you would say that the other submitter, who happens to be a major Australasian bank who offers some pretty comprehensive data with their submission to us, are wrong when they suggest that actually a growth in the regulatory environment, more stringent regulatory arrangements, has had a significant impact on this fall-off in productivity, when the Institute of Economic Research suggest that the current effective marginal tax rates are having a very significant impact on people's preparedness to work? Are they all wrong? Why are they seeing these things when you, as the Reserve Bank, seem to stay right away from any of that stuff? Is it a fear of upsetting the political masters, or are they wrong?

Bollard — Look, I just repeat, we are completely independent on this. I don't know what submission you're talking about so I can't comment on it.

Smith — I'll tell you, it's the ANZ National Bank—that fairly big international bank. They offered a fair bit of data, a lot of graphs around the private sector labour productivity, labour productivity, private sector capital productivity, multifactor productivity—more data than the Reserve Bank seems to have come up with, yet you acknowledge it's a huge issue.

Bollard — I've got no more comments. We've given a very thorough view on productivity in here. We think it is an issue for New Zealand.

Swain — I agree with the comment that at a time when unemployment, for example, drops from 7, 7.5 percent to, what it is now, 3, 3.7, 3.8 percent, you're going to get a lot of absorption of labour. You're right—the world trend shows that there's a short-term productivity drop-off as a result of that. It's pretty common sense and I think you deal with that in your paper, actually.

The question I had was that there is quite a lot of work going on around the productivity debate with the CPU, for example, because it's New Zealand. Do you have any input into that? I think the question we're asking is that we all agree I think we need to beef this up—this debate—and actually some actions coming out of it. I wondering whether you are engaged enough in this debate, whether you see it as your role to engage in that debate, and maybe the one thing that you think we should be focusing on to try and get some action out of this?

Bollard Look, I am sorry. We do monetary policy and price stability and that's where we're focused. Of course we keep in touch with all those people and all the debate going on. We don't have a silver bullet on this. We think it's just something New Zealand's got to keep focused on.

Jones Are we moving to a situation where the market or consumers, families, taxpayers, are going to be harder hit by changes in the exchange rate as opposed to gradual changes in the interest rate?

Bollard I think it's true in a lot of OECD countries the exchange rate has been taking the brunt of adjustment more than, say, prices have, and, yes, by analysis, than interest rates have in many countries. But there's no doubt in New Zealand that what, say, the homeowner is looking at is the interest rate and the mortgage rate, not the exchange rate.

Jones Have you given any thought, as you've explored with other experts, to different instruments—the Chilean instrument, where they sought to moderate the impact of these rapid inflows and outflows?

Bollard Yes, we have. We've looked at that in great detail.

Jones Can you share a little bit of that with us?

Bollard We don't think we can do it in New Zealand in international capital markets with the big flows around. We're dealing in an imperfect world. It's been a very hard world, particularly with, for example, the Japanese flows of funds. To some extent that has neutralised over the last couple of months with some of the changes going on. We see the re-pricing of risk in international markets as a very good thing for us. Sometimes it's going to mean money is more expensive to us, but it's going to reflect risks that are there. We think that's going to help in all of this.

We've looked at the Singaporean experience, Chilean experience, and all the other obvious ones we can find. We don't think we can make them work here. We've also modelled what would happen if we were to focus on the exchange rate and try by monetary policy to use that as the stabilising influence. The answer is you have to move the interest rate around by massive amounts to do that.

Jones — Has it informed a debate as to the viability of us remaining in a single currency?

Bollard — What we take out of it is, if the country is significantly at external imbalance, and there's other things going on in other parts of the world, e.g. Japanese savings that are going to impact through on that, then you are actually limited in what you can do through monetary policy. You've got to be quite slow and careful with the way you run your monetary policy otherwise you can get an indirect but quite marked exchange rate impact out of that. I think it puts more onus back on Government to make sure it's running a very neutral sort of tax system, for example, and a neutral fiscal system.

Jones — I don't want to draw you into a discussion about the viability of the Kiwi dollar, but I would make the observation that we get a hell of a lot of complaints both to this committee, through various routes, that every time there is an interest rate change then it attracts what you might call "hot money" and then it annoys all our exporters and the people—far too many—that have been known to vote for Doug Woolerton.

Bollard — There's been two ways that small economies have dealt with that. One is inflation targeting like us, the other is to go into a big currency union, like particularly the EU. Now we don't have that option. We've got Australia. Australia's got just exactly the same problem with the exchange rate as we do.

Chauvel — One of the submissions we had a couple of weeks ago, Dr Bollard, was on the theme of a third alternative, which was said to be going into a big basket of currencies. Is there any view you want to express on whether that would help ameliorate the fluctuations, and therefore the risk premium we're said to face as a result of the currency fluctuations that you spoke of in your introduction?

Spencer — Well, the fixed exchange rate, or the target exchange rate, is always an option, and potentially can facilitate trade in terms of reducing some of that exchange rate volatility that has been a concern. But what it does on the other side is take away our independence in terms of being able to run an independent monetary policy, and takes away the exchange rate as a buffer against shocks that are specific to New Zealand. I think we have seen a lot of shocks that are specific to New Zealand and the exchange rate response to that helps the adjustment process. So if we are pegged to other currencies, then we're going to be having shocks in other countries transmitted back to New Zealand because our currency's going to be riding with those other currencies.

Chauvel	But don't we get the double whammy at the moment in that we experience those shocks anyway and then we experience our own domestic issues? Is it such a downside to have to face those external risks?
Bollard	If Australia's riding on a huge mineral boom and we weren't getting commodity prices, yes, we would really suffer in a situation like that.
Foss	One of our terms of reference is the relationship between fiscal and monetary policy in New Zealand. Is the marriage between fiscal and monetary policy in New Zealand an equal and fair one in the current conditions?
Bollard	It's not a marriage; we are sort of next door neighbours, really, more. We keep in touch.
Foss	No one jumps the fence?
Bollard	Sorry?
Jones	We don't want any domestic advice from you, Mr Foss. Focus on nuts and bolts.
Bollard	We express our views on where monetary policy is going and what the implications might be. We hear how fiscal policy is going—particularly the net fiscal contraction or expansion going on. Yes, absolutely, they have to be in some harmony. They should not be fighting against one another, and monetary policy should never be trying to do the work of fiscal policy.
Foss	I note in your submission, and earlier when Ms Fitzsimons was speaking, you were talking about hindsight. Perhaps you actually should have hiked sooner and harder earlier, or along those lines—page 14.
Bollard	Well, we say "perhaps". It would depend on the exchange rate through that.
Foss	Yes, sure, to be fair, but you do point to—as a result of fiscal choices—Government consumption increasing rapidly, work-related employment has also increased rapidly, etc. So you are constantly balancing out. So in that analogy of being neighbours—do you talk to your neighbour, the guy in charge of the fiscal policy, much and does he listen?
Bollard	Well, we've got a close relation with Treasury, which is sort of quite a careful but very professional relation where there's no surprises one way or the other, but we do our own forecast and our own decision-making. With the Minister, I meet with the Minister quarterly and tell him about our forecasts. I will occasionally meet with him and sometimes the Secretary of Treasury at other times, and, yes, we'll share views, background views. He doesn't tell me what he's doing with fiscal policy.

	We tell him about broad monetary constraints, but not where we're thinking of moving things next.
Foss	So you generally read about what he's up to—fiscal policy—in the papers as much as we do, plus briefings from Treasury, I guess?
Bollard	We rely heavily on the Budget Policy Statements and Fiscal Responsibility Act - related documentation on all of that.
Foss	OK. Just a question that's a little bit technical, but I'd like you to expand a little bit on the approved issuer levy you touched on in your submission. You do say that an increase in AIL would result in a small increase in New Zealand interest rates. But as the way I understand that, the AIL is deductible by the New Zealand banks. The Minister's told me about $70 million a year gets raised from that and he predicts about $75 million for the next 5 years—each year. It's tax deductible as far as the banks are concerned. Do you see that as a very important lever, or, again, one thing that we should just consider further because it's been, as it has, since, I think the McLeod review?
Reddell	It's definitely in the second category, but you've put a minor refinement that we think is worth looking at. The AIL appears to us to have been progressively—people have found clever ways around it is probably the best way to put it, and so the revenue that's been collected from it is dropping. But you're quite right, to quote our numbers, that the impact on the overall level of interest rates would be modest, but it would be in the right direction to increase the cost of finance in New Zealand without increasing the returns available to foreign savers and hence minimising the resulting pressure on the exchange rate.
Foss	Right, OK. So that would flow through. I want to go from there to your other discussion point in your document about variable GST. I've read what you've said in the submission, but the actually practicalities of that and is there somewhere where that has actually worked in a modern, fast, new millennium economy—other than maybe Singapore in the 1960s or 1970s, or whenever they did it?
Reddell	Yeah, we're not aware of a case where it's been implemented in that fashion and that's why we not positively recommending it. We've phrased the discussion there in the sense of if the committee wanted to consider alternative instruments that would help supplement monetary policy in a discretionary sort of way, variable GST is one—there could be some more work done on it, but it would need a lot more—
Foss	I doubt it would be rated that highly, would that be presumptuous to say? It's not high on the agenda of supplementary instruments.
Spencer	No.
Bollard	We think it's got theoretical advantages but practical problems.

Foss	OK, and just finally, just on the PTA. That's essentially unchanged since the PTA was first signed, essentially, isn't it, apart from the 1 to 3—the parameters from inflation?
Bollard	Well there's been other ways of dealing with the exceptions, but broadly.
Foss	How many times has that been resigned in its current form, apart from that?
Spencer	This is the eighth PTA.
Foss	This is the eighth PTA—it's essentially unchanged. Earlier you spoke of cycles. We've been through some downturns, some upturns, and you think we're at the peak of this cycle. What are we at the moment – 8.25 percent OCR? So isn't the message there: "Look, this agreement, as it is, is robust, it works through the cycles we've had, yes, things are stretched at the moment, but actually it is working as is." And isn't the proof of that that you've just resigned it again—or 5 months ago?
Bollard	Yes.
Foss	Simple as that, thank you.
Tremain	Just further to what Craig has said about monetary policy largely working. Most of the submitters are saying avoid the supplementary instruments unless there is real hard evidence about them being effective. The only thing that crossed nearly all the submissions that they say we need to be focusing on is the level of the statistics that are currently coming out of the statistics department. It's the only level of real commonality and I want some comments on people who demand better statistics, what they should be, in terms of timeliness and quality?
Bollard	I'm sorry they're not sexy recommendations but they are real and of course a lot of our decisions are totally predicated on getting a good view of the economy. With a forecast it's not just where you're going, it's where you've been over the last year and unlike forecasters of weather we can't look out the window and say "Is it raining or sunny?". Our views change on all of that and make a very big difference. So that is crucial in helping us avoid mistakes on misinterpreting where things currently are or where they've been recent history. We've got a bit more detail on particular things—if you're interested in that—but, you know, it's important.
Gosche	Dr Bollard, the submission both from yourselves and from the board—and I thought I'd just use the board's one, because it's nice and concise—it summarises this: the current legislation framework is sound, the PTA is appropriate, and the bank has been meeting its targets. But—and this was the last point—we've still got significant imbalances in the New Zealand economy. I'm presuming that the significant imbalances

are not because of the three points above—the Act, the PTA, and the performance, if you like.

Bollard Well, that's the board's submission, but yes, we would agree and think they're not primarily due to monetary policy.

Gosche But it primarily mirrors the sort of things that—

Bollard Well, we know that the exchange rate is a common factor running through all that.

Gosche So the debate that we've been having in the last 6 to 12 months is that some people don't agree and they say, in fact, what you're doing with monetary policy or what we do in New Zealand monetary policy, because of the Act, the PTA, and the performance of the Act is causing those imbalances, so what's your answer to that? That's surely the crux of the issue we're trying to grapple with.

Bollard I mean I think you're talking about that via exchange rate—that's what they're broadly seeing. They're seeing us as bidding up the exchange rate with higher rates and seeing that as leading to more imports and consumption and less exports.

The interesting question would be what would be happening if the Reserve Bank wasn't in this at all. It's quite conceivable you might have rates, if there was such a thing as a free market setting all that, pretty much where they are. And why? Because New Zealand householders have been very, very keen to borrow and confident enough to do that, and borrow at quite high rates. Because there's been this glut of liquidity internationally and they're being prepared to lend, that's one of the reasons that's been determining the exchange rate. In a way, we've sort of been a meat in the sandwich. We've been part of that in the markets there. But underlying that is this fundamental desire for overseas funds by New Zealanders that has bid up the exchange rate. That has sent through signals that we don't think are healthy for the structural balance in the economy, which is: import more, export less. That is now changing. We think it is taking longer than we might have hoped to change, but it is now definitely changing.

Gosche But isn't the worry what damage may have been done to the export sector. Some parts of Federated Farmers, for instance, don't agree. The meat and fibre part, obviously, have got a different view to the dairy part and may be able to argue. Certainly with the number of manufacturers having departed, maybe the damage has already been done. With our, I suppose what people have perceived as a single focus on the housing market, the collateral damage in dealing with that issue is what people are concerned about, and doesn't that reflect on the statements that the Act is OK, the policy target's OK, and the way in which you've operated is OK?

Bollard — We've only focused on our housing market because New Zealanders are focused on the housing market. That is where they are using funds—and what they have felt was still quite cheap funds—and they have been prepared to import, to borrow funds from the Japanese housewife through the markets.

Gosche — But haven't New Zealanders been told—certainly the baby boom generation—that there is uncertainty about your future when you get to retirement, you'd better start saving? The way they've done it is to go and buy a second property. So it's like, why criticise them for doing that. I don't necessarily agree with those perspectives, but I just think it's important to tease the argument out; that's what a lot of people have done. The very same generation who probably bought their first home on 18 to 22 percent mortgage rates are not frightened by your 8 or 9 percent. So you've had real difficulty putting the screws on the housing market, and that's why people are squealing about exports, the dollar, etc.

Bollard — I should say that the numbers we're tracking now suggest that we are having a significant bite into the housing mortgage market. So we are seeing the sort of response that we've been looking for. It's been coming through pretty much as we forecast. It's not falling off a cliff, but it's been coming through showing some contraction there and we think that has to happen.

But we've been expressing our views about household balance sheets for a long time and they're broadly along the lines of—you may get capital gains through investing in housing at certain times, they are not guaranteed, you can't necessarily assume you'll get those over the cycle or over your lifetime, and in addition, it doesn't make sense to put all eggs in one basket.

Just on the export sector, the export volumes out of New Zealand have held up surprisingly well through this period of high exchange rates. Generally there has been growth in volumes of exports through this period. I think where it has been more hit has been the manufacturing sector sales into the domestic market, which have been hit more by the Chinese and other type cheaper imports.

Gosche — Your advice to the committee is to say essentially what we are doing in New Zealand monetary policy is OK and leave it alone. But there could be some other things that are causing these imbalances that we should look at?

Bollard — Yeah, broadly.

Jones — Earlier, in one of your presentations to us, reference was made to the fact that you'd consulted a social scientist to get a fix on what might explain the Kiwi predisposition for higher levels of debt than you're

	seeing in Hungary and other such sadly comparable places. What did you learn out of that experience?
Bollard	We're still probing, Chairman. New Zealanders have behaved a little differently from almost every other OECD country through this period. As I said, they're prepared to take on more debt. Some of that's generational, some of it we can't fully explain, and we look forward to your views on it.
Swain	Some of it would be a strong employment growth, wouldn't it?
Bollard	Absolutely. Strong employment growth; role of Government, if they don't think they have to save for precautionary problem times. Some of it's younger generation.
Jones	Well, a key point of what you've said in your submission to us is that if you are worried about persistently high interest rates, then tackle savings.
Bollard	That's correct.
Jones	To me, that's the guts of what that five pages means, once I strip away the troublesome banking rhetoric.
Bollard	Yes, well clearly New Zealand does need to keep saving and save more.
Foss	If New Zealand's been out of whack OECD-wise over this last cycle and has surprised yourself and various other economists, etc., doesn't that imply that it will reach its average so actually there's potential for a very sharp and rapid correction to behave like the OECD average at the end of the day over the next cycle perhaps?
Bollard	We think we've been going very much like the OECD cycle, which is broadly slowing in Western countries' savings as house prices have gone up. The same thing's happened here, but we're at more extreme levels than any other country.
Foss	Which implies a more volatile period?
Bollard	We haven't seen in the past a response back to high savings levels. We'd be interested to see what happens this cycle.
Jones	Us and Iceland. What an odd bedfellow. Bye bye, Alan.
Bollard	Thank you very much.

Joint presentation of ANZ National Bank Limited (Submission MP/47), Westpac New Zealand (Submission MP/55), ASB (Submission MP/35), Bank of New Zealand Limited (Submission MP/34)

Mr Cameron Bagrie (ANZ), Mr Kirk Hope (Westpac), Mr Brendan O'Donovan (Westpac), Mr Nick Tuffley (ASB), and Mr Stephen Toplis (BNZ)

Jones	OK, Kirk and the banks, please. Welcome folks. Guy Fawkes isn't here, Brendan, so quietly and diligently represent yourself today.
O'Donovan	I was wondering if we should follow what the clerk of the committee sent to all the banks as a framework with the five questions that you're most interested in. If we ran through that, then all of us can chip in at the same time, rather than doing a set piece.
Jones	Yeah, OK. That's a very good idea. Just to kick off, you guys want to quickly introduce yourselves and then I'll open it up to our colleagues. [*Introductions*] OK. First, on behalf of the committee, thanks for agreeing to appear together and thanks for putting in the time to come and address us. A number of you have already spoken to other committees dealing with related issues, such as the affordability of housing and the love affair of Kiwis with housing, etc., so thanks.
Smith	I would like, if I could, to pick up from where I left off with Dr Bollard. I am just so fascinated by the fact that more than one of you have mentioned the huge drop-off in productivity from the 1990s to the 2000s and the severe problems that is causing us in terms of our capacity for non-inflationary growth. I just wonder if any of you wanted to expand on that. It just struck me as being such a classic difference. There's the Reserve Bank, responsible for setting monetary policy and helping us understand the different factors that cause problems, saying that productivity is a huge issue, yet their analysis is so different from yours. Theirs is sort of saying: "Oh well, we seem to be getting more capital investment going on, so productivity should, in consequence, improve.", whereas you guys are looking at it and saying how there is a real problem on the supply side here—productivity growth has fallen off, and there seems to be some real issues around the operation of markets. Would any of you like to offer any comments on that?
O'Donovan	I will fly into that. I think to be fair to the Reserve Bank, they are highlighting the issue, just as the rest of us are. When you look at people's forecasts of what the potential growth is in this economy, the Reserve Bank is around 3 percent at present, and we would be around 2.75 percent, so actually in their forecast they are not far off the mark from where we are. So they have certainly factored those considerations in. I think from our perspective productivity performance has been the key issue that has made the Reserve Bank's job a whole lot tougher. So when we compare it to the second half of the 1990s, multifactor productivity in this economy was around 2.3 percent per annum, between 2001 and 2006 it had dropped to an average of 0.5 percent, and that is using averages, because productivity is cyclical, you need to abstract from economic cycles. But whichever way you look at it, it has been a marked, marked drop-off in the productivity performance of this economy.

Another way of expressing all that is that in the second half of the 1990s the Reserve Bank was able to accommodate around 4 percent real growth in this economy each year, without it proving inflationary. It can now accommodate close to 2.75 percent real growth in this economy without it proving inflationary.

Another way of expressing all that is if trend productivity had kept growing at the same rate that it grew at in the 1990s through into the 2000s, we would now be looking at core inflation measures closer to 2 percent rather than 4 percent. We would be looking at lower interest rates as a response, and also probably a lower exchange rate as well. So the productivity performance is the crucial one for New Zealand's long-term income and wealth generation, but that decline in productivity is also having a cost for this economy in terms of current interest rates and exchange rates that it faces.

Smith — I want to follow with a question. You guys, though, have suggested reasons why this has happened. You heard the Government saying, oh probably the reason why this has happened is the increase in employment or the reduction in unemployment. You guys have offered very different views of that.

O'Donovan — The change in the composition of the labour force has some influence, but I would put it as minor. I don't see how even in peak years, when employment growth was at 60,000 and is now close to 30,000, how that's going to change your productivity across 2 million workers. It's a very marginal effect. It's not the predominant one. For us, when you're looking at productivity at its broadest, the Reserve Bank is completely right. It's not a monetary policy issue at all. That comes from fiscal policy. When you look at the influences, it's brought us level. It's the health and the education of your workforce. It comes down to compliance costs. It comes down to your regulatory regime, ensuring competitive outcomes in your communications and utilities sectors. It's the use of the Resource Management Act as an anti-competitive tool. It's open economies, so it's trade policy. I'm passing no comment at all. In some of these areas Government policy has actually been best practice, and in some others it has not been as good as it could have been. But to my mind the key factor in terms of productivity performance has been tax. To us, tax has a major impact on people's incentives and economic outcomes, and I think it's the tax policies that have had, more than any other, a dominant impact on New Zealand's productivity performance.

Fitzsimons — You are saying that a major effect on productivity is high effective marginal tax rates from things like Working for Families making people less inclined to work, yet the statistics show that New Zealanders work more hours than most other OECD countries, so how can you square those two?

O'Donovan I don't want to dominate the proceedings. I can answer that directly if it's directed at me.

Most of the deterioration in the benefit tax interface has been in recent times. It hasn't been over that entire period. So a lot of the growth in the labour force through that period wasn't influenced by the tax benefit interface, but I think when you look at where we've got to now, then a number of families are faced with effective marginal tax rates of 80c or 90c in the dollar and when your effective marginal tax rates are that high you're always going to have somewhere in the income distribution that problem of where your benefits phase out and you have higher effective marginal tax rates than what your marginal tax rates are. But it's pushed up very high in the income distribution now, particularly through Working for Families. If people are faced with effective marginal tax rates of that magnitude, then the incentives are fairly clear. You work less.

Fitzsimons A major problem in the 1990s, as I recall, was very high effective marginal tax rates from some of the welfare tax policies at that stage. Those effective marginal tax rates are high again now, but we don't actually have any evidence yet, do we, that people are working less.

Bagrie Yes, we do. If you look at hours per full-time equivalent employee, our hours per FTE in general, that's actually been declining over the past 6 years. That's not a problem in itself, as long as if New Zealanders make the conscious decision to work less, we also need to consume less. I guess New Zealanders at the moment are looking for the free lunch. They expect to work less but also consume more, and it's just an incompatible situation to be in.

Fitzsimons But if people who have been working 60 hours week drop back to 50, that's not necessarily a bad thing for total human well-being, is it?

Bagrie No, well certainly my partner would like me to work less, but if you look at the numbers, they're saying that New Zealand, we were working on average around 39 to 40 hours per week. I think the numbers at the moment are down to around 38, which is still, I guess, reasonably high across the OECD but it is trending over time and the more important question is, if we want to work less and earn less, what are we going to do to our consumption behaviour?

Swain I have one question to you, and one to the BNZ. The first one is that you are arguing that absorption rates late in the 1990s kind of had marginal effect. You are saying tax is the big issue and there's a huge disagreement, as we know, about that. Surely, it is common sense that at a time when there's a lot of labour and it's cheap and that's being absorbed at a very high rate, say, for example, in the late 1990s and through to 2002, 2003, and 2004, to the rates of unemployment we've got now, that that's going to have a bigger impact on productivity than the issue of a tax change around what is potentially quite a percent of the population, that somehow you're arguing that when we get to capacity constraints, which we've got now, we're starting to see the problem where people now can't just pour it into more labour and are going to have to borrow to put it into more machinery, whereas previously it was cheaper to do the other thing. So for us on this side it's hard to hear this argument that somehow the absorption of labour during this period has been a marginal impact, whereas tax is such a huge issue, so if you wouldn't mind commenting on that.

Secondly, the BNZ I think makes a comment in here which is reasonably strident and it says here in the summary that the discussion of alternative instruments diverts attention away from the real question, which is whether the central bank has used the tools already available to it appropriately, and we would argue it hasn't. We have had arguments about too soon, too early, not soon enough, but that's quite a strident kind of comment and I just wouldn't mind that being fleshed out a bit, too. Maybe if you would like to comment on the first comment about tax versus labour absorption.

O'Donovan I find it surprising that you say the tax only influences 5 percent of the population. It is markedly more than that. If you're just looking at the top marginal tax rate, then it captures 13 percent of the population. But we're not just looking at those directly affected by that change alone. If you are looking at that change alone, the move from 33 percent to 39 percent on your top marginal tax rate actually increased the value of a residential property to an investor by around 23 percent. So you can't just look at things in isolation for their impacts. The impacts are quite broad based. Just like when you look at the structure of the New Zealand economy, about 94 percent of the businesses are small to medium sized and the way that most of those businesses grow is through retained earnings; it's not through venture capital funds or angel investors. The tax rate applying to your company sector has a large, large impact on the behaviour and the operation of this economy.

One of the conundrums in all of this is that investment rates have actually been quite strong in recent years, and we've actually seen quite a large expansion in the capital stock. The conundrum we're all dealing with is, is the productivity payoff from that investment still to come, or has the composition of that investment been skewed towards bricks and mortar, and you're not going to get so much of a productivity payoff from it. That's an issue that all of us in the economics profession are trying to deal with. We're saying there has been quite strong investment and we're not seeing any productivity payoff from it, and we don't have the answers yet as to why that is.

Toplis To give just a quick comment on productivity. It worries me sometimes that the whole discussion around productivity seems to be about finding quick fixes, and there is a whole discussion just on monetary policy stuff.

It's about quick fixes, and there are none. Particularly when you're talking about productivity, you are talking about stuff at the very margin—things that are not going to make massive quantum changes in productivity, but will make a small difference, and if you can get enough of them right, then in combination they will make a large difference. I think when you're coming to labour supply issues, it's really about every single piece of Government policy, every single piece of legislation, whether it be directly to do with monetary policy or not, should really have a question mark at the end of it: does this improve productivity, or doesn't it? What is the monetary policy response? Does it improve the supply of labour, or doesn't it? Does it improve the demand for labour, or doesn't it?

The choice may be that you actually make a conscious decision to reduce productivity through some particular policy measure. But to actually try and find the sort of quick fixes, change taxes, do this, do that, and everything will be solved, I think is the wrong way of looking at it. It looks to me that we need to contemplate policy more holistically.

Swain I agree with that and it may come down, for example, to spending more on training, which is what's happened. You get people who say that the Government should not be spending any more on this and that and other things, and other people saying it should not spend more on this and that and other things.

Toplis In some ways with productivity decline you become the victim of your own success, particularly in labour markets, because by definition, and this is not being critical of any individual, by the time you have employed most people, the people who are left will have been disenfranchised for whatever reason, so bringing them into the labour force is unlikely to add as much value in the first instance, whereas if you have got a 10 percent or 15 percent unemployment rate, you've got a whole pile of hungry people who are desperate to do anything for anything, so you get large productivity gains. Part of this is that we are sort of a victim of our own success stuff, which we shouldn't overlook.

Coming back to the comment on monetary policy and the central bank's effectiveness, I guess the issue that was really starting to bug us was that, again, we're trying to rush around and blame the system for the problem and, therefore, if we just change the system, it will solve everything. It sets up this whole mantra that all we have to do is to pull a lever and everything will be all right, which is the wrong message to send. I think that if you look back on it, in hindsight—we would say foresight, but for most people it is hindsight—the central bank made some wrong decisions. They clearly made those wrong decisions for the right reasons. But rather than changing the system, why not just go back and say: where did they make the wrong decisions, why did they make the wrong decisions, how do we not make the wrong decisions in the future? I think that's a much more constructive—

Jones The guts of that is they tightened too soon.

Toplis In our perception, yes. I think it's also revealed by the way the property markets developed, by the excess demand that is being built up in the economy. Again, they may have done that for very good reasons. But don't change the system because you are changing the wrong gear.

Swain Isn't it true that someone has to do that—make those decisions?

Toplis Absolutely.

Swain And in the end he was a little bit more cautious to seeing where the cycles were, the impact on the real economy, etc. So you can criticise that, and you do, but in the end I suppose other people would say that potentially in some other parts since then it's been tightened too tough. So someone has got to make the decision, and that's what you're talking about, essentially not tightening fast enough.

Toplis That was our perception, certainly.

Foss I think you really hit the nail on the head there, in that when the governor has used the OCR tool over this last cycle, every time it has a 0.25 percent change, and in his own submission they say that perhaps we should have moved higher, faster, quicker, earlier—all of that. A lot of conjecture has been around: "Oh, it's blunt now, because many mortgages are fixed." But they knew that when they were hiking or not hiking. So a 0.25 fix, a 2-year mortgage, no one is going to notice the difference. When they come to roll over and it's 200 points higher, boy, the OCR is pretty sharp there. I have seen some work of yours looking at how much more interest has been paid out of the economy from 2006 to 2008, I think. It's actually working and it's sharper when it hits the person who has essentially borrowed from the Japanese housewife at the end of the day. Is there room for the Reserve Bank governor to use the instruments more aggressively at times of need, such as hindsight is showing us now? In fact, if they had hiked half a point or three-quarters of a point aggressively, enhanced their reputation, would that have made a difference to where we are today?

Toplis It could well have done. We will never know, I guess. But I think the most important thing that comes out of this is that for central banks to operate effectively it's all about them being seen as being credible. If we're all rushing around, trying to say: look the tool is no good, it doesn't help their cause nor does rushing around trying to find alternative instruments. What we're actually saying is these guys have no credibility and the process has no credibility. We're sort of shooting ourselves in the foot in the process.

Foss And the credibility of a central bank goes right through the credibility of our financial systems.

Toplis	As a small example of that, look at what the federal reserve has done today. I'm not suggesting that we should do that, or have done that, but what I'm saying is that they are seen as being credible. So what they do will have an impact. If you're rushing around, saying that: these guys are incredible, what they do is pointless, that the OCR doesn't work, then you're actually making their job that much harder.
Swain	I think the summary of where we have got to date is that people really aren't saying that. Where it started was that this was mid-1980s we had this policy tool. Has the economy changed, got more complex, and therefore we need to have a look at it to see whether it's appropriate in the early part of this new century. The general view of the submissions is no, it's basically still fundamentally right, and there's some things around the outside that need attacking, like, for example, productivity. I think that's kind of where the submissions have come to.
Jones	Just so you understand what the process is going to be. I'm going to go to Doug, then come to Mr English, and then I will open it up again, and I've got a question for our friends from the ANZ. But Stephen, without a doubt, of the community of bankers you and the perspective of the BNZ has probably been the sharpest on challenging the actions of the Reserve Bank and whether or not they are undermining its own credibility. That's certainly my view, anyhow.
Woolerton	One of the pressures the Reserve Bank governor has to consider before he raised interest rates was the effect of that exporters, and that's the question I wanted to ask. Several of you have mentioned our high current account deficit, and that's all a fact. But I was wanting comment on the issues surrounding that, when the incentives for exporters have been all bad during this period when the Reserve Bank governor has been trying to dampen internal demand. His way of doing that is raising the interest rates. We have discussed that. My question is, are there any other incentives of a positive nature you could put in to make exporters export more, or whatever? While we are talking about housing, we also have the other side of that coin, which has been hurting the—, so they're not going to help to fix the current account deficit, are they? They are being hit on the head.
Toplis	I guess there are a number of issues there. The primary source of the current account deficit, in my view, is not the paucity of exports; it's the quantity of imports, which has actually been because domestic demand has been so strong. It may seem perverse but actually bringing domestic demand to heel will stop everybody rushing around, buying plasma TVs and all the rest, and actually bring the current account a lot closer to balance. When talking about export volumes so far, I think we're seeing the first signs that they may be responding.
	The other problem we have, clearly, is that New Zealand is primarily still an agriculture exporter. Volume responses for agriculture have far more

to do with climatic conditions than interest rates or exchange rates. The returns have a lot to do with interest rates and exchange rates, but not the volume of production. There is very little they can do there. Thirdly, on the more general manufacturing front, I think the bigger issue there has simply been a dominance of the emerging markets in production. Frankly, if you're talking about some of the costs of producing in places like Viet Nam, Thailand, China, and the rest, if we had a currency of 10c to the US dollar, it still probably wouldn't make us a cheaper destination for production, so that was a process that was always going to occur anyway.

English: You refer in your submission, as a few others do, to the unusual nature of the current cycle, and I presume—and this is one of the reasons that we have ended up with an inquiry, is that the cycle has been a bit difficult to understand. What does that imply looking ahead, though, to the extent that we are looking at monetary policy frameworks? It can't apply to the cycle up to now, and it probably couldn't apply for at least a few years. So, if the cycle has been unusual up to now, and we have talked quite a lot about those effects, and they are covered in your submission, is there going to be anything unusual about the next phase of the cycle that is relevant to what we are sitting here thinking about?

Tuffley: Well I think what we are going to be going through, going forward, is a big unwinding of what has built up. We have had a housing market with the strongest boom in, say, about 45 years, when you look at real house prices. You have got the unwinding of that to go forward; an exchange rate that has, at times, been quite high, and we are already undergoing the unwinding of that process going forward; and, globally, some of the issues there, you could say that there is some unwinding that could eventually happen there. We had an environment where, for example, Japanese interest rates have been incredibly low. The Japanese economy has not exactly been recovering very well over the last 15 years, but to the extent that that starts to recover you will get some normalisation of those sorts of factors there. So I think, that environment, going forward, is going to be a reflection of the unwinding of some of those factors. The housing market is likely to be quite subdued for quite a prolonged period, say, when you compare it to past downturns in the cycle, for example. At some point some normalisation of Japanese interest rates, and so some reduction in that extent to which we have seen people funding out of the yen and going and investing elsewhere. We are seeing some reduction in that due to change in risk perception.

But those sorts of factors I imagine will be things that the Reserve Bank will be taking into account, going forward. It does not necessarily mean that the structure of monetary policy should shift. No, I do not think so, but it has been a bigger test, I think, of the framework than we have had since it has been put in place, because of all these unusual things that all lined up at once.

English	Are we going to get some asymmetric effects? For instance, if the housing market has had its biggest boom in 40 years, then normalising means either prices are going to drop a lot, quickly, or a little bit for a long time, because if the cycle is unusual in the upside, it is hardly likely to be completely normal on the downside, is it?
Tuffley	Well I guess you can take some examples where in most housing cycles you get the price boom, then you get, say, a year where prices soften, say 5 percent in real terms, and then they tend to plateau and go sideways, and do not much at all. You have the 1970s example where you had a very, very strong boom, and then prices in real terms went back to where they started. So over an 8-year period you basically ended up where you started. So you can say there are two extremes there. I think I would take a view that, going forward, we are going to have a period where it is a relatively mild adjustment, in the sense that it will be more similar to the ones that we have normally had, so a period where prices perhaps fall very slightly for a period, and then go sideways. It is something a bit normal, despite the extent of the boom. One reason I think we have to bear in mind is that the labour market has been incredibly strong, and we are not going through that sort of recessionary-type period where people are losing their jobs and their ability to finance the mortgage—layoffs, and things like that. So the economic and background environment is pretty benign.
Jones	But hasn't your thesis been migration as being the key driver, as opposed to punters in New Zealand emulating Sydneyside speculative activity?
Tuffley	That is part of the story. I think all you have got to do is put a chart of migration against house prices, and you can certainly see the last two housing booms, how strong that influence has been. So it was, I would say, one of the fundamental drivers for the extent of the boom back in 2003-2004, but it is certainly not really a good explanation of why the housing market has held up so well over the last couple of years.
English	Could you get some asymmetric effects of monetary policy because of the borrowers? If you take the housing market, which has been so endlessly discussed, borrowers went into fixed-term mortgages, in my view precisely to deal with volatility of interest rates; that was the point. Now they are going to be dealing with reasonably sustained high rates, maybe over a 2 to 3-year period, and they may turn round and switch to floating rates in quite large numbers at some point, it is quite possible, if they do not want to lock themselves into high interest rate structures, which would, on the way down, make the OCR quite sharply effective, possibly.
Tuffley	I think we have still got a situation where about 85 percent of mortgages by value are fixed. So at the moment the impact of that will be relatively

muted. I think when we look at the impact of mortgage rates on people's spending choices, and house-buying choices, you have got to divide it into two different categories. One is, obviously, when there is a shift in mortgage rates, with all the fixed-terms, for example. That affects the person right there and then who is deciding whether or not to borrow more money, so you have that immediate impact there. But it is certainly the case, because of the nature of the amount of fixing, that impact where people roll over and fix on consumer expenditure and the like, does take a lot longer than what it used to.

English Yes, OK. Can I just ask one more question to anyone who wants to answer it. We were asking the board of the Reserve Bank this morning, or I asked them, actually, whether they could give this committee a sense of direction, from their view, about the performance of the bank. It is their job to monitor the bank, its performance as the operator of monetary policy. The evidence is that they have operated within the agreement and kept inflation roughly pretty much within the target zone, even if it is at the top, rather than in the middle.

So we were asking them if they could give us a weighted opinion on whether the problems that had arisen as a result of monetary policy warranted the speculation about extra instruments, and this kind of activity of having an inquiry into the framework, which is, in a sense, a political judgment that the job has not been done right, otherwise we would not all be here. They could not really give us a sense of direction, actually, just to give you my opinion of their answer. They could not really tell us whether the problems were serious enough to warrant the politicians considering change. Here we are running an open, public forum discussing monetary policy framework when it has never been under more pressure, as you have just pointed out, in 18 years. Do you think the bank board is doing its job if it cannot tell us, who appoint them, whether it is worth looking at changing the framework or not?

O'Donovan Well I think you step back and you ask the basic question: has the framework worked? And the answer to that is an undoubted yes—both in terms of the length of the economic expansion we have seen since 1997, but more importantly in terms of the economic volatility we have seen around the economic cycle, and that has been the really big testament to, I think, the Reserve Bank's success here. Sure, they have been probably pushing the limits of the upper end of the inflation band; we have been close to 3 percent. But if you look at output volatility that has been far lower over the past 10 to 15 years than prior. And importantly, I guess, for businesses to households, while we do not like to see a lot of interest rate and currency volatility, there are financial instruments to households, businesses, that can mitigate against that sort of risk. You cannot mitigate against output volatility. So you would far prefer to see the volatility on the exchange rate and the interest rates, as opposed to output.

English	So why couldn't the board, who are ultimately accountable for all this, say something like that, instead of wandering around for the last 12 months endorsing a kind of Chicken Licken strategy, which is the sky is falling in and here are six ways I might be able to prop it up?
Jones	I think Stephen is chomping at the bit to answer that!
Toplis	I think there are two separate issues. There is, did the Reserve Bank get it right? No. Did they get it wrong, knowingly? I think you would be hard pressed to suggest that they were being intentionally negligent in their duty. Given that the board's responsibility is really to identify that intent, rather than the success or failure of their objectives, it puts them in a very difficult position. Clearly you are not going to find a board member saying, look they buggered it up. But to the same extent, they would defend very, very strongly that the bank thought it was doing the right thing, but the end final outcome proved otherwise.
English	But isn't that the odd thing, that the performance is within the bounds; that the intent was good, and decisions were made knowingly, and you can argue they were the best decisions at the time, the results actually are pretty good, for an economy that has been in a tight corner; but the bank and the board—and the board endorsed the strategy this morning, and said it had been discussed—have spent the last 12 months giving the opposite impression?
Toplis	I think the board, as have many people, have got dragged into this debate on alternative instruments having been distracted, partly through the political process. While, as Paul says, basically people here understand what is going on. I still think for any one of us wandering around the traps out there over the last few years, for every presentation we gave somebody came up with some hair-brained idea on quick fixes. And that was the view out there, and I think the bank, you guys to some extent, we to some extent, and the board, have been dragged into that process, and that is why it worries me a little bit that we have been deflected from the core thing here of, are we doing it right in the first place?
Jones	Brendan, when you guys are overseas raising dough for the banks, do you ever receive observations, hear concerns from the international funders about monetary policy, conduct of the Reserve Bank?
O'Donovan	The only concern is around communication, so there is never ever a concern around framework. And that is the important thing here. The framework is international best practice, and that is why about 30 other countries have replicated us. It is worthwhile pondering that there is no other country that actually utilises some of the supplementary stabilisation measures that are being advocated, and I think that is for good reason; it is because they do not work.

Whatever framework you put in place is not going to give you 100 percent foresight. The Reserve Bank—I think the mistake was actually in 2003, by cutting, when they had a booming domestic economy, but that is hindsight. That is gone. You live a long time with those mistakes. But the framework has actually delivered us strong economic growth, low and stable inflation, and it has actually worked. In a time of a booming world economy, the Reserve Bank tightened monetary policy, and this economy slowed from 4.5 percent growth down to 1.5 percent growth. The thing is working. I think the most useful thing is to actually firmly endorse the framework.

One of the concerns we have is that there have been three changes to the policy targets agreement over time, and all of them are towards tolerating more inflation. Equally, with the Reserve Bank's behaviour, with hindsight, they have averaged just below 3 percent inflation over the past 3 years. Their forecasts have got inflation at 3 percent over the next few years. The problem with all those changes, and by operating policy towards the top end of your target band, is that you push up inflation expectations. People expect you to be going easy on inflation and that, perversely, makes the Reserve Bank's job even tougher. One of my suggestions would be to give them a point target. Make it the middle of the current target band, then there is no doubts about what you are targeting. That anchors people's expectations. It actually makes the Reserve Bank's job easier.

A lot of the reason for the angst has been the exchange rate. The reality is that New Zealand is a small, open economy, and we are faced with volatile conditions. That volatility has to show up somewhere. If you anchor the exchange rate, that volatility does not disappear, it will either show up in higher interest rates, or it will show up in greater output variability, which Cameron was referring to. Well that is code for saying you will get a lot more job variability—you will have periods of strong job growth, but big job losses. One of the remarkable things through the entire period that we have had this monetary framework is the excellent economic outcomes that we have experienced.

The Reserve Bank has got a very difficult set of circumstances to deal with at present, because we are in the biggest terms-of-trade boom that we have had in 33 years. If you adjust our exchange rate for commodity prices, it is actually 8 percent below its historic average now. Exchange rates and other financial market prices cannot deal with individual sectors; it has to work on averages. So we cannot have a separate exchange rate for our manufacturing sector, a separate one for dairy, a separate one for meat. We cannot have separate interest rates for each sector. So I think the exchange rate issue has actually been a red herring through all of this, and just don't throw the baby out with the bathwater. This is international best practice and it has worked extraordinarily well for this economy.

	The Reserve Bank is not the cause of the inflation pressures; they are just responding to the inflation pressures out there. If you tell them to go easy on it, then there is only going to be one result, and that is going to be higher inflation, and the cost that that brings.
Woolerton	Can I just ask a question about setting— in the committee, talking of the 1 and 3 percent target rate, how would we describe that? How would you say that to the Reserve Bank, this is your target? Would you say only in exceptional circumstances you can go to 3 percent? How would you do that? I am just interested.
O'Donovan	"Your inflation target is to keep inflation at 2 percent on average over your business cycle."
Woolerton	So you would change it back to 2 percent?
O'Donovan	Yes.
Woolerton	You would take out the 3 percent?
O'Donovan	You would take out the 1 to 3, because it is actually seems to be encouraging behaviour to target the top end of the target band, and ultimately that makes a more difficult problem.
Woolerton	You are saying you would leave the 3, but you would—
O'Donovan	Yes.
Fitzsimons	There is wide agreement, and you have said it yourselves, that the major inflationary pressure is New Zealanders wanting to borrow for consumption that basically exceeds their current income. Aren't you guys collectively responsible for a lot of that? We have had years of you with really aggressive advertising—"raise more equity on your home to pay for your overseas holiday, to pay for your new car, to pay for your new TV." You are pushing credit on to consumers quite aggressively. I am amazed at how many times people want me to raise my credit card limit; I do not want to raise my credit card limit, but I am sure other people do. Isn't this sort of behaviour, where you are actually pushing debt harder than you are pushing other banking services, part of the problem?
Toplis	There are two bits to that. First of all, it is a demand-driven process, not a supply-driven process. People are demanding that money. There is a speculative boom in housing. You try and find a single bank economist who has suggested to you that houses are undervalued. We write this stuff, we promote it, our banks promote it, but people want to keep borrowing. If they don't borrow it from us, they will borrow it from someone else, whether that be directly offshore, which is more problematic, or, as we are currently seeing, from non-bank financial institutions, and we are seeing the fallout from some of those things,

because they do not fall under the same regulatory and compliance issues as the core banking sector.

The second point, and the Reserve Bank has made this, is that the banks have been a little bit aggressive in lending. The central bank has a tool to push interest rates up. Just keep raising rates. If you think rates are too low—and we always get this—it is quite interesting, again, to go round the traps, and people are saying: "You guys are lending money to us at such a low rate." Well, if you want to pay more, everybody in the bank would be very happy if you'd voluntarily do it.

Jones "You guys" in singular, not plural.

Fitzsimons If it is demand-led, rather than supply-led, and you can't influence it, then aren't you wasting your money doing all that TV advertising?

Toplis You name a single industry anywhere that makes a joint decision not to advertise because it would be in the best interests of the industry. We advertise because they advertise, and they advertise because we advertise, and it is the same in every industry you name.

Jones Now, we do not want Marketing 101. Have you got any other observations, Jeanette?

O'Donovan In light of that, our appendix 6 in our submission deals with that, and a lot of the increase in the debt has got good economic fundamentals behind it. It was lower inflation, more stable economic environment, and lower interest rates than what they were previously.

Fitzsimons You actually put requirements on your staff to sell a certain amount of debt. You not only give them bonuses if they do, but you actually make it a requirement of their jobs that they go round selling debt to their family and friends. It is a very aggressive policy that you are following.

Bagrie New Zealand is not like the US sub-prime market. We're not issuing what we call "ninja-loans"—no income, no job, no assets. We're actually here to protect our shareholders and ensure risk is appropriately priced. I also think there is a broad concept that is relevant, namely individual responsibility. As an example, since I have been in this job I have put on about 3 kgs. I like the odd bar of chocolate. Do I blame the supermarket because I am putting on weight?

Toplis There is one very important point to make in this debate. One is that clearly we do not determine bank policy on relationships with the rest of the staff. But there is a Government-owned bank in this sector which is behaving in exactly the same way as all the other banks, and in fact is currently advertising mortgage rates less than anyone else.

Jones Stephen, thank you for that unhelpful observation!

Smith Mr Chairman, if I could please come to Cameron Bagrie, because I think you have got some very interesting data here on productivity, and I think that is a serious issue. What is fascinating about that data is, if you look at labour productivity changes, if you look at capital productivity changes, and multi-factor productivity out, I presume you have fitted some regression lines to the Statistics New Zealand data there.

What I want to ask you is, you speak of your own research in relation to these changes, with multi-factor productivity growth your progression line's horrific at approximately a peak of 3 percent annual growth in multi-factor productivity in the mid-1990s, the 1995 to 1997 period, say, down to virtually zero now—just above zero. Likewise, even capital productivity is declining a horrific amount, whatever way you look at it. Labour productivity—in the 1990s we were actually ahead of the United States in labour productivity growth, level with Australia, but now, of course, since 2000, we are only half the United States. You say your research is demonstrating growth in regulation as being a really serious issue. I just wondered if you would care to add—as a constituent MP I see the problem of someone trying to invest, and it taking 3 or 4 years to get the approval processes completed.

Bagrie I guess one of the issues, and I think it has been touched on across the group, is that we have had a pretty sound business investment cycle, but relative to historical investment cycles it has been what I would call pretty muted. Businesses have not responded to the same degree as what they have had over history. So I guess it leaves a bit of the question as to: why have businesses not responded to classic pricing signals? So the price of labour has gone up, the price of capital has gone down; there should be a big substitution effect going on, and it has been relatively muted.

We put out a paper at the start of this year, and it is part of the ANZ knowledge base series. It was all about us looking at some of the hard issues New Zealand is going to be facing over the next 5 to 10 years, if we are going to catch the odd magic bus and move back up through the OECD rankings. One of the issues we homed in on was the idea of regulation. Obviously it is a dangerous area. We very much went down the qualitative route, and we provided some numbers that we can demonstrate that the regulations we are seeing in some industries, such as telecommunications, plant machinery and equipment, and I think electricity, were leading to inefficient resource allocations, and that was actually impacting on their economic cycle. Secondly, we could quantify what the economic impact of uncertainty was. If you go around New Zealand at the moment and talk to some key industries—telecommunications, energy, and the like—economic uncertainty is delaying much-needed investment. Part of the reason we are seeing inflation pressure to the degree which is apparent today is because of a period of under-investment over the past 5 to 10 years, which I think in part reflects uncertainty, particularly on the policy front.

Tremain	Staying with that productivity message, ANZ and National talk about the restraint on the productivity commission. I just want to know what the benefits from that are, whether it's just another bureaucracy, and whether something like that would have any impact on our own productivity.
Bagrie	I think Stephen touched on it earlier on when he said that every new policy initiative should ask a key question: what is it going to do to productivity? Is it going to raise our living standards? Is it going to make our children better off 10 to 20 years down the track? Now, it is fine if we make the conscious decision that the answer to that is no, but I think what is disconcerting at the moment is that I don't think the question is actually being asked. So I think there is a role here for an independent organisation to ask that question across a number of policy initiatives, because quite often it is not the initiative in isolation, it is a collection of initiatives across a broad area which carries the true cost.
Tremain	And do you think the Australian commission has had a major impact on improved productivity in their jurisdiction?
Bagrie	Quantitatively, I could not answer. Qualitatively, I would say yes.
Tuffley	I guess there is also the issue "out of sight, out of mind"—if you do not have it consciously, and when you are thinking about policies, you run that risk of not feeding it into your policies. And I think that is why one of the recommendations I put down was actually having Treasury assessing Government policies for what implications they would have for long-run growth outcomes. So you have got it at least upfront; at least the box has been ticked and considered at the time when you are doing policies.
O'Donovan	On the question earlier of the living arrangements of monetary policy and fiscal policy—fiscal, in our mind, should be firmly focused on the medium term. It is doing what is right for the structure of this economy, what is right for its medium-term growth. You let monetary policy deal with the short-term cyclical factors; that should not be the gambit of fiscal at all.
Hope	Just in terms of your question, Chris, around the productivity commission—it is the credibility the commission has in having a look at these policy issues and raising it in the Australian environment which is the key think, I think. And it does have that credibility, so it is a useful mechanism. Just on another point, the regulatory impact statement process is already under way. It has been in legislation for a long time, but it is not particularly well done. I think one of the issues is trying to take a real focus to that process, but it is quite difficult to do. It is a standard cost-benefit test. It is kind of a "lick your finger and stick in the air" type

	process, so there probably are not enough well-trained people to undertake it appropriately, particularly on some of the bigger policy issues.
Swain	Just commenting on that, had anything to do with it. You are right, it is a difficult thing to do, and, two, we don't really have enough people skilled enough to do it. We have actually got deals with Australia to give us a hand on it, but I still think we are still quite a long way away from best practice.
	The question of the productivity commission, we have thought about that, and the question that Chris asks is, is it just another bureaucracy sitting outside, kind of bleating? The problem was, how does it engage in the process, so that there is actually an outcome? And that is often, when you are setting up, something that can be easier said than done. What bureaucracy does then, is it says: "Oh, shit, productivity, that's right, that is that job over there.", and we just get on and do what we are doing. But it is an issue that people have raised, and we are going to get some advice on it from the Australian end, the kinds of things we need to think about, because the productivity issue is the one, I think, that a number of really—
O'Donovan	I think your biggest difficulty on that is that you cannot look at any policy in isolation, because the productivity outcome is how the policies interact with other policies that are in place.
Swain	It is often getting them to Government agencies' thinking, rather than narrowing, and that is quite a big challenge.
Jones	Brendan, Nick, we have got to the end, but a terms of reference always includes a line "and any other matters". In terms of concluding our session, what observations would you make in terms of how the sub-prime drama is likely to manifest for borrowers, for businesses in New Zealand?
Tuffley	I think the main issue that it has had on New Zealand is really through, it came in and it has knocked the finance company industry at a time when it really did not need it, and I think that is where some of the spillovers that we are seeing in that sector—
Jones	Is that a matter of sentiment or numbers?
Tuffley	I think it is a big sentiment thing at the moment, particularly in that area. In terms of the size of the industry it is very small, but you are just seeing that flight to quality. A lot of what we have seen in the world over the last few years, it has all been about chasing a return and not bothering to pay attention to the risk, and now it has gone to the other extreme globally, and in our finance company area, that is what you are seeing; people just want their money out in a pile in front of them, or put it in the bank where they see it as being safer. So you do risk having in that

sector there—we are seeing some finance companies where loan books seem to be perfectly fine, but they are suddenly getting starved of the funding, and getting into trouble when it just seems to snowball. I would say that is probably one of the more serious, I suppose, side-effects we have had that I can see.

O'Donovan The main effect, globally, is going to be an expansion of credit spreads. The relative price that firms or households have to pay had got too skinny. People had been under-pricing risk, so there is a reappraisal of risk going on, and that is going to tend to mean that credit spreads expand.

On the finance company stuff, I think that will tend to be overplayed. There is something like, just shy of 80 finance companies. The sector as a whole is quite small—in terms of the total financial sector it is less than 5 percent of the total financial sector assets. There is quite a concentration with the industry itself, so the top 15 finance companies have about 70 percent of assets under management; your top 20, about 80 percent of funds under management. So the reality is that with the new regulations, and the like, you are going to see a lot of consolidation in that sector. But even if you get a number of—it is only the big ones you really have got to worry about. You can have numerous small players fall over, and it will have no material economic impact because, at present, it is not an asset-quality issue—those assets would not suddenly disappear—it is a funding issue for these organisations. So I think the impact of that has been overplayed at present.

Jones OK. On behalf of all the members of the FEC, thanks for putting the effort in. Your submissions have been well presented, and we will read them further.

Asia Pacific Risk Management Limited (Submission MP/65)
Mr Roger J Kerr, Director and Mr Chris Hedley, Analyst

Jones Roger and Chris, welcome. It's a pleasure to have you here. We hear from another Roger Kerr, so we're going to study very carefully what you've got to say to us and give you a tick.

Kerr OK, I'll be careful what I say, then. We've got about 20 minutes, so Chris and I intend to just outline the main points and our recommendations of our submission over the first 10 minutes, and allow some time for questions. I am director and principal of Asia Pacific Risk Management. We advise companies around New Zealand on interest rates, exchange rates, and risk management, and Chris Hedley is our economic analyst.

The main points of our submission, firstly, are why monetary policy has been ineffective over the last 5 years—to address that question. I think that, as the bank economists were just pointing out, it was an extraordinarily long period of economic expansion. As we got towards the end of it, certainly resources were stretched and inflation pressures were up. I think the fixed-rate mortgage phenomenon was underestimated in the early days by the Reserve Bank, which made it difficult for them. They would push interest rates higher and there would be no response. The higher interest rates drove a higher Kiwi dollar. A higher Kiwi dollar meant cheaper consumer goods in the stores, and people could afford things they could not afford before, and kept on spending in the retail stores. The Reserve Bank was trying to dampen down that demand, but of course the lower prices were driving greater demand.

I guess the main point of our submission is that a lot of the inflation we have had in the last 5 years has not been from the demand side at all. If you analyse the numbers and dissect the numbers of where the inflation is coming from, the sources of inflation, a lot are from the supply side of the economy, which high interest rates and high exchange rates don't impact—so, that is, the electricity prices, petrol, local body rates, health sector, education sector.

To illustrate that point we put a supplementary submission, just a one-page chart, which I hope you have in front of you. Chris is going to talk to some of it. We are talking about specifics here. We are not talking about general inflation. We are not talking about macroeconomic settings. We are talking about what prices went up and what prices went down in the last 5 years, so that people can understand exactly where the inflation is coming from and why high interest rates and a high exchange rate have been ineffective. I will hand over to Chris.

Hedley I think monetary policy, especially through the mechanism of the impact on the currency, has been very effective in the parts of inflation that it can control. However, that is roughly only around one-third or so of the composition of the overall CPI index. When you look at things like electricity prices, household energy, increasing at a 7 percent or so annual rate, it is only 3.75 to 4 percent of the overall CPI. Local government rates, again, are increasing at a 6 percent - plus annual rate—again only 2.2 percent—but between those two factors that is about 0.4 or 0.5 percent per annum of the overall inflation rate. So if you are trying to keep that at 2 percent, well you've already got 0.4 or 0.5 percent on the table from something that is completely not going to be impacted by interest rates or the currency.

In terms of some of the other measures, petrol is obviously well-documented. Monetary policy is not going to impact on that in terms of the interest rate or the exchange rate. Again, food prices, especially unprocessed food prices, are dependent upon climatic situations, global supply, and global demand in terms of alternative sources for fuel, as well. There are these large pockets of areas within the economy that are not sensitive to the impact of interest rates, and whether that is because they are not competitive or they are in global areas—it's a bit of both.

Jones So really, Chris, you then would have in mind the so-called burgeoning science of local government, cost of ongoing local government etc.

Hedley In terms of around things like infrastructural spending, catching up—

Jones Well, those areas that are not responsive in terms of what you have just said.

Hedley That's right.

Kerr If you look at electricity prices and local body rates, they are only small components of the CPI, but in the last 5 years, if you took those two out, the inflation rate would have been 2.5 percent instead of pushing up to 3 all the time.

Jones Yeah, you are making that point well.

Kerr We have dissected the inflation rate into three components. Take out food and energy—because they are climatic; they are global—as many other countries do, and concentrate on core inflation. Divide core inflation into competitive economy and non-competitive economy. In competitive economy—as you see in the blue lines—we have had a lot of deflation. So that is price-setting behaviour and price setting that is influenced by exchange rate and competition. You go to the red, which is the non-competitive economy—the public sector and monopoly industries in New Zealand—and there is no market discipline over price-setting behaviour. That is the problem, in our view.

Jones But a lot of that reduction, wouldn't you say, is just China exporting deflation?

Kerr It's part of that. Certainly, consumer goods prices have gone down, and we've had a high exchange rate so they have come down considerably, because it is all imported. Import penetration in New Zealand is very high. But you get the Reserve Bank trying to push down retail demand, but that retail demand is being pushed up by the fact that prices are cheaper. Why are prices cheaper? The exchange rate is higher. Our argument is that the Reserve Bank have been focusing on the wrong sources of inflation. They haven't been addressing the real sources, which we say are out of the public sector and the supply side of the economy.

I guess the other points we would like to make in terms of the main points of our summary is we believe the biggest thing that can control inflation in New Zealand, which I have not seen mentioned in the Reserve Bank's policy statements for about 4 years, is, in fact, competition. If you've got competition, you will have price discipline, and we just don't see it in big parts of the New Zealand economy. I think the competition has gone down.

Consequences of the monetary policy ineffectiveness: clearly a big part of the economy is the disproportionate adjustment that has fallen on particular parts of the economy, through the high exchange rate, which is a consequence of the high interest rates. It has been the export sector and the productive sector that have taken the pain, and we do not know what the economic cost of that is going to be for several years to come. I think it is going to be considerable. We have had a big missed opportunity, one might say, by having to have high interest rates and high exchange rates, through this period when growth should have been 5 and 6 percent in New Zealand. It was 3 and 4 percent and now it has dropped down to 1 and 2 percent.

I guess the other thing—and it was talked about with a previous bank economist—is that we have had excessive volatility in the exchange rate. We advise a lot of exporters that they can hedge the currency risk for so long, but at the end of the day if it continues to be volatile for 5 or 6 years, then they don't invest, they don't expand, and they don't create jobs. I think that too big of the burden, or the cost, has fallen on that particular sector.

We think the Reserve Bank has actually failed to identify the true sources of inflation in terms of the supply side. They have concentrated on the demand side and they don't know what prices are going to go up. They say general demand will push prices up. But in reality, if you are concentrating on the supply side of the economy, it is about specific prices—why is the demand and supply is out of whack in that particular industry or that particular supply of goods or services. You've got to look at specifics. We don't believe they have done that.

Just coming to our recommendations, I guess we say the OCR regime probably overall has worked. We are not advocating anything different to the OCR regime. I think it has transferred a bit of volatility from interest rates into exchange rates, which makes life difficult for increasing investment in the export sector, but overall we would say stick with the OCR regime, but have a good hard look at the policy targets agreement between the Minister and the governor; perhaps concentrate more on core inflation, because obviously interest rates and exchange rates can't control the food and energy; and maybe even go back to what we had in the 1990s when certain price increases were excluded from the Reserve Bank's responsibility, because they just can't control them—particularly Government charges and oil—and maybe, as others have suggested, make some change to just 1 to 3 percent on average over the business cycle. I guess the question is—it is too inflexible, too tough, on the overall economy?

The second recommendation that we make is to impose greater price discipline over the Government and public sector, because that clearly is where a lot of the price increase is. There is a cost-plus mentality; there is no market discipline over price-setting behaviour. We have just had that come through into the CPI—it is pretty clear from the analysis that we've done. It is not just about Government spending, per se. A lot of people concentrate on that. In our view it is price-setting behaviour—Government charges, levies, taxes, and user-pay charges.

I guess some of the other questions that we addressed in terms of our recommendations, just briefly, is whether central banks should be tightening or loosening monetary policy because of asset bubbles. We have had a housing bubble in the New Zealand market here. If you look at the housing market and the impact that had on actual inflation outcomes, you would have to say that—certainly we've seen it on the demand side through construction costs, but that is a very small part of the CPI—most of the inflation we've had in the last 5 years has come through the supply side, not through house prices going up and people spending money in the shops, at all.

Jones — So you don't buy into that notion of equity withdrawal boosting consumerism, Roger? We hear quite a bit of that from the Government.

Kerr — Has that strong consumer demand pushed up prices? Please tell me which prices have been pushed up—only in construction costs of houses, and maybe a shortage of resources in that sector a few years ago, a shortage of houses.

Jones — But your submission basically says that it is a supply side story, with problems of regulation and land availability.

Kerr — Yes.

Foss — Just a quick reference to your graph there. Why did you only choose 2002-07—5 years of the cycle?

Kerr — We could have chosen a longer period.

Foss — If you did, say, go back to 1990 perhaps, what would it look like roughly? Is it the same kind of ratio?

Kerr — If you went back further, I think your reds, your public sector, would not be as high as that. We didn't have 7 to 10 percent every year local body rates increases. We didn't have a 40 percent increase in electricity price over 5 years—we did not have that. Electricity just stands out. You've got five big players in the market, and three are owned by the State. You can draw your own conclusions out of what is going on there. Wholesale prices haven't gone up that much.

Foss So if you did that, does that add weight to your argument? In fact, if you use data over a longer period—because over the same cycle we've been at capacity max here—it actually does add weight.

Kerr I think we'd have to do the exercise, but I think it would add weight to our argument.

Foss Because that is when you would have had more competition. The real estates have followed the property boom—they've had more tin to chuck around. In the early 1990s it was the other way.

Kerr It's good to see the real estate cartel with commissions has finally been broken. It's been in place for a long time.

Swain I think the graph's quite interesting. I have thought about how we break this down and see what impact this particular policy has on a particular area. I think it is quite interesting. I'm not sure quite yet how we will use it, but it is certainly a very interesting graph. On the issue of the energy, I take your point about two controls of the market, but if the electricity companies were sitting next to you they would say: "Oh yeah, we've heard that before.", but in fact this is coming off the base of, relatively speaking, cheap electricity, cheap energy—that is, supply and demand. We've had some climatic changes and therefore that is obviously going to drive price, and, of course, we are trying to give some signal for reinvestment in new energy." That is, I am sure, what they would say if they were sitting there. How do you respond to that?

Kerr My response to that is that there has been a massive shift in subsidy in the electricity market in terms of price. Go back prior to 5 years ago, and businesses were subsidising households. We have had a massive change. You would have to say then that the electricity price to business has not gone up by 40 percent in 5 years, but the retail price has. So clearly the electricity generators and retailers are making very big margins on the retail customer base. You could say all that is about is getting the price up so new-generation construction is economically viable and feasible—and it's wind and it's geothermal, and that's more expensive. Clearly, building dams is probably the cheapest form of electricity we have, but that is a bit harder these days. So all those things certainly come into that argument. But you can't say there is real competition between the players on price.

English I'm just trying to unpick the bundle of things that you have said. One thing you have said is that, say, food and oil prices shouldn't really be counted. Is that right?

Kerr Changing interest rates and exchange rates are the tools that the Reserve Bank has. They can change interest rates, which they know has an impact on the exchange rate. They cannot influence, generally, food and oil prices. You've just, perhaps, got to accept in a small open economy like this that the volatility of food and energy prices going up and down you are going to have to live with, because you can't influence the price-setting behaviour.

English — But aren't those essentially imported prices, in the sense that they reflect world prices? If you think of what the New Zealand public is interested in, this week it is butter going up 23 percent and the threat that bread will go up by similar amounts because the world price is—what—double what it was 3 years ago for wheat. So those are essentially imported inflations.

Kerr — Certainly petrol and oil are. Local energy is not; it's a domestic market.

English — Righto, but they are part of the tradable sector of the economy where inflation has been relatively low anyway.

Kerr — If global food prices go up, you'd expect the New Zealand dollar to go because of higher commodity price, and that offsets that a little bit.

English — So are we going to see it flick up in tradable inflation? We are going to import those ones, quite apart from the exchange rate effect?

Kerr — Yes.

English — The other thing you have talked about is public sector price-setting behaviour. It's 16 percent, or something, of GDP, isn't it?

Kerr — Yes.

English — Isn't there an argument that says that the OCR and the monetary policy framework just take a longer period to work on? I'm thinking of the kind of public prices that are evident to people. One is, say, rates, where, as people face higher costs of credit and a bigger proportion of their income is going out on servicing that debt, they get more sensitive to other price increases, and so you get a political effect if not a real economic effect where they say: "Whoa, 9 percent compound increases in those prices is probably not where we want to be." So we've had a local government review—again. Something may come of it; something may not. But in the long run, the tightening consumer demand still has an effect on public sector price setting, even if it takes awhile.

Kerr — Yes, I think that point where you might get political opposition to what is happening, and get people to say: "Hang on a minute. Don't push prices up. Don't do this and don't do that to local government.", it might take a while.

English — So I presume your economist's answer, though, is that that pricing behaviour should be more open to competition. You actually used the energy sector as an example.

Kerr	Perhaps we would say more discipline and control around prices that are set out of the public sector on to the consumer price index, because you don't have competition in that sector, therefore there probably has to be more discipline. Clearly, in the private sector you have competition, which provides discipline over price-setting behaviour. We look at the situation we've got to, where one or two sectors in the economy have taken all the pain—export and manufacturing. What you could say, from the public sector's point of view, instead of putting prices up, a particular department or a particular Government agency doesn't recover their cost increases with price increases; it falls on all taxpayers.
English	There is an example here, and this is pure speculation, the education bars that you've got there, which show primary and secondary education. I'm not exactly sure what they are measuring there, but the rate of inflation there is twice what it is in early childhood, and early childhood is definitely subject to competitive pressures. You just can't move your price too far or you lose business. So is that the kind of difference you are looking at?
Kerr	Exactly. I said right at the outset, competition is probably the best discipline over inflation. If you want to achieve inflationary objectives, it is all about competition, and you have to accept that in the public sector you don't have that competition, and therefore you need other mechanisms.
English	What difference does all of this make to our considerations of the monetary policy framework? You know that public sector price-setting behaviour is not going change in a big hurry, because it is subject to political constraints and policies and things. So that is a source of inflation; it is going to remain a source of it.
Kerr	But does that mean that the Reserve Bank has to force the rest of the economy into deflation to offset the inflation they can't control in the public sector?
English	Well, yes, it does, unless we made some change to the framework. So what is the change to the framework?
Kerr	We are saying in our recommendation that certain Government charges will be excluded out of the Reserve Bank responsibility, in terms of the inflation that they are measured against. So we are recommending a change to the policy targets agreement—back to what we had in the 1990s, actually—to exclude certain Government charges so that is not in the measurement of the 1 to 3 percent.
English	So this is on the basis that you include only those price changes that you believe are controllable, so it excludes imported inflation?
Kerr	No, I'm not saying that. I'm saying Government charges and oil.

English — Government charges and oil.

Kerr — Oil; petrol.

English — What about imported food inflation, though?

Kerr — Obviously, as I said earlier, normally when that is high you would expect the exchange rate to be higher. That would offset it. So that adjustment mechanism is there in that case. In the others it is not.

Jones — What sort of response did you get to your 3 October letter from Alan Bollard?

Kerr — He said that it was all very interesting but that it was not going to change how they viewed things. I guess the point we were making is that raising interest rates was going to have very little impact on inflation, because the inflation is not coming from those sources, and all it would do is push the exchange rate higher and cause pain in the export sector. And that is what happened.

Jones — There was one point here that did capture my attention, Roger. I have heard enough about Government being the source of all the woes—not our Government; definitely not. But your reference here to: "Do not be pushed into a decision you will regret by hawkish economists who seem more motivated by interest rate and exchange rate volatility." Were you talking about the ilk we just had here with us?

Kerr — Yes. You have to remember that bank economists are working for the bank first and foremost, maybe before the good of the overall economy, despite what they say. Bank dealing rooms are interested in volatility in interest rates and exchange rates, and they are very short term. We are giving our clients advice over 2 to 3-year time frames, not 2 to 3 weeks. That is the point we are making.

Jones — So what is the pattern at the moment, with the dollar between US70c and US80c? Are people sort of going back to spot or are they still covering?

Kerr — Oh no, companies have hedging policies that they must remain within, between minimums and maximums. That is what we do: we design those hedging frameworks and those policies. It is very difficult to generalise, really. If you are an exporter in US dollars at the moment, it is still very tough and you are not making money. If you are an exporter in other currencies—Aussie dollar; other currencies—you are back in hedging quite large amounts at the moment, as the rates are right down. We've come back to below average levels.

Woolerton — It's quite interesting, though, because when you talk about the disincentives to an exporter that is just a fact of life. You can kick the hell out of a housing market, or make comment on opening up more sections for sale and that sort of thing, but the sector that produces the wealth just has to get on with it. It is assumed that it would get on with it in spite of all the circumstances, whereas I believe there is a lot of capacity there if an incentive was shown to them.

Kerr — It is a fact of life: exporters have to deal with volatility of the exchange rate, and New Zealand companies are not bad at it. But when you have 5 years of your currency going to very high levels, in the end it has a cost, and that cost to the economy is, as was described earlier, a complete lack of investment. Exports were 30 percent of our economy 20 years ago, and are still 30 percent.

Jones — That point is well made—having suffered the problems of the foreign exchange woes in my earlier life.

Smith — I would just like to pose this question for you. I understand what you saying about excluding some of those factors like oil prices and core Government departments, and those sorts of things. Isn't one of the benefits at the moment that where they are included, and cause therefore the Reserve Bank to have to respond in such a Draconian way—and therefore cause a lot of pain around the place—that that analysis like yours can then direct, should direct, the punishment to where it is due, and that is at bad Government policy. But if you exclude them, where is the discipline over Government policy?

Kerr — But if the Reserve Bank cannot influence and change it, should they have the responsibility? You put the responsibility on the people that actually are setting the prices.

Smith — You make the point that they are not commonly. You say that the Reserve Bank has been either unable or unwilling to address this issue with the Government. It is an interesting observation that would suggest their analysis has actually not been as—

Kerr — I don't believe they've been doing their job, because I don't believe they've been addressing the real sources of inflation—or are unwilling to, maybe.

Smith — But by having them in the overall formula, at least if the job is done properly, the finger can point.

Kerr — But our experience in the last 5 years is that they are unwilling to point the finger. You have to ask why. Are they independent or not?

Smith — I tried that this morning.

Jones — OK, thanks, mate.

Wigram Capital Advisors Limited (Submission MP/68)
Mr Rodney Jones, Director

S Jones OK, our final submitter for today is Mr Jones. Welcome, Rodney.

R Jones Thank you.

S Jones We have your submission, and we have certainly read it, in particular page 2, "Key Points", (i). We've got an additional handout. So how we've been encouraging people to do it, Rodney, is speak for a short period of time and then open up for questions, because the committee members do derive a lot of value from interacting with experts such as yourself.

R Jones OK, let's do it that way. Just to introduce myself, I'm Rodney Jones. I'm the principal of Wigram Capital Advisors. I provide advice to hedge funds in the US and UK. I've been back in New Zealand 3 years. I spent 15 years in Asia, where I was a managing director and partner with Soros Fund Management for a lot of that time. What I do is central bank watching in Asia, so I visit central banks regularly. I was at the Bank of Japan 2 weeks ago, the People's Bank of China, and I was at the RBA yesterday. So although I'm back in New Zealand, I still do what I did when I was in Hong Kong, and meet regularly with central banks. So I'm not a New Zealand expert. I've been away for a long time. My expertise is on Asia, and when I look at New Zealand I look at New Zealand through the prism of Asia and through what other central banks are doing.

To me there's four key points that I want to convey. One is I think that we have tinkered a lot. We have a tendency to tinker. We find it hard to be settled, and we do tinker. The changes made in 2002 to the policy targets agreement probably were a mistake in hindsight. They weren't intended that way, but they were effectively a loosening of our commitment to low inflation. I think the intent was to move closer to the RBA, where the target of 1 percent to 3 percent over the medium term, which is very similar to the RBA's language. In practice, it was a loosening; it encouraged the Reserve Bank to take risk in 2003. They cut rates through the winter of 2003 in response to Sars and the perception of Asian risks. You've heard about that today—Brendan's brought that up; Stephen's mentioned it.

In terms of the positive changes that can be made, we heard from Arthur Grimes. A lot of my recommended changes would probably be more appropriately directed to the board rather than legislation. Again, I think we can learn from the RBA. If you go back over the last 50 years, all but one—I think this is correct—of the RBA governors have come from the Reserve Bank of Australia. Within New Zealand we appoint our governors from outside. That creates a learning on the job time. You make mistakes in the early years. I think if we look at the transition from Mr Bernie Fraser to Ian Macfarlane to, more recently, Mr Glenn Stevens, the Australians have managed very smooth transitions. We tend to have fairly disruptive transitions.

What I would also consider is a move away from a single decision maker towards some sort of monetary policy committee. I spent a lot of time watching the Bank of Japan, meeting with policy board members. That is similar to the UK monetary policy committee. New Zealand is too small for that sort of approach. We don't have enough independent experts who want to be policy board members or monetary policy committee members. But there is scope within the team we have at the Reserve Bank now to have one or two outsiders and have a formal monetary policy committee that the governor chairs. He is still the key decision maker; in every central bank the governor is the key decision maker. But I think moving away from the single decision maker would be a positive change. That is something we can do, and I think there is scope there that your committee could look at.

The other thing I would recommend is term limits for the governor. This is maybe somewhat controversial, I think it worked for Greenspan being chairman of the Federal Reserve Board for a long time, but it's quite a risky strategy. Ensuring turnover—a limit of, say, two terms, and then a new governor—ensures a fairly smooth transition that strengthens the institution. It allows for growth and development. A lot of what we are talking about are human resource issues—how to best manage the human capital we have in the Reserve Bank. When it comes to the framework, the framework is actually fine. It's about making the right decisions at what are tremendously stressful and difficult times. It's a tough job.

The other thing, moving along, that should be applauded and reinforced is FX intervention. The world has changed. We have sovereign wealth funds now that are enormous in size, and I think the steps the Reserve Bank has taken are very positive. What we need to change is reduction of criticism. The RBA intervened in London on August 17 and bought Australian dollars. There was no criticism of them. When the RBNZ sold New Zealand dollars in June there was intense criticism, and if we look back, the main the criticism you would make of them is the size was probably not large enough. These sovereign wealth funds have enormous assets—they tend to be trend followers. When I talk about sovereign wealth fund, I'm talking about like—

S Jones Singapore.

R Jones —in Singapore, China, Korea—they tend to be trend followers. What we're seeing in the markets is they tend to exacerbate volatility rather than reduce it. So I see increased intervention, not in the sense of defending a line in the sand, but as a chance for profit and to reduce some volatility.

The final point, and this is within my area of expertise, is we see a lot of looking over the neighbour's fence to Singapore, saying the Singaporeans do it better, or we talk about monetary union with Australia and go and look at Hong Kong with the currency board. On *Morning Report* the other week we had a US academic—who I think Larry Summers described as a snake oil salesman when he tried to peddle a currency board to Indonesia—who was peddling a currency board here. The reality is that if you look at Asia, the Singaporean system is under enormous stress. It was introduced in the late 1970s by Goh Keng Swee, and they operated it for 30 years with relative stability. The last 3 or 4 years they have come under tremendous pressure from global capital flows, from globalised capital. So the Singaporeans would be having much the same sorts of discussions behind closed doors as we're having. In the last 12 months, their reserves are up nearly US$60 billion. Their economy is a similar size to ours; that's 45 percent of GDP. So they said: "We want to manage the Sing dollar. We're going to intervene to defend the level.", and they have, and they ended up buying $60 billion, and I've got a chart of that in my supplementary evidence—just a precedent.

So the issues we're talking about here are not unique to New Zealand, by any means. We're in a very dynamic global system that's growing rapidly. That creates its own strains. Finally, Hong Kong, just in terms of monetary union with Australia, comes up a lot. Hong Kong has a currency board with the US dollar. If you're going to fix the currency, even if we fixed it against the Australian dollar, you put the pressure on internal assets prices. In Hong Kong, from 1997 to 2003, to maintain the peg, the Hong Kong property market fell 65 percent. By 2003 you had 500,000 people on the streets calling for democracy. It was basically about falling property prices, and I think in a democracy like New Zealand's it's just not sustainable to think that a monetary union with Australia would be a panacea. So those are the key points.

Swain That was very interesting. Just going back to one of the small points, really, with this broadening out of the decision making to a committee or a group. You might not have been here, but they defended the current system, but they would, wouldn't they? I'm wondering what extra value you'd get from that in a country the size of New Zealand. I mean, you were saying in the end that the governor would be the ultimate decision maker. But I'm just wondering whether that's a kind of a flit around the margin—whether you'd get anything extra out of it.

R Jones Yes, I think it would just strengthen the institution. You would maybe publish the minutes so the discussion would be released to the market, say, with a 2-week lag. People would analyse the minutes, you'd see what different members were arguing for. I think it's just, again, psychology. Decisions made by groups tend to be better than decisions made by an individual. And I think, you know, in reality it may not be that different, but there will be particular times where it makes a difference.

Swain	And maybe at critical points?
R Jones	At critical points. And like the August easing in 2003 was probably pushing it too far. The world was recovering strongly. It's very easy to use hindsight—
Swain	I know.
R Jones	—you shouldn't really do it—but I think, at times, a committee would add value.
Foss	It's great to have a check from a real-world submission there. Just a couple of points. Just that one about the FX intervention. The key test should be whether the RB considers that such an intervention will be profitable. They only know that after the fact, or is that because it's stretched so far over—
R Jones	It is stretched so far. They spend a lot of time talking to the market. I mean, I think a lot of central bankers would make good hedge fund managers. I mean, you look at the RBA's investment record over the last 10 to 15 years.
Foss	Were you here when the Reserve Bank Governor was submitting—
R Jones	Yes, I was—
Foss	I asked him about the marriage between fiscal and monetary. I was just wondering towards how he saw that balance, and he saw it more as a couple of neighbours chatting over the fence, more than anything. You make the point here in point 38 that that's exactly where we are now. We've got loose fiscal, tight monetary, currency overshooting. This is the exact current policy mix in New Zealand. Obviously, tight fiscal, loose money—it will undershoot. With your observation of other countries and the interrelationships between the RB and the fiscal side, do they see it more as a balance? Does one lead the other, or is it a partnership? You obviously cannot have one without the other.
R Jones	Government policy has to work independently, but I think it needs to be more of a partnership, just in terms of timing, in terms of a tighter fiscal policy contributing at particular points in time. Here I would place more emphasis on the spending. It's a democracy, it's hard to restrain spending, but there are times that it needs to happen.
Foss	Sure, there is an equilibrium there somewhere, but it is miscued at the moment, because that's fed through to the currency, as we're seeing right now.
R Jones	Yeah, it increases the pressure.

Tremain	You appear to be a strong proponent or an advocate for a capital gains tax on residential property.
R Jones	I never said that.
Tremain	You didn't?
R Jones	Nowhere in my text did I say a capital gains tax.
Tremain	Because if you look at Singapore, in 2001 it had a capital gains tax but it still had strong volatility.
R Jones	Well, Singapore doesn't have a capital gains tax.
Tremain	Now it doesn't.
R Jones	No, I lived in Singapore in the early 1990s. There was no capital gains tax.
Tremain	OK. Well, obviously the briefing I have got here is wrong, so my apologies.
R Jones	Actually, what I would—
Tremain	So you're not in favour of a capital gains tax?
R Jones	What I do see as a problem is an equitable treatment of investment taxation, and that problem has become less with the FDR, but it's still a big problem. We have to—
Tremain	So the quality of the—
R Jones	An individual should be indifferent between investing in equities or investing in property, and I think that's the problem. I would actually go for no investment tax. If you've got a low savings rate, why not experiment with no tax on equities. Because the FDR is still, in a sense, an asset tax.
S Jones	The banks have relied a lot on Japanese housewife money. Do you have a sense as to where their appetite might be for shovelling that money into New Zealand via our banks?
R Jones	I think they've had a tremendous shock with the sell-off in Kiwi yen and Aussie yen, but I wouldn't see it as permanent. Until Japan finally recovers, this is going to be with us, and at some point it will build up again. On Japan—Japan has a very tight fiscal policy, low interest rates, and the money goes offshore. So if you're to look at relative policy mixes, they're at the other extreme.
S Jones	Rodney, when you're talking to international clients or traders and investors, when you make your overseas trips, etc., what's the

	overarching impression they have about how well we're doing in terms of our own monetary policy framework, the conduct of the Reserve Bank, etc.?
R Jones	I think we struggle with communication. We tend to get whipped around with communication. New Zealand is seen as a bit too hyperactive. If there's something we could learn from the Australians, it's just—and in some ways this inquiry reflects that—just chill!
Swain	Is that the bank or public criticism of the bank?
R Jones	It's both. The intervention and the criticism was pretty intense. But I think the Reserve Bank is on message now, and so if I was to applaud Dr Bollard, I think he really has built the institution. I think the team we have now compares very well with any other central bank in the region.
S Jones	Comparatively speaking, does he offer views to the public more often than his colleagues in the other countries you go to?
R Jones	No, he's probably the same. There's probably more dialogue that could be had with the market. That's just a personal observation.
Smith	Compared with the Federal Reserve Bank, there is the decision made by the governor or the board? Who actually makes the decision?
R Jones	The Federal Open Market Committee, which is made up of bank presidents—
Smith	From this?
R Jones	—and of governors—the board of governors. So it's a composite committee.
Smith	To come back to your comment about chilling a bit more, I guess one of Greenspan's great strengths was one where he would comment, from time to time—often it was a calming comment. Was that in the back of your mind—the effectiveness—
R Jones	Yes, I think we have undermined it by saying monetary policy doesn't work.
Foss	By having this inquiry.
R Jones	Yeah, we do hand wring in public too much. We tinker and we hand wring, and if we could restrain both instincts—
S Jones	Yes, I hope you're listening there, Mr Foss.
English	Your submission is alone in advocating a tightening of the target. The submissioners either seem to have accepted that the tinkering has effectively meant that for the foreseeable future 3 percent inflation—

we've had it for a while; we're going to have it for a number of years. No one seems overly concerned about the compound effect of that, but that's another matter the committee can talk about. Either they accept that or they say, as I think was quoted in the media today, the psychotic focus on inflation is ruining the economy—I think that was BERL this morning. So they're saying: "Relax, 3 percent is not that bad. Maybe we could have a bit more and have a lower exchange rate." So why are you advocating going in the opposite direction to everybody else?

R Jones — Because I see that the pressures that we're living with today will only grow more intense in terms of the emergence of China. Just take a number to take away. Five years ago the auto market in China was 1.5 to 2 million autos a year. Today it is 9 million; by March it could be 10 million. The US is 15 million autos. In 5 years they've almost caught up with the United States, so the demand for resources is going to be intense. It was interesting Greenspan talking about the end of deflation in his book—I haven't managed to see it yet. I think that when Japan and Germany grew very rapidly in the 1960s and 1970s, inflation was more of an issue. I think inflation will be an issue, so it's not a time to relax. I think we're doing a good job. We're managing our way through. National income next year will grow 6 percent. We've had a down cycle in commodities for 80 years, and now it's turned, but I think a commitment to low inflation is particularly important, because if you look at the lesson of the 1970s, Japan and Germany had that commitment. The Anglo economies didn't, and lost out for that. So that's the perspective I'm coming from.

English — So that's a picture of continued higher commodity prices, and that's all commodity, so feeding through, one way or another, into imported—

R Jones — And rolling, I think we're in rolling shocks. There was oil a couple of years ago; this year it's protein. Next year it may be the grains—the grains have started. Six months ago it was proteins; today it's grains.

English — But the general notion that we can import low inflation, as we have done, is running out.

R Jones — Chinese export prices used to decline by 2 to 3 percent a year; they now rise by 2 to 3 percent a year. So if our currency is stable we will be importing inflation from China in manufactured goods.

English — So in our situation, then, should we be concerned about the picture we've had, which is a graph that shows 4 percent plus non-tradable, zero tradable inflation, on average, for 4 and 5 years. So a sort of pessimist's view, looking ahead, is that the tradable inflation is going to tend to be rising, on average, regardless of our economic cycle, and if that comes on top of a persistent non-tradable inflation, then the inflation outlook is not that flash for us.

R Jones	Yes, exactly. We'll be doing well if we can get to 2 and 2—2 percent tradable and 2 percent non-tradable. The risk is it's more like three, three and a half each.
S Jones	Prepare for global inflation. That's your message, is it?
R Jones	This year it's China, in 5 years it will be India. There's a demand on resources, and that will persist. So now is not a time to relax. We shouldn't look through the rear-view mirror, and we're actually doing a pretty good job right now.
S Jones	OK, Rodney. That was a very animated and enlightening submission. Thank you very much.

Transcripts

Inquiry into the future monetary policy framework

Finance and Expenditure Committee

10 October 2007

Members

Dr the Hon Lockwood Smith (Acting Chairperson)
Charles Chauvel
Jeanette Fitzsimons
Craig Foss
Hon Mark Gosche
H V Ross Robertson
Chris Tremain
R Doug Woolerton

Witnesses

Wood Council of New Zealand Incorporated (Submission MP/29)
Mr Doug Ducker, Chairman and Mr David Anderson, Chairman, Wood Processors' Association

Smith Could I welcome Wood Co to the monetary policy inquiry. Just before I invite you to speak, we have 25 minutes, so I'd urge that you don't use all that time in making your submission to us, so that we can question you. Welcome, gentlemen; we are yours to hear your submission.

Ducker Thank you, Dr Smith. [*Introductions*] It is not our intention to use the full time, so we'll do our best to manage that. As the Wood Council—just to give you the brief background, which is outlined in the submission—we are representative very significantly of the forest industry in total within New Zealand. It incorporates the forest estate and the processing and remanufacturing activities associated with that. Collectively, it's in excess of 70 to 80 percent of the total industry, so we see ourselves with that backing.

The reason for meeting with you today is in line with the submission made with regard to monetary policy. In particular, we'd just like to outline to you a little of the practical outcomes, I guess, of the current monetary policy and, therefore, indicating some directions that we would like to be part of this process in terms of forward assessment to see what can be done differently. A key thrust is that we certainly perceive things need to be done differently to what they are today. If things continue as they are today, we will see the consequences we have today, which are—certainly in our industry—putting at risk the combined wealth of the nation in the context of what is the third-highest revenue earner for the country, and also has other repercussions in terms of the forestry estate, carbon, and the like—and we'll touch on those elements.

I'm working on the premise that you've read the submission; I will just really target here to highlight two or three elements that are coming out from that. As I indicated, we are very heavily export-focused. In doing so, however, we do need also a strong domestic economy and we do need strong domestic activity to supplement the full utilisation of the forest resource that we have in New Zealand. What we see is that in particular with regards to impacts on exchange, the current tool—and I put that in the singular, as we perceive it—that the Reserve Bank has to administer the monetary policy controls by way of the OCR is inadequate and needs to be reviewed and modified to impact in a way that makes our businesses more sustainable, and hence the nation's capability to be sustained. In particular that reflects on the exchange rate and the effect that has on our business activities. We are very heavy exporters and are subsequently vulnerable. We are vulnerable in a double capacity: we are trading in a foreign currency and, in addition to that, we also have at point of sale often quantify the value of our goods based on the US dollar. So that has a secondary impact on us.

The implications of the last 5 or 10 years has been to create a situation in New Zealand for the forest industry that has us extremely vulnerable. It's been highlighted through various representations and also been acknowledged, I believe, by all elements of Government in terms of understanding the perception that is a reality—that New Zealand has been unable to generate the onshore processing capacity to deal with the wood resources that we have. And this has been as a direct consequence of the instability and uncertainty associated with the value that can be determined to add value to the processing of lumber.

In my own case I am here also as the managing director of Pan Pac Forest Products. That is a wholly owned international company in that context, owned by the Oji Paper company. I have with me my colleague Dave Anderson, a similar situation. Both companies have operated with a very long-term perspective. That is the nature of the forest industry. We plant a tree on the grounds we'll harvest it in 25 to 30 years' time. On some occasions, some of our owners are planting with a 40-year time line. So it isn't about growing lettuces that tomorrow can be tomatoes; we are growing trees for the long term with a target to add value and sustain value.

In our own case the combination of instability that New Zealand has demonstrated in recent years has eliminated the capability to provide for expansion despite the fact and the irony that we have resource available. We do have capacity to increase wealth, but we are unable to put in the plant that enables that conversion to be made. So this is where the impact of the monetary policy ultimately reflects back on our industry's capacity. An answer is to export the log. That is not, for us as an industry, the answer. It is about securing value and in securing that value I see that as being the continued employment of people within New Zealand. We are representing some 23-24,000 direct employees as an industry, and it is about maintaining the employment of those people that is a key to our activities.

The market opportunities are real. There are market opportunities for our product but we are impacted, again, in the way in which we can effectively put an argument to an international board that says "invest in New Zealand to enable conversion."

Therefore what we are looking for from this process that we are all part of today is to, from our perspective, support a drive to make changes that can give enhanced ability and enhanced performance. We need to keep the trees onshore, we need to keep the by-products of those trees onshore, we need to continue and develop the replanting of the forestry estate, and as you will be aware from various sources, that at the moment is in crisis. We have a deforestation situation occurring. Recent Government initiatives are targeted to turn that around. As an aside we are a little sceptical as to how well that will work but we will certainly, as an industry, work to make that work as far as that is concerned. But certainly the loss of trees and the loss of plantings is a real concern, and therefore the base that we have today is under threat, let along the growth that we would like to believe is possible.

We have shared with you in the submission some examples of independent study on company activities, and I just leave that to be tabled. But overall it is a matter of how can we move forward. We don't present to you today with the answer. We do present in a manner of supporting one option that has been developed in terms of it being fairly assessed and evaluated, which is the interest-linked savings scheme that you'll hear a little more on later this morning in the presentations.

As an industry we are looking for change. We need to make a difference here, and the critical element therefore is that we can affect some outcome from that. The input to that process needs to be made in a manner that there is a broad understanding, at both the public level and at the business level, as well as within the Government sector and the banking sectors as to what the full implications are.

A move in exchange rate for our own company moves the bottom line by $1 million per point. That's on a business that has a profitability on occasion that can be as low as $4 million per annum on an investment that is in excess of $400 million. I just leave you to do those quick numbers through your head. Would that make you invest? What we do have are investors who are keen to do so. So we need something that can give us stability to exchange and stability to internal policies and provide for more targeted and more directed use of revenue. The current mechanism we would see as funding external investors, Japanese housewives, Belgian doctors are spoken of. I am not here to verify whether they are the particular investors, but the consequences are that they are benefiting at the expense of our own export industry and our export activity.

A secondary consideration that relates to the impact of the exchange situation, and more specifically the current monetary policy and its management through the OCR as we see it is, in fact, the impact of Government expenditure itself. We have seen that expanding over recent years and would certainly seek to see that actively reviewed. Because that does not reflect more directly on the inflationary numbers that are being seen in the same sort of manner, but does reflect in the ability for people to have money to invest. If we can re-secure diversion of funds that are now simply being channelled into—effectively—interest payments for those that are subject to them, which is most of the nation, I think, in one form or another, to be channelled into investment into the business sector we would see internal growth without actually needing external investment. But in saying that, I certainly stand to you today in a position to assure you that should the conditions be right we can generate foreign investment in New Zealand to secure the outcomes.

As I indicated many of the international parent companies associated with the New Zealand forestry sector have a focus on determining and expanding capacity in the long term.

I really don't need to take that too much further, but I would just like to walk through in summary the recommendations we have. One is that any outcome of this process in terms of the monetary policy needs to reflect the importance of maximising the export returns. We are an export nation and we rely on the movement of product and the recovery of value from those products rather than simply looking to manage the domestic inflation situation.

The discussion is open and consultative. This is part of that process, but we would seek that it is as open as it can be made given the importance as it goes forward, and particularly as it impacts on the export sector. As I indicated, the study and evaluation of alternatives such as ILSS or others, we would welcome. We don't take a hard position on that, but we know we need to do something different. It seems to make sense to us, but there are people more expert than us to draw that conclusion. But that is an example that has been fully researched to date in a manner that we would look to see support to the evaluation of that option.

Governmental spending, as commented—we would just look for that to be reviewed, not necessarily that it is an easy challenge to the participants here at the table and to others around this table, but we need to be looking very closely at where we are spending our money. Because that money, in the main, we would see as being sourced from our export revenues. So it is at our own peril if we see the export activity annihilated. Associated with that is just then the element of the price-setting behaviour that we see flowing through into some of those sectors, and therefore needing a process that ensures that we are watching what's happening with price increases and developments across the nation. So that can effectively then ensure that we've got policy target-setting programmes for the Reserve Bank to administer to effect the correct outcomes.

Smith Thanks very much for that submission.

Fitzsimons Thank you, Doug, for your submission. You are arguing that the Reserve Bank should be given the goal of managing exchange rates, and—exporters alongside price stability. But it's still got a single flaw, which is the OCR. So it's got three options: you can put it up, you can put it down, or leave it where it is. Given the second goal it's still only got three options: to put it up, to put it down, or leave it where it is. So you are essentially arguing, I guess, that there should be a trade-off that the Reserve Bank manages between price stability and exporters and the exchange rate. So presumably what you would want them to do is to be less likely to put it up and more likely to put it down because of the effect on the exchange rate. Now the other line that's been argued by some here is that it would be better for Government economic policy to adopt certain changes, leaving the Reserve Bank in charge of just price stability, and there's a number of other things the Government could do. What do you say to that? Are you really saying that all should be managed inside the Reserve Bank, or—because you're also talking about private investment—look at later on today. Wouldn't it actually give you a wider range of good outcomes if it were Government economic policy that takes on some of this—rather than expecting the Reserve Bank to manage—.

Ducker The immediate response to that is really we believe there needs to be more tools than we have. In terms of how they are affected, whether it's through Government policy or the Reserve Bank is an issue that's bigger than we as an industry group can necessarily reflect on. What we're endeavouring to communicate, I guess here is what the impact of the signals that currently are generated actually have. I do not perceive a direct correlation, for instance, between OCR and exchange rate. If you actually plot them for a given year you won't necessarily see that one follows another, but there is a lot of implied assessment of one against the other as things have moved, hence our sensitivity to that particular area, because it has such a direct line effect on our bottom line.

Fitzsimons I think we all understand the point about the significance of the exchange rate to exporters. I don't think that's lost on any one.

Ducker Certainly, by a tool it effectively ensures that the income that is created as a consequence, or the cash flows that are impacted, is a consequence of any policy or implementation programme actually reach the correct targets. The current one is a big hammer to effect a smaller outcome.

Woolerton Just a quick one specific to your industry. You are in an industry that has—and you have huge investment from static investors who want to own the forests, and so I'm just trying to get your concerns sorted out. You are reasonably OK with that, but the investment is not going into any ongoing manufacturing—that's your concern. They're happy to be here, sitting on a long-term investment and, this is not in question, presumably because it's safe—or are we the only stable country in an unstable world. Is that why they do it? Are they hoping for something to happen in the future, or will they actually turn into investors in your sawmill side, or in the manufacturing side, in the future? Where do you see the investment coming from?

Ducker The core investment in forests, and the core reason for any investment, is to ensure some profit. It's nice to be able to say we're doing this for the good of the nation or otherwise, but at the end of the day it's about generating a profit as a consequence of the investment. The critical thing with regards to the forest industry is that it's got a combined effect. It's a long-term investment, yes, so the commitment's being made to plant trees today for a harvest in 30 years on a basis that your business can sustain for that sort of period.

Woolerton They're different people aren't they?

Ducker They are different people in terms of where they impact. But the point I was making about the need for a strong domestic situation as well as the international situation is that it is actually connected. One won't stand without the other. The industry needs a domestic operation and domestic conversion in capability. Because once we cut the tree it's got a very short life in that context. While we're growing the tree and we have some degree of flexibility we can adjust things, but only over a certain span as well. We talk of a life cycle of 30 years, and it can be 28 or 32, but it can't be 45—we'll end up with a net degradation of the forest resource anyway.

Anderson Just very briefly, they are two different type of investors and I don't believe that you'll get a crossover between the type of financial investor that you have growing trees or owning the trees, because they simply see it as a financial instrument. Now I'm not involved in that type of business, but that's how they see it. They don't see it as processing because processing is just a different stream, a different type of investment; it's held through a different instrument. So no, I don't believe there'll be a crossover.

Tremain Thanks for your submission, Doug. You come here proposing to support the ILSS policy. In saying that, the body of opinion from the submitters that we've heard to date believes that the current Reserve

Bank Act and the policy targets agreement that we have in place are the best practice for our economy. If we were to stay with the current regime, what will be the biggest impact on your industry right now under that regime to help control the exchange rate? What would be the biggest impact that we could make to monetary policy currently?

Ducker Well, under the position presented in terms of the pure economics of the businesses that we're operating we need improved returns from our operation. We're seeking and securing high prices at point of sale, but the return value, once it returns to New Zealand, is very low. It's impacted on other factors like shipping and the like, which is also a matter of location. As I indicated we don't have the absolute answer, but we certainly know that the current model is not working for us.

Robertson Doug, you've made criticism of Government agencies and the like, things like local councils and SOEs, that due to the absence of competitive pressures they've contributed more than 3 percent inflation over the past 3 to 5 years, and then you go on to say that this leaves the Reserve Bank no option but to force deflation in this sector. That's a pretty harsh analysis. Could you explain?

Ducker Well it's fundamentally because we see our survival at risk, and we believe our survival is critical to the nation, so that's why we get "harsh" if you interpret it in that way. A very simple example, if I can quantify that. We're talking of electricity situations—we're all exposed to electricity pricing. We heard on this morning's news the indication that our electricity prices will further increase by 6 to 8 percent under Murray Jackson's statement—I'm just repeating what I see in the press, and when I check my own analysis the spot rate for electricity across New Zealand yesterday was 3.5c a kilowatt. It's half of what the average has been for the last 5 years, and is probably only 20 percent of what it was 2 years ago, which was the reasons for lifting electricity prices in New Zealand. If we don't get live markets we have got inflationary pressures that will directly flow through as a consequence of that. So that's the sort of example that we struggle with, because as industries we are having to respond immediately to any pricing signal we can have. We're then told: "Well, that's fine, hedge." But hedging is high risk. Hedging on the New Zealand currency market in the last 12 months has been extremely risky in some respects—that has seen adjusted positions making it very hard to manage. What we need is stability, and we certainly need some improved profitability where it can be generated.

Smith Thanks very much for your submission. Thanks for answering our questions, and we certainly appreciate the importance of your industry and the importance of stability in the economy. So thank you so much.

New Zealand Business Roundtable (Submission MP/44)
Mr Roger Kerr, Executive Director, Dr Roderick Deane, Chairman, Fletcher Building, and Dr Bryce Wilkinson, Consultant

Smith Business Roundtable. [*Introductions*] You gentlemen know the realities of submissions at select committees. We have got 25 minutes, Roger, and obviously though, we would like to hear your very interesting views on this thing. So fire away, we will not waste any more of your time. Do leave us some time to ask you some questions.

Kerr Of course, thanks. I think you know Roderick Deane, and Bryce Wilkinson is a consultant to the Business Roundtable in this area. I am just going to make a few summary remarks about our submission, Roderick will add a few words, and then we are very happy to take questions.

What I want to cover is the five main headings of our submission, but to start by saying we were strong supporters of the Reserve Bank of New Zealand Act from the outset. We think it is absolutely right to have the single goal of monetary policy being focused on inflation—it can't do anything else, and that's delivered major benefits. We are open to other ideas, such as adopting another currency. We did a serious study on that, which you have as part of our submission, but our conclusion is that that wouldn't be a feasible improvement for us at this stage. So, basically, the Business Roundtable is very supportive of the current framework.

First heading of the submission is "Inflation". The key point that we are making there is that inflation is about money—too much money chasing too few goods, you know the story. I think that Monopoly-game analogy, simple as it is, illustrates that in quite a nice way. So, by contrast, inflation is not about increases in specific prices—oil, housing, wages, etc.—or about capacity constraints or about excess demand, as measured by the balance of payments, see the chart in annex one. So all that talk is really 1970s economics. We get very frustrated about the idea that somehow we need to cool the economy down to get inflation down. Faster growth is often good for inflation. High-growth countries like Ireland, for example, in the 1990s weren't getting sky-high inflation. Annex two demonstrates that there's no relationship between consumer spending and inflation.

So what this is really indicating is that understandings about monetary policy changed after the stagflation of the 1970s. It was recognised as a monetary phenomenon that central banks could control, and we have had—now, after a period of disinflation—a couple of decades of low inflation here and around the world. There's no debate, I believe, in economics on that issue. We quote Prescott there, a recent Nobel Prize winner.

So it follows that the Reserve Bank's got full control over money and over medium-term inflation. We readily acknowledge that it is not a simple matter for the bank to get monetary judgments right, but absolutely no need to blame the tools that it has got. They are substantially the same as the Reserve Bank in Australia and many other central banks.

So second heading, "alternative instruments". We think all that discussion is a red herring, there's no case for special focus on the housing market, tax rules are not relevant here. Any changes to tax rules would have a one-off price effect, they wouldn't have an effect on ongoing inflation. By all means, debate those issues, but they are a matter of tax policy not monetary policy. For the same reason as we note in the submission, and quote Bernanke, tax cuts are not inflationary. They're about resource allocation and incentive issues. They've got nothing to do with money and inflation. Similarly prudential issues. So we say the search for alternative instruments should be abandoned—do not waste more resources, but, and I shall come back to this, we should also look at policies that are making the Reserve Bank's job harder.

Third heading is about recent inflation problems. Looking backwards, it's very clear now, just as a factual observation, that the bank has got it wrong. We have had an average of 2.7 percent annual inflation since 2000. In paragraph 4.2 of our submission, we talk about some of the errors. The problem, we think, has been exacerbated by the changes to the policy targets agreement. If you look at the graph in Annex II of our submission, you'll see how inflation expectations have notched up each time the PTA has been widened. Apparently the Reserve Bank seems quite happy with inflation of around 2.5 to 3 percent. We see that as a very unsatisfactory state of affairs. The Reserve Bank used to regard price stability as about 1 percent, given the drift in the index, and so 2.5 to 3 percent—and we look as though we are going to be going above that in the period ahead—is simply not consistent with section 8 of the Reserve Bank of New Zealand Act, which requires the bank to pursue price stability.

Fourth heading is about what we see as bad communications. Series of points there—inflation is not about demand outpacing supply, the Reserve Bank shouldn't be saying that sort of thing. I mentioned housing, we think the focus on banks is also misplaced, likewise saving, likewise fixed and floating mortgages. None of these things relates to money. Then we have had these bizarre episodes of the visit to Japan to say, "Don't invest here", and the recent foreign-exchange market intervention. So we see that as a serious catalogue of confusion, and all of it has reduced the credibility of monetary policy.

Fifth heading, chairman, "Monetary policy needs mates"—you've heard this from many other submitters. The earlier disinflation, I am talking about the late 1980s and early 1990s, was greatly helped by improved fiscal discipline, freeing of the labour market, and other forms of deregulation. Recently inflation control has been made harder by Government spending increases. There's a box on page 15 which talks about Government charges and related Government impacts, and then there is creeping regulation of recent years, which Roderick will elaborate on after I have finished. All of that has had impacts, of course, on the exchange rate and the export sector. We have got a very imbalanced state of affairs, and it's also contributed to the slump in productivity, which we illustrate there in Annex IV. This is a terrible state of affairs for the country, with productivity growth, we estimate, virtually grinding to a halt in the last year. So if you think about inflation as being too much money chasing too few goods, one consequence of that is that we need more goods, and higher productivity growth would reduce the need for monetary pressure.

So our conclusions: we see New Zealand risking a return to stagflation, to a price and wage spiral. In the Government's recent announcements about climate change, it's operating on the basis that economic growth over the next 5 years will average only 2 percent a year. That's a terrible state of affairs. Michael Cullen has always talked about 4 percent-plus growth being the target that he aspires to. The Government looks as though it's counting now on only half of that, and all of this going along with persistent large current account deficits.

We suggest that the first contribution of your committee's inquiry should be some re-education on monetary policy, just getting it much clearer again that inflation's a monetary phenomenon and explaining what the Reserve Bank's job and capabilities really are. In terms of helping in the immediate environment, reining in Government spending would make much the fastest contribution to reducing some of these pressures. We then recommend that the Government or your committee should commission some research on the meaning of price stability—is it correct, as the bank previously assumed that price stability was 1 percent? Clarifying that point would be very helpful. The PTA, we suggest, should be reconsidered in the light of that research—1 to 3 as a band would not be consistent with a 1 percent price stability assumption. We suggest that you should look at options for improving the Reserve Bank's accountability, a point target, perhaps, for the PTA or a lower band. Another idea which used to be discussed is a fixed salary for the Reserve Bank Governor to have a bit of a personal incentive not to let inflation get out of control. We think action should be taken to curtail foreign exchange market intervention, basically by reducing the bank's reserves. Then the Government should be asked to focus on other supportive policies; the things I have covered—Government spending, tax, and regulation.

So, overall, Chairman, we submit there's no case for changing the basic monetary policy framework. The Svenson review concluded it was fundamentally sound, he was a top expert. We have got no reason to doubt that. Possibly in operational terms, the bank could look at a somewhat more passive operational regime, and we refer to Professor Peter Hartley's suggestions at the end of our submission. Let me invite Roderick to add a few points.

Deane Thank you, Roger. Thank you, Chairman. Just a couple of points. I used to be in the Reserve Bank for many years. Of more recent times, I have been in the business world, associated with a range of different companies and still live in that world.

Thinking back about the central bank over time and monetary policy, we used to have multiple objectives. We never achieved any of them. We used to have numerous tools that we tried to work with, including many direct controls. None of them ever worked. We used to have high inflation as a consequence of having multiple objectives and numerous tools and the result was ineffectiveness. So we used to have high inflation. That was usually a guarantee of low growth, and for many decades, of course, New Zealand had exceedingly low economic growth and ranked at the bottom of the OECD.

We then moved, in the late 1980s early 1990s, to one objective for the Reserve Bank, the control of inflation, and one tool, which today is essentially, the OCR. The consequences, of course, as we all know, are that we have had the lowest inflation rate over the past decade or so that we have had for many decades. That, of course, during the 1990s was accompanied by strong economic growth and high productivity growth, one of the highest in the OECD region. If you look at the last page of our submission, it actually shows that from 1992 until 2000, the rate of multi-factor productivity growth rose at 2.3 percent, and since 2000 that rate of productivity growth has only been one-third of what we achieved before, and we have to say to ourselves, why is that the case and to what extent is that associated with us having a higher inflation target than we used to have and also, of course, with the regulatory problems that we have had over recent years, which have now become extensive.

So what is the story as far as the business sector is concerned? Having worked in and been chairman of the largest bank in New Zealand, the chairman of a telecommunications company, the chairman of the largest building products company in New Zealand and associated with one of the largest retailers in New Zealand as a director, what we really would like you to come up with is basically the endorsement of the present framework, but with a bit of a tougher attitude towards low inflation and not a tolerance towards running in the top of the band the whole time.

Essentially, what business needs is an increase in certainty and a reduction in uncertainty. Regulation leads to uncertainty and the higher a rate of inflation then a higher uncertainty for business. As far as we are concerned, stability is about price stability, it’s about very low inflation rates. That’s what then gives business the confidence to invest and the ability to grow. If we can minimise regulation, which slows everything down and increases costs, if we minimise regulation of all the various forms we have, then we can actually get productivity growth going again, as well.

Can I use the housing sector just for 1 second to illustrate the problem? A lot of people worry about house prices and talk about house prices being an illustration that monetary policy's not working. Let me just make a couple of points. First, there's a lot of concern that house prices in New Zealand are higher than in Australia. We have just done a study of that at Fletcher Building, and the major explanation, surprise, surprise, for the difference in house prices between Australia and New Zealand is the higher fees in New Zealand. The higher fees come out of more extensive regulatory requirements.

The problem is not just fees, of course. The problem is also the time that it takes to get everything done. So you have to say to yourself, why would a company like Fletcher Building, the largest building products company in Australasia now, have exited the housing market, apart from building some houses in Auckland and in Queenstown? The reason for that is that it just became too difficult in the housing market—too much regulation, too complicated to get everything done, and just too difficult to make money.

One other illustration in the housing market, the risk-weighted capital requirement imposed on housing by the Reserve Bank on bank lending for housing is only 50 percent of the capital required for other forms of lending. In other words, the banks have a very strong incentive to lend for housing to a greater extent than for other forms of lending, because the capital requirement is half of what it is for other forms of lending. So the Reserve Bank creates this dilemma of a great incentive to lend for housing, and then proceeds to worry about housing lending. Well, of course, one has to go back to fundamentals and say why would one have a regulation that actually encourages house lending to such an extent relative to other forms of lending? The theory is that that's a lower risk area of activity, but of course what's happening is it's being created into a high risk form of activity as is now being discovered in other countries and will, no doubt, be discovered here as well.

So, Mr Chairman, what we are really after is an endorsement of the present framework essentially, because it's worked really well for New Zealand, and it's good for the business sector if we can achieve low inflation, and we think that this is unquestionably the best mechanism for doing so.

Robertson Just on the issue of low productivity, and while I concur that productivity's important, the only way to increase the standard of living, you made the point that between 1992 and 2000, labour productivity was 2.7. Between 2000 and 2006; 1.3. I put it to you that couldn't the reason for that difference also be due to the fact that in the early 1980s, 1990s, and even before, the productivity growth in New Zealand—not so much growth but the actual productivity—was very low. What we have got here is we have come off a low base, and so it's easy when you come off a low base to get a bigger improvement, as we did with the 2.7, as opposed to what we are coming off now. Recognising that since the economic reforms New Zealand industry has been much more competitive, in fact, follows best practice. If one compares—and I have done both New Zealand and Australia—and looks at some of our workplaces as opposed to the Australian workplaces, our work performance is better than what it is over there. Maybe they have an abundance of mineral wealth and the sort of things that we don't, but I think it's drawing a bit of a long bow, wouldn't you say, that there's been such a drop-off in productivity that we are looking at the workplace performance, because I would put our work performance down against any state—.

Deane The figures speak for themselves. They're not our figures; they're the Department of Statistics' figures, and they do show that productivity growth over the last 6 or 7 years is now only a third of what it had been in the previous 8 years. You can go back 12 years and you'll get a very similar answer. Certainly productivity growth had historically been very slow in New Zealand, and we would argue that the deregulation of the late 1980s and early 1990s led to a lot more flexibility in the corporate world—it actually gave the corporate world a hard time as well, of course, and half the companies disappeared off the stock exchange in the late 1980s—but the consequence was that that degree of flexibility allowed people to really generate new ways of doing things, and that was contributed to greatly, of course, by the staff in all of those organisations. The worry is that we got off that low base, we got productivity really motoring along well, and why are we now slowing down again? That's what we have to ask ourselves.

Smith Let's stay with this productivity issue since it's a key part of our terms of reference and obviously a huge issue. I'd just like to ask you guys and—Rod or Roger—you make a very interesting point on page 17. You say, "research indicates that institutions and policies are predominantly responsible for productivity improvements and hence differences in per capita incomes." Obviously, this is quite a crucial issue now, thinking about productivity. Some people argue—as I suspect Ross has been alluding to—that it's a cyclical thing; that we have just been going through a phase since 2000, where more people are being employed, they're less productive. So our overall productivity's coming down, but you're saying their research indicates that institutions and policies are the key things. Would you like to just enlarge on that a little bit?

Kerr Sure. I might borrow from a conversation that Roderick had a while back with the head of the Australian Treasury, Ken Henry. As I recall your account, Rod, you asked him why is Australia doing so well, and his answer was: "Good policies." Roderick said: "What else?", and his answer was: "Good policies." That's clearly the case. Australia was a relatively poorly performing economy up until the time in the 1980s when it started to reform. Having a lot of natural resources in the ground doesn't necessarily do much for any economy—it's not even a very big chunk of the Australian economy to this day. I mean, the financial services industry in Australia is larger than agriculture, forestry, and mining put together. So the Australian story was of a major lift in productivity, just as we saw after our reforms. The periods in those graphs are much too long for any cyclical factor to be of any consequence. Going along with productivity growth at well under 1 percent, as it would appear now, is well below OECD norms. Even the pretty sluggish countries of the EU have managed a couple of percent productivity growth a year and are continuing to do so. So I don't think you can put this slump down to any other factors than those we have mentioned.

Smith — Could I just ask one further thing. If you were to identify the most urgent policies then to help productivity, what would you identify as the most urgent issues to be addressed?

Kerr — We'd say going in the same sort of direction that Australia and other more successful countries have done to carry on freeing up the economy while maintaining overall stability. I don't think there's any other lessons that one takes from the economic literature today, and the Government has been moving in the opposite direction. We have not been saying, you know, this is doom and gloom and the sky's going to fall in. New Zealand is a much better economy than it was, but its basic fundamentals have been weakened, and we haven't kept on doing what a country needs to do, just as any business needs to, which is to strive for continuous improvement.

Deane — It's not just about less regulation; it's about more effective regulation. So much of the regulation now just takes so much time to wade one's way through it all. I mean, the Kyoto business is a really interesting example of that. The business sector's not opposed to doing a sensible job in this area, but what have we got? We have had several cracks at this—the fart tax, and then the negotiated greenhouse agreements, then the carbon tax. The carbon tax idea really has got quite a lot going for it if one's going to address this problem, and the Government rejected it and the NGAs after 30 months of negotiation we had at Fletcher Building. A whole lot of our business units went through all these detailed negotiations, and then all that work went down the gurgler. So now we are into emissions trading, which of course, the emissions trading in Australia has just fallen over in New South Wales. So these are some of the dilemmas, that it takes so much time and wastes everybody's time. Same with the Resource Management Act. I mean, there's a lot of stuff in the Resource Management Act that's just common sense and nobody objects to it; it just takes so long to get everything done, and that makes it just a pain.

Gosche — Dr Deane, I just want to revert to the comments you made about the Reserve Bank basically incentivising banks to lend on housing ahead of other investment. Could you just indicate what you think the remedy is for that?

Deane Well, the remedy is for the Reserve Bank to be even-handed about any requirements that they might make with respect to capital ratios. My own view, actually, is that the Reserve Bank is exceedingly unwise to elaborate what the capital requirements for banks are, because that simply takes the responsibility away from the boards of directors and the management of the banks, or at least eases the responsibility for them, because they then say: "Well, the Reserve Bank says the requirement for first-year capital is 8 percent.", or whatever, "and that's what we'll have," rather than sitting down and saying: "Well, what do we really need?" It might be significantly more than that, and how can the Reserve Bank—who doesn't actually have to run a trading bank and most of its staff never have—make those sorts of decisions? Then if they make discriminatory decisions and say: "Housing's a lower-risk form of lending, and we'll say you only need half the amount of risk-weighted capital for housing compared to other forms of lending." Then house lending booms away, and they say: "Oh dear, what are we going to do about this?". I mean, it's just regulation leading to the need for more regulation on the face of it. So that's the dilemma.

You need regulation to be even-handed, and it shouldn't take the place of judgments that people are making in the commercial world. Much of the prudential regulation is like that. For example, the Governor of the Reserve Bank has to approve the appointment of any staff member reporting to the chief executive of a bank in New Zealand. You can't appoint somebody reporting to the chief executive of a bank in New Zealand without the approval of the Reserve Bank. I mean, how ridiculous is that? That's the sort of level of detailed regulation we've now got into. So that means when you want to appoint somebody, it can take the Reserve Bank 6 to 8 weeks to give you the OK. I don't know what sort of assessment processes they go through. That just slows everything down, puts up costs. That's why we don't have good productivity growth rates.

Gosche So is that an operational issue within the Reserve Bank, or is it something that would require legislation?

Deane No, it's something that's required in order to get a bank licence. They've got a whole lot of requirements that they lay down, that if you want a bank licence; you have to meet their requirements.

Chauvel That's not a unique requirement to New Zealand though, is it? As I understand it, a similar requirement operates in Australia via either APRA or the RBA.

Deane It varies from country to country. In some countries there's a requirement with respect to directors of banks, but in New Zealand it's both directors of banks and any report to the CEO of the bank. I am not aware of the reports to CEOs of banks requiring any approval of the Reserve Bank in Australia, and I am not aware that APRA, the Australian

	Prudential Regulatory Authority, requires it either. But it's just an illustration of the dilemmas we are faced with in the business world today.
Fitzsimons	There was just a clarification of something you said there. When you talked about the capital ratio, were you talking about the capital deposit the bank has to—or were you talking about the deposit on the house purchaser has to make when—.
Deane	The capital-ratio requirements that the Reserve Bank imposes on trading banks are the amount of capital of the total balance sheet. So if it's an 8 percent requirement, the balance sheet's 100, they have to hold 8, to back the lending.
Foss	Two quick ones—you're here as the Roundtable today. Your membership is a cross-section of industry, importers, exporters, large, small?
Deane	Yeah, pretty much.
Foss	And you're representing their views today. Are there any wood processors in there or people in the forestry industry in your membership?
Kerr	No, not that I can think of. Fletcher Building hasn't got any involvement there now.
Foss	The previous submitter though made the point that about a third of the economy is not contested, it's not competitive—i.e., the Government SOEs. Roderick, you started to talk about the fees, the ongoing costs, which I think a lot of the monetary-policy arguments here were actually arguments about the wrong thing. We are talking about monetary policy, where you've essentially argued here today that it's the execution of monetary policy which is now somewhat fuzzy, given the change in the PTA etc. But if we go back a few steps, in your opinion, would our interest rate premium, our inflation, etc., in New Zealand—do you think that would be lower if, in fact, there was more competitive tension in amongst parts of what the Government's actually doing at the moment?
Kerr	Well, that would help. What we are saying is that there's nothing that monetary policy can do to shield the internationally trading industries from the pressures of large increases in Government spending and regulation that push up costs. It just can't be done. So the more competition you can get into any sector, the better, and most of the economy is open and pretty competitive. The areas where you'd worry most about monopoly-type problems, or inefficient performance, we would say are in the public sector. The indications about productivity growth in the health sector suggest that it may even have been negative in recent years. That's the area that we'd focus on.

Smith: We'll have to close at that point. Thanks so much. You've given us much food for thought. Thanks very much.

Canterbury Manufacturers' Association (Submission MP/27)
Mr John Errington, President, Mr John Walley, Chief Executive, Mr Gordon Sutherland, Managing Director, A W Fraser Ltd, Mr John Heng, Managing Director, Click Clack Ltd, Mr Scott Yates, Managing Director, Cee Cee Industries Ltd

Smith: Canterbury Manufacturers are next. Gentlemen, we've got 25 minutes. As everyone does, we have a very distinguished delegation from Canterbury. John, welcome. I take it you're going to be leading the presentation. I won't say any more; I don't want to waste good time, but do leave us some time for questions.

Walley: I've done a short presentation that I'm just going to work through—that won't take very long—and then I'll introduce the people who are with me and they will make a comment of their own, and then we'll open for questions. Is that OK?

Smith: Just don't let it get too long.

Walley: We will try. Well, we're speaking today largely as the manufacturers and exporters' association. That's been formed as a result of the pain that's currently being felt in New Zealand's tradable sector. It's really bad out there, guys. Now, you heard it from the wood processors just as we walked in the door, and I'm going to try and outline some of those things.

Monetary policy in the context of fiscal and broader Government policy is not working for all New Zealand. This has manifest in the emergence of two economies, with negative impact on growth, productivity capability development, and the retention of worthwhile activity. This leaves us all vulnerable to economic shocks, and many of us are worried about the future.

Looking at the terms of reference for the inquiry, I'm not really going to touch on inflationary pressure or effectiveness, but focus more on the broader interactions. The earlier points have been well covered by a number of people—I'm underlining Bryan Gould, Selwyn Pellet, Malcolm Bailey, and Talley's, among others. Currently, economic policy framework is delivered. We take two large companies: one a manufacturer of sophisticated capital products with almost 100 percent of sales in exports, the other a major supplier of processed materials to the building industry with roughly 80 percent of sales to the domestic market. One says things have never been better for a generation; the other says things have never been worse. You pick which is which. There has to be a better way. Two economies is no way to run a country. This theme is repeated constantly in many of the submissions to this inquiry and we hope the threat to productive activity is not being lost on you all.

There is a clear and present danger that the single goal, single tool approach will fatally deflate our producers and not in a time frame to be meaningful impact existing asset-holders. Policy support for wealth creators is long overdue.

Note the difference in inflation rates of the non-tradables and tradables. How to control the problem-sided economy without hitting tradables at both interest and exchange rate impacts is a key issue. If the policy response to domestic inflation does not become more sophisticated, at some point all of us will become sub-prime as the export sector contracts and the property bubble bursts.

I've tried to show the world as we see it in the diagram. Monetary policy doesn't exist in isolation, and it's difficult to imagine insufficient global liquidity that will not swamp New Zealand, providing interest rate spread exists. The interest rate spread is driven by policy and performance contracts between jurisdictions; having only the interest rate response we create the worst of times, the best of times. Internal settings buy us investment towards property, further spinning up the problem.

The interest rate spread can only be managed if there is a more sophisticated policy response to inflation. Ignoring inflation or simply continuing to increase interest rates in the presence of inflation is not viable options for exporters in the short term, and they're not good for any of us in the longer term. What you do next is very, very important. Continued pressure on the tradable economy as a result of exchange rate volatility will see the reduction in the diversity and complexity of our exports. That will increase our susceptibility to external shocks, political and economic—the cost of oil, carbon credit crunches, commodity prices, and the like.

From where we sit it's pretty simple: if we want more productivity, we need more productive investment. If we want higher productivity, we need to redress the bias against productive investment. If having things offers a better return than doing things, it should not be a surprise where the investment ends up. It's worth keeping in mind that the vast majority of New Zealand exporters are small companies, without the balance sheet strength to push through multi-year adverse variations in exchange rates. As our exports dwindle, we're becoming increasingly exposed to problems impacting those that remain. Most critically, the reduction in skills and the capability associated with a diverse export mix will stymie future developments that depend on access to those skills.

The clock of the economy will run down; it need not be so. It's been said before—monetary policy needs mates. The export sector also needs mates and equitable treatment. If we want to increase productivity in the economy, bias policy support towards productive investment, create stability in the external economy, minimise the inter-jurisdictional policy contrasts and eliminate them where possible. If the current situation continues the tradable sector will stall and fail, the complexity of exports will fall, and hard-won capability and skills will be lost to the future. Commodities, raw or processed, will not be sufficient to sustain current living standards, and the cracks are beginning to show.

So I will now hand over to comments from my colleagues, who will introduce themselves before they start—Scott?

Yates My name is Scott Yates. I am an SME from Auckland, and I will focus on two issues. One is that of accelerated depreciation, because if we could look at that and address that, that would make the funding of SMEs, or all companies who are producing wealth for the community, a lot more easy. The second issue, which I'll focus on a little bit later, is the actual type of funding that we could put in place very simply and very quickly to support the people that are hurting out there in the export market.

The products that I export are made with the help of a machine, which we developed with a business development board grant before it was wiped. We can fill up a container with MBF-type products easily in less than a day because of the ability that we gained by developing that machine.

As we all know, to catch up with the rest of the world, we're going to require some urgent changes. I think it was Robert Wade of the London School of Economics who said we've dropped from First World status to a developing nation status. And the changes must be radical. We just can't fiddle with the edges—they must be radical. We've got to do something, because we are hurting out there.

I heard the figures of productivity being mentioned before, but I did have some notes. In 1987, for an 11-year period, our productivity increased only 5.2 percent; Australia, by 21.9 percent. So we look to you, as the Government and Parliament, to provide the impetus for us to get ahead and stay afloat, because that is one of the risks we are facing now. We see companies moving offshore, we see companies closing, and we can't afford to let that lie. So the policies that must be created must encourage the entrepreneurial activity and support those who are prepared to take the risks—the wealth-creating community. I think you all understand how important depreciation is and having to fund tools and equipment for a manufacturer. If we could do as I think other countries can do—and I think may be the case in Germany; I'm not sure of this—they are permitted to expense the cost of the capital—it must be a productive capital item—in the year of purchase. In other words, what that is doing, that company is allowed to increase its expenses, although the asset will last longer, but it is allowed to write it off in the year of purchase. What that does, it doesn't reduce tax; it changes the timing. It means that the profit for the year when that machine is purchased will be reduced by the cost, but subsequently they will pay full tax the following year.

We must also appreciate with depreciation that technology is changing rapidly, at a very, very fast rate. Unfortunately, when you buy a machine now, a modern machine, tomorrow it could already be out of date. There could be a competitor with a more modern machine. And if we don't appreciate this, we may as well close up now.

Tax take in the medium term is likely to increase, not reduce, because with better machinery we'll be more productive, we'll have better employment, and we'll pay more PAYE. Also in the case of many companies, to get around this issue, they expense their asset purchase. They treat it as a purchase because whilst that's not avoiding tax, it is delaying it, but, by law, it is not approved. But the reality is some companies have to do that because the funding is so difficult. New Zealand needs encouragement to invest. If we don't invest in our productive resources again, we're on the road to nowhere. So the net cost to New Zealand for better depreciation really is nil, but it will help the wealth creating—

Smith: Gentlemen, I need to just point out that there'll be no time for questioning at all if everyone has this time to make their comments.

Yates: OK, I'll just briefly touch on funding. Banks do not like exporters, and that's mentioned in the Austrade report. It said two of the factors which deter most firms from exporting are the high initial cost of export exploration and, secondly, the traditional reluctance of most finance providers to fund that process. The next issue is, much more can be achieved if we had sensible access to lower costs of financing investments. I do have a copy of the Australian scheme, but because of time, maybe I can pass it round afterwards. But what it does achieve is that the bank becomes the underwriter for a loan. A company seeking to borrow more gets the support of this scheme, goes to its bank, and gets additional funding, without having to put in place any more securities. Thank you.

Sutherland: I'll just introduce myself—Gordon Sutherland, managing director of a company called A W Fraser, based in Christchurch. We employ 180 people. We export in excess of $50 million a year, turning over in excess of $60 million a year. We are a bronze foundry and machine shop. We process approximately 20 percent of New Zealand's scrap copper. I, along with some others, bought this business from investment banks, and if we turn to page 16, the very last graph shows the exchange rate. We bought it at point C, which was slightly above the long-term average exchange rate against the US dollar. We bought a business that was in drastic need of investment, and we started to undertake that investment. What we need is a long-term, stable, and reasonably priced New Zealand dollar to be able to invest. For a business like ours it's about the investment of capital. We all hear about China and the cost of labour and so on. We will win and we will beat some of our Chinese competitors by the proper and best investment and best equipment that we can. What we're looking for is to be able to have profitability through a reasonable and stable New Zealand dollar, so that we can invest in our business and we can compete against China—and we can do it.

Tremain	What sort of remedy do you propose?
Sutherland	It's actually a lower exchange rate. If you look at C, when we bought that business—almost every bank economist in New Zealand and every economic forecaster were forecasting the dollar to come down. They have continued to forecast that dollar to come down. So what we actually need is enough stability so even the economists actually, their views are realistic, which you can say they're everything but realistic so far. So what we need is a reasonably priced dollar, much less volatile, so that we can in the long term invest in plant and equipment so that we truly can compete internationally—my quick summary.
John Heng	John Heng, Click Clack Ltd. A lot of the submission stuff going on today has been quite anecdotal. Just to get you back to the real cause and effect, in our company 4 years ago, 425 employees; today, 200. Now, we are an exporter. We take a lot of the people that no one else wants to train them up to become unskilled, semi-skilled workers, and they're very proud of the things they do. But when you have to completely take out worker after worker because we're not competitive due to the New Zealand dollar exchange rate, it becomes a pretty difficult decision on who goes next. When we closed our Christchurch plant down in June, it wasn't a matter of whether the best plant should stay, it was the social responsibility of the employer that if we took Levin out, the effect on Levin, by taking 200 employees and putting them down the road, was going to be more disastrous to that community than it would have been to Christchurch, even though the best decision may have been to stay in Christchurch. This is what we as an industry are up against at the moment. We've had all sorts of discussions on productivity, but to us, productivity is the utilisation of capital assets to the best possible means in best of class—best of class is China, 7 days a week, 24 hours a day. That's exactly what my colleague said; that's what makes us productive. At the moment we're competing with Working for Families, where for guys getting $17 an hour, which is not a great amount, it's better to stay at home some days than it is to come to work. So these are some of the issues in the monetary policy that must be addressed, because by next year at this time, we'll be down to a mere 140 and moving another $6 million off to China in the next 4 months—not that I want to do it; I just can't wait, because no one will have a job if we go completely belly-up because we're not making profits.

Errington I'm John Errington, the president of the MEA and also a manufacturer—and I'll be brief; I know we're pushed for time. What I want to emphasise is that my colleagues here and in our written submissions, we've talked about the technical things. We've made a variety of points. But what I want to emphasise is that above all of that, this is a plea, an argument, for equity. There's no point punishing the productive exporting sector for what are essentially the excesses of a domestically driven asset bubble, and the mantra that there's no alternative is just wrong. I mean, embedded in this, embedded in the technical things, are those choices. They represent a menu, a tool box, and some of them will be more politically acceptable than others. But certainly what we're saying to you is, look at the tool box, choose the tools that are available to you, and do something, because you can't continue to expect a First World economy when you drive the productive exporters to China—just as you've heard from John. The sorts of points we've made are summarised on that last slide, and I'm sure we're all be more than happy to talk in great detail about them, but if you just take away messages that the tools are there, but the mantra there's nothing you can do is dead wrong, that would be great. Thank you all for your time.

Fitzsimons John, you listed a number of sort of supplementary measures in documents—standard ring-fencing losses. If those two were put together, how important do you think that is, as a tool, in terms of the State advising the way the health of the market is driving inflation and, therefore,—.

Walley I guess we've come from it from this point of view of equitable treatment. If we arrange a series of biases—and I tried to pick that on the bias towards low productivity slide—and we bias things towards things that are tangible assets, rather than towards things that do productive things, then we shouldn't be surprised that the money ends up in the fixed assets. And that's what we've created. Any number, whether it's Scott's point about being able to borrow, we've heard it from the Roundtable earlier about capital's treated rather differently—we've got property rather than activity. So we haven't come here today with a prescription that says "Do this.", we've come with a problem: we've got two economies. How can we create one economy? Because if we don't do something, there will be one economy—it'll be awful, what we've got. And it is that serious.

Sutherland Could I just add to that. Currently, if you invest in something productive and we make a profit, we're taxed. If you invest in a property as a secondary property, you are not taxed. It is two different things.

Fitzsimons We've had so many of the submitters putting their hearts into this. Why do you think it is that most politicians regard it as political suicide—which is a word that gets used around this table a lot—and—you guys do to change that perception—because it's obvious there is support in the business community?

Walley I make the comment; it's the absence of tax balance. We tax some activities but not others, and then we criticise the fact that we're not seeing productivity growth when all of the effort goes into those—you know, if I've got a big asset and it's inflating, then I can borrow against it and put it into other assets that I can take a capital gain out of and not do anything in the meantime—not create wealth.

Fitzsimons So do you think that where that revenue was recycled—valid point that it's meant to be given back in some way?

Walley Basically, if capital gains tax came into force, then you would lower profit and income taxes to balance. It's not an argument for more tax—please, less tax.

Fitzsimons Do you think that solution—

Walley I actually think it's a myth that it is a near-death experience in New Zealand politics. I think it's a myth, and I think it's because you guys don't want to do anything—sorry!

Errington I think that a huge number of New Zealanders are now responding extremely sensibly to the signals they've been given. I was chatting with the taxi driver as I came in here, and he's got an investment property. Now, there's a huge groundswell who need to have it explained to them that there are other options which are better than where they are at the moment.

Walley Might be better if the rules were different.

Errington Exactly—I mean, they're not better now; they're rationally sensible right now.

Foss But, so picking up from that then— to the gentleman from Click Clack—I was very interested in how you described one of your biggest competitors as Working for Families. Picking up on the signals that people are given, we've got a very tight labour market and—by the way, thanks for the kind of decision you've made in regard to Levin, I guess, but could expand on it because that's all about productivity, actually. So just how big a problem is that?

Heng It is a serious problem because it's a compounding problem, not only with the fact that there is an option not to work full time, but more importantly, when you take it back to the skills base, there are other issues whereby the training that's going on—and I am a founder and chair of the Central Region Apprenticeship Trust—whereby, trying to create skills, we end up by having to create training organisations that really do not capitalise on the training that's supposed to take place. So

	we have a whole bunch of young fellows that we want to employ who are boy racers. They can sign up for 6 months on a training course, turn up for one, and be on a benefit, which is called the training benefit, for 6 months. So they're completely out of the workforce.
	Now, my own workforce in skills, average age—before I came down here—for my skilled tradespeople: 56.3 years. And because I'm no longer doing tools—I do them in China—my young toolmakers who we had on an apprenticeship, we don't have that any more. We can't offer these trades, and they've now got a generation of skills which are going to die off, and there's no replacement. We're talking generational now. It's not a matter of infrastructure; you can't bring in the assets if you've got no one to actually utilise them. And this is happening right now. The clock is well past the midnight date—you know, we just cannot get those skills back into the system unless I can make money here in New Zealand by being a producer. I've got to do it offshore, and you, the Government; you lose out on your GST, your PAYE. It's coming out of another country, and it's not coming back to New Zealand first—straight to the States, straight to the Middle East. And these are some of the key issues that I'm passionate about only because I'm old.
Smith	Gentlemen, thanks very much. I'm afraid we're chewing into the next submitter's time, but thank you for a detailed submission and your first-hand experience of the real world that you've shared with us. Thanks very much.

EROS Capital Limited (Submission MP/14)

Mr Phil Verry, Executive Chairman, Mr Bryan Gould, Director, Mr Anthony Byett, Economist, Mr Michael Houlahan, Chief Executive, Tuatara Consulting Limited, and Mr Steven Becker, Chief Analyst, Tuatara Consulting Limited

Smith	We now have EROS Capital Ltd—Phil and his team. Welcome, Phil. Please get straight into it. I won't waste your time. We've really only got 35 minutes left, I'm afraid, so just as brief as you can be in putting your interesting proposals to us.
Verry	Thank you, Mr Chairman, and thank you for the opportunity to appear. I have with me today Mr Bryan Gould, on my left here, who is probably known to you as a company director, former vice-chancellor of Waikato University, and he had a prominent political career in the United Kingdom. I have Mr Anthony Byett, who is on my right here. He was a prominent economist, the former chief economist of the ASB bank. Mr Michael Houlahan is the chief executive of Tuatara Consulting—they are a very prominent New Zealand firm of foreign exchange consultants—on my left here at the end, and Mr Steven Becker, who is the chief analyst for Tuatara consulting.
	I have left with the secretariat some letters of support from the Council of Trade Unions, from the Employers and Manufacturers Association,

and from a major exporter. There are many others we could have brought here, but they are just representative of the support that this delegation comes today with.

We will divide our presentation between myself, Mr Byett, Mr Bryan Gould, and Mr Michael Houlahan, and Mr Becker will, if you like, come off the bench during questions and answers to address any issues that he feels he can assist with.

By way of background, I lived in Wellington for 32 years, for my sins, and I pulled out as a senior partner in a firm now known as PricewaterhouseCoopers, so I do come to this issue with a professional background and a very diverse experience base. My present personal involvements: I'm executive chairman not only for EROS Capital, which is our entrepreneurial company, but also Red Stag Timber Ltd, which operates New Zealand's largest sawmill and timber processing plant in Rotorua.

There's been some talk, and we have heard it today, about productivity. Well, just to give you an example of how we see productivity, last year we invested to increase our production by 50 percent, from 200,000 cubic metres a year to 300,000 cubic metres a year, and we did that with the same staff. Now that's productivity, on a per capita basis. That enables us to plug in quite a good bonus scheme, which we have done, and that's feeding some of that return back to our people.

So we understand productivity. Last week I had visits from two overseas organisations, one from the United States of America looking for a JV in production here in New Zealand, and also distribution in North America. They were followed on Friday with a company from Malaysia who are looking to set up a major plant in the timber processing industry here in New Zealand for export production. Both are interested in JV-ing with our company, because we have the resources that could make that possible.

The issue that comes to us when we look at these projects is not that we don't have the capability; we do have the capability. We have the logs on our doorstep. We have the people, we have the expertise, we have everything we need to make those projects happen. But what we lack is confidence. The reason we lack confidence is because we do not have an environment in this country that gives companies like ours confidence. Our company targets the domestic market. We export by default, because we get some classes of timber we must put into the international market, but we actually target the domestic market. We should, and could, be targeting exporting, but we are not.

So when we look at these projects that were offered to us last week, we come up against the issue of exchange rate volatility and extended periods of overvaluation. We're not going to put ourselves into a position of risk. We do not need to do that. We have unsatisfied demand for our company's products on the domestic market. So if the Government wants to inspire companies like ours, and we like to think we're good operators, to actually go out and do good things for New Zealand, you've got to create an environment where we'll do that. Right now we do not have it.

We have distilled down some thinking on this issue over many years. When I was a Wool Board director in the mid-1990s I identified monetary policy as one of the big issues affecting that industry at the time. The other was its marketing system, or the lack of it. Neither of those issues, 12 years later, have been addressed, so we're not actually very good at addressing issues and changing direction before it's too late. We saw that on Sunday morning over in Cardiff, so we've really got to start to take on board that we can't just embrace our problems; we must recognise them and do something about it.

In our submission I put in there a scorecard of New Zealand's real economic performance, because there's a lot of myth-building about how well we're doing and how we should be pretty proud of what we're achieving. I actually think it's largely mythical. You can look at the real scorecard. It is not actually a very good picture, at all, and that scorecard is supported by the official statistics, so we don't need to debate whether it's valid or not. It doesn't make sense to me to be running this country at a loss of about $13 billion a year—$13,000 for every typical family of four, on average. This is what we're doing at the present time with the current account deficit. It doesn't make sense to me to have a million Kiwis living offshore, or 25,000 to 30,000 a year continuing to shift to Australia, for example. It doesn't make sense to me to be training up and educating people and giving them experience, and everything else and then say: "Goodbye, go and do your wealth development for another country." People say: "Well, Australia's got mining advantages." The biggest mine and the best mine Australia has got is New Zealand, because they come in here and they take our best people, they take our businesses, they buy our resources, and they own a hell of a lot of this place. So, really, Australia has the benefit of their economy, plus ours.

When we look at what the real cause of all this is, I think we've got to recognise that the OCR is a dead duck. It hasn't worked for the last 18 years. If it hasn't worked from that period of time it's not going to work, and there's a good reason for why it can't work in the future, and that is this: the global financial markets have changed. We now have huge carry-trade funds sweeping around the globe looking for yield. When they come into a country like ours we offer the highest yield in the world. So, of course, we're going to get money pouring into this economy from debt, and that replaces exporting. So we're living on debt—that's why we've got a current account deficit. We're borrowing money to buy our groceries, essentially. So that's the essential change. Now we haven't got control over money supply. That has been controlled by international capital funds debt movements. Unless we find some way to put a border around our financial markets that's going to continue, so we must face that reality.

In an environment where we use the one instrument, the OCR, to try to control inflation to get one statistic into line—forget all the others that you've heard about today, like manufacturing and exporting, and all the rest of it; they don't seem to matter—that one thing that's important under this policy is inflation, which is important. We're not saying it's not important, but it's not the only thing that is important. Low inflation should serve a purpose, and that purpose should be, ultimately, to provide better prosperity for New Zealanders. If it doesn't do that ultimate purpose, why do it? There is no purpose. So it must serve that ultimate purpose. It is not an end in itself; it is a means to an end. We believe that low inflation can be obtained by different instruments, and that's what we've outlined in this presentation we've got here. I won't go into the detail of that, because we need a lot more time than we have, and we've got other people who have got very useful things to say to you, as well. But I'm happy to come back and answer questions on that issue.

The key thing I think we need to recognise is we have been doing this now for 17—coming up to 18—years. We've got all this accumulated damage, which is measurable, and we've given you a list of them. We've outlined in here what we think is a very robust solution. Nobody has credibly faulted it to date—nobody. So we have no analysis from anybody else who has come to us and said: "Hey, you've got a flaw in your logic." Nobody has been able to say that. We're pretty certain there is not one, because, fundamentally, the natural antidote to inflation is savings—domestic savings. That is what we're proposing: to swap from using an instrument that is giving away our money by interest rate surcharges to foreigners. That is our savings, potentially, we are giving away, and then we borrow it back as their debt. And we're saying: "That's good."! How can we possibly become prosperous if we give away our wealth, and then destroy our exporters by that process? It is simply not possible, and it is not happening.

So if we want to make something happen for New Zealand's future, this, in my opinion is the most important issue facing Government at the present time. I know that all the other issues are important, as well, but if you solve this one, a lot of other consequential problems disappear. If you start pumping the cash in prosperity, you then end up with not having the other problems that the Government is looking at, which are symptomatic of this fundamental problem we have here. I will pass across, I think, to Anthony, who will take up on a few points there. We want to leave plenty of time for questions and answers, because we think that's a pretty useful way to interact. So we're happy to deal with that later.

Byett

OK, I guess the main thing is, really, there's no doubt that we have a problem. There's been talk about productivity being low, and I don't think there's any need to go there further. But what hasn't been said today was how deep the problem is. We don't have all that much productivity. The small amount of productivity we do get extra, we're passing off some of that as profits and interest overseas. So the impact of that is if you looked at gross national domestic income per person, it grew by 1.9 percent in the last 5 years, on average—0.7 of that was taken away, passed off overseas. It was very lucky during that period that we had a terms of trade—higher export prices. That added 0.4, so we ended up with 1.6 per capita. To put that in international terms, it should be more like about 2 percent, or even better. So not only are we not producing enough, what we are producing we're giving some of it away. So we have a problem.

What's part of the problem? Well, I guess we could argue all day what's causing the problem, but some of the things we can agree on: there's a low stock of capital, export performance has been poor, large external debt, large current account. We know New Zealanders, to use the Reserve Bank's words, have been willing to borrow even at interest rates that would have had a much more contractionary effect in other developed economies. I think whatever way we look at it, part of the solution is going to be more investment and more exporting. So anything we can do to encourage any of those two things—any policies that we can put in place—are certainly worthy of further study.

Just turning to monetary policy itself, there are two shortcomings, one which is general and goes across all policy, and that is everyone works in a world of uncertainty. I might come back to that later if I've got time. More precisely, what we have is an imprecise link between the OCR and inflation, and in particular it is undermined by two processes. One undermines it, namely the fixed rate lending, and the other process, of course, which makes it difficult, is we end up with a lot of exchange rate volatility and the pain is endured through the export sector.

In terms of the undermining by fixed rate lending, I do not know—maybe I'll just put some sort of stats on that to give you a feel for it, if you doubted the significance of that, in the last 5 years. At the moment the banks themselves—primarily the banks—fund a net $79 billion from non-residents. Over the last 5 years that's grown by $42 billion. It's no coincidence that the issuance of Eurobonds and Uridashis have been around about $40 billion at the same time. Household lending over that time has gone up by $62 billion; it would be even more so for fixed rate lending. The money that's come through from overseas has been a huge part of what's gone into the fixed rate lending through the banking system in New Zealand.

One of the difficulties with the OCR: it only indirectly influences that part of the yield curve, and this is where the ILSS goes more directly to the issue and tries to put a surcharge across the whole of the yield curve for mortgage lending.

Exchange rate volatility: it's large in New Zealand. Currencies are always volatile, but the New Zealand dollar is even more volatile. The OCR has a role there, I think people generally agree. Again, what would be nice would be to put a wedge between what the foreign investor is earning, and what the local borrower is paying, and that is what ILSS proposes. It does take it one step further, of course, in that there is: "What do we do with the surcharge once it's collected and there is the possibility of using that for foreign reserve management, as well. So it's one step further down the path the Reserve Bank's already taken, to use reserves to try to dampen the extremes in the currency cycle.

The Reserve Bank itself has looked at the MIL—a very similar scheme, or there are a lot of similarities. The challenges, we generally agree, the enforceability of this sort of system—it's unconventional, appropriate governance framework. Well, I would suggest the first and the third thing deserve further study. The enforceability—there is some promise there—and governance. These are things that need to be considered and looked at, hence what I'd recommend to this committee. I did note also that the Reserve Bank board would recommend that the committee look further at supplementary stabilisation instruments, which this would fit into that sort of category.

If there's something unconventional about the New Zealand economy, then maybe there should be something unconventional about our solutions, as well. We've led the way in terms of developing monetary policy, and maybe it's time to take that one step forward. But even if you don't want to think of the policies as too unconventional, the ILSS doesn't necessarily need to abandon the OCR; it doesn't abandon a floating exchange rate. It is a change at the margin, if it was deemed necessary to do that, or it can be taken to a greater extreme.

Just to finish, I think the economy can do better, and I think the current system is very unfair, particularly on exporters. I think the ILSS is a proposal that deserves further study. Thank you.

Verry — Thank you, Mr Chairman. I will ask Bryan Gould to address you.

Gould — Thank you, Phil. I very much welcome this inquiry, because I think it shows a recognition of the fact that our problems haven't just come upon us all of the sudden. They are not short-term problems; they are not here and now: they're long-term problems. They've been building for 20 years. Why have they built with us rather than anywhere else? It's because I believe we are on a sort of treadmill. Unlike other countries, when we use the OCR it's not just a light touch, occasionally, on the tiller; it's a permanent state of higher than needed interest rates. And we've become addicted. We're in a vicious circle. We can't get away from that, because of the consequences of that permanent state of high interest rates and what then happens.

The reason that permanently high interest rates are so destructive is that, first of all, they damage our competitiveness and our profitability. They do that because high interest rates in any economy mean a bias against investment. In the balance of interest between borrowers and lenders, the balance is struck in the interests of lenders. So those who hold assets do well. Those who want to create new assets are penalised. That problem is compounded by the fact that we pay the interest rate surcharge—that extra market surcharge—principally to foreign investors. And as we know—you don't need me to rehearse the point—that creates a drastically overvalued exchange rate. That has enormous consequences, not least of which—perhaps the most obvious of which—is the huge current account deficit. Our reliance on the OCR then exacerbates that deficit by increasing the amount we have to pay across the exchanges both in interest rates and in repatriated profits because of all the assets we've had to sell to try to finance that deficit.

We then end up with a split in our economy. As you heard—I caught the tail end of what John Walley was telling you; I know he has made the point very effectively—a split between the tradable sector, which has nowhere to go but to face the competition and generally fail to face the competition, and the non-tradable sector, the sheltered bit of the domestic economy, where in the end all that money we suck in to finance our deficit, that is where it goes: it goes to the non-tradable domestic sector, which means principally the housing market. It's a perfectly rational response by New Zealanders. There's no point in criticising them for failing to save. They do what the policy settings tell them to do. So all that money flows into the housing market, inflates the value of houses, becomes the major source of capital gain, promotes in people the notion that they have assets against which they borrow. They then borrow, and what do they do with their borrowings? They spend their money—every overvalued dollar that they can lay their hands on—on artificially cheap imports.

So what do we do about that? At present what we do is we put up interest rates again. And off we go again. And you will be told, and have been told, that there's nothing we can do about that. That is nonsense. The reason that I have come with my colleagues here today to support the ILSS is twofold. One, I think it demonstrates the nonsense that there is no alternative—that simply cannot be sustained. Here is a perfectly sensible alternative. Secondly, I believe it has very real merits that should be seriously taken into account by this committee.

It comes with the authority of people who know what it means to run a business, and to address the export market in today's economy. The way I would characterise it is that I think it uses essentially fiscal measures to mimic the counter-inflationary impact of the OCR. But it does it with significant differences, and, I would say, advantages. It does it because it, first of all, will be more effective as a counter-inflationary measure than the OCR. It will address, for example, all those fixed-rate housing deals. It will address any range of borrowing that you choose to identify. It will be more effective, too, because it's more easily targeted. In other words, it has a better spread, if you want it, but it won't clobber the whole damned economy while you're trying to solve a problem that affects only part of it. Because it's more effective, you could also reckon to get a better counter-inflationary impact for any 1 percent surcharge than you would get with the OCR. So in that sense it's more effective, as well.

Very importantly, it avoids all that collateral damage—that unnecessary collateral damage—about which you have no doubt heard a great deal. It does that because we no longer pay huge premiums to overseas investors, which costs us money and then forces up our current account deficit. It enables, in other words, for those interested in the way markets should be allowed to operate, interest rates and the exchange rate to do their proper job in the economy. It allows the exchange rate to clear the market—it's a market-clearing price—and it allows us to balance our trade and to move our resources to the most competitive parts of our economy.

Further than that, the proceeds of the surcharge enable us, if we wish, to boost the investment in the New Zealand economy. Instead of the money flowing across the exchanges and disappearing—as far as we're concerned, at any rate—into the stratosphere, we have the option of using the money raised through the surcharge to reinvest in the New Zealand economy. It would also be, for this political gathering, as it were, politically more acceptable than the OCR. It doesn't do anything worse than the OCR does, but what it does do is at least give the option, depending on what was decided to do with the surcharge, of returning it, over a period, to those who've paid it—in other words, a sort of compulsory savings scheme, if you like, that would, in the end, I think, prove to be a major boost to schemes like KiwiSaver.

For those who are nervous about taking a new step—and I sometimes think it's simply that inertia that has kept us where we are— no one, perhaps unhappily, is suggesting that we should cut the throat of the OCR; we simply keep it in a cupboard and wheel it out, if for any reason it should be needed again. It's always there, in other words, as a fallback.

I believe this scheme will work. As Phil Verry says, no one has shown why it won't. I think there may well be practical issues in terms of its application—perhaps wrinkles that haven't yet been seen that might require further work. But by comparison with what we know to be the huge downsides of current policy, it's surely worth exploring this proposal, to see what the downsides may be, if any, and how well, I believe, it will stack up against the current orthodoxy. We're not suggesting that you should put this in place overnight, but we do ask that you recommend that further work should be done on it, and I hope that's what you will do. Thank you.

Verry — Thank you, Bryan. I will just ask now Michael Houlahan to say some words to you.

Houlahan — Thanks, Phil. We at Tuatara are currency specialists. We work with importers and exporters, and we have done since 1991. It is interesting sitting here today and thinking why are we here now after 18 years of essentially the same monetary policy being driven from the same perspective. We've given you a supplementary handout there with some graphical representations. The red line is New Zealand's interest rate relative to the respective trading partner, whether it be the US, Australia, etc. The blue line is the currency. I think if you look at those you'll see there is a reasonably clear correlation between the interest rate differential or the extra interest rates that we offer, relative to our trading partners, and what happens to our currency, not only against the US dollar but against the Australian dollar, the pound, the Euro, and the yen.

Sometimes there are leads and lags in terms of how quickly the currency responds to that, but in general, I think, it's very clear to us as currency specialists that, in the main, it is the extra interest offered by New Zealand that is the main driver of the currency.

But in thinking about things and listening to the previous groups present, I think there's perhaps one other point that we as currency specialists would make. We're going through a very similar exercise as we went through in the middle of the 1990s. The Reserve Bank responded to an upturn in the housing market by raising interest rates. That drove the currency up, it put pressure on the export sector, and eventually we had a big slow-down in the economy, housing cooled off, and the currency came back down again.

We've gone through the same exercise over the last 4 or 5 years. This time around the currency is not cooling off to anywhere near the extent that it did previously, which tells us that something has changed. Indeed, something did change. Probably the big event that has got us all here today is after the Asian crisis in 1997 and 1998. All those Asian economies said: "Hell, we're not going to go through that again. That was such a dramatic shock to those economies." So they said: "We need to build a wall of money to protect ourselves from those types of financial shocks that occurred to those countries through their currencies depreciating dramatically."

So we've ended up with the world essentially awash with cash. China itself has accumulated something like US$1.2 trillion in foreign reserves—mind-boggling amounts of money; I think they accumulate US$20 or $30 billion worth of reserves every single month, largely because they have a very, very cheap currency.

But one of the problems I think we have in New Zealand is that we've tended to implement monetary policy as if we operated in a closed vacuum, if you like. Ordinarily, if you put interest rates up and it was just New Zealand savers lending money to New Zealand borrowers, then eventually the high interest rates would have their effect, cool borrowing, people would move across to the savings side. But we don't operate in a closed environment; we operate in an environment where there's a massive pipe attached to the side of the New Zealand economy, and as much money as we want to borrow can be provided. So the more our interest rates go up, the more money that comes in. I mean, Anthony's numbers were something like $42 billion over the last 2 or 3 years. And that's leading to this excess in the housing market, and I think the Reserve Bank are doing the best job they can in the environment that they have got.

What we need to acknowledge is that the game has changed, and as a result of the game changing, I think there is a clear case for saying: "Do we need to adjust the way the monetary policy is implemented?". That's the idea behind having some supplementary instrument that the Reserve Bank can use. You go to breakfast meetings, lunches, and Dr Bollard gets up and says: "We can't ignore the housing market. It's too big a part of the economy." The challenge, then, is to give him a supplementary tool that if we do have periods of excess demand in the housing market, that he's got a tool that he can specifically use to address that demand, without trampling over the export sector in the process.

Because we have got this one-size-fits-all approach, we keep driving the OCR up, which keeps sucking in more money, which drives the housing market, and the poor old export sector, well, we're just like: "Well, that's just the consequence.", and this term of collateral damage is used. That's just plain crazy. We can't just trash the export sector and leave it to control demand in the housing sector.

I think the challenge for you as a group is to realise the magnitude of the change in the global financial marketplace. There's just so much more money looking for that extra return. That, I think, is the thing that drives the need for a supplementary tool for the Reserve Bank, because, quite literally the game has changed. The world financial scene is radically different to what it was 10 years ago, when we last went through this exercise, and monetary policy proved reasonably effective; it put pressure on the export sector in the 1990s, but we survived, and obviously we had that corresponding period where the currency was very cheap and exporters were able to restore some profitability, and we got some extra investment, and we're probably seeing the benefit of that now across some industries. But the currency is not coming down. We see these brief periods where we have these dramatic shakeouts in the currency, but they are very short-lived—maybe a month, maybe 6 weeks. We advise exporters on their hedging profile, and it's difficult to say to a large exporting firm: "You need to hedge all of your year's exports today, because the exchange rate is about to rocket back up."

So I guess our point, in joining along with Phil, in terms of this submission, is to acknowledge that the world has changed a lot, and I think even the Reserve Bank would acknowledge that that's the fact. That, I think, is what drives the need for a change or an enhancement or an improvement to the tools available to the Reserve Bank, rather than anything else.

Smith Thank you. Is that your presentation completed, Phil?

Verry Yes, we're happy to take questions now.

Gosche I am not sure whether you have covered it in the report, but what do you think the effect would be on the exchange rate, if you did this?

Verry Well, what we've just heard is driving the exchange rate is interest rate differentials between us and foreign jurisdictions. What we're saying is take out the surcharge that goes on interest rates imposed by the OCR, so that magnet effect won't exist, so the exchange rate should fall down and become more stable. But the ideal thing for New Zealand is to have a New Zealand exchange rate that's real boring, so we don't get it kicked around as a toy, which some people overseas call it, and just let it serve its real purpose, which is to transact trade.

Foss So you'd be happy for it to stay boringly at 80c, say?

Verry I don't think it will. It won't stay at that level, because we've got a current accounts deficit which is going to tell us that that's not going to happen.

Foss What is the right level?

Verry Well, everybody's got an opinion on that. My own view is around about 55 to 60 versus the US is pretty right. It depends on whether you want to stay in a position where we're not going backwards any longer, or whether you want to go forwards. If you want to go forwards, you've got to have an aggressive exchange rate—something which actually empowers your exporters to go for it. That is why China is doing so well at the present time; they've got a very aggressive exchange rate.

Tremain You said that the exchange rate could improve or is starting to improve?

Verry Yes, that's right. Obviously, the exchange rate mechanism is sure to have some redistribution of wealth effect. In other words, if exporters do extraordinarily well, then, obviously, I think it's reasonable that the exchange rate should lift, because that reflects the reality. It is not an artificial lift at that point; it's real. Therefore, that wealth can be redistributed by cheaper imports. That's really what the exchange rate should do.

Robertson Phil, has this type of scheme, or other scheme of this type, been used elsewhere?

Verry Not to my knowledge. Certainly, I wasn't able to find anything that was going to suit New Zealand's requirements when I came to look for it. So that's why we've sat down and designed one that is for this purpose. This actually was inspired by a series of meetings I had with Don Brash and his colleagues in the Reserve Bank back in the mid-1990s. They concluded by Don saying: "But, Phil, we've only got one instrument." So I thought: "Well, we'd better go an find another one." And that's really what's led to this research to come up with this solution.

Fitzsimons It's a really clever idea. In your view, is it necessary that the ILSS be operated in terms of the OCR both by the Reserve Bank, or would you have the ILSS operated by the Government or the Reserve Bank—to the OCR—.

Verry No, the way I would see it, actually, is the OCR would stay in the cupboard, as Bryan Gould said—well, it'd be there if something went wrong, but I can't foresee what would go wrong, because if you look at the ILSS proposal, there's a suite of instruments, and there are various levels of stringency, if you like, that can be applied.

Verry Yes, and it doesn't cost more, because we're already paying an OCR surcharge. So what we're doing is not asking people to pay more; we're simply saying: "Don't pay it to foreigners. Keep it."

Tremain I have two questions. ILSS appears to be quite a valid option or policy, and because of that there is a paradigm shift that you propose. I don't see a raft of other supporters. My understanding is that there's fewer supporters from the wider communication.

Verry Well, I think in some ways you have had a few. I think BERL was talking the same language. I think Mr Poletti—was he an economist who came here—was talking very similarly. You heard today from major industry sectors, who really are saying, in their own way, the same thing. Sometimes they're not identifying the solution. Bear in mind that to get up a submission for this process required me to spend a bit of time to generate it. By the time that was done there wasn't any time left to distribute it prior to other people making submissions. So all the submissions were in before they really knew where we were coming from, unless they picked up on some of these points I'd been making publicly prior to this.

But when you talk about paradigm shifts, sometimes that is necessary, and I think Mr Houlahan has described why—because the world has changed. We now have globalisation of markets. We can't control our money supply any longer. It's been controlled by market forces, so you can't use an instrument that assumes ability to control monetary supply, because we can't do that any longer.

Not so long ago, just to give you an indication, and this is not a view that's held only in New Zealand, I might add, Professor Steve Hankey, who is a very prominent USA economist, and was voted some years ago as one of the most influential people in the world—he advises Governments and presidents and all sorts of people—he on Leighton Smith's programme described the New Zealand economy as being in a "death spiral". Leighton Smith asked him why, and when he gave his explanation—because I was asked to listen in to this programme—it was exactly the analysis that we have in this submission we've made to you. In other words, he's recognising the same deteriorations, and he was saying: "If you keep on doing what you're doing, the death spiral is only going in one place.", and that's, really, what his analysis is.

Tremain — One technical question. Because there's obviously an interest rate margin differential in the New Zealand interest rates against overseas countries, how do you address that overnight?

Byett — You could do it incrementally. We talk about a paradigm shift, but we don't have to leave the OCR. The OCR can be there. It will be there, in fact. You'll need an overnight cash rate. This can be done incrementally, where you introduce that extra surcharge and reduce the OCR at the same amount, and just incrementally narrow the two until eventually—well, it's my view—the OCR would end up, roughly, the average world interest rate, but other people will have different opinions about that.

Tremain — There's a problem I have if the interest rate is essentially going up, it's OK, but not if it's going down. In this model we can't start from a situation of falling interest rates.

Verry — We have had situations in the past where the New Zealand interest rate probably didn't have a surcharge on it, so it does go through cycles where because we have recessionary influences in the economy, where the interest rates just decrease to a point where there probably isn't an incentive for foreigners to invest in this country by preference, because the incentive is taken away. So a lot of it comes back to timing.

What we're advocating—and just to wrap up, Mr Chairman—is we're not asking, as we said before, to do this tomorrow; what we're asking is for a process, and what the process is, and we've given it to you in writing, which the secretariat will distribute to you, is to say if you set up a task force to look at this proposal, and then we'd want you to model out and make sure there are no wrinkles, and I don't believe there are any significant wrinkles—there are no obstacles to this; this is actually not hard to do. Let's do it through having a task force, so you get the political comfort of knowing that it's been properly developed.

Then do some modelling going forward for, say, 15 years, assuming ILSS and then assuming, as a comparison, the OCR. I think you'll be amazed at the difference you'll have in 15 years from now.

Woolerton Just very quickly, Mr Chairman, in regards—I think China is the smartest place on the planet right now. They've identified their market, set their dollar a bit lower, and look what happens. But they're big. America doesn't like it, and they can't punish China. Can you see much coming through us by the introduction of your scheme?

Very No, none whatsoever, because we're asking for the market to operate without interfering with it. So the market will find its own equilibrium points. It'll solve the problem; just don't get in the way of it. What we're doing at the present time is we're getting in the way of the market, and that's what's causing these severe imbalances in our domestic economy.

Smith Gentlemen, thank you very much for a very interesting submission. I appreciate that very much.

Transcripts

Inquiry into the future monetary policy framework

Finance and Expenditure Committee

24 October 2007

Members

Shane Jones (Chairperson)
Charles Chauvel
Hon Bill English
Jeanette Fitzsimons
Craig Foss
Hon Mark Gosche
Dr the Hon Lockwood Smith (Deputy Chairperson)
Hon Paul Swain
Chris Tremain

Witnesses

New Zealand Exchange (Submission MP/63)
Mr Mark Weldon, Chief Executive

Jones	OK, Mark, you've got about 15 to 20 minutes. We've got your submission, ploughed through it. Generally how we've conducted these proceedings is to give the submitter 5, 10 minutes to open up, and invite my fellow committee members to quiz you. So the longer you talk, the fewer questions—over to you.
Weldon	Thank you. I will give a short introduction, in that case. When monetary policy was put in here it was world class, driven by the need for transparent governance arrangements. All those things have worked perfunctorily and are not under discussion, at least from my perspective. However, what we have in our monetary framework is actually a system that needs looking at. So we certainly welcome the inquiry. Unfortunately, most assessments don't look at how the parts of the system interact and how they might play out under different scenarios. So that is what I will focus on.
	Monetary policy simply put—back to basics—provides the conditions under which long-run potential GDP and national welfare can grow. It is not an end in and of itself; it's a means to an end, albeit a tremendously important means. My view is that there are five things that we would encourage the committee to look at and think about how they interact together, and have some recommendations on each of those.

The first is the nature of the targeting, which is very strict. It is strict in a particular context, which is that of a small, open economy. That strict targeting in the context of a small, open economy has become a real driver of risk in the broader economy and the real economy for a few reasons.

The first: it implicitly provides insurance for currency traders who can speculate on the dollar with a reasonable degree of certainty around interest rate changes. In essence, the so-called Greenspan put is reversed. We've actually got a market with a put on the bank, which is the wrong way around—it keeps the interest rates and the exchange rates reasonably high. The strict definition does not allow sufficient judgment around the long-term impact of short-term data and short-term interest rate changes.

If you look at the higgledy-piggledy nature of the interest rate, the OCR graph over the last 6 years, you can see there is no long-term structural initiative in terms of interest rate setting. It is very short-term driven. In conjunction with the fact that it's operated on a 6-weekly cycle, you inevitably end up with a situation that I would phrase as being "prescriptive, narrow, and mechanistic" where short-term data drives decision making and what that forces in the system is a tactical bank rather than a strategic bank.

The second main area is the narrow scope of inquiry because of the nature of the CPI and policy targets. The bank is unique in ignoring equity markets, paying scant regard to long-run potential outputs, so, quite simply, comments such as "the economy's overheated at 2 percent growth" are impossible to make sense of unless we have a sense of what is happening to the potential GDP. If the potential GDP is expanding at, say, 3 percent because of technology adoption, change in the immigration mix, or skilled workforce, then 2 percent is not actually a big number. Conversely, if potential GDP is at zero, 2 percent might be a big number. But that number by itself is essentially meaningless, and work needs to be done on assessing what's happening to potential GDP.

The next main point I would make is around tail event risk. At this juncture I think there's enough work being done internally and externally that potential damage of a housing market collapse would be significant. Creditable international work from Columbia University and elsewhere is showing of all the 17 OECD countries we're at the greatest risk and have the greatest impact. But under a narrow CPI approach the way the system would work we could, for example, end up with oil prices going up, food prices increasing, any exchange rate fall increasing, imported inflation, and a real recession in the real economy, which monetary policy narrowly scoped without regard to long-term output changes, would be ineffective and mitigated against. This is the complete opposite of what I would recommend, which is the Federal Reserve approach, which is a balance between price stability and long-term output, one that is less prescriptive around the exact data that is looked at, therefore provides less insurance for the markets, provides greater risk—two-way genuine two-way risk for currency speculators—and allows tail event risk to be taken into account—that is, strategic decision-making in the context of short-term data.

Finally, two very quick things. Currency: the Reserve Bank should not speculate on currency. If it does we should be held accountable to a return equivalent to what a market trader would require for that risk. I would put that risk at about 20 percent, so if you put a billion in you would expect a $200 million return annually, should perform against that.

Finally, seeing as how the Reserve Bank waded into the sphere of immigration in the context of a real economy where interest rates are high, the cost of capital is very high for the real economy to restrict immigration and an already tight labour market does two things: one is it puts wages up, which directly flows through into wage pressure and wage inflation, and puts consumer credit up as wages grow and lending grows on the consumer side. But, more importantly, from a number of companies and corporate economic health perspectives, it really means that the two drivers you have to change your productivity settings, which are capital and increasing the talent of your labour, become very, very difficult to do.

So those two things in conjunction—a high interest rate environment, tight labour market and high exchange rate with a prescriptive monetary policy framework—in a downturn creates some real risk for us. So we recommend a broader scope, move away from 6-week cycles, expand the data looked at to include equity markets' potential output, change the focus on immigration, and eliminate speculation on the currency.

English — I'm just trying to work out what you mean by that. What actually looks different?

Weldon — In what respect?

English — To make the changes you've talked about, what actually looks different in a formal prescription of that framework?

Weldon — You would move away from 6 weeks. You would have the banks explicitly charged with taking the long-run output into account and thus its behaviour would be less predictable, and less insurance would be provided to the market. And if you extrapolated, for example, that the housing market were to collapse and it were to result in an 8 percent decline in GDP over the next 2 years and that would result in this, then you might treat short-run price data a little bit differently. The concern obviously is if that is imminent, under the current framework, there is not a lot of ability to make strategic change in the OCR.

English When you say it's too short term—focus on the long term; I'm trying to work out what your major concern is. The major concern lay with the interaction between the bank and the markets and the way that extreme examples—the market's got an option against the bank rather than the other way around. Is that it or is interest rate structure being too high? What particular concerns are driving the—short term?

Weldon Yes, those both. One is that the bank is an actor in the market not external to the market and the put is on the currency trade. They do not have the right amount of risk under the current framework. The second is in the context of the high interest rate environment with a potential recession, which is a scenario even if we were on the upside should be considered in assessing and determining your ideal framework. You do not have the flexibility with a narrow targeted approach to take into account changes that may spiral on long-term output. So the framework itself might—in my view, quite probably would be—a catalyst to deepening any recession that we move into.

English So you would say: "OK, we are not now going to target inflation—we're now going to target longer-term output."?

Weldon No, you would target price stability and incorporate longer-run output as a factor. But it wouldn't be prescriptive data-driven, so right now if you just get on any website or look at what happens when a particular item of data comes out, the market has a model, they feed that in, they see what's going to happen to the number, they know what happens to the chance of the bank changing the interest rate.

Jones So what number would you be happy with? Would you have the Reserve Bank go into freefall?

Chauvel Would you go under 3 percent?

Weldon Yes, I don't think there's a problem with the number of 3 percent; I think the problem is that it's prescriptive. People understand how it's derived, how it's defined, what feeds into it, the bases that feed into it, and the fact that nothing longer term does feed into it.

Jones So Mark, how would you see, then, people managing their inflation expectations over the course of the year? Because arguably a firm 3 percent gives them an anchor around which they are going to root certain expectations.

Weldon Yes, that's possible. You would also argue that firms who manage their wages will look at what the State sector pays. So 4.5 percent, or whatever the number was a couple of years ago, that was, in the private sector at least, bandied around as the number that was baseline for wages. So I'm not really sure. I think it depends on what decision you're looking at making. But I don't think you would change the number of three. I certainly wouldn't have any appetite to put the number up or change the number. You wouldn't want any framework and I don't think under the Japanese or the US frameworks, which are more balanced, less point based, there is a noticeable difference of inflationary expectations.

Jones — But really what you're saying is you're wanting to take the potential for gaming out of the system.

Weldon — Potential for gaming out and potential for flexibility risk management up, exactly.

English — What does that actually mean? We've been through a process in the last 10 years where each time there's an argument about monetary policy framework, it boils down to people saying: "We want more flexibility.", and if you look back over the 10 years, the result of it is there's a higher base of inflation, but we haven't actually been able to—cycles or exchange rate cycles—that sort of happens anyway. So you seem to be suggesting a variation on the words in the PTA, which currently include taking account of stability—. So what difference do you think that's going to make? It might change the balance of risk with the market—well, it might or it might not. Five years down the track, what would be different?

Weldon — Well, there was some work that looked at the US and Japan, which, as I say, have broader definitions against countries that don't, and showed that data which was short-term, inflationary, surprise data had a lot less impact, or null impact, on the exchange rate than in countries like New Zealand. So the first is that simple feed-through mechanism would be dampened. There's no question about that.

English — Less volatility.

Weldon — Less volatility, yes, which for our economy and our exposure on imports and exports is pretty material, probably more material than to Japan, certainly Japan probably to the US. Then, secondly, I would just want to understand—I cannot get my head around how right now in an economic real-tail event how the Reserve Bank can adjust monetary policy over any period of time to take account of that and what it actually does.

Swain — Yeah, just a couple of questions on—package, there'd also be many, many a fiscal high priest ensuring—. Two questions: firstly, how would you describe the change in a broad sense? Is this a big change or is this a minor change with some adjustments within the framework? And the second thing is, what's the answer back to the high priest who say: "As soon as you take the focus off one day, people lose the ball."?

Weldon — Yes, in terms of the first question, I think it's a series of small changes that, overall, rebalance the system and its scope, rather than a fundamental shift away from inflation targeting to price stability targeting. Clearly, that is fundamentally important. In terms of how you would look at this in a general equilibrium neo-classical model, it shouldn't really change. I don't think there is a lot of criticism of the way the Fed conducts inflation targeting. But it is more opaque. It's less set in what a given bit of data will do to their decision making. And they certainly do, as was recently seen, have more flexibility around setting strategy.

Smith When I read the submission, the bit that struck me most powerfully was that you seem to ignore the circumstances in which monetary policy's operating at the moment and advance an argument that it's not working very well right now. I wondered why you ignored such things as the impact of fiscal policy—all about whether or not monetary policy is being asked too much, whether in fact the wider policy setting also impacts on inflation by putting so much pressure on monetary policy it doesn't matter what kind of monetary policy you have, it's going to be in trouble. Because if we took your argument about the long-term use, right now one could interpret that as saying you think the Reserve Bank's—tighten up too much, so you want a bit more inflation in the short term. By and large New Zealand's history is not great on that. There's a significant sector of our economy that can't pass on inflation. I just wondered why you ignored the other factors. Monetary policy does not break the bank by itself; there are other factors that have such a profound impact.

Weldon Yes, great question, thank you. I didn't feel there was any evidence that the Reserve Bank was not making the right decisions under its targets and that that was clearly not in scope. I didn't think that having something that was in particular driving a framework because of what the data happened to say right now was really a sensible way to look at something like monetary policy, which is a very long-term issue. So I really wanted to focus my inquiry on how the bits of the system and the framework work together under different scenarios rather than expand it, and say at this point in time what could the Government, broadly scoped, be doing better on monetary or fiscal policy—.

Smith I suppose what I'm getting at is—the Institute for Economic Research argues there's a lot of pressure coming from New Zealand economic fiscal policy and the supply side issues around taxation—that kind of thing—that is making the challenge for monetary policy almost impossibly difficult. It doesn't matter what kind of monetary policy settings you have, that the challenges we face on monetary policy are just too great for these other factors.

Weldon Yes, but if you went down that line you would have to start looking at what the lending policies at the banks are in terms of fuelling the housing market, which is equally material to some of the asset pricing pressure that we've got. So I think those are certainly questions that someone should be asking. I just didn't feel it was my job.

Foss — Just a couple of points. One is this tail event risk. You talk about the Reserve Bank looking at the risk of the—approach, that is fine. But I just wondered if could you talk on the chances of a full housing boom in New Zealand, a full peak recession with the loss of 8 percent of GDP, that's about $15 million, I think. So—what chances are there of, say, a housing boost in New Zealand do you think there is?

Weldon — I think they are reasonably material. I think the circumstances in New Zealand are quite extraordinary with the amount of leverage on every average household balance sheet, with the proportion of housing as a percentage of total assets owned by New Zealanders, with not a lot of ability to change short-term demand dynamics, particularly around immigration, and the sticky nature of mortgages.

One of the things the banking sector has done in reaction to the nature of the OCR is it's said: "Well, look, consumers aren't happy to have their interest rates move around every 5 seconds.", so over the last 5 years of constant changes the private sector has moved to fixed rates. So you've got people locked into fixed rates, which if you see asset prices collapse you will then start to see consumer demand for jobs start to change and the whole thing really would feed upon itself pretty dramatically here. It's not an economy that has a lot of resilience of its household balance sheet outside of housing.

Foss — I read that you're pretty critical of the RB's execution. I think it is the—when you start to—expressions. We don't want more inflation. We need some certainty that the next—report's going to be moderate. But then the point that you people talk about—you're very staunch on this—the RB should be prohibited from currency speculation. Now, Dr Bollard argued that they were hedging the New Zealand balance sheet—or something like that; I presume that's the changes they've made. So totally prohibited—right now they've probably made some million and they've probably lost that—currency snap either—. So again would you have the exchange rate play much of a part in that model—that general model?

Weldon — There is certainly a lot of work out there that says small open economies should incorporate the exchange rate in their monetary policy settings. There's other work, which I would agree with, that says if you have long-term output as a factor you don't need to include the exchange rate explicitly because that's how it gets incorporated. The danger, I think, in our economy of including the exchange rate explicitly is that it's the single most immediate lever the bank has on inflation. To change interest rates, exchange rate changes are important in inflation changes. So you start to create some real moral hazard if you include the exchange rate explicitly, which is why we'd look at long-term output, and the level of the exchange rate is an input into long-term output.

On the exchange rate speculation, I think intervention is something a police person does with the legal ability to break up an interaction. The

Reserve Bank has no legal ability to change the level of the exchange rates, not in intervention—it's trade. A couple of days in the last few weeks there's been $25 billion go through on a day.

So in aggregate if they speculated a billion the potential ability to change the market's about zero. It's bad for our banks' brands globally. I don't know if you read the editorial in the *Financial Times* the next couple of days. There's not a lot of upside; there's financial risk, in my personal view. Risk managers don't make great speculators.

Foss — So prior to that intervention, was it your view the financial markets—the RB's reputation in financial markets is a little bit lower than that, of course; they—intervene a few months ago—.

Weldon — Yes.

Tremain — One of the points you made—point 7 in your recommendation—about us having a high interest rate policy and that being one of the reasons that it's promoted a housing bubble—in summary. The point that you make—it hasn't been made in a lot of the other submissions—is the need for us to focus on the finance companies that are—. Just talk me through that, just quickly. Why do you see that as—bubble?

Weldon — The reason I didn't mention it in the introduction is obviously there is legislation under way to address most of those issues around finance companies. It will change the cost of capital and the monitoring of those.

Tremain — And you think that the cost of capital—more accurate in assessing their risk profile—.

Weldon — Yes.

Fitzsimons — You've been predicting a big increase in inflation—taking the heat of wage bargaining and then for taking the heat off—. Wouldn't that be countered by the effect that would have on house prices if you suddenly reduce demand to 20,000 new homes. Wouldn't that then inflate the housing bubble further, probably—that you're talking about and make it worse when it happens?

Weldon — If wages go up an extra percent—I don't have the data, I don't know what percentage of GDP wages are, does anyone know? But if another percent goes up that's a reasonably material number. The other thing on housing is that estimated prices and availability of credit do play through a little bit more slowly. But, again, it doesn't talk about the housing market in the Reserve Bank Act; it actually talks about the CPI there. So it really should only matter how it flows through into actual consumer demand and prices.

Fitzsimons — Are you saying the Government shouldn't be concerned?

Weldon	No, they clearly should be concerned but I think the longer-term and more material concern is that wage pressures are growing. There's no question about that at a point of time right now where capital costs are high for firms and the labour market is very tight it will feed through immediately. It is feeding through immediately into wages, which goes to inflation and goes to consumer demand. It goes to a whole bunch of things, including productivity, which we haven't discussed but is clearly something that the Reserve Bank mentions occasionally in its—
Fitzsimons	Are you basically saying that Australians' wage bargaining pressures are more important than Australian—.
Weldon	Yes, although with the use of the word "wage", I'm not necessarily saying everyone would come in at the wages sector versus the salary sector, if that's a distinction. It's across the board, really. Top down.
Jones	You're saying in relation to risk appraisal you've invented a new paradigm and the current account deficit is actually irrelevant to the psychology of those people who are driving the value of the currency. Have I understood that right? Actually, we regard with some wariness anyone who's discovered a new paradigm.
Weldon	I think there are a number of people out there. What you do is you hire a bunch of smart quantitative people, look at when the next announcement is, assess your risk, and make a trade. It's pretty simple. It's not a long-term paradigm; it's a "What's my investment?", "What's my trading horizon?" question. Look, some of these guys over time will get it wrong, but their view is they're less likely to get it wrong and they'll take that risk than someone who will speculate based on the current account. I think the average number per day is on our trade $500 million of exchange rate flow versus a day where you've got $25 billion transacted. I think the view that most people who are on that $25 billion have is that the dollar is tradable as an asset. It's traded for its return rather than the ability to buy produce. It's just a weight of money argument.
Smith	In some ways that brings more stability.
Jones	Let's not get into the vagaries of trading currency.

Gough, Gough and Hamer Investments Limited (Submission MP/92)
Mr Robert Gerrie, Chief Financial Officer

Jones	OK, Mr Robert Gerrie—Gough, Gough and Hamer chief financial officer. Firstly, on behalf of the committee, thank you very much for making the time available to come to talk to us, and not surprised that we have a few questions we'd like to pose. You're familiar with the terms of reference of our exercise here. I invite you to make whatever introductory remarks you think are appropriate. We're genuinely

interested in the position that your firm has in relation to the volatility in the dollar, interest rates, and other observations you might have about the productivity. So, over to you, Robert.

Gerrie Gough, Gough and Hamer is a privately owned company. We've been in business since 1929. We've been a Caterpillar dealer for 75 years. Presently, we import Caterpillar equipment, engines, heavy transport equipment to the transport sector—hydraulics and fork lifts. We provide a network of services and parts throughout New Zealand and Australia. We also do testing of oils—sampling. We also have a finance company that supplies finance for the equipment that we sell and other appliance finance needs. We do that by a securitisation vehicle and we fund that through the commercial paper market.

Our activities involve supplying equipment into forestry, earth moving, construction, trailer building, trucking, and manufacturing industries. We provide employment for about 950 employees through about 65 locations through New Zealand and Australia. We believe that a strong and profitable export sector is very important to us.

A lot of our clients are spending capital expenditure and infrastructure, and the influence of a high exchange rate and a high interest rate has an impact on us in terms of their ability to purchase and fund in the medium term. So we are very interested in the way that the mechanism for setting both the exchange rate and the interest rate in New Zealand impacts on our business.

Jones So do you have a sense of what level of dollar value enables the domestic production to continue and still allows you to bring in equipment at a sharp rate as an importer? Like 55c has been the traditional 10-year average. Presumably it's moved higher now.

Gerrie We think somewhere around about the low 60s with the US dollar would be where we would consider it to be a good trade-off between the return for exporters and a reasonable price for the imported product.

Tremain And then, looking at your own business, if you were looking at the dollar's trading over the last few years, and your own business turnover in terms of—small businesses, has that change in marketing—.

Gerrie Especially in the forestry industry. We had a concentration of over about 50 percent of our volume going into that forestry industry. The downturn in 2003 and 2004, plus the increasingly high dollar, we've cut that exposure back to around about 33, 35 percent and put the investment in other areas. So it has an impact on where we sense that. Obviously, we're heavily into roading construction, so obviously the Government spend is quite important to us in terms of the infrastructural change.

Foss	With the currency—do you plan a sort of long-run average throughout your—or something now. Do you pass those costs on, so you can afford equipment to resell—so you pass those costs on, so therefore those people even in the export industry—or roads and forestry, etc.—even they can invest in capital cheaper than they could? In another exchange rate, of course, their receipts are going to be the other way around. — that you see that.
Gerry	We basically pass it on. We don't return a higher or lower margin based on the exchange rate. But it obviously impacts on the ability for those individual companies to actually pay for what they've purchased, both at the time of purchase and the fact that we financed them into that sector. But we sort of obviously hedge as the currency was increasing, and obviously we take a gamble both ways and probably don't hedge everything. But we hedge on the way up, but if it keeps going up in the long term that makes us a little bit uneconomical to be positioned in the marketplace.
Foss	You don't have to answer this if it's confidential information. Your turnover, when the currency was around—or even 40c, your turnover then versus your turnover now, say, there is a marked percentage change. You are moving a lot more equipment and goods with this exchange rate. You're selling a lot more?
Gerrie	No. It's pretty static really. There have been a couple of aberrations in the fact that we've supplied a large amount of mining equipment that doesn't come year on year. So we've supplied it to the Reefton mine last year and to the Otago mine back in 2003. But year on year, no, we're not seeing a massive increase—in the exchange rate. So it's reasonably flat.
Foss	You've got the finance company—where do you source the funds if you wanted to—.
Gerrie	Our—vehicle into the commercial paper market, and locally. It has been reasonably stable up until about the last 3 months, where the market both changed and the supply dried up, and also the price went up about 40 points.
Foss	And what was it—prior?.
Gerrie	It's usually about eight or nine points below the bid rate.
Foss	And that's purely a function of the dominoes—. So that's drying up short liquidity?
Gerrie	It has, and obviously to some extent we've used standby banks to facilitate that position.
Jones	You can't afford to run out of liquidity in your business, mate.

Gerrie No.

Smith I congratulate you on the longevity of the company. Gough, Gough and Hamer would be one of the few New Zealand business I can think of that's been around all my life. I remember the days of the old—in the 1960s. But the question I'd like to ask is, you talked about the impact of the exchange rate on the cost of appointing—the growth of businesses you supply. The construction industry used to be an industry you guys serviced hugely. In days gone by most road construction in New Zealand was probably done by—going back years, and it was done hugely quickly. I remember, for example, the sight of State Highway 12 in Northland, and it went through—with a fleet of I don't know how many—a massive number. These days I observe the ALPURT sector, B2 being constructed in Auckland, and think there were a couple of smallish earth-moving machines there, and it was the most expensive project of roading construction being done in New Zealand. To what extent does regulation, involving your clients and businesses—to get on and do things quickly affecting demand for your product, because, as an observation, there seems to be so much regulation around the way we do things now that—might be used for a longer time, your clients' business seem to be so constrained by regulation. Is that an observation that's way off?

Gerrie I think it's a little bit extreme to one end. I think that some of the regulations about operating within time frames, especially over the winter period around the Auckland area, has some major short-term financial issues in terms of the cost of capital of holding these kinds of machines, versus the productivity that goes through them. I think that's probably the biggest factor. I think using the equipment effectively over the capital life of that equipment—.

Jones Less idle time.

Gerrie Less idle time, yes.

English What do you want it to look like—the monetary policy framework? From what you've said, the ideal for you is a stable exchange rate—.

Gerrie Well, if that's where the economic stability of New Zealand sits, that's fine, but what we know is there's a lot of short-term volatility in the currency, not necessarily directly related to the actual productive growth and productivity of New Zealand. We see that as a little bit speculative. We also think that a high interest rate impacts on business in terms of having to adjust its working capital to stay within its banking constraints to be an impediment to ensure that we've got the appropriate level of equipment to actually sell and invest. There are some issues worldwide with earth-moving equipment. The supply side of it is quite difficult and the lead time is quite long, and in fact most of it ends up in China. That brought some issues. We tend to hold higher stock levels because the

	customer doesn't really want to wait 12 months to get a digger. He just wants to get a digger and dig a hole. As the consequence of that, high interest rates and holding costs cause us concerns about the capital level of the business.
English	So are you making permanent adjustments or temporary adjustments—we see about the outlook, say, for the next 3 years tend to indicate that inflation is going to stay high, interest rates are likely to stay high even if they don't go up, and, given the way the equation works, the exchange rate is unlikely to be a hell of a lot lower. So do you have to make a permanent adjustment or do you think these things are going to pass over and be back into—
Gerrie	We make a permanent adjustment about the working capital level we have to have in our business, and that will restrain our productivity to grow our business.
Jones	How long does it take to get one of these large carriers or something like that made?
Gerrie	You might have 6 to 8 months' lead time.
Jones	OK. So you put an order in, confident that road-makers, forestry guys, etc., will want X amount. You've got some forward orders. You fix a particular time and at the moment with the pressure on the supply side, are you getting them all within a year?
Gerrie	In most cases yes. There will be some specific equipment to go into certain areas that you might wait 18 months for.
Jones	And ordinarily, you do the transaction, you fix it all?
Gerrie	If it is a specific piece of equipment for a specific purpose and we've got a fixed order we will fix the price.
Jones	So you get to say the truck prices.
Gerrie	If it's something we know will be sold over a period of time we will hedge some of it and take a position that that will be the price we'd sell it to the market.
Jones	So when the dollar gets to 78c or 80c you're able to take a period to cover, confident that you're going to have the sales to meet the—obligations?
Gerrie	For certain sectors of certain parts of the equipment, yes, we do that.
Jones	Just coming from an export background myself, we hate the—.

Gerrie — I've spent some 12 years in the meat industry, so I know exactly what the high dollar is.

Jones — OK, for fear of Dr Smith talking about Belgian blue cattle, are there any further questions? OK. You're possibly the only one that we've heard from who's got hands-on—approach, and I'd like to thank you on behalf of all the committee for making time available. If there is anything of a more detailed nature that either we or our Treasury officials would like to hear about, we'll get back to you.

Gerrie — The only other point I'd make is that one of our biggest problems at the moment is getting skilled labour both in New Zealand and in Australia. And we're finding it increasingly difficult—

Jones — The Aussies are pinching it. They're taking it all over there.

Gerrie — Even in Australia we've got an operation where we supply trucking parts and trucking operations, and we find it extremely difficult to get people to do welding and simple things like that. We'd have lead times of 8 or 9 months to get work through our workshop just because of the lack of skilled labour.

Swain — Do Gough, Gough and Hamer do any kind of apprenticeship training system?

Gerrie — Yes, we are doing that, but what we find is that we spent a lot on training our people and they either get stolen to go into the mining industry in Australia, where they've got the Caterpillar equipment, or they'll go overseas. Even at the higher level where we do—level training and stuff like that, with the shortage of skilled labour in New Zealand we get them stolen. So we've spent a lot of money on training and then we lose our quality staff, so it's a bit of a loss, really.

Swain — What's the answer to that?

Gerrie — Hopefully attracting more people to either come back to New Zealand or to come to immigration with the appropriate skill levels.

Swain — Have you used the immigration process, and how do you find it?

Gerrie — We find it very good, but we're now advertising for people getting on a plane to Heathrow to come back and, catch them before they actually get here so that we can employ them. Once they get here the demand is that strong that we lose them or we don't get even get a chance to actually hire them.

Jones — OK. Thank you, very much.

Talleys Fisheries Limited (Submission MP/23)
Peter Talley, Managing Director

Jones	OK, welcome to Mr Peter Talley. You need no introduction to our committee. You're aware of our terms of reference, and it's a pleasure to welcome you as a member of the export community. Over to you.
Talley	How much time have I got, Mr Chairman?
Jones	About half an hour.
Talley	Well, I won't go through the introductions. For that last 10 years New Zealand has lived at a dollar rate of about US55c, and we've all become accustomed to operating export businesses in that bracket. For the last 3 years, of course, it's gone up and I've now come to the conclusion—or I should say, we have now come to the conclusion—that our dollar is not going to go back to those levels. I think that all of New Zealand has to learn to live with a high dollar, because it's obvious that you can't control it with the mechanisms available to the central bank. There's too many outside pressures on it, and so in our own business we have tried to shape the way we do things so that we can survive. I've developed gills in the last 18 months so I can live under water, and it's amazing what you can do when you have to. So I don't think New Zealand is going to go back to a cheap dollar. I think we've got to learn to live with a high dollar, and that's a major swing for me, because I used to wake up every morning praying that the Reserve Bank would drop interest rates and the dollar would go down. I've now come to the conclusion that that's not going to happen. Now, if we are going to have to live with a high dollar, it's absolutely critical to New Zealand's future that we have an economy that allows us to be competitive. At the moment our economy is not competitive. You only need to look at the number of export businesses that are disappearing offshore, or closing down, or relocating. In Australia they are far more export orientated in their business, in their economy. The Australians' exports are three times higher as a percentage of their GDP than they are here in New Zealand. I have got a vision for New Zealand, that if we could make it a strong economy, it allowed us to be competitive, it lowered taxes, we could easily entice a large percentage of those million New Zealanders that are living offshore to come back here and live, because there is no doubt about it; New Zealand is a much nicer place to live than Australia, and I must say it's a much nicer place to do business than Australia. Australia, as you know, is over-regulated, over-governed, and New Zealand is definitely simpler, but we are just not competitive, and unless we do wake up and get competitive I have a strong concern that we could end up just another Pacific Island nation. There is no doubt about that—that our economy is slipping. If you want to propel New Zealand further up the OECD countries, as our Prime Minister has said she wants to, we're going to have to achieve a 4 percent growth rate and we are just not going to do it on the policies

we're operating on at the moment. For the last 6 years New Zealand has experienced tremendous economic growth, and all of the benefit from that growth has been squandered on what I call an over-bloated bureaucracy. The bureaucracy has taken all of that benefit out of the system. Our hospitals are no better. Our infrastructure and our roads are no better, and it's a shame. Some of that money should have been directed back into the economy to make us stronger so that we are more competitive.

In our submission you will see that we talk about a productivity commission that the Australians have. This is a wonderful bit of legislation, in so much that if a regulation comes up it has to come to this independent commission that will say whether it's going to affect the productivity of Australia as a nation or not. I would strongly recommend that New Zealand has a good, hard, close look at that.

One of your terms of references as a committee is productivity, so I really want to focus my short time I've got with you here on the productivity point of it. I really don't know much about the OCR. I find it very, very confusing and, I must say, very disappointing. So we've made the decision to live with it, and what I want to do is try and make New Zealand more competitive so that all of the businesses are not shifting offshore, and that is what's happening at the moment.

You look our Feltex; our company did due diligence on trying to buy Feltex. Well, we were horribly outbid, as were other New Zealanders that bid. It was taken by the Australians. No sooner did they buy it than they shifted everything offshore to Australia. One of the interesting things in that due diligence programme was that Feltex, right up until their last dying throes, they were picking up about $15 million a year from the Australian Government for their operations over there under a programme called SIT, which is the Strategic Investment Programme. They were getting $14.7 million, is the exact figure they were receiving. So it was understandable that the minute the Australians bought Feltex, they'd shift it offshore.

All I ask you to do as a committee; you should really have a look at this Strategic Investment Programme, similar to what Australia has got, because there are ways of increasing the productivity in New Zealand without costing the taxpayer any money. I will give you an example of that, and that is accelerated depreciation on certain items of equipment. In the meat industry, for argument's sake, our industry is dragging the chain in productivity. We are just not anywhere near as productive as what we should be as a major sector of the New Zealand economy. There's a huge amount of capital to be invested in such things as auto-weighers, auto-packers, hock removers—the list just goes on and on. Most of these machines cost anywhere between half a million and a million dollars each.

People just aren't going to buy them when they get a 10 percent write-off because you've got it sitting in the shed and by the time you've come to pay it off, it's redundant because there's a new one down the road. So what I'm suggesting is that with those types of machinery, and you can have it tightened up, you need to say: "Right you can have accelerated depreciation on that item—even 100 percent write-off." It's only a timing thing for the tax collection. It is not as if you're giving the industry a grant, but you're giving the incentive to get out of the bed and make some investments in some productivity growth. If we don't fight this productivity issue on the head, all of our jobs are going to disappear to China and to India.

I only need to look at my own industry, the seafood industry, where now you've probably got over 50 percent of all the fish is now being processed offshore in China. I think that's deplorable but it's a reality. You only need to look at the number of businesses that are relocating offshore. It's because we can't do it here. What we can do, we can compete with China in any business sector where we've got a high level of mechanisation, and today you can get a high level of mechanisation in virtually—even in the meat processing industry, you can go it. But you're going to have to give us the management tools to do it, because we haven't got the stomach, we haven't got the confidence, and we haven't got the money to do it under the present regime.

If you look at business now in New Zealand, you're paying about 8.75 percent overdraft. You are very, very lucky in any business sector to get an 8.75 percent return on your business. You just can't do it. You should really be getting a 20 percent return to keep things charging ahead. So businesses look at it and they say: "Well, what am I going to do? I'm going to sell." They put their business on the market, and the Australians and the private equity funds come over here and buy it up, and so you find a whole lot of well-established businesses disappearing offshore into foreign hands. I think that that is wrong, and it could stop.

My vision of New Zealand is if we take the bull by the horns and really have a steady hard look at what we can do to our economy to make it more attractive, we will find that we could compete with those countries. But it won't just happen unless somebody says: "We have got a problem." I think there is too much complacency in the New Zealand economy. I don't think enough people realise just how serious the situation is. Every day in our own business we've got people coming and telling us that they're going to live in Australia, and its really quite unnerving, actually, particularly the skilled people.

Jones — What are you finding, Peter, when skilled New Zealanders are migrating? How big a jump is it for your other employees to increase their productivity to replace those skills? Because that is something the committee is genuinely interested in; the application of productivity thinking not only to capital but to the skills of the labour, as well.

Talley We're not tying up plant machinery if we haven't got skilled operators. We'll bring them through and we'll put supervisors on, so instead of having one person doing it, we'll have one guy supervising three machines through an able person, or something like that. So the cost is there. Our productivity has dropped because of the lack of skilled workers, but we are getting by with it.

Jones Presumably it's provisional. We heard an earlier submitter today point out that they start at a sub-standard level but provisionally it changes, and how good are we at doing that in our New Zealand terms?

Talley Well, the hard fact is there's not enough apprenticeships in New Zealand. Everybody that wants to do it in business really wants to do it. But the reality is in the, dare I say it, the olden days the Government, through the P and T and through the railways and all those sorts of Government divisions, were the breeding ground for all these technical skills that we acquired. We haven't really replaced that enough in the private sector as yet, but I can tell you they are now. I would doubt very much that there's any major company in New Zealand that has not really sat up and taken notice and brought through as many cadets as they have. We with our company would have 40 or 50 cadets going all the time as apprentices.

Smith Your focus on productivity, Peter, resonates very strongly with me. I'm just fascinated one of the examples in your submission about something as simple as axel weights and max axel weights. You point out that New Zealand having the lower max axel weight at the moment of 44 tonnes compared with, say, Australia, at 62.5, you've just got to have so many more vehicles—to transport so much freight.

Talley I can give you a perfect example of that. But the problem here is—this is where I say, the politicians have to have a vision of New Zealand, and they have to realise what we've got to do to fix it. It's deplorable that it's taken 6 years of lobbying to fix that problem, and it's still not fixed. I'll give you an example. What you did with Telecom with the unbundling was absolutely magnificent. I don't think you'll find any business sector in New Zealand that did not pat the Government on the back for that one. You need to now to the same with the railways.

The monopoly that Toll has on our railways is deplorable. We are building a plant now in Ashburton that comes on stream in March next year, and this particular plant is going to turn out 350 tonnes of French fries every day, 7 days a week, 24 hours a day. We want to put our own railway on to cart it to the port of Lyttelton, but we can't. We're going to get the pants taken off us by Toll, who want to do it. And it's wrong that I can do it cheaper on a truck than I can on a railway. If I could rent the railway wagons and an engine, I could load that train up and send it every night through to Lyttelton. You need to look at unshackling the monopoly that Toll has on our railways.

I went to Mr Duynhoven, Harry, and talked to him about the trucks, and do you know what he said to me? This was only 3 weeks ago. He said to me: "Look, Peter, if we do what you ask with the trucks, we're going to send the railways broke." That's exactly what he said to me. He said we've got to worry about the railways. Well, I couldn't care less about the railways. I will give you an example. If you've got a 40 foot container, which is what the exporters all use now because that's what the customers want, you pick the container up on a 40 foot container lifter and you go to the plant and pick up the full container and put it on the truck. You can't put it on your truck because it's overweight. So what do you do? You have another truck following on behind it empty. You pick it up with your container lifter, putting on the other truck, and your container lifter has to go back empty. Now that is ludicrous. If you could shift it from 44 tonnes to even 50 tonnes you could pick up every 40 foot container and carry it there and back on the same truck. Now, that is huge, but it should not take 6 years, and that is where our politicians are wrong, and that is where our bureaucracy is totally wrong. They make it so difficult. If that was a business problem, I'd fix it in 5 minutes. It is not a question of safety because we've told Harry that we would build—it would only apply to new trucks—put the crash barriers on them, bigger tyres, bigger axels, anything you wanted. We just wanted to do it, and we can't. I implore you; those are the little issues that need to be tackled. Sorry to be so long-winded.

Smith No, no; you've highlighted the problem I was getting at. The other interesting thing you argued about depreciation rates. Would it be fair to reason that the depreciation regime has been in place for many years now? I guess with the kind of equipment you mention, the 10-year depreciation rate has I think has been in place—. Is it reasonable to suggest that technology is now changing so rapidly that a depreciation regime that may have actually reflected the commercial life of equipment 20 years ago simply no longer represents the commercial life of modern technology, which is changing so fast? The real commercial life has shrunk and therefore the depreciation regime should be adjusted to match the realities of the pace of changing technology.

Talley It definitely should. I remember going to Damien O'Connor a few years back now, who was my constituent MP and still is, and I said to Damien about the depreciation because we had plant and machinery in the back shed that we hadn't finished paying for that was redundant. He said to me: "Yes, I've been to my caucus. I can't bring it in, because if I do it's going to put too many people out of work." That's exactly what he said, and I will say it to his face. That situation is no longer there today. Here we are, in a business now where I can't get workers. So now is the ideal time to bring it in. If you don't do it, you're not going to get the plant and machinery that New Zealand needs to really pick this country up and shake it.

Swain	OK, a question about railways, having had a bit to do with it. The issue, of course, is that it was a privatised company—and that is obviously—anybody else back into it, or now the Government's getting back into rail—complicated issue here—I mean, it was complicated to deal with—
Talley	Yes, I understand that.
Swain	Was it optimal for New Zealand to bring the rail back? And there were a whole lot of other issues. You're not the only one that makes the point about getting—. As far as trucking is concerned, that is another issue. I understand that point completely, but then again you have to look at whether—changes need to go up to cover the cost of extra—bridges and that potential damage on roads. So it's not just simply fixing it, and then of course you have a whole pile of military—from tourists and all that sort of stuff that are stuck behind these things—. I understand the point you're making, but it's not quite as simple as what you're saying. Never mind, I understand the points and I get the general flavour of what you're saying.
Talley	Thank you.
Swain	You were saying about people going to Australia, which is obviously an issue. Are they going primarily because of wage rates, lifestyle, and are any of them coming back?
Talley	That's a good question. They are not going because of lifestyle, Minister. They are going because of higher wages. Every man, woman, and child in Australia gets 35 percent higher wages than they get in this country—every man, woman, and child. So if we want to match that money we're going to have to increase our productivity and get it up, and that's the problem. Yes, to answer your question, they are coming back when they are retiring. That's not when we want them. I want them when they're in the age group between 30 and 55.
English	I just want to ask you about the comments you made about investment. How do you—you talk about this specifically—industry that there is a whole lot of technology that could be brought in—I mean, on the other hand, the industry also has—. You have made a number of comments—conflicts, but there must be some compelling reasons for survival that drive investment decisions. So I'm just wondering whether some shorter-term depreciation is going to be enough to shift that level of confidence.
Talley	It certainly will. Look at it this way. In your constituency now, in Southland, we've have got a milk powder plant under construction right now. That milk powder plant, the thing is, it's going to have a turnover of about $200 million a year. It's got four car-parks. You go to our meatworks there and there's 400 car-parks.
English	The meatworks got blown away recently.

Talley	What's going to happen is that if we don't mechanise the meat industry, that processing is going to go offshore. In America right now 85 percent of the chickens are sent in a whole form to China for reprocessing and then sent back to America and Japan on kebabs and in fresh packets for the supermarket trade.
Foss	Are the feathers still on the chooks?
Talley	No, no. What they do is the people there, he takes the feathers out, takes the guts out, and puts them in inert gas, ships by rail to China—through America to China—and they're over there and they're processed with their cheap labour and then sent back to the United States. If this meat industry started processing some of its finer cuts into China, you can kiss goodbye to production in New Zealand. You can now buy a machine that will make the lamb rack automatic. Those machines are about $800,000 each. I would venture to say there would be only five of those machines in the country, and there should be 45 of them. This machine does everything automatically, and it can do a nicer job than what you can do with a blade. At the moment they do it all by hand. That's where we need to go to. We need to get there, to that stage. Now, there is no cash flow in the meat business at the moment to make those investments.
Jones	Rationalisation beckons.
Talley	I don't know whether that's the answer, either. It does beckon, I know, through necessity.
Jones	That's the natural conclusion of what you're saying, that all industries are going to rationalise or they're going to lose jobs overseas. That's the sort of underlying message.
Talley	People investing in New Zealand, they are crazy. Money, as I said, has got no conscience. The best place to put your money now is certainly not in this country. Now, that's not our family's view. We want it here. But I would say that 75 percent of the people who have got surplus cash are taking it offshore to invest it, and that's sad; that is really sad. What you have to do as politicians is create an environment here where people can find meaningful employment, get paid a decent wage, and enjoy a decent life. At the moment the only way they can enjoy a decent life is by having two people in the family working, borrowing themselves to the hilt off those greedy banks, and then getting bankrupt by them when they fall over. It's absolutely deplorable what's happening.
Tremain	You made a couple of comments about this idea—in Australia and the assistance there to—talk about Feltex taking advantage of it. Right now we have a similar programme in New Zealand, the regional development—a series of funds that supposedly—business given you feedback, and has your company received any of that funding?

Talley Waste of time.

Tremain So you didn't buy it. Why?

English It's a lot of money. It's about a quarter of a billion that goes out.

Talley Yes, but it's wasted. It's done for these knowledge-based industries and it's done for something that's got a nice big blue sky. It's not done for something that smells or eats grass in a paddock. That is where New Zealand's productive future lies. It doesn't lie in a knowledge-based industry; it just doesn't. Any person who wants to start a knowledge-based industry has set up in China or in India. He will not establish it in New Zealand. There's people based in Auckland right now, from the Singapore Government, that as soon as somebody starts an IT business they pounce on them, they say: "Bring it to Singapore. We'll give you 10 percent tax, we'll give you this, we'll give you that.", and it's disappearing. We aren't getting those businesses. We might develop them with EDA loans and get them going, but as soon as they are going, they're gone. You can't take a cow offshore.

Tremain What would you do in that—chances are that you—.

Talley I don't know enough about it, Chris, to actually pass a considered opinion on it. All I know is that the EDA thing is no use to my business at all, and we've got 5,000 people working for us. It's just a waste of time. They have got offices full of bureaucrats. They have got parties, with the cheese and the wine flowing everywhere, but there's no work going on. There's nothing good coming out of it.

Smith Photo opportunities going on—.

Talley It's a disgrace.

Jones Peter, you respond to that unwanted remark at your peril—from one Dalmatian to another. OK, are there any final remarks? Pete, thank you very much.

Dr Girol Karacaoglu (Submission MP/9)

Jones Our final submitter for the day is Mr Girol Karacaoglu. Thank you for making the time available and for offering us a submission. We have had the opportunity to go through it. Just as a brief word of introduction, we're very interested obviously in your references to Singapore, etc., but in addition to that, we would like to invite you to speak for 5 to 7 minutes and then invite my colleagues to ask questions of you.

Karacaoglu Thank you for your time; it is much appreciated. The key concept that sits on top of all the detail of my presentation is the concept of efficient inflation control, not just the pursuit of inflation as an end in itself. I totally respect the wisdom of promoting price stability as a sound basis for high, sustainable, and equitable economic growth. I also totally respect the wisdom of focusing monetary policy primarily on inflation control.

But once you focus on efficient inflation control and not inflation control per se, then you realise two things: firstly, monetary policy alone cannot do it, and, secondly, how you pursue inflation control becomes critical. After all, we can try to control inflation by simply freezing prices. We can do it by edict. We can do it by threatening people who raise prices, with their lives. And we all know that that would be counter-productive, inefficient, and so on.

I'm giving these ridiculous examples to make the point that how we control inflation is critical. After all, if the pursuit of inflation is going to hurt the growth prospects of the economy, then we're defeating the whole purpose of it, because the whole purpose of inflation control was to promote growth and equity. If the methods we use to control inflation create low growth, growth in unproductive sectors, and inequity, then you have defeated the purpose of the whole thing.

I believe the way we implement monetary policy in this country has converted the New Zealand dollar into a speculative currency, and that is hurting our growth sectors. By doing that, it is gradually shifting the resources of this country into unproductive sectors, and that is hurting our growth prospects.

I recommend in my submission that serious consideration be given to looking outside of the Anglo-Saxon economies to some of the smaller Asian economies where exports are as important for prosperity as they are in New Zealand, and also to smaller economies such as Switzerland, where in Singapore they have switched from an interest-rate-centred to an exchange-rate-centred policy where we have a managed float against the trade-weighted basket of main trading partners' currencies. It is not a fixed exchange rate regime. It is conceptually equivalent to joining a currency union with a group of countries, rather than with one. I note that there is a lot of press given to a currency union with Australia, and to my surprise that seems to have some sympathy. In fact, my proposal conceptually is a currency union with our main trading partners and in all aspects therefore it's superior to having a currency union with only one country, such as Australia, because that currency union puts you in a straitjacket, with little or no flexibility, and that is the worst way to deal with an uncertain world.

The Australian dollar, furthermore, is as speculative a currency as the New Zealand dollar. It is subject to the same weaknesses. With a floating exchange rate you're getting the best worlds, of having both a currency union in effect and also the flexibility of getting out of it if the world economies switch away from an inflation focus to something else.

The reason I recommend the currency managed float is because in the current world where most of the trading partners are very effectively controlling their inflation, a managed exchange rate locks you into a low world inflation in the traded good sectors. If we were a Singapore with our exports and imports independently being over 100 percent of GDP, that in itself may just do the trick. In New Zealand we do not have that situation. We have a very significant non-traded goods sector, and therefore a managed float regime will not deliver the goods. It won't deliver low inflation on its own; nor will it deliver efficient inflation on its own. That is why my recommendation is not a single-dimensional recommendation. It rests on three legs. It has to be complemented by a better coordinated monetary fiscal labour market trade policy, and it has to be supported by a more flexible suite of monetary instruments.

There are ways of better coordinating policy than we are experiencing in New Zealand. I am the chief executive of a company and I am accountable to a board, equivalent of a government, and I have a set of people whom I manage for a common goal, a strategic goal. We do not have a coordinator and integrator of policy design and implementation in this country. We have a bunch of silos, under their Acts or regulations, who are pursuing their own ends, and when it gets tough the Reserve Bank governor says: "Oh well, it's not my fault. It's the Government's fault." But this is one country with one Government, hopefully with one economic strategy. There needs to be somebody who thinks about the system and how to coordinate it and deliver an outcome, like a chief executive does, coordinating the efforts of all the people around him who are focusing on what they need to do but also are coordinating efforts towards the common end. I do not see that happening here.

In terms of the tools of monetary policy, my final point is that in addition to a managed float we need to focus, as Charles Goodheart reminds us, on liquidity management, liquidity control, and a capital adequacy regime that is more flexible than we have now. In Singapore, for example, when they had a similar problem to what we are having now with house price inflation getting out of hand, they didn't compromise the whole purpose of economic policy by simply jacking up their exchange rate. They stuck to the exchange rate regime. They complemented it with alternative instruments to make sure that inflation was effectively controlled, but at the same time the export sector and overall strategy of economic policy was not compromised.

That is the essence of my thoughts. I am happy to take questions.

Smith Thank you. I will ask colleagues—who would like to ask questions?

Fitzsimons Initially, thank you. Could you explain to me how you can make what appears to be a big move away from an interest-focused tool to an exchange-rate-focused tool without changing the policy targets agreement or any of the other legal parameters within which policy operates?

Karacaoglu The Reserve Bank of New Zealand Act simply focuses the central bank of this country on monetary and financial stability. By monetary stability, which is what I am focused on today, we mean low inflation and sustainable inflation. I believe there is no need to change that at all. The policy targets agreement says to find a way of implementing it without hurting the rest of the economy, so it gives total discretion to the central bank to select its own instruments to pursue low inflation, without hurting the rest of the economy. In that sense, therefore, I wouldn't change anything in the Act or in the policy targets agreement. They are properly focused—brilliantly so, in my judgment. Best practice around the world, whether you're dealing with Asia or Europe or North America, it's simply the selection of instruments. That's one point I want to make.

But the critical point I should repeat ad nauseam is that monetary policy alone will not do the trick. To me, the bigger transformation is not reconsidering the Act or the policy targets agreement. The bigger transformation is conceptualising a more effective way of coordinating policy across Treasury, the Reserve Bank, the Department of Labour, and so on. That is the critical aspect, because monetary policy alone cannot deliver efficient inflation. That is the fundamental point. If there is nothing else that I can offer, that is the fundamental point. That is why everybody is thinking single dimension. Everybody is talking about monetary policy per se.

Unfortunately, my solution is difficult; it is complex. But the reality is that monetary policy alone cannot deliver efficient inflation. It can deliver low inflation, and it is doing that. When the governor says: "What's the problem? I am meeting my targets.", he's absolutely right. It's not his problem. It's the overall politicians' problem to say, actually, like my board's problem. My board doesn't tell me to just go and maximise profit. They look at my people's happiness, my customers, and all that. I have a group of people working across those, in a vertical sense, but at the end I am the one who is accountable for delivering the total article.

So what I'm saying is that the current design of policy in New Zealand, to use jargon, is misaligned with the strategy of this country. There is a disconnect between strategy and structure. That's the fundamental problem.

Fitzsimons The committee has been very interested in complementary policy measures with Government to support the aims of monetary policy. I would be interested in your view of—if we're going to do that anyway, what are the added benefits of shifting to an exchange-rate-focus tool rather than an interest-rate-focus tool? How much impact on interest rates do you believe a managed float on the exchange rate would have?

Karacaoglu The benefit of having a platform for monetary policy managed exchange-rate regime, trade-weighted, is that it actually supports the main platform of economic growth, which is your export sector. So it basically says that my strategy is to grow this country, sustainably and equitably, and it says to do that as an exporting nation I have to make sure that my traded-goods sectors are not disadvantaged. That is the point there. In the jargon of the economist, that is a necessary condition. But because we are not Singapore and we have such a huge non-traded-goods sector, it's not sufficient. That's where the other tools come as complementary measures. The anchor, the starting point, is a managed exchange rate to anchor you to the rest of the world.

I'm repeating, however, that it is not a rigid commitment to it. Suppose that all of a sudden our main trading partners give up low inflation as a main target. Then a managed exchange rate regime which is anchored to the exchange rate of the rest of the world, would not deliver even that part of it.

Fitzsimons I see the wider benefits that this would have for the economy. What I'm trying to get to is, would a managed focus exchange rate in itself contribute to lowering inflation and by how much.

Karacaoglu Yes, it would benefit by linking our traded goods inflation to the inflation in the rest of the world, and it would be simply a third of the story, or at most half of the story. Most of the pressure is coming from non-traded-goods sectors anyway, so that's the reality of today.

Chauvel Just a very brief question on the managed exchange rate point. We have been told by advisers in response to earlier submissions along those lines that the flaw in the theory is that to tie our exchange rate to those of our trading partners would expose us to the shocks that they encounter, when they do encounter them, in a much more magnified way than occurs now. Do you have any comment on that response that we've received?

Karacaoglu You are living in a world where you're subject to shocks all the time. It is not clear at all that simply having a managed float exchange rate, with the exposure to shocks worse than what we have now—the shocks that we're being exposed to now is every time the world feels good about itself, given our interest rate differential, it actually climbs into the New Zealand dollar and our export sector is shocked. If there is a global shock, then New Zealand, whether it's following a fixed or managed exchange rate, cannot protect itself from it. We're exposed to those shocks anyway. The kind of shock this regime is exposing to, on an ongoing basis, is extreme volatility in our exchange rate and also a high level, because of the ongoing interest rate differential, in favour of New Zealand.

The unfortunate part is, whenever the world feels good about itself the speculators jump into New Zealand and hurt us. So when I wake up and I feel that the world is feeling bad about itself, I say that is good for New Zealand, because they will leave the New Zealand dollar alone. We have really turned this into a total speculative currency.

Chauvel Again, this is back to your point about silos and no one taking the overall responsibility.

Foss Just that currency mix, or aligning yourself to some basket—OK, you do that. Where's the steam belt of the economy there? This economy might move in different cycles with that basket, or the finance Minister may go berserk, or some such thing. Where will that volatility get transferred to? Will it transfer to interest rates, under your model, or higher unemployment, or what? Muldoon tried to fix the exchange rate in various baskets and that just got transferred to high interest rates to the point where actually no one would lend to us.

Karacaoglu That's absolutely right. In other words, if you're trying to fix something then the shock that you receive will have to be absorbed by something else. The proposal I have is not fixing; it's managing. That's one point. Secondly, to repeat, and that's my indirect answer to your question, it forces you to be disciplined about other aspects of your policy. Overall, therefore it's a good outcome. As of today, we don't know who's accountable for what. Whereas, if you actually manage your traded goods sector in a way that is efficient and linked to the rest of the world, then it sort of changes your perspective and says: "What about the rest of the economy?".

We do not dispute any more where the inflation shocks and various other things are going to come from. We just explicitly focus on the other sources of shocks, whereas today it's confusing all the time. We say we have an inflation problem or a high interest rate problem. The Reserve Bank turns around and says: "Well, it's not really my problem. I'm doing what I'm supposed to do. It's either a labour market problem or a fiscal problem." It has to be managed in a coordinated way.

Swain I wish I hadn't skipped a couple of your lectures in the 1980s.

Karacaoglu That's right. You were one of my better students.

Swain On the issue of coordination, can I just make the point that the Government has spent a lot of time trying to achieve that in both innovation—sectors all the way through. The point about this being as complicated as—vertically rather than horizontally, which is the point you try to make. So, we're trying to say that it's quite hard to do, but necessary. Coming back to the Singapore issue, you say that when there was inflation—you said that they didn't give away the target of—exchange rate—other measures. What specifically?

Karacaoglu Two types of measures. One was around how much you can lend in terms of the loan valuation ratios. They also have liquidity ratios, which we don't any more have. But the third point, which doesn't suit us, because we're not Singapore, is they also do the edict bit. In other words, about 80 to 90 percent of the land on which the houses are, is owned by the Government. So what we need to do is to do, in a democratic way, what they have done through edict. But the instruments that they use are not foreign to us, apart from the edict piece. The liquidity ratio moves, trying to limit lending growth through capital adequacy adjustments, trying to limit lending rate by saying you can only lend up to an LVR of 80 percent, and suchlike, are not outside the domain of what the likes of their respectable economists, such as Charles Goodheart, are still saying today. They are saying we have gone too far in terms of focusing on only capital adequacy. We have to worry about liquidity and certainly about the long-term growth of credit, which is what dominates all the problems we are having, as well as what dominates trend growth in inflation, which is the Switzerland model.

Jones Thank you very much for making time available and sharing that invaluable insight about our colleague's earlier years. Yours was a submission that we paid a considerable level of attention to, because you've spoken and written publicly about the need to look at the Singaporean model, and in the event that we need to come back to you, or either our officials, our clerk will make contact with you. Thank you very much for making the time available.

Transcripts

Inquiry into the future monetary policy framework

Finance and Expenditure Committee

7 November 2007

Members
Charles Chauvel (Chairperson)
Jacqui Dean
Jeanette Fitzsimons
Craig Foss
Hon Mark Gosche
Moana Mackey
Dr the Hon Lockwood Smith (Deputy Chairperson)
Hon Paul Swain
Hon Judith Tizard
Chris Tremain
R Doug Woolerton

Witnesses

Steel and Tube Holdings Limited (Submission MP/90)
Mr Nick Calavrias, Chief Executive and Mr Tony Candy, Company Secretary

Calavrias —the New Zealand economy. We have a turnover of around about $500 million, and I guess that we import probably about $200 million a year, but the other $200 million is priced basically on a import-substitution basis, which means that it does get affected by the import price in the currency.

I guess that the single most concern we have is the volatility of the exchange rate, and that affects us considerably. I have actually put a graph in the back which just illustrates the volatility and how not only we but all importers in New Zealand have to manage the situation. In fact, if we just turn over to that, what you'll see there is the red line, which is the US dollar rate, and the blue line is the price in New Zealand dollar terms based on a product which costs US$800, which is a reasonable standard-type product, and assuming that there's no price increase in the US dollar base price. If we start off in January 2006, when the New Zealand currency was 67 cents against the US dollar, the price of the goods was $1187. By March, the currency dropped down to 60 cents, and it pushed the product up by 12 percent. You can just see the fluctuating line, that blue line there, how it went. So it went from $1187 to $1323, $1350 down to $1000 a ton. I guess the volatility you just can't manage, especially on a downwards trend. I mean, each shipment you bring in is cheaper than the one before, so you're really selling it at that lower price, and that does affect all companies. It may be useful for inflation, but any business finds it very very difficult to manage.

From our point of view, we don't really care what the currency is as long as it's stable, so we can live with a high rate or a low rate as long as it's fairly stable. Being a manufacturer as well, what tends to happen is you are pricing your goods on a domestic base against the same principle. So as the price for imported goods is cheaper, you've actually got to match that as well, and it gets to a point where, as a manufacturer, you've got to think and say: "Well, if it's going to be like this, we'd be better off importing and stop manufacturing." So that's the pressure that goes on as a manufacturer as well.

The reasons for the New Zealand currency being what it is are is well documented. It's not fully understood. We use the interest rates to slow investment, domestic housing or consumer spending, but the unintended consequences of having high interest rates is attracting funds from overseas and pushing the exchange rate up. Generally the first casualties are the small to medium businesses in all sectors of the economy followed by commercial construction, and then as the currency strengthens, the airport sector. The intended audience of the consumer or housing, because we have a vast majority of them on fixed mortgages, don't get affected immediately. So I guess that's, in essence, what I have to say.

Tremain: Firstly, thanks for coming in. While I know you didn't put a submission in at the start, we are very keen to hear from the importing side of the equation, so thank you. Do you think you would've, if the currency had been going in a different direction than it has been trending over the past 18 months, do you think you would've put a submission into this select committee, and would many other importers have been putting a submission into this select committee?

Calavrias: Well, we certainly would not have, no.

Tremain: Would that have not made your goods a lot more expensive on the New Zealand market than they currently are and have made a more difficult trade issues for you than where the currency's gone, as an importer, today?

Calavrias: No. I guess, there's two parts to the equation. One is that we are a supplier of goods generally to manufacturers in New Zealand. Now, some of that is just manufactured for the local economy, some of it ends up being exported, and there's some commentating factors in all that. In respect to that, you're buying US dollars virtually for some raw material, but it could be exported to Australia in Australian dollars, so depending what the currency is there. So I guess most people would look for it to be reasonably stable. I don't think anybody wants to live with a 59c exchange rate or a 75c, but probably the fair value, the so-called experts

	call as somewhere in the middle. So we certainly would not have been making a submission either way.
Tremain	If other importers in general had benefited from where the exchange rate had gone, would've been making submissions that the exchange rate was—.
Calavrias	I guess what tends to happen is that there's winners and losers in every part of the economy. So if an importer, it's more expensive for them bringing in, it depends whether they're actually competing against the local manufacturer. If they are, then it will make it more difficult for them, but then there'd be and advantage to the domestic manufacturer.
Tremain	Are you saying in your business, you're not really—.
Calavrias	No, we are generally supplying goods to those people. The things that we tend to manufacture, like roofing iron, you don't import anyway – that's all domestically sourced. But there are types of products that one of our factories makes, which we are on the edge right at the moment, saying, "Well, look, it's probably not worth our while to manufacture any more. We should actually import that product."
Smith	Would you be able to indicate—.
Calavrias	Well, there's a simple thing like nails, for instance. We have a nail factory that we have progressively been importing nails from China, because they're about 30 percent cheaper than what we could actually make them for. So there's one, and that's what we have started to do, but there are other things that we actually manufacture as well.
Smith	Do you think that even if the exchange rate wasn't as high as it currently is that—.
Calavrias	Well, the difference would be a lot cheaper, and then maybe you can live with it. It's all about the difference in the pricing.
Woolerton	My questions, I'll do both of them at once. One was do you notice when you're selling to your manufacturing people who are exporting that you have known, at various times, whether they noticed they're getting into trouble? The second one was the volatility of your workforce—do you train people or does your workforce go up and down very often with the a large variation, so whether or not they're affected?
Calavrias	The first one was to do with our customers and the difficulty in payment. I'd have to say that our experience is that a lot of the small manufacturers in New Zealand are basically turning over business, because they have to—they've got their investment, they've got to do it—but their margin would've been squeezed considerably over the last couple of years. Payments, yes, some people do get some difficulty and want some extra time to pay, and it just turns over, but overall our

debtor days are reasonably consistent, but within that we change and some people might go up to 60 or 90 days and then come back into 30 days. You give them some assistance.

Woolerton The debtors haven't increased?

Calavrias No, overall, it's much of a muchness in managing. And the second question was the fluctuation of our staff. No, because what's happened here is that volumes are still reasonably stable, and so we still need the same amount of people to move tons in and out of our warehouse and so on. Where the damage has been done is just purely in margin. It's just difficult to manage the profitability.

Woolerton Thank you.

Foss You point out a lot of people make themselves earn some time from the OCR—for a fixed period. So basically they've just paid up somehow to get rid of that volatility. Your graph there, I guess you've decided not to lock in or to hedge or to, say, to get rid of the volatility as far as your own—. So have you decided that the costs are too expensive or do you actually—.

Calavrias The experience I am hedging, really, is that you win some and lose some, and over a period, you're not really going to be any further ahead. But what that graph there illustrates is that a company like ourselves, we have got to order product, virtually the same sort of product, on a monthly basis. So therefore, if you look at that graph anywhere you're hedged, it'd be wrong. If you took a hedge halfway through and fix your costs at that point in time, the exchange rate just carried on going. So the hedging I think is more relevant to us on a reasonably stable-type currency but not the way it's going.

Foss But if it's going all over the show like that, at least doesn't a hedge give certainty to your own accounts, your own budget projections, however long you can hedge. So regardless of what happens out in the rest of the world who are suffering that volatility, you've got rid of it?

Calavrias No, not really, because what will tend to happen is that we would fix it at a point at time. Maybe look at that graph just halfway through, you fix it, and your competitors are still bringing in product. It's all right if everybody hedged it, but it's not if only one person does.

Foss But wouldn't some loss and some gain if you've got your price—

Calavrias Well, the marketplace dictates that you've got to be competitive all the time. So it's really just an erosion of margin. You've just got to stay competitive.

Foss Thanks.

Tremain	I just wanted to ask—I was speaking to John Walley yesterday from the Canterbury Manufacturers' Association, who was talking about a large number of manufacturers that he's dealing with, and obviously a big chunk of your business is manufacturing as well. He was saying that every manufacturer that he's spoken to in the last month or two months are really having a close look at their business model in New Zealand, because of two key factors: the volatility of the exchange rate that you've referred to and obviously the interest rates that businesses have to deal with here in New Zealand. Are you looking at your own business model at the moment, and how you plan for going forward?
Calavrias	Yes.
Tremain	What are the real considerations that you're looking at?
Calavrias	Well, we are going to have to seriously consider about importing more product than what we do at the moment to replace manufactured product.
Tremain	Are you looking at actually also setting up any operations offshore? He talked about a number of his—
Calavrias	No.
Tremain	So import substitution is what you're looking at at the moment?
Calavrias	Yes.
Chauvel	On behalf of the committee, I'd like to say thank you for responding positively to the invitation to come and give evidence. It is always helpful to us to be able to solicit information from out there in the real world, and it is good to have your perspective, so we are grateful for your time.

New Zealand Amalgamated Engineering, Printing and Manufacturing Union (Submission MP/91) Mr Andrew Little, National Secretary

Chauvel	Again, Mr Little, thank you for responding on behalf of your union to the invitation to come and give evidence. We felt it was important to hear from a perspective of a union involved in the manufacturing and export sector. I think you probably know the members around the table, but what we'd be keen to do is hear a brief summary of the views of the organisation you represent and then if you're willing to take questions, that'd be very helpful. I'd just like to also welcome the delegates from the New Zealand Business and Parliament Trust, who are observing the proceedings of the committee. It's great to have you here in Wellington.
Little	Thank you, Mr Chauvel and members of the committee. Thank you for the invitation to come and comment on the inquiry. I appreciate you'll have had volume of figures and statistics and more academic papers than I could ever produce, so what I've really produced here are some

reflections, I think, on the issues as I see it, from a manufacturing union's point of view. So without reading what I've written here verbatim, just the key points I would highlight is that the recent period, you might say, of higher interest rates and escalating exchange rate has coincided with the growing number of manufacturing plant closures and the transfer of manufacturing capacity overseas. Some of the reasons, and they are by no means exclusive, but some of the reasons cited for the plant closures to us as a representative of the workers affected by it, and also the transfer of capacity overseas, including the perceived ability of the owners of those businesses to retrieve greater returns because of the thin margins enjoyed here—margins that are thinned out by our volatile exchange rate—exchange rate volatility itself, and because the combination of high interest rates and uncertain exchange rates are impeding decisions to invest in manufacturing, including in expanding existing manufacturing.

In terms of general points, the key point I guess I wish to make is that to the extent that the OCR is used to address inflationary threats, particularly rising out of the property market and the fact that people borrow on inflated values and so on of their properties, it has led to significant pressure on the productive sector by making borrowing for new investment more difficult and putting untoward pressure on the exchange rate, which affects the return that exporters receive on their goods sold overseas. In our view any policy or instrument that the Government has to manage the economy or any part of it needs to used consistently, with the overall objectives that the Government of the day has for economic development. We welcome the overall Government objective at the moment of creating an environment for high-value, high-skilled, highly remunerated jobs, and those jobs are largely to be found in the manufacturing sector. But to this end the Government needs to ensure that one policy instrument, namely using the OCR, is not wielded in a way that causes imbalance in the economy as a whole or compromises other important policy objectives.

Generally speaking, what we are saying is that there needs to be a more balanced approach to managing those issues, and when we have extreme break-outs, you might say, of potential inflationary pressure or if things like property price increases, then how that is managed needs to be cognisant of the whole economy, not just addressing single parts of it. Paragraph 11 probably summarises it: "If we are serious as a country about securing a sustainable and competitive manufacturing base, and in our view this should be a priority objective because of the more widespread wealth effects manufacturing generates, then the full range of economic management policies and levers need to work in harmony to achieve this. At present, management of inflation is having a deleterious effect on one sector at least."

And just apropos of some comments I've read that other submitters have made, particularly Federated Farmers and the New Zealand

Business Roundtable, both of whom have suggested that other Government measures, including employment law and other employment regulation—to the extent that they say that those are causes of inflation, I simply say we reject this, and if it correct that the new requirement for all parties in the employment arena to act in good faith as inflationary, then all I can say is we would need to argue for more inflation, probably to Zimbabwe's sort of levels.

In summary, the EPMU calls for a range of economic instruments to be used in order to achieve a balanced outcome for the economy as a whole. No single policy or instrument should be relied on when to do so demonstrably create damage and distortions between different sectors. And a priority factor in deciding which instrument to use or how to use it must be promoting and encouraging the productive sector.

Smith I'm fascinated, Andrew that you picked out Federated Farmers and the Business Roundtable submissions—employment regulation yet made no comment on their submission to us about the problems caused by—.

Little Yeah, I thought the figures they relied on to make that statement were somewhat devious, as I understood the figures they used, they included spending on non-inflationary aspects—so, spending on infrastructure, spending on New Zealand superannuation, the Cullen fund, and what have you. So I was just dubious about the level of new expenditure that they were drawing attention to. I wasn't sure if some of it was new or even if some of it was inflationary.

Smith You don't accept that the rate of increase of income and spending apart from—.

Little Well, I think one of the other problems is, of course, that—and this may be a political judgment call; in fact, it will be—but I think there is a view, of course, that there had been, you might say, underspending in a lot of areas. So additional spending, for example, in health and in education lifting spending to ensure that we're able to retain nurses and doctors and what have you, and we still have issues about there, as I think it is important to maintain at least some semblance of a modern, world-class health system. So I think you might say some of the additional spending since 1999 is in a sense catch-up for spending that some would argue would otherwise have taken place during the 1990s.

Smith OK. How do you explain the extraordinary collapse—looked at productivity growth from about the 1970s through to the 1990s and then since—. What's remarkable about the productivity growth is that—from the 1970s through the 1990s New Zealanders—. That jumped up to 3 percent plus during the decade—.

Little Yeah, I think—I'm not an economist, and what I believe I understand is largely from experience and observation—a lot of things have happened.

I think one of the issues we've had going back some time is a lack of investment in capital, and modern technology too, in the productive sector. So we have been more labour-intensive than, I think, comparable countries. That's a productivity issue. It means that the value of output, certainly, per person or per measure of capital has been lower. Combined with that is, I think, certainly in the last 6 or 7 years there has been a bit of catch-up with wages, because—you know, if you talk to a lot of working people, they will certainly say that their experiences of the 1990s is if they didn't suffer a decline in real terms, they certainly had pretty modest increases in wages and incomes. And I think the other factor more recently is the economy is largely at capacity. That reflects a lack of investment in expansion growth, particularly in equipment and machinery, going back some years. That has been trying to get greater and better and more comprehensive investment has being impeded to some degree by the cost of borrowing because of interest rates. There are some businesses that have taken advantage of a high exchange, been able to import capital equipment at a time when the price is good, but for a lot of businesses, the difficulty has been financing the expansion, or indeed financing whole new productive enterprises. All those factors, I think, go to drive down our productivity levels.

Woolerton Thank you, Andrew. Obviously you're at the sharp end of labour relations and wages and that sort of thing, and we've had discussions with other submitters around what low wages or high wages do as incentives to bringing in more technology, being machinery and that sort of thing, to enable us to compete with the very low wages of China, and that sort of thing. I was just wondering if you could just give us a few words on where you see it heading in the future. Can we stay competitive with those countries and what, in your view, we should do about that? Because I think it's interesting to hear from you on that issue, and obviously it's where you must have expertise.

Little I don't think there's any future for our manufacturing sector to try to compete with the low - labour cost countries that we're clearly competing with at the moment—or suffering from at the moment. Partly because of our size, we're never going to have the scale of some of the Chinese outfits that we're competing with, and what have you, partly because of the location—our place on the planet doesn't make it easy for us to get low-margin goods at a higher volume into markets around the world. So I think part of the challenge is to focus on what it is that we can do and what it is that we can do well. I don't accept—and a converse argument we sometimes hear is that we'll focus on design and can sort of make things here, or we can design it here, and somebody can make it offshore, because you'd be hard-pressed to find anywhere where a design facility lasts very long without manufacturing being co-located with it. You need one and the same. So I think we have to focus on what it is that we make and can make and can do well. That will be a product of our investment environment, so things like high rates of borrowing, high cost of borrowing, is going to impede that. I think initiatives that the

Government can take, and have taken to date, by tax incentives on research and development are a good start. I think we need to see more of that. I think reducing the corporate tax rate again will assist that, but I suspect we could probably do more and be bolder with some of the measures that can be taken to incentivise investment in the type of manufacturing and production that is sustainable here in New Zealand. But we've got a way to go before we get there.

Woolerton OK, thank you.

Fitzsimons Thank you for your submission. You talk about a distorted economy and the need see investment being directed into the productive sector. What's your recipe for shifting investment into the productive sector, and when you talk about that imbalance, are you talking about an imbalance between the investment in assets which depreciate versus productive sector.

Little Yes, exactly.

Fitzsimons Do you have a recipe for—that shift?

Little Yeah, I think I've hinted—and if I haven't, let me be more explicit—at terms of more balanced policy framework and a balanced tax framework. We ought to look carefully at taxation on property investments, and particularly people who are investing in property to take advantage of the capital gains, whether on a speculative basis or even on a more long-term basis. I think that will at least send signals about that as an investment and at least go some way to tilting decisions back towards more productive investment. Then I think the issue with those who are interested in investing in productive enterprises and activity create—partly through the tax system, partly through other measures—an environment in which investment in those activities is incentivised and encouraged.

Fitzsimons When it comes to productivity, apart from the obvious area of training, do you have things you'd like to see done to raise productivity?

Little I think skills and training, obviously, is a huge issue. I think management skills is another issue, and New Zealand businesses underinvestment in training and getting good quality management—we could do more in that respect—and then I think a focus on using technology, using the technology that's around the world, to do things that currently perhaps we're doing in a more labour-intensive sort of way.

Fitzsimons And finally, just picking up on Lockwood's question—reference earlier to the submissions of Federated Farmers and the Business Roundtable, we obviously can improve our productivity numbers by employing only the most productive workers and tolerating very high levels of unemployment, as happened in the 1990s. Do you think that's—productivity numbers?

Little	No, I think that's short term. I believe in the dignity of working people. I've yet to meet somebody who doesn't want to be gainfully employed and feel valued and useful, and there's always stuff that people can do. But I also have yet to meet somebody who doesn't want to use the skills and talents they have to the best possible level, including using technology and all the rest of it. So I think keeping people working—and there is a social dividend to go with it, when people are occupied and feel good about themselves and are earning and providing for themselves and others. It's a much better recipe for social cohesion than when you've got large numbers of people who have got nothing to do.
Smith	Can I ask you a supplementary—Andrew, if you look at employment rates in the 1980s and the 1990s did unemployment go up during the 1990s or down.
Little	I can't recall those statistics, Lockwood. I'd have to defer to your best advice.
Smith	The answer is unemployment went down during the 1990s significantly—
Mackey	Twenty-one percent in Gisborne.
Smith	—and multiple factors—.
Little	There were also quite significant wage cuts, certainly during the early part of that period, as well, which—I think the unfortunate thing is we gave a signal to a lot of employers in the 1990s that, if you get cheaper labour, don't bother investing in new plant and equipment, because you can get it done there—the problem the Chinese have at the moment, actually. So I'm not sure that the 1990s was a good basis.
Smith	But how would that explain—productivity growth? —because, OK, I can accept your argument that—labour.
Little	Because the economy wasn't working to capacity in the 1990s. There was capacity left, you could add labour and produce more—people could work longer, and what have you.
Smith	What's the—that's at the heart of this whole issue: why can't our economy grow without inflation?
Little	Underinvestment in skills and training and learning, and underinvestment in plant and equipment.
Gosche	Just following on to that, we've had a number of people who were involved in making that decision. Peter Talley was in here talking about the cost of a machine that would obviously displace workers, but in bringing in a machine of that nature, and you're going to have someone else who can operate it, maintain it, etc. So a number of people have

come in and called for accelerated depreciation rates so that there would be a greater investment. Now, if that were to happen, and there was greater investment in machinery and technology, are we training enough, are we creating enough skilled workers, to step up that point. Because I noted the Prime Minister's comments earlier this week about our literacy rates, for instance, which are quite frightening. If we're not doing enough, what's the EPMU's views on how we accelerate the skill development that would take advantage of investment in better technology and machinery?

Little That's a complex question. There are a number of initiatives that I think have started but need to be more rapidly developed. One is the workplace learning representative. The thing about a lot of learning, whether it's literary or numeracy, or whether it's more skilled stuff, is that both employers and employees seldom know where to go, and how to plug into the system that we've got. So we can do more and do better at initiatives to connect people with learning and so on that's out there. But I just reiterate and underscore the point you make, that we undersell and we undermine the next generation if we aren't rapidly looking at a rapid uptake of training and learning now, because the future is going to be in improving productivity. It's going to depend on a greater uptake of technology—more sophisticated technology—and we need people to do it. Of course, people need to be able to read and write and count in order to do that, but they're not going to get to the sort of next level of skills if they don't have that base level. So all I can do is confirm from my own observation and experience the need to do more and better. Industry training organisations are struggling to keep up with demand and make sure their money's put in the right places in that regard. Certainly, they need all the help they can get to make sure that happens.

Gosche Just following on from that, it may be anecdotal, but what's your feeling about—I mean your union's traditionally covered the traditional trades, which are still hugely important in New Zealand into manufacturing. We're always going to have a significant agricultural sector that requires those sorts of skills. What's the age profile looking like? We know that all our secondary school teachers are all getting older. Are our tradespeople looking much the same?

Little Yes, I had understood that the average age—certainly within our membership—of a tradesperson, a fitter, an electrician, was sort of 48, 49. I met an employer the other day who told me that the average age of the tradespeople he employs is something like 59, and I met a member the other day who turns 65 next year. He's an electrician. He's just been asked by his employer to continue working till he's 70. So I mean, we do have a major problem.

Gosche So with the people we are producing, because obviously we—. Modern Apprenticeships and the industry training and stuff, what needs to be done to keep them here? Because if you grab one of those skills and get one of those trades, there's a short plane ride to Australia and a fairly attractive sort of scene, so we keep on getting told, although I sometimes doubt that.

Little Yes, there's an international marketplace for trade skills whether it's the old black trades, as they used to call them, in fitting and welding, or whether its sparkies or whether its construction trades—building, carpenters, and what have you. There is now a quite aggressive international market for those sorts of trades, and we will be, as we have been, loosing that skills base, because we can't command, or we don't command, the type of prices that people can get through a little bit of mobility offshore that they can get elsewhere. So the issue about reward and remuneration is a big issue in terms of keeping our skills base here. The discussion we often have with employers, and often where it gets a bit fraught, is as a union we are certainly very keen to support genuine productivity improvement initiatives, but it's got to be on the basis that people share in the gains that go with that as well, and often that's where things fall apart.

Gosche With all the pressures we've been hearing from the manufacturers and employers coming to talk to the committee around the cost of the dollar, the cost of infrastructure, etc.—how much is that a factor in them suppressing the wages that we are actually able to offer in New Zealand?

Little That's not a future at all in my view. Because New Zealand still aspires to be a First World country, which is why I go back to my point about the future for New Zealanders. In my view it must have a manufacturing base, and the future of that manufacturing base is at the very high technology, capital-intensive end of manufacturing—the more skilled end. So we need to create the workforce to support that. And in order to do that, in order to get that investment to that end, we need a range of things, which includes a stable exchange rate, stable inflation, and incentives to promote that investment through things like the tax system.

Foss You acknowledged just then that we're in an international marketplace. So would you agree that it's very, very important for New Zealand to be able to pay internationally competitive, after-tax wages?

Little To pay competitive wages, yeah, if we want to avoid losing our skills base offshore—absolutely.

Foss I guess, as far as the members are concerned, or the normal person, it's the after-tax rather than the gross which is very relevant to their personal circumstances?

Little I think the total social wage, which would be gross income tax, public provision of things like schools, hospitals, and things like tax credits like Working for Families, the whole thing goes into the mix in terms of people's living standards.

Foss	Yes, because I saw your comment on the CTU's submission a while ago, and they made a particular point about the increase in house prices and property, which you've touched on as well, but also during that discussion we also touched on both sides to that ledger as, yes, there's the property price, but, of course, there's people ability to service or purchase not only their first home, but their next home. And then, of course, we've just been talking about Australia here, so I'd be interested in your comments in that the after-tax ability of your members with their after-tax income is to service the expectations of a First World economy compared to, say, some of your members who have now moved to Australia.
Little	The pressure on wage growth is always there. People want to keep pace. I suppose gauging the impact of things like Working for Families, and more recently, assistance with childcare, and what have you; put those things into the mix. I suppose it comes back to the general sense: can people live a fulfilled and satisfactory life—they do the work, is the remuneration enough for them to support the family, spend time with the family, take the holidays, do all those sorts of things? The reality is, depending on which sector you are in, there's a growing sort of divergence there. Manufacturing workers are struggling to keep their heads above water. You talk to electrical workers, Telecom workers, and things are looking a fraction brighter to them. You talk to aviation workers; things are getting a little better for them.
Foss	What's an example of an electrical worker, for example? What ticket would they be on here—just some gross annual pay, roughly?
Little	Gross income, anywhere between probably $70,000 or $90,000.
Foss	That's not too shabby. If that person, given all that you just said, migrated—so after-tax income there would be mid $50s or $60s, or something, I guess?
Little	It depends if they're getting Working for Families, as well. So a sparkie's wages.
Foss	What would that same worker get in Australia, roughly, at the moment, on the gross?
Little	The gross would be probably over $100,000. We know that a couple of years ago Northern Ireland did a recruiting raid in New Zealand for electrical workers. They were offering about $110,000 gross—it was the Republic of Ireland; €110,000—for the same sort of work.
Foss	And that $110,000. Would that be Aussie or Kiwi?
Little	It would be Aussie.
Foss	So what's that—about $125,000 or $130,000 Kiwi?

Little Yep.

Foss So moving across the ditch, just before we even start talking about tax, that person for their family making a very rational economic decision, then they have got to mesh that with all the social issues that you just spoke of. There's about 40,000 to 50,000 people who move to Australia every year from New Zealand. I mean, that's your entire membership, actually, migrating to Australia every year. Isn't that a major concern? Because we are at full capacity—you're quite right—but we aren't replacing that. We're struggling to even tread water at the moment.

Little Yes we are. We're struggling to replace that skills base, and it is a big issue--, absolutely. If I was to give you my view about why we're in that situation I'd be accused of being political, and I don't want to disrupt a perfectly civil conversation so far. But there are a lot of factors in that, and the other one, I suppose, is the underinvestment in skills and training going back some years. It's a major one.

Foss OK. On a different tack completely, when we were first asking various submitters, we did invite you particularly to talk about the productivity and what you've done with that on the unionists. There's some good stories there in the various submissions and things. Should the productivity—how best can they be shared. I think there is a general agreement that that's the way out. We will argue forever about how we get there, but there are some good stories and there are some wins there, and your union has been at the forefront, I think, of some quite innovative agreements historically. So I wonder in the few minutes we have left if you could just touch on what lessons we can have for the future?

Little I think the key gains in productivity that we've worked with employers on have largely been around work organisation, and a lot of that has been reposing greater responsibility on the guys on the front line, and taking out levels of management, and creating—so giving people more responsibility and rewarding them for it. I suppose the example that immediately springs to mind is in Fonterra or New Zealand Milk Products—a programme called Maintenance Best Practice. It's taken 2 or 3 years to put in place, but the general model there is they've stripped out a layer of supervision and management, given the guys on the tools the responsibility: "Your job is to ensure plant or liability of this level. You have these mandates in terms of purchasing gear, consumables, and all the rest of it. You're required to do this, take these preventative actions, and if it's plant breakdown, then you're required to respond in these sorts of ways, and this is what we're going to reward you with." Now, it was quite a step change in terms of reward, and what New Zealand Milk Products did that many other employers wouldn't do, is they provided the reward upfront. So they said: "We don't expect it to work immediately or in the first year, but we're going to reward you know as if in 2 or 3 years' time it may be expected to be working fully.

That's the kind of reward system you'll be getting." So the guys got a taste of what it was like, got a taste of managing themselves, of working to a set of targets, goals, and so on. I spoke to one of our guys recently down in Timaru about it. He said he would never go back. In fact, he's working fewer hours. The plant reliability has gone up. He's getting paid more. It's a win for everybody.

Foss So that was a kind of incentivised arrangement there, with buy-in from all parties. But there was an incentive to help make it happen as a team, and everyone's a winner at the end of the day.

Little It was a range of things, and credit to Fonterra management too, because they took a big risk with it. The one thing that could have happened is guys get the money up front and they carry on as if nothing's changed. But they didn't. They had good management that drove it, guys engaged on the front line. The ones who couldn't handle it, they've been treated with dignity. Some have been managed out. Some have made the grade. But the skill of management was creating a climate and an environment where that could work, and, unfortunately, we lack that in a lot of other New Zealand workplaces.

Swain Sorry if I've come in a bit late and you've answered this. In paragraph 11, you talk about—the general trust of things being too narrow, you talk about the full range of economic management policies—then you say—.

Little I suppose one is whether you change the policy targets agreement to include—so the Reserve Bank governor has to take into account factors other than just inflation, using the tax system to change incentives for different types of investment decision-makers—so incentivising people away from property assets to more productive assets. Those are the two things I'd have in mind.

Swain Other people have talked about other countries—you know trying to target—.

Little Yes, I did see one account from Ronald Reagan's economic adviser, suggesting that New Zealand would be better served by pinning its exchange rate to a basket of currencies or the US currency. I'm not qualified enough to know how good an idea that is, but it would certainly assist, I would have thought, with the volatility issue.

Chauvel Thank you, Mr Little, for your time. It's much appreciated, and I know the committee's benefited greatly from your perspective.

National Council of Women (Submission MP/86)
Ms Margaret Cook, Vice President, Ms Beryl Anderson, Parliamentary Watch Convenor, and Ms Bridget Mayne, Communications Officer

Chauvel I would like to ask Beryl Anderson and Bridget Mayne from the National Council of Women to come to the table. I apologise that we have been running late, but we are very grateful that you have responded to our request to come along and give evidence. We do think that the perspective your organisation has to offer is going to be of value to our consideration. I think you have another submitter who is coming in by telephone?

Anderson — On the telephone is Margaret Cook, the vice-president, who is based in Invercargill.

Cook — Good morning.

Chauvel — Apologies for keeping you waiting. We have your two colleagues, Beryl Anderson and Bridget Mayne with us, and the members of the committee are keen to hear from the three of you and then to pose any questions that they might have.

Cook — Beryl will outline the process that we have agreed to.

Anderson — The submission from the National Council of Women has been prepared from a background of our policy decisions and consultation with our members. You'll have noted that the submission did not work systematically through the bullet points of the brief, but took the opportunity to raise issues around the general intent. As always, the submission draws on the collective wisdom, expertise, and experience of our diverse membership and our established resolutions.

In respect of this submission, the resolutions cover topics as varied as universal basic income for all New Zealanders, tourism tax, family whānau carers receiving assistance equal to that reimbursed to foster parents, family support payments being linked to the consumer price index, and the impact of Government policy on middle and lower-income families. We have a wide range of resolutions that are relevant to this topic. However, the emphasis is on how decisions made at Government level impact on women and their families, and in the current climate women contend that mixed messages are the general order of the day.

The National Council of Women has been advised that there is an expectation that Government policy development will encompass a whole-of-Government attitude, implying that ministries and departments will confer with each other, and this is something we commend. Advice has also been given that there is an expectation of gender impact reports on all policy, and that also is commended. But there is some cynicism as to whether this is actually happening. In the concluding comments for New Zealand at its 39th session this year, the Committee on the Elimination of Discrimination Against Women supports this practice. It recommended that the State party—that is, the New Zealand Government—require gender impact statements for all policy papers submitted to Cabinet and to all Cabinet committees.

No matter how sophisticated the current financial and business practices appear to be, nothing has changed as far as the households are concerned. It is generally low and middle income women who bear the burden of making ends meet, who have to decide whether to pay the power bill or to eat meat this week. Economists report that the gap between the haves and the have-nots is widening, again. Some members remember when a family could live reasonably comfortably on a single income, with a universal family benefit for the mother. Now they watch anxiously as their children juggle two or three jobs while trying to ensure that the grandchildren participate in community activities, while the dream of owning their own home becomes less viable.

Members struggle with many issues: with the logic of current monetary practices, where Government surpluses have accrued yet New Zealand continues to pay interest on public debt to overseas banks; with property speculation that is almost rampant, as overseas interests buy our land at high cost, which then ratchets up other land prices, causing it to be out of reach of the average New Zealander; with the Government policy that says it is better for both parents, and even solo parents, to be in paid employment when truancy is increasing, and when parents can't afford the choice to stay at home to be with their children; with the banking practice that encourages debt by making 100 percent of loans available, and with business enticed by "buy now, and pay much later" attitudes.

The National Council of Women notes that other submissions to this inquiry have made these points as well, and we ask, what is wrong with encouraging us all to live within our income? What is wrong with expecting local and central government to do the same? What is wrong with adopting habits of prudent husbandry of resources through savings and investment, so that a new asset can be bought and paid for by this generation and not be a burden to the next generation with debt as well as maintenance? And we urge that when developing future monetary policy, particular emphasis be placed on the gender impact analysis and modelling before final decisions are made. Thank you.

Woolerton With monetary policy, it sort of takes a while to get through, and there are a lot of people who say that rate rises and that sort of thing largely—on the property market—house prices, etc., etc. How bad do you think the ability to find a house, to be able to—now? Is it getting a little bit worse, a lot worse, or where is the feeling?

Anderson Our membership covers a wide range, from high income to low income and every point in between, from those who rely on benefits to those who are in full-time paid employment—and a benefit includes superannuation. For some people, it is a lot easier than for others, but for those who have not yet purchased their first property, it is harder.

Smith Thank you very much for your submission. Could I ask you to expand a little on exactly what you are driving at, what you mean, when you say members ask that multi-scenario realistic modelling be initiated to avoid negative effects on families—to prove the point within low income families in particular? What is it about monetary policy that particularly impacts on them?

Anderson Margaret, did you hear that question?

Cook Not a word

Smith Sorry, you mentioned in your submission and in your oral submission also that you want to see gender impact analysis and modelling before monetary policy decisions are made, and in your submission you say that members ask that multi-scenario realistic modelling be initiated to avoid negative effects on families. I am just wondering a little bit what you are getting at there, because I guess if monetary policy operates through an official cash rate mechanism, every time it's tightened and raise interest, and consequently that means every time the official cash rate is put up, it could be argued that is going to have a negative impact on families. But that is the whole idea of tightening monetary policy: to make it a little harder, or to make families think twice before they spend more money. So I am little unclear what you are after there.

Cook Do you want me to answer that? One of the issues is yes, that is the effect and if that's the intention, fine. But the modelling could show that those on low incomes who are spending everything to survive actually are impacted very negatively on that. They don't have choices about what they spend it on, and I am personally in contact with many families in that way through Habitat for Humanity, where budgets just don't stretch. The interest rates kill any savings that they might like to make—again, saving for a home. NCW does appreciate that that is the intention, but the modelling which we ask for, and have asked for with other submissions as well, could show how that could be mitigated for the lower incomes.

Smith Thanks for explaining that. Thank you.

Fitzsimons Good morning, Margaret. You mentioned the speculative nature of the economy. You were talking particularly about the property market there?

Cook Yes.

Fitzsimons You've also mentioned fairness between—I cannot remember exactly the words you used—the productive and the property markets. Do you believe that the tax system which taxes incomes but not capital gains contributes to that speculative market?

Cook Members have not responded particularly to that, but anecdotal discussion would preclude a capital gains tax being favoured as a first choice.

Fitzsimons	Even if it was not on the family home? If it was on second and third houses?
Cook	Oh, haven't considered that.
Anderson	From the anecdotal discussions I have had around that issue, yes it does make a difference if it's not on the first home.
Fitzsimons	You also mentioned the Tobin tax as a way of stabilising and reducing speculative activity internationally in the financial markets. Do you have any information—because I know you've been interested in this for a while—about whether any other countries are starting to move on the Tobin tax, and what would be the opportunities for New Zealand to work internationally on that issue?
Cook	My understanding with the Tobin tax is that it needs the cooperation of countries, because it is a taxing of the flow of finance from one country to another. I think from that has come the financial transactions tax, which I notice the CTU mentioned in their submission, which I know you have done some work on, Jeanette, some years ago. That is also NCW policy, and that would seem to be favourable instrument to be used in New Zealand.
Fitzsimons	But internationally you do not see any opportunity right now for linking with other countries that are also pushing for a Tobin tax?
Cook	I personally would hesitate. But NCW does not have policy on it.
Chauvel	Thank you, members, and thank you very much to the representatives of the National Council of Women, particularly for your patience in waiting until we could get to you.

Professor Viv Hall (Submission MP/52)

Chauvel	I would now like to invite Dr Hall to the table, and just really to make the same comments to you, Dr Hall, as I have made to others. Thank you very much for being willing to come and give evidence. Perhaps the best way to proceed is if you would like to speak to the submission or make any additional comments.
Smith	You realise, Mr Chairman, that Professor Hall has did appear in front of us before, so we've invited them back for the opportunity for questioning?
Chauvel	Yes, but if there are any initial comments you'd like to make or any particular issues that have arisen to your knowledge during the inquiry that you'd like to address, then you should feel free before we simply open it up to questions.

Hall — Thank you, Chairman. I am happy to be guided by what the committee wants. Either I can summarise very succinctly what my position was—and we did run out of time to turn to questions on that. I have had a few thoughts since we last met. So I could—

Chauvel — I think it would be useful if you were to run through those, and then we can reopen it to questions. But I do not think we want to just break into questions immediately. If you've got some thoughts you would like to share initially, please do.

Hall — Do you want me to state the guts of what I said last time?

Chauvel — I think that would be helpful to the members as well, if you would just briefly summarise the earlier position and then also deal with what we did not get to, because after all that's the purpose of trying to get you back.

Hall — The hard ones we postponed, I guess. My position in my submission was that firstly I considered New Zealand's monetary policy framework internationally recognised as fundamentally sound. It has been operated for some considerable time now in a flexible inflation-targeting manner. One could quibble at the margin about the logical consistency and operational credibility of PTA clause 4(b), but basically since the early 1990s, monetary policy has coped remarkably well with various internal and external pressures. The set of challenges it's been facing since around 2002 have, in my view, been exacerbated by a lack of support from the demand side elements of fiscal policy and a lack of policy focus on the supply side of the economy—in particular, those various arms of policy which can affect better productivity and growth performances. The challenges to monetary policy over at least the next 2 years will be at least as demanding as they have been in recent years. So that is on the framework of monetary policy itself.

On additional particular policy instruments which could sustainably assist monetary policy, I haven't found a compelling case for any one of those, but I did put a couple up for further discussion in the context of a fairer and more efficient tax system. The third overall point I made was that if you were considering making material changes to the framework for monetary policy, then that should have either bi or multiparty support.

In terms of since we last met, I think we've had mixed news of the pressures on monetary policy. One would like to think there is cautious optimism on pressures easing a bit in the housing and construction sectors. There's bad news from the US monetary policy front, and the movement in their exchange rate relative to the New Zealand dollar, and on the recent fiscal and surplus numbers, as I understand them. Depending on the way that's handled, that could be either a plus or minus.

On that fiscal front, as I understand it the surplus has come out greater than projected. Whether that can be considered structural or not, I have not seen the figures to be able to pronounce on that. That can be a potential positive, providing the right thing is done. That surplus, in my view all of it, the extra over and above projected and budgeted for, should go into the New Zealand Superannuation Fund. None of it, or a minimal amount, should go into income tax cuts unless that were to be offset by other tax increases such as GST or expenditure cuts. In other words, any package along those lines, even if it is a relatively modest one, under current pressure conditions, should be at least revenue neutral. In other words, all of this is aimed at achieving fiscal prudence to lessen the pressures on monetary policy and hence ease the pressures on interest rates and ease the pressure on the exchange rate.

So in summary, then, in the context of my view that it has been the demand affecting elements of fiscal policy and supply-side aspects affecting productivity and growth, No. 1 fiscal policy should be further counter-cyclical rather than further pro-cyclical in the shorter term and neutral thereafter. On the productivity front, I make the observation that currently there seems to be no department or ministry that has primary or sole responsibility for overseeing the issues of productivity in the sense that the Australian Productivity Commission and its long-standing predecessors have had over the years. So I think one might seriously consider a recommendation to set up such a body, ideally with considerable statutory independence, because that has been the basis on which the Australian institution has survived various pressures over the years. That would address in a holistic fashion for the economy both key industries over time and assess the implications for productivity and growth of key specific microeconomic policies and legislation in a way which my observation is that it has not been done in New Zealand. As successive legislation is coming through affecting industries, the productivity implications have certainly had a back seat.

Chauvel: We had a similar comment from Dr Karacaoglu last session, when he talked about the siloed nature of responsibility in our economy. Can you tell us which Minister is responsible for the administration of the Productivity Commission in Commonwealth terms?

Hall: No, I cannot.

Chauvel: The point is, it's at arm's length.

Hall: It has moved somewhat over time, but would have to defer to Australian experts for current practice.

Swain: OK, I have a couple of questions. Is it fair to say that—involved in the discussions and so on. There are kind of two sides to the argument—actually go after the—. The other issue is that when you have still got—also involved in that will say: "Oh, well, that's all right. They are worrying about that —why do we not try to acquire all the relevant agencies—focus on this rather than backing out and saying: Oh, we don't need to worry about productivity. So I suppose from your observation, how has something like the—been able to plug in to the institution, the funding and the Government policies—marginalisation—.

Hall Clearly such a body has to have credibility in terms of its leadership and the quality of the work that it is doing. Those successive bodies, starting with the Tariff Board, the Industries Assistance Commission, the Industries Commission, and so on achieved that by the quality of their independent research over time. The fact that they have survived rather than being put out of existence would mean that they were sufficiently well tapped into the political and departmental process. For what it is worth, I think it is actually probably harder to mandate a whole set of departments and ministries to focus on this and to come up with a summary overall view on industry structure and the economy than it is to give it to a particular institution who can then come up with a reasoned view, having taken into account the information from these other places. I am normally a bit against setting up new institutions and so on, so one would try to take the bits out of the other ones to be able to do that in a personnel sense.

Swain And I think probably that's ultimately where we go to too—if you take, for example,—what does productivity mean and how do you—have to come back to—measure of productivity—you have to come back to that sort of measure of productivity to prove that it is doing well. The question then is, how does productivity—I'm just interested in having the discussion. How does productivity—apart from, for example, Nelson—.

Hall It's a good point, and it's not a new one. I was involved in research on productivity in the sort of mid-1990s, and at that stage one of the things which was frustrating in doing the assessing was how do you measure productivity in services sector, where there is not an obvious measure of it and there's not an obvious distinction between inputs and outputs. Back in the mid-1990s there was very little progress in terms of getting these measures together. Statistics New Zealand have since gone considerably down the track of producing capital measures and these kinds of things to assist on the so-called productive sectors in terms of their measures. So I think our database is a bit better and a productivity commission - type institution can clearly keep up with the best techniques, new measures, and so on. But in the services area we're still learning as to what is productivity, and health is just one example of these—and, I mean, education and others. One can actually produce a whole lot of statistics and reams of paper and so on which are so-called productivity, so I think it has to be a combination of, shall we say, a productivity commission taking on board the latest advances in a generic sense, in terms of measurement, and then taking on board the coalfacetype experience of these institutions—whether it be health or education or whatever area which is a service-based area.

Woolerton The question I want to ask is around your idea of taking surplus over and above the projected income from tax—parking it in the Cullen fund or investing in the Cullen fund—that's interesting in the light of the fact that we tend to want tax cuts, or extra services, shall we say, for the public, and so there's the political question of how they would react to attempts to take that out. But my question is around, can you do that ad infinitum, or is there, like if you—you obviously see that this is a temporary position. That's the question: is it a temporary position—take the top off the money, which is too much money chasing too few goods, or if that continues, would you see a situation where you could obviously tax to the point where you do that as a matter of policy? We're not told, but it seems that it's just happened. I think you understand my question.

Hall I've opted out of saying, in terms of whether this is a structural or a cyclical surplus or not, but, yeah. I think my views, which I have just expressed, are a reflection of where we are at the moment in terms of degree of pressure on monetary policy, which is the primary focus of what we are on about. We've got pressures coming through the private sector, including offshore from dairy. We're not sure that the pressures have eased in the consumption area, and I think that the consensus would be that fiscal policy has put as much pressure as is reasonable on monetary policy, and it certainly should not get any more demanding over the next 12 months, even though it's obvious that there'll be pressures to do so. So my suggestion was, in essence, on a temporary basis, once taking something which hadn't been projected for, that the fiscal position had been attained as to what is reasonable in terms of pressure on monetary policy, you've got now got something extra which is non-trivial. You certainly don't turn around and fire it out into the community. I could give a particular example of that prior to the last election—I don't want to get into the politics of it—was that, in essence, it looked like things were settling down on the monetary policy front, and then people at large got more enthused about the possibility of either tax cuts or increased money in the pocket and so on, and off they went, even ahead of when anything was actually potentially going to end up on the table. I think what we have to do is to try and head off at the pass that kind of thing, which—

Woolerton So you're suggesting parking it—.

Hall Yeah. But it's only in a one-off basis in this context. I guess if it keeps going, then until the pressures ease on monetary policy, given that one's concerned about the exchange rate, concerned about interest rates, if that can help, but it's an operational rather than an additional instrument in that kind of thing.

Smith Thanks for coming back. First of all, I am really interested in the issues that you mentioned around productivity and around also the fact that the pressures on monetary policy have been exacerbated by both fiscal policy and certain supply side aspects, because another group of submissions to us that also focused very strongly on productivity were the consortium of trading banks. I don't know whether you've had the chance to see their submissions, but they also supported having a productivity commission, and they argued that productivity was the key issue that was causing it, or one of the key issues making the Reserve Bank's job harder. Then they went on to argue—and I am just going from my notes the day they were here—that one of the key factors affecting productivity was tax, and I'm interested in that in relation to your comment about the supply side aspects, because the Institute of Economic Research has also made some comments in that area, and I note that while you have no enthusiasm for reducing income tax willy-nilly, are you concerned at all about some things? For example, one of the guys from the trading banks said that they believe that tax is one of the key factors, that effective marginal tax rates of 80 percent to 90 percent, some New Zealanders are now seeing New Zealanders working less and that unless these supply side factors are dealt with in taxation, there will remain serious problems around productivity—that's one thing they said about tax.

They also said about tax that increasing the top tax rate, when it was, increased the value of property to an investor by 23 percent—just by putting up the top personal tax rate increased the value of property to an investor, I suppose, because as people sought to avoid the top tax rate, it made property suddenly a much more apt investment. I am interested in your views of those comments put to us by the group of trading banks, including ANZ/National, Westpac, BNZ, ASB—the four main trading banks that spoke to us that day.

Hall Let me deal with the last one first. I haven't thought intensively about the issue. It's correct, as far as I can understand, that if you increase top marginal tax rates, under current enforcement tax provisions and legislation, it probably does enhance the incentive to invest in property. I think that just sort of logically goes through if you do the numbers. That's probably all I want to say on that.

Going back to productivity and the link with taxes, on productivity my comments were in a medium to long term sense and sustainable productivity. I think I said last time that in the early stages of the business cycle, most countries can make significant productivity gains, because the economy's been relatively flat and there is scope and there is the attention of the employers and so on to be able to get on and do that sort of the thing, and that the longer the growth period goes—and in particular, towards the top of the so-called business cycle—not only does the attention to productivity wane, because you're flat out trying to satisfy sales and hire staff and all this kind of thing, so it's much more difficult at that end, and so there is necessarily going to be some cyclical movement in productivity and what one's got to aim at is to keep the trend up.

On the link between reducing taxes and productivity, there is no doubt conceptually that if you reduce taxes, whether it be personal income tax, that is an incentive in a lot of cases to either increase more or take a job. If you reduce corporate taxes, then that reduces the overall cost of capital, and that's a better incentive to invest. If you're reducing GST, of course, that's an incentive to people to spend and that may or may not be a good thing. So if we stick to the income side of things, that reducing in particular marginal tax rates, where people have a choice about investment and are offering more labour, then that can help productivity. The context in which I put "don't cut taxes" was in the current stage of the business cycle in the sense that actually there's not much more labour to be able to offer, because virtually all of it is fully employed, immigration is trending down a little bit, and so at this stage of the cycle, it's really probably going into demand and spending and so on, rather than affecting these incentives, which are medium to long term in a lot of cases, and they are at the margin so they don't apply to everybody.

Reducing corporate taxes is somewhat different in the business tax package. I think that element of reducing corporate tax was helpful in terms of providing incentive on the supply side for further investment and a range of industries.

Smith — Thanks for that useful advice. Could I just ask, in the past we've traditionally looked at tax rates and the conventional tax scales and started the low-income earner rebate 15 percent, 21 percent, 33 percent, 39 percent, but since probably the late 1980s and early 1990s and the growth of support systems of tax credits of various kinds, for anyone with one or more dependent children, of course, those basic-scale tax rates don't apply at all in terms of their effective marginal tax rate. I was just wondering, have you done personally any analysis at all of what are the effective marginal tax rates New Zealand families face today? Because over the last decade or more, more than a decade, probably over the last 15 to 20 years, there's been a growth in these kinds of measures that have been built one on the other without any great analysis of how they actually fit together. The Institute of Economic Research has done some work there, but I am wondering if you've done any yourself, because I would suggest that there's so many New Zealanders now that traditional tax rates that we think of aren't the effective marginal tax rates at all.

Hall — I haven't done any work on this. It is very demanding and complex work which requires a detailed knowledge of both the tax system and the benefits system and any other things which impinge on it. I first became aware of this kind of complexity when I was working in Australia and they were thinking about changing these things, and there were a number of organisations which had modelling capacity to be able to try and get on top of this. They had started from zero understanding of these marginal effects and so on, and I think there is some of that in New Zealand, looking at these interfaces. My recollection is that these often occur at unanticipated boundaries, you know, that there is something new that is introduced and one's tried to take account of all these things, and then something was not thought of—investigative journalists would find somebody who's marginal rate has gone by 75 percent, because they're in this particular income or welfare bracket - type thing. So I don't there's a magic answer on those.

Smith Do you think it would have an effect on a person's preparedness to work if, for argument's sake, as we mentioned, there's not much more labour to work. There are quite a few people on a domestic purposes benefit, for example, and they're the kind of person who'll be tossing up do they do more hours of work, because they've got family responsibilities, and IRD figures show that, in fact, someone on a domestic purposes benefit working, say, 13 hours a week, which is quite a bit, at $15 an hour, if they sought to increase their hours of work, say, another 20 hours work a week, which is quite a bit for a person with family responsibilities on domestic purposes benefit, at $15 an hour. They've got dependent children, two or three dependent children, the effect of the marginal tax rate they face for all that extra 20 hours of work would be over 90 percent, and would that trouble you in terms of the supply of labour in the economy if those figures were correct?

Hall I am sure you can find examples like that, and it sure as hang would trouble me. To be able to sort of nail all these shall we call them anomalies is actually quite difficult now. As you've said, these things have sort of built on each other. If one can sort of simplify things rather than adding more to what one has in this area.

Smith Let me just throw another example in. I was at an employer's place the other day. Employers are getting significantly more money for their produce. They sought to pay their staff a production bonus that might've improved productivity, and they wanted to give them a 5 percent bonus. One particular employee on $65,000 happened to have five children. Of the extra 5 percent production bonus, the employee would've got less than 40 percent of it. How do you stimulate productivity through incentive when you try to do it, and the employee gets so little out of it? And that's two totally different areas of income. One where we are talking about $10,000 to $15,000 income; the other $65,000 of income. There's a range of incomes yet the same impediment to greater effort, because you get nothing out of it.

Hall I think there are a range of these. What I would say is when these things are introduced, whether they be in the benefit system or the tax system, it's much easier for people to assess what I would call the demand-side aspect. If they get more money in the pocket, then they decide whether to go out and spend it or save it, and the lower the income level they are, the higher the proportion they will spend. So those are identifiable in terms of effects on the demand side. The effects you're talking about are on the supply side and the incentive. They affect a much smaller proportion of the population, because they only make these decisions at the margin, just as employers make the decisions when their new plant comes up, you know, if there's a change in the depreciation rate or whatever it is, and so nailing down the supply side and the incentive effects are actually medium term in nature and much harder. But in my view—just as was the case with the either famous or infamous 1991 fiscal package which looked at incentives, benefits relative to minimum wage and all those kinds of things—it is the incentive effects over time rather than straight away, which are obviously when you're in a position to change your behaviour.

Smith Thanks.

Fitzsimons I've got two questions; I don't think they'll take very long. What are the main reasons, in your view, why the Singapore model of linking the exchange rate to a basket of trade partners would not work here?

Hall Number one, we did try to run a trade-weighted basket prior to when we went to a floating exchange rate in the mid-1980s, and the pressures to successively break that and the degree of medium-term confidence in it was unsuccessful. Secondly, Singapore's a very different country and economy. They have a much more direct hand on the extent to which capital flows can take place, and their system of setting these things and their governance arrangements are very different from the monetary policy framework in New Zealand, plus their people and their parliamentary system is quite different. The people, in essence, are more amenable to being led into savings behaviour and other things than Kiwis are. Part of the monetary policy framework in Singapore, there's very heavy parliamentary involvement in their governance structure and so on as opposed to the operationally independent system here. So in some ways you would have to change the parliamentary structure in New Zealand if you were going to be akin to the Singapore one. The other thing is that New Zealand, even if it wanted to intervene in the foreign exchange market to any significant extent, has minimal experience in it, and Singapore has obviously done it well. It's based on a long period of confidence and trust. I think New Zealand has potentially got far greater operational problems in trying to make that work.

Fitzsimons Thank you. The other question is one of the tools of the first report, you suggest, is a mortgage levy. I am wondering why—would support that which would impact most heavily on low-income home-owners who are struggling to cope now and not support a capital-gains tax on property other than the family home—. I mean, why would one be a useful tool for supporting monetary policy and the other be opposed?

Hall — My recollection, and I am just turning to my submission on page four, is that I didn't support the mortgage instruments levy, that I thought there wasn't a sufficiently strong case for using it as an additional demand-management instrument for monetary policy purposes.

Fitzsimons — Sorry if I misread that.

Hall — One issue on the capital gains tax was that I said that the committees which looked at these things hadn't looked into the issue of taxing capital gains at the same rate as other income. I said that I felt the committee could look at the pros and cons of that as a possibility and also the counter-cyclical GST were the two that I singled out, that I didn't support the use of either of them in a primarily monetary-policy context. If they wanted to be considered in the context of a more fair and efficient tax system, by all means go down that track but not in the monetary policy.

Fitzsimons — So you're saying it's not reason to do it.

Hall — No, because I think the reason why this capital-gains tax thing received most of its traction was in concern about the housing sector and so on, and I said, well, that's one class of asset, I would not single it out. I've actually gone on and looked at the capital-gains stuff a bit more, given we didn't cover it last time Mr Woolerton raised a question on that. I haven't changed my broad view on it, but I think I'm slightly better informed.

Fitzsimons — I would agree with you about not singling it out. I don't think anyone is suggesting that you would just do it on the property market, but across the—a fairer balance?

Hall — If you're looking at a fairer and more efficient tax system, New Zealand, as I understand it, is the only OECD country that doesn't have some form of capital-gains tax, and so one could make the case on those grounds. The real difficulty, say, given that conceptually why aren't capital gains and income treated as the same thing, how do you actually operationalise it in an efficient way? By and large, it's been operationalised in most countries in a partial fashion, either on property or something else. The major drawback I see—even if you're trying to go across the board—is that it's usually taxed on realisation, in other words, only when a thing is sold, in which case people hold back making decisions as to where to put their money and that's not a very efficient use of funds. Say it's held in property, why shouldn't it go into a new business or something like that? And it's tied up. So I think it's this realisation issue.

A land tax has been proposed as a subset of that, and in particular a land tax on all land, and that might be considered as a least worst form of capital-gains tax, because we've actually got valuations—it doesn't have to wait until realisation. In a monetary policy context, what I would say is that there's no evidence that lower or higher local rates—you know, a land tax is sort of like that – has been of assistance in terms of the monetary-policy aspect of it or in helping, shall we say, the shifting of funds out of property into setting up new businesses and that kind of thing. Then there are a whole lot of nuts-and-bolts things in terms of who owns the land—whether it's farmers or iwi or whatever it is. I think the least worst that I could find was the McLeod review proposal on the risk-free rate of return method, whereby it was looking at, you know, the possibility which is already implemented in investment offshore. They thought maybe one could consider that for under-occupied housing. In other words, that's a smoother, lower type thing. Again, that's not a monetary policy thing.

Chauvel — Brings us back to your point about not doing things without multiparty support. I think Mr Woolerton's question's been answered, so Mr Foss has the last question.

Foss — I think at the start there, you were talking about fiscal policy to be more counter- versus pro-cyclical.

Hall — At the current stage of the cycle, counter-cyclical, in other words not adding extra demand side pressure into the economy, that one either goes neutral or takes more out because other sectors are putting a bit more in.

Foss — Is it fair to say that's going to clean up some of what we often think of as the role of monetary policy?

Hall — Well, until recently, I haven't thought of monetary policy as a counter-cyclical instrument. That has arisen given that monetary policy is medium-term focussed. Then along came its mate in terms of the Fiscal Responsibility Act and the Public Finance Amendment Act, which says fiscal policy should be medium term in terms of public debt to GDP and very long and that kind of thing. As I understand it, an increasing number of people said, well, okay, fiscal policy's off in terms of any significant acyclical policy, in other words counter or pro, and I don't support fine-tuning a fiscal policy. So they said, well, actually, given it's off limits for fiscal policy to be doing anything in the way of this counter-cyclical policy etc, it's got to go back to monetary policy. I think there are dangers in that.

Foss — So you touched on the US subprime issue. So we have a freely floating currency. We essentially have, after 180 days roughly, we have a freely floating interest rate, so actually if fiscal policy behaved itself, was disciplined, do we actually need a monetary policy? Because the effect of the subprime in the States has been felt here. The easy credit has dried up, so those marginal developments are stopping, which is really what Dr Bollard has been on about; the housing market's slowed down; there's a strong debate whether the RB in New Zealand has had an impact on it or perhaps more so international events have had an impact on it. It's kind of a devil's advocate question here, but there is a dog and a tail here and if our interest rates in New Zealand had stayed exactly the same as they were, say, 6 to 12 months ago, the subprime issue would have still happened and the availability of credit in New Zealand would've slowed down, the credit margins would have spread out. I am just wondering how much influence does the RB actually have over our economy, over our monetary policy?

Hall That's actually quite a complex issue. The US subprime initially started out as something nice and fortunate for us, if you believe the exchange rate is too high or comfortable, and so it took a lot of the wind out of the carry trade in New Zealand dollar. So, in essence, our exchange rate dropped like a stone to something which is probably closer to its medium rather than ideal level. Since then, of course, and this is what I referred to at the beginning, the US Fed has made things worse for New Zealand by getting a link between the liquidity problem occasioned by subprime and the US banking system and saying: "We are scared about systemic stability.", and going over to the real sector of the US economy so therefore we are going to cut interest rates by 50 basis points, which increased the margin between our interest rates in the US and has actually made it difficult. So there are a mix of things involving the US economy and New Zealand.

In terms of whether New Zealand's monetary policy, do we need it? Yeah, of course we do, because monetary policy has a specific job—stability and the general level of prices—and while it is true that the leverage of the official cash rate, the speed of operation of that has changed in recent years because of the proportion of fixed-interest mortgages, other countries are starting to face the same problem in terms of the proportion of fixed-rate mortgages, so I think, in essence, what this means is in principle, it's a given. People are making rational decisions about their mortgages and so on. It's unfortunate that our trading banks can borrow at such low interest rates elsewhere. I mean, if the interest rates in the rest of the world were a bit higher, that would be really helpful to us.

Foss Why is that so unfortunate that our banks within New Zealand can source funds at a low rate—why is that unfortunate?

Hall Because they then are free to put it out, in essence, into one sector of the economy in an already pretty full-capacity economy. So the Reserve Bank has to work harder to offset that.

Foss But if those New Zealand banks couldn't, as they currently can, source a relatively low price for those funds, our interest rates would be in double digits easily, and if the Japanese housewife packed up tomorrow, we'd be in somewhat of a large problem.

Hall	Who would have a problem?
Foss	Well, wouldn't New Zealand?
Hall	I don't know. People would be borrowing at rates which were more greatly driven by domestic conditions than the gap between domestic and foreign interest rates.
Chauvel	The entire regime would be different, wouldn't it?
Foss	That's right. Actually, we could talk about it a lot more, but—
Smith	I just want to ask why couldn't you borrow at that cheap rate? If you wanted to carry the currency risk, why can't you borrow? If you're a business, why can't you borrow at 2 percent or 1.5 percent?
Hall	Turn it around to saying why can't a corporate do that, some can and some can't, but there's are fairly big amounts of money, as I understand it, put together by financial institutions which bring it in, and because they are banks, it goes to them. If a corporate tried to do it at that rate, it's got to have credit ratings and all these other kinds of things based on their business. If it were me, I mean, obviously, who am I to be able to borrow at 2 percent, unless one actually had a bank account.
Swain	Probably.
Hall	Plus, I thought the exchange rate would move downwards a little earlier than it did. So I have no particular expertise in movement of exchange rates.
Chauvel	Thank you, Dr Hall. I do very much appreciate your time. I know the committee does as well.
Hall	Thank you, and I wish you well with your deliberations and report.

Transcript

Inquiry into the future monetary policy framework

Finance and Expenditure Committee

14 November 2007

Members

Charles Chauvel (Chairperson)
Tim Barnett
Hon Bill English
Jeanette Fitzsimons
Craig Foss
Hon Mark Gosche
Tim Groser
Dr the Hon Lockwood Smith (Deputy Chairperson)
Hon Paul Swain
Chris Tremain
R Doug Woolerton

Witnesses

Reserve Bank of New Zealand (Submissions MP/46 and 46A)
Dr Alan Bollard, Governor, Mr Michael Reddell, Special Advisor, and Mr Bernard Hodgetts, Head of Macro-Financial Stability

Chauvel — Welcome back, Dr Bollard and officials. It's a pleasure to have you here, as usual. Would you like to begin by addressing comments to the committee, and then perhaps we'll go through questions, as we have in the past.

Bollard — Thank you, Mr Chairman, and good morning, committee members. Thank you for hearing us again. I want to briefly make a few updating points, if I may. First of all, we've been through an interesting time around the international financial markets, with turbulence being recorded, and we've picked up a couple of lessons out of that that I think are relevant here. One of them is that we have actually been in a pretty good position in New Zealand, with a reasonably vanilla financial system, and in addition having this single regulator, the Reserve Bank, whose roles go across from monetary policy, bank regulation, lender of last resort, to financial stability. That should avoid some of the situation that say, for example, the Bank of England, the FSA, and the British Treasury found themselves in, around some of the recent financial turbulence there. In addition, I guess these events, internationally, have confirmed how important liquidity is, for banks—and we'll be looking at bank liquidity policies for the next year—but in addition to ensure there is liquidity in domestic markets and overnight markets. And that is important for monetary policy in the sense that that is the channel through which we put in place the official cash rate, and have that transmitted through to the markets.

We did have a short-term period in later August where there was quite a spread between short-term rates and, effectively, without it intending, monetary policy that tightened temporarily through that period. We've got it back to normal, and that's where it is now. But it does show how important liquidity is through this.

I guess also, from a macroeconomic point of view, there's been some developments, as well. We're now seeing monetary policy having its impact through on the housing sector in quite a significant way. It is having the sort of impact that we've been forecasting. It's having the sort of impact we think it needs to have, so we think that's quite appropriate, but it certainly gives a picture of monetary policy now having been slower than it might have been in previous cycles, but definitely having an impact in the way we would expect.

Actually, we also think, as commodity prices remain high, we are starting to see some required and desired rebalancing of the economy—the domestic sector strength vis-à-vis external sector strength. It's only a start but it's definitely in the right direction.

I know the select committee has been focused on an important part of all of this, which has been the pressure the New Zealand dollar has been under, over the last couple of years in international markets. Currently, we're seeing some quite big moves still going on internationally but the pressure has moved from the New Zealand dollar to the dollar of other countries. I would say particularly to the Australian dollar and the Canadian dollar, which are both at record highs under quite considerable pressure from carry trades and others, partly feeling pressures from the US dollar depreciating, and partly from strong economies and some potential inflationary pressures in those countries, also. They're the ones that are having a tougher time of it at the moment, compared to us at the moment.

One of the points we did want to make is that, as you know, there's been a huge amount of work done on monetary policy around the world. It's not a new technology. It's one that is well established now. That's partly why we sent through to the committee a paper from a member of the Federal Markets Open Committee in the Federal Reserve, Professor Frederic Mishkin—not because we particularly thought that that had all the arguments you would necessarily want to buy into, but we thought it was a very good update on all the work that's been going on in the sort of evolving views on monetary policy worldwide.

There is plenty of other comparative material available if the committee is interested. The Bank of International Settlements has been doing surveys across banks on things like governance and things like monetary policy decision-making. On things like monetary policy communication, there's a huge amount of data now available, and either we or Treasury can help you with that, if necessary.

I'm not sure if the committee is also aware that both the British Government and the Canadian Government have now done significant reviews of their own monetary policies. It's sort of 10 to 15 years into their cycles. They're reviewing, like you're reviewing.

Chauvel — It was the House of Commons in Britain, wasn't it?

Bollard — The House of Commons in Britain, and the Bank of Canada and the Treasury there, or the Ministry of Finance there, as well. But I think the Canadian one is possibly more relevant, in that our system in some respects was based more on the Canadian system. Most of that shows that the Reserve Bank is sort of near the forefront of practice, but I would say not markedly different in most respects now from international norms.

Just turning briefly to some of the other submissions you've had. Some of them have talked about desirability of a wider range of goals for monetary policy—wider than simply price stability. Our submission is that we should be limited in what we focus on, because we don't want to be focused on areas that we can't reasonably expect it to have effects. I don't think that the Government in New Zealand should be relying on the Reserve Bank for broader stabilisation, which is more in the fiscal arena, of areas that go well beyond price stability. I don't think we have ever said that we can effectively operate in some of those areas. We do see ourselves, and have always seen ourselves, as having limited objectives there.

The Australian and US regimes around monetary policy do have broader goals written into their statutes. To some extent that actually reflects the periods in which those statutes were written—in some cases quite a long time ago now. We have modelled how they react to monetary policy shocks, or to shocks in the macro-economy, and you can see some of that stuff in our submission. The answer is, not that differently from us. It's hard to see a big difference, and therefore we don't actually see that those statutory broader goals have made that much difference to the way that they have operated.

A number of submissions focused on exchange rate volatility and exchange rate strength. We share a lot of those concerns. We don't think that the strength and volatility of the New Zealand dollar has necessarily been as damaging as some of the submitters would say. Actually, if you look at our export record, volumes have held up through this period, even in some areas where we would otherwise think they would have been hit. And of course as you know, for those exporters into countries like Australia using inputs and imports in US dollars, for example, some of those have actually been in quite a good position.

The Singapore story has been suggested by a couple of submitters as a possible solution for us. We don't think, unfortunately, that it would work in New Zealand. We are happy to clarify why.

Other instruments? Well, actually we think that the official cash rate now is pretty much standard in terms of the international experience. The Reserve Bank itself has moved on in some of these things. For a while, of course, we were using other instruments such as the monetary conditions index, which wasn't standard. The bank has moved on from that and has now, I think, learnt from international experience on that.

Again, there were a lot of submissions around supplementary tools: when they might work, when not. We wouldn't discount those. We do talk about some of those ourselves in our submission. They have all got distortions and mediation problems, and a downside to them. But it's not a first-best world. If we are trying to operate monetary policy in an area where there's either domestic distortions to it or, more likely, international distortions, then we have got to be realistic about that, and that's where you might look at supplementary tools particularly for limited periods—limited periods being ones when they are likely to do less damage.

Going back to our recommendations, we have recommended that you might think about recommending more resources for macroeconomic statistics, particularly if they are targeted in these areas. There is the potential to get big leverage off that. If we understand where the economy is, and has been in recent years, and are not making mistakes around that, then quite small amounts of money can avoid big monetary policy errors and help good monetary policy, and it doesn't take much to multiply out quite big effects on welfare and the economy as a whole.

We repeat our points about housing supply and land provision, and ensuring that it's not unnecessarily restricted, particularly at times of strong migration. The response of the housing sector is really important in terms of seeing smoother reaction and less build up of pressures in the housing arena. We repeat our points about tax treatment of investment income, not only but especially income of investment housing. We do think that's an area for focus. We repeat that we do believe that low average savings in New Zealand is one reason why we have higher interest rates than some countries. Our returns on savings, particularly financial savings, among which we have bank deposits, are taxed relatively heavily in New Zealand compared to other countries.

On the fiscal side, we repeat that it's important to recognise the implications that large changes in discretionary fiscal policy can have, if the broader microeconomy is under pressure. That's a generalised statement; we think that would always hold. If resource pressures are intense, then that is important. And in that sense it's always important for us to be in a position where we can understand what is currently and likely to happen around fiscal stimulus. As we have said, it's the net fiscal stimulus we're looking at. We have used the tool out of Treasury of fiscal stimulus indicator. We understand they're doing further work on that. We do recommend that they do further work on that. It's pretty important we've got an appropriate view on where that goes. We know that some of those fiscal stimulator measures are not that sophisticated. We would like to see them more sophisticated.

Finally, Mr Chairman, we would say on the productivity side that we are sure you will keep that part of your remit in your attention. We think that's a terribly important part of it. We've actually had some better short-term news. I would not generalise this too much, but the data we've had out of both GDP revisions and, more recently, out of labour market statistics, the QES, HLFS, and other data, suggests that we've got slightly better productivity coming through than we might have thought.

Now, our picture on productivity is terribly important for monetary policy. It is the key as to whether or not we are ever in a position to allow looser monetary policy at a time of reasonably strong growth. If we believe that the potential growth is higher, then we are less inclined to think that further activity is overheating an economy, and less inclined to feel we need to tighten monetary policy, and more inclined to think we've got room to allow the economy to just continue at its pace without tightening the monetary policy. That's very important. Thank you. I will leave it at that.

Fitzsimons — Thank you, Dr Bollard. You spent a couple of years warning us all that the overheated housing market was a big problem and was contributing to inflation. Now we have seen that subside somewhat. I guess I was going to ask today: do you think that problem is over and we shouldn't be trying to devise measures to prevent what is no longer a problem, or do you think it is an ongoing, structural, cyclical thing that will repeat? You seem to be saying today that it is still an issue, so you're not saying the short-term problem is over, we don't have any work to do, and we should still be looking at supplementary measures that could be taken?

Bollard — Yes, I think that's a valid point. Firstly, we are seeing pressure coming off in the housing market but there is still pressure there. So, we are still seeing house price inflation, as you know. It's just coming down, and we expect it to continue to come down. So actually where we are, even cyclically, there is still pressure on the economy from the housing market.

But what you are also saying is, structurally, are we through this event; will we see it happen again? It's been an unusual period of an internationally connected housing boom around a bunch of OECD countries, with some reasons partly relating to availability of credit. Some of that credit has now tightened and we're seeing the effects through on housing markets. Will we see it again? Yeah, our housing markets are cyclical. They go up and down. In New Zealand we should always be focused in on that.

Is that problem over? No, I don't think so. I am pleased that you don't have to sit and deliberate about a particular problem, wondering whether or not monetary policy is going to be effective on it. I think it is being effective on it, and I think you're right. We should be looking out into the future, and not being like a general fighting the last war. But I think it's actually a good time for you to be able to say that we might be through it this time, but it will come again, and consider what's appropriate for that.

Fitzsimons As a result of that reduced pressure from the housing market, and perhaps investors being a little bit more wary about what's happening to housing prices, are we seeing any increased flow of investment into, perhaps, what we might call productive activity, rather than asset-holding as a result? Does that show up yet?

Bollard Well, we've had reasonable investment into the business sector through this period, and that's been a very positive sort of story. That's one reason why we're not gloomy on productivity outcomes, because as they come through that is going to help. Part of this has been of course that we've got a very tight labour market, and people saying you've got to have increased capacity and good quality farm equipment. But, you know, it's very important that continues. I think, from the expenditure side, it is happening. I think your question relates more to how we're financing that. How are we financing it? We have been financing it quite considerably through overseas loans effectively, although again the corporate sector has been saving at times through this period. The Government sector has been saving strongly. It's the household sector that hasn't been. It is sometimes a bit hard to disentangle some of those.

Are we seeing households putting money more into investment-focused areas? Well, yes, over the last year or so we have seen financial instrument holdings by households going up. That mainly means money in the bank and in some cases money in some finance companies. I think it is desirable that they are clearly putting money more down investment routes rather than consumption routes. Of course none of them will say: "Well, we've been putting money into investor housing, and that is an investment." I guess our argument there is that it is probably poor investment. They are probably not going to get great returns, on average, off it, and they're relying on capital returns. I think things are sort of heading in the right direction, but the household accounts in New

Zealand still look quite different and quite fragile compared to many countries that I compare ourselves with.

Smith A couple of questions, if I may, Dr Bollard. You mentioned the international financial market situation and what you have learnt from it. Do you believe that it has played out yet, or did we see a further ripple running through the United States in the last 10 days that may not have played through yet? What is your reading of that? I realise it's not relevant, but—

Bollard It is an interesting question. We don't think it has completely played out. First of all, it was US subprime, then it was international implications of that, then it's been balance sheet implications, and what is the market's reaction to that news? We're still seeing that coming through. A lot of the US publicly listed investment banks report very quickly, and you tend to get that bad news coming out very quickly. It's not necessarily all out yet. We don't think that from the non-listed organisations like hedge funds and other private equity, it is all necessarily through, and the market spreads have flicked out again recently so that says the market doesn't think it's necessarily all through yet, either.

From our economy's point of view, we're not expecting any particular bad news. We've been reasonably insulated from this, but we know if the US economy does actually get hit—the economy as opposed to financial systems—then everybody gets to feel the implications of that.

Smith With respect to the liquidity issue you mentioned that has been important in helping deal with this problem, I just want to make sure I understood you correctly. When you spoke of the overnight cash rate, or the short-term cash rate, and when you spoke of that difference, were you seeing there for a while that rate getting above the official cash rate, as it normally is? Is the overnight rate normally quite close to the OCR, and for a while you saw it get higher?

Hodgetts That's right. The overnight rate was trading at a significant premium above the official cash rate, and we took steps to ensure that the market remained liquid and we have subsequently seen the two rates come much closer together again.

Smith The OCR sets the floor for that overnight rate?

Hodgetts That's correct.

Bollard The OCR is a floor and a ceiling, effectively. It was an interesting little test, in a way. We sort of sat there and said: "Well, actually, monetary policy has just tightened at the moment. Will we be happy to leave it there?". We said "No" pretty quickly. This tool about our overnight rate should not be used in an independent way. It's not another tool; it's a liquidity issue, and that's pretty much what the Fed, the RBA, and others were saying.

Smith	The bank used to set overnight daily cash balance requirements. Do you still have a cash balance requirement, or has that gone, now?
Bollard	Sorry, I should have introduced, for those of you who don't know, Michael Reddell, special adviser to the bank, and Bernard Hodgetts, one of the senior managers in the bank. Actually, Michael is probably the person to answer that question.
Reddell	You're right. Back in the 1980s and the 1990s our monetary policy system was based on control of a quantity, the settlement cash target, and for most of that period it was a very small settlement cash amount, typically about $20 million. About 10 years ago, 1999, we shifted to the OCR and we said there the quantity of balances the banks have in their bank accounts with us don't matter greatly. We're going to manage directly the interest rates. The transition wasn't that dramatic, but we've shifted there so that now we adjust the level of funds in banks accounts, simply in response to those price signals. As Bernard and Alan have said, when the short-term rate got out of line with our policy rate, we took measures to help bring those rates back—not immediately or overnight, but gradually over the course of weeks.
Smith	And what would be an example of that kind of measure?
Reddell	The two specific measures that we took were that we agreed to take in our overnight—what we call repo facility, our lending facility, to banks—bank bills issued by a bank. Normally we will only give banks cash against the security of Government securities. They have got to be holding those. They can bring them to us and borrow overnight at 50 points above the official cash rate, and we said that for the period ahead, while there was this uncertainty, we would lend against other banks' papers. So the BNZ could come to us with an ANZ paper and we would lend to them at 100 points above market.
Smith	And that effectively increased liquidity?
Reddell	Yes, it gave them a greater degree of confidence that they could use those assets for cash if they needed it.
Foss	It was any triple A paper, wasn't it? Didn't you change it?
Reddell	That was another measure we also were planning to take in any case, which was to say that in addition to taking Government securities we would take triple A paper issued by super-national agencies, people like the World Bank or the Inter-American Development Bank, and those sorts of people. But that had been something we had been planning to do anyway. It wasn't a specific response to this period of pressures.
Smith	With respect to the inquiries, you mentioned the inquiries by the British and Canadian Governments but you didn't actually say what they had found. Are they not complete yet?

Chauvel We've got the appendix to the British inquiry in our papers.

Bollard We can certainly just get you a summary.

Blackmore The House of Commons has reported back to the Government. It has put forward some recommendations on the processes around appointment to monetary policy committees, etc. But in essence it saw a general—with a broad agreement with the broad operation of the Bank of England, etc., and the monetary policy framework. So what other considerations, what other recommendations the committee put forward, are being considered by the British Government at the moment. But in essence they weren't major—.

Bollard Canada, I guess—they're focused on price targeting and just what you would target in some of that stuff.

Swain Yes, thanks. You mentioned Singapore, and we have had comments about Singapore. I am wondering, first of all, have you seen Girol Karacaoglu's submission, so that's really what I am going to ask about. I mean, putting aside the obvious framework factor, New Zealanders are far less obedient than Singaporeans. It'd be a nice way to run the place, if you could get that level of obedience, but that's not going to happen here. He was suggesting a number of things. First of all, he was not saying that the framework is broken—he was saying, essentially, if the framework did break—but he's more proposing a focus around currency union and exchange rates focus, relative interest rate focus regime. And there were a number of other instruments including loan evaluations, policies, liquidity ratios, and all that sort of thing, which he says, when they had a similar housing problem, they didn't try to back away from the main issue but kept trying to keep their exchange rate target about the same, and tried to manage it in other ways so that it didn't affect the real economy, which was the guts of his point.

So I am wondering if you or someone could just expand a bit more on—I think your comment was, Singapore, well, it's not really appropriate and you would happily explain. So I am keen for you to explain that a little more and just maybe give some response to what Girol mentioned in his submission.

Reddell OK. We set out some of this in our submission that we sent to you but are happy to elaborate. The Singaporean experience is a tantalising one; there's no doubt about that, and the centrepiece of it is the management of the exchange rate. They don't tightly control it in the sense of 1 or 2 percent either side of a range, but they do manage its pathway through time. I think the essence of what makes it viable for them rather than for us is not so much that it's a directed society or anything else but that their people have a strong preference to save. For them, they can set the exchange rate, manage the exchange rate, with interest rates that are around those in the US or even below, and it doesn't lead to substantial inflationary pressures because the citizens have, in addition to the compulsory savings requirement they have, just a strong cultural preference to accumulate savings.

I think the best way to think about what the ramifications of trying to do their system here would be to think about what would be the implications if interest rates here were set 300 or 400 points below where they are now. Because that's in a sense what Girol and a number of others are essentially pointing to. If you want to stop the exchange rate rising, you've got to be willing to take a lot of foreign reserves and you've got to be willing to set interest rates at those sorts of levels.

If we had interest rates at 300 basis points below where they are, and nothing else was changed about New Zealanders' willingness to borrow and to save, our best judgment is that we would see a strong accumulation of inflation pressures. This economy hasn't shown signs in the last few decades of being able to live with Singaporean levels of interest rates or, indeed, even Australian levels of interest rates.

Swain You mean Singaporean people would borrow more?

Reddell That's right. We look at the experience this year. As the governor was pointing out earlier, monetary policy has been achieving its bite on the housing market this year. We've raised the OCR by 100 points; mortgage borrowing costs have risen that much further. If our interest rates were at levels that Australia or US ones have been, there's nothing that would have stopped householders, and indeed firms, from borrowing more. From the firms' side that wouldn't necessarily have been a bad thing; it would have encouraged more productive investment. But from the aggregate economy perspective, it would have put more pressure on fully employed resources and simply exaggerated the inflation pressures.

Swain I understand that point. I think it's a fair point. You wonder then—maybe it's your consideration when KiwiSaver really beds in over 20 or 30 years maybe. I don't know; that's one thought I had as you were talking. But he's also saying that there were some complementary things that went in around it. He raised an issue way beyond your control, which is that the coordination of policy out of the silo and all that stuff, which, as I pointed out to him, we all want to do, and it's bloody easy to say but that's quite hard to do.

But he also did move these other things. He raised the issue about various ratios and things that the banks are required to hang on to, that we don't have that any more. So I think what he was saying is that it's not just the exchange rate regime and holding on to that, notwithstanding the different culture there; there are other things. So I suppose the base question is, why don't we have a tougher liquidity regime on the banks? You've explained that before, but I've forgotten about it, so maybe you could do it again.

Bollard — That's right. It's something we have focused on. I'll take two things. One is, yes, there are cultural features in all of this, and savings and so on are important—hugely important. I think New Zealand will change. I think it's going to take quite a long time. KiwiSaver will help. A lot of people are now doing quite a bit on financial literacy right through the system, and that's got to continue and continue, but it's obviously not going to bring overnight change.

On liquidity, we do have the advantage that we are the bank regulator. We have fairly normal bank regulatory tools. Capital adequacy is the principal one and that's been revamped internationally at the minute with this Basel II new approach to capital that says: "Don't worry so much about the old accounting rules on it; worry about the economic impact—require risky areas of lending to have more capital than less risky areas."

That's a bit of an issue around the OECD at the minute because the less risky areas tend to be mortgage lending and none of these regulators are that keen to see banks get less capital requirement for mortgage lending just at the moment. That's something they're working through and we're working through. We're hoping that we' re broadly on track to see many of the New Zealand banks, like the Australian ones, getting into Basel II arrangements next year. We have had to work through just what that would mean for requirements on lending by type of risk. But, quite apart from that, Basel II allows what's called Pillar 2, where an individual country, for particular country-specific and, if necessary, time-specific reasons, can put in other requirements. We're looking at that quite closely in this sort of context.

As you know and as we've said before earlier this year, we went round all the banks and did a review of riskiness of mortgage lending, size of mortgage lending. We found it was slightly riskier than it had been, but generally didn't rate badly by Australian standards and we didn't think we had any of the sorts of issues around US-type subprime mortgage lending. That was encouraging for us, but we also shared with the banks our concern that this lending was going out and just building up too much in the way of leverage in the household balance sheets. Since then you have seen a lot of this lending tightened up and cut back, and we're pleased about that.

We also simulated what would be necessary in terms of increasing capital requirements to actually slow the banks down that way. The answer is a big increase in capital requirements—not a small one, a real big one—because they hold more capital than the regulatory requirements, mainly to meet credit rating agency requirements.

Swain — When you say "big", what kind of order of—can you remember?

Bollard — I can tell you that from some of our figures.

Hodgetts	In terms of the margin above the regulatory minimum it's anything from 4 percent points upwards on a minimum of 8.
Bollard	But just what extra they were already holding over the top, and what these different arrangements require—what I'm saying, it's not a sensitive, subtle tool; it's a bit of a sledgehammer approach. It's still there for us. We haven't closed off on it, and the banks know that and that's been quite important in terms of moderating of behaviours. There's information I can't share in open committee on how they've responded, but we're not unhappy with the response we're now seeing.
Swain	Well, we've had a bit of advice from our unpaid consultant on behalf of the Japanese housewife over there—both of them—and maybe they might want to ask a question.
Tremain	A different group of profiles, using the capital adequacy ratio to affect those—is that used in other countries, at all?
Bollard	Yes, absolutely. Other countries that are going to advanced Basel II, which is all of Europe, Australia for the big banks, US only for the big banks—pretty much the standard around the world. But having said that, there are a lot of complexities around it and there is still room for these country-specific approaches. We've got to tie ours in; we want to tie ours in with the Australian regulatory response. That's going quite well.
Woolerton	I listened with interest to your responses to Ms Fitzsimons. A few of the submitters that came along to us said that inflation is dead, it's dead for ever, and why are you worrying about it. I was waiting for a chance to ask for your comments on that.
Bollard	Well, the reports of its death are much over-blown, I would say. Actually at the moment we're seeing worldwide food price pressures stronger than would have been the case since, I suppose, the 1970s. I mean, you can't have record oil prices, record dairy prices, record animal feeds prices, and some other commodity prices at these record levels without having massive price pressures. Countries are different in the way they're reporting those, and in some of the target indices used, and some of those will exclude things like food and energy in the short term; they still have to take account of them in the more medium term. Right at the moment, as you know, the inflation rate in New Zealand's quite low but the market's completely expected to have a big jump up from that in the next December figures. Now actually some of that is statistical—there's a negative that drops out and that pushes up the annual quite considerably. The market—can you quote me a market figure?
Reddell	I think the market is mostly expecting inflation to be around 3 percent for December, maybe just under. That's probably the widespread market

sense of where the core inflation has been—around 2.5 percent to 3 percent at the moment.

Bollard So, not dead, unfortunately; not even sleeping.

Hodgetts And certainly most other countries around the world are finding similar sorts of pressures coming through. So they likewise are finding upward pressure on their inflation rates.

Bollard It's quite interesting watching at the minute. So the Federal Reserve has been cutting rates—interesting—mainly in response to, I think, credit issues and financial market concerns. Quite unusually, the markets have pushed up the yield curve in a very steep way, which is the market saying: "Well, you can cut rates in the short term, but medium term you've got to increase them because you have got an inflation issue there."

Gosche Just to follow on from Paul Swain's question. There's quite strong criticism from the Business Roundtable about your calls for people not to jump into the housing market over the last year in line with their claim. I don't want to misquote them, but as I understood it the capital requirement for the mortgage part of bank lending was too low, and you were in fact encouraging the banks to lend in that area. Their solution was to have no such interventions and just to leave it to the banks, and I won't say what I think about that. I'd be interested in your response to their claims that you were actually encouraging this with your actions over here in terms of regulating the banks at the same in terms of trying to talk people out of it. Can you just respond to that?

Bollard We just don't accept that; we think it's wrong. The banks have had light-handed regulation. On that basis they have lent very strongly. The banks are going to lend into what's their best interest—of course they will do that. That's not necessarily the macro-economy's best interest, and we had reached the point where we saw a very big increase in household debt—it had doubled in 5 years and the banks were still lending very strongly. That's why we went out and talked and did some things. We think that's appropriate. To have left them in that position we would now be in a situation—it's hard to know—where quite possibly the housing bubble would have gone even further. We can't know that exactly.

As to talking to the household sector about what might happen, all we're trying to do is say: "Look, we're putting monetary policy in place because of existing concerns. We think"—this is what we said 2 years ago—"that in a couple of years, the housing market is going to come off. We think you should be thinking ahead for that so you do not find yourself in the embarrassing situation of having house prices coming down, your capital falling away from you, and interest rates still very strong. There are lags in all of this; please take it into account now." I'm sure a lot of households did exactly that and are now pleased that they have done that.

Gosche That mechanism of being able to require more capital to be held by the banks is obviously available to you now, and you said just earlier that you would have to bump that up quite considerably. What would be the consequences of you doing that?

Bollard Well, we'd be out of step internationally.

Gosche Would that matter? We're out of step internationally with our interest rates.

Bollard True.

Gosche As a country, I mean.

Bollard Would that matter? No, we think we might find other things happening like the finance company non-bank sector expanding hugely, and disintermediation and arbitraging around the banks. We think we'd find New Zealanders going offshore and New Zealand corporates going offshore to fund directly to get around those sorts of regulations. So they're not clever regulations in a way. You might use them for a bit of a shock to press things, but it would be quite a big hit and we're not exactly sure how the Australian parents would react as well—whether they would effectively just funnel more capital across the Tasman temporarily to deal with that, but actually have no impact on their lending policies.

But it could have an impact. It could also lead to them closing up shop. I don't mean closing up shop on operations here, I mean taking a much, much more conservative attitude to lending, and we don't necessarily want that either. We don't want to see New Zealanders kept out of that market; we want the ones who can support loans having access to loans.

Gosche So it would, in fact, make it even harder for first-time buyers trying to get into the market.

Bollard Yes, it would, but some of what we're doing is making that harder as well and some of that, I'm afraid, is necessary.

Groser I'm interested in exploring a little further the nexus between interest rates—or more particularly, the OCR—productivity growth trends, and the issue of what's happening, underlying, in terms of productivity growth rate. Starting off from the back end of that question, while I'm aware there's a very sophisticated debate going on about how to interpret the most recent data on productivity—with some in Treasury suggesting maybe the signs of a bit of an upturn; others producing their own estimates suggesting it's going to get even worse—there doesn't seem, on balance, a lot of argument about what's happened on the broad picture over the last 10 years, which is that there was a remarkable growth of productivity peaking in 1997 to 2000, to 3.5 percent per annum on average. And that held up fairly well for a few more years into the early part of this century and there has now been a considerable slowing down. Whether it's sustained in the future is simply another question.

Now, my understanding is that since the bank—thank God—put the MCI back in the closet and just uses it now as a vague tool to judge with rather than a mechanistic thing, you've used the output gap as the central analytical tool to your judgments on the OCR. As I understand it, dumbed right down, the OCR is essentially a measure of a gap, which can be anything either between zero and positive or negative, or between aggregate supply of goods and services in the economy and aggregate demand. And when a positive output gap starts, you see the rise of inflationary pressure, and this triggers a decision on the governor's part: "Should we increase the OCR?".

Now, I've seen estimates outside the official sector, the private sector, which I think was the ANZ Bank, that suggested, and I won't have my figures exact here because I am relying on my memory, that—how would we put this—had productivity growth simply not slowed down by an average of 0.2 percent per annum over a recent period like the last 3 or 4 years, and I forget the period they use, the output gap would not have existed. That probably would have influenced your judgement on interest rates.

So this seems to lead to a pretty important conclusion. I recall in your comments—you very quickly passed over it, but you emphasised the crucial importance of productivity in terms of interest rates—that had productivity growth not slowed down in the last few years, interest rates, ceteris paribus, would have been lower than they are today. And we wouldn't really have required a very significant shift in the right direction of productivity growth for that statement to be true. Would you like to comment on that?

Reddell I think you ought to be cautious about mechanical interpretations of how we do things or of the role of productivity. Productivity is absolutely imperative to living standards of people in this country. But the implications for monetary policy are more complex, because were productivity to be growing faster, you would expect that we would all wish to be consuming and investing more in support of that.

If this were an economy, hypothetically, that were growing at Chinese levels—10 percent per annum—then you would expect also that the investment would be taking place in support of that, putting pressure on resources; consumption would be growing rapidly in anticipation of the income gains. So the broad direction of the ANZ analysis in a short-term, mechanical sense is right, but I wouldn't go too far in reaching that conclusion.

You've got to look back on this half decade and say the housing boom has probably been the biggest manifestation of inflation pressures. Had the economy had a stronger growth potential during that period, do we believe that the housing boom would have been smaller or perhaps greater? I can see reasons why it might actually have been stronger.

Groser — I understand the point you're making, and I certainly do not look at these issues in terms of some mechanistic relationship because at the end of the day there are vast other complexities that bear down on this issue. Nevertheless, it does seem true as a general statement that had productivity held up rather better, the probability is that we would have interest rates lower than we have today. I find it difficult to take a view other than "Yes" to that question.

Hodgetts — I mean, if labour productivity had been faster and we'd enjoyed the same growth rate in the economy that we actually have enjoyed over the last few years, then, yes, all things being equal, we could have lived with lower interest rates because there would have been less inflation pressure for that given growth rate.

Groser — Thank you.

Foss — You have mentioned many of the submitters. Some have said "fix the currency", some have said "a basket of currencies", some said you should intervene whenever you like. But one that stuck out for me was the NZX submission which actually said the RB should be prohibited from intervening in the FX market. Now around the time of that submission—July—you did intervene to the tune of about $1.5 billion, I think, over June, July-ish—something like that. So could you expand on that a little bit, given that we are now probably about the same level or higher than where you intervened at, and if it was worthy to intervene then, why isn't it now?

Bollard — Yes, sure. We disagreed with what NZX had to say. We think we're running a system that's actually pretty much best practice, international standard, and not that dissimilar from, say, Australia and others. We've always, of course, had quite limited expectations and aims from FX intervention. We've always said it's only likely to be at the peak or trough of a cycle. It can only work under certain, very limited circumstances, and only likely to have limited effect.

We've found ourselves a bit in the role of hosing down commentators' views on all of this. They almost all seem to think that we've been trying or able to do stuff that we can't do. It's a limited intention, and it's pretty much worked the way we had anticipated in that sense. I suppose I would say: "Why wouldn't we use that tool in a limited way provided we are aware of its limitations?". You won't expect me to make comments about intervention and appropriate levels or anything in this open committee. But we would make a distinction between what's happening

	to the US dollar at the minute and what's happening with the TWI. So the US dollar, as you're well aware, has been dropping over recent months quite significantly. The trade-weighted index is another story altogether, because the euro is very strong, sterling's strong, the Aussie dollar's very strong, and that's meant that the TWI hasn't been dropping like that.
Foss	Your position was against the dollar.
Bollard	So we'll look at a bigger picture rather than just the US dollar picture.
Foss	Because I think your recent tables—and correct me if I'm wrong—I think you must still hold the position.
Bollard	Sorry, say it again?
Foss	I think you still hold the position. I think your tables, the other week—essentially you're still holding—
Reddell	It was the end of September numbers that were released.
Foss	So you're still running the short Kiwi position—which is why I asked: if it was good then, why isn't it good now? But I will just move on. I was very interested in your comments about capital adequacy and a couple of members over there have picked up on it. But can you talk me through a bit about your considering quite seriously your powers under Basel II to have something unique for New Zealand. Are you trying to frame up something now that you would use in an emergency, or would you say: "Hey, guys, if this criterion is met, therefore this will be the new capital adequacy ratios for your New Zealand banks."? How would you implement that? Would you flag it; would it be public knowledge prior?
Bollard	Look, I think there are two things there. One is top-up capital that we may be requiring on the formula that's there under Pillar 1. So Pillar 1 has got all these not exactly formula but model-driven numbers that come out that lead one to add up what capital's required in a bank for certain portfolios of lending. Pillar II allows us to stand back, look at New Zealand's particular situation, and say we might want to top up for certain purposes—and that's where we're thinking at the moment. In addition, we could use Pillar II at particular times to bring in particular extraordinary requirements. That would be unusual and costly but we wouldn't discount it. As far as our discussions with the banks, we're keeping that open at the minute until we see the full package of numbers. You'd expect us to keep it like that until we effectively deal with the banks.

Foss	So once you've finalised your framework that's sitting there on the shelf, would that be in the public domain or not?
Bollard	Well, yes, generally it must be. As to where we're thinking about going in future, some of that will be private discussions. But, yes, I think I'm right in saying that we would have to—
Hodgetts	We would all come through the general disclosure process.
Foss	Right, OK. Another thing I mentioned last time and I've just been thinking about it a bit further—I asked you about the approved issuer levy. I think it's in here somewhere in case you can't find it again. The problem I have with it is that most of the assumption is that it should be higher to try and equate foreign lenders to what New Zealanders have to pay—that's fine. But because it's tax deductible, the net cost to the institution in New Zealand is actually— it doesn't really matter what the approved issuer levy is, does it?
Reddell	I think the point I forgot to make to you last time, of course, is that all interest is tax-deductible, as well. So it's no more favourably treated than any interest, and the case for, in a sense, setting the approved issuer levy, or preventing the ability of banks to avoid paying it, is simply about slightly increasing their costs. All of those costs are tax-deductible but that doesn't mean that they're not, in after-tax terms, a real increase in the cost of funds that lenders would face.
Foss	Yes, so it's really a small margin, isn't it?
Reddell	Yes, but the margins the banks operate on, obviously, as you are aware, are a small proportion of the total overall cost of funds.
Foss	Yes, OK. Just on ring-fencing. You spoke about it again in your introduction there, Dr Bollard. Many submitters have come through—and again it's from across the whole spectrum—and you're still keen on it. But we've actually had IRD, and I think the Minister, come out quite hard and say "We've looked at existing law. Existing law is adequate and we will be making sure we pursue it as intended." Right?
Reddell	On capital gain, yes.
Foss	Yes, on ring-fencing. They're all about the intentions of investment properties. So they've been very open about that. So what do you contend? Are you still contending that the ring-fencing should just disappear, or that it should be bucketed up, and how should the investment be treated differently from a business investment?
Bollard	Two things: one is we are pleased to see that Government's given more money to IRD for enforcement of existing law. We have always recognised that existing law is quite difficult in terms of its interpretations in courts. So we'll be interested to some evidence of

tighter enforcement there, and see how the courts treat that. I think that's still an ongoing story. On the other issue—

Reddell I think the overall tone of our submission, though, is one of saying: "We think ring-fending is something that may be worth looking at." We didn't strongly champion it in here deliberately. We said: "You want to look at the overall treatment of returns to investment assets. We want to make sure that housing in its overall economic effect is not more favourably treated by the interaction, for example, between the tax system and bank lending policies than other sorts of financial returns. But perhaps even more fundamentally, we want to encourage the committee to consider ensuring that all investment returns are treated in a fair, neutral way, and perhaps a way that encourages a savings culture in New Zealand as one of the ways of helping to lower our neutral, sustainable level of interest rates here.

Foss So does that give us a flavour to where you're going on this capital adequacy stuff, because the attractiveness of a bank to lend on a house or property is 50 percent better than on a business—right? So is that where you're headed with your capital adequacy changes?

Reddell I think that's not a one-to-one appropriate comparison. The 100 versus 50 comparison is a comparison between a secured loan and an unsecured loan. So the 100 percent basic capital adequacy requirement is what a bank would, under the current regime, have to hold if it lent to you or me, unsecured. If you're lending on a mortgage, you've got a very large degree of security. That, on most mortgages, is a substantially lower risk loan.

Foss Well, a bank will lend on bricks and mortar rather than hopeful cash flows.

Reddell Well indeed, and from a pure financial stability perspective, you would expect them to require less capital for that. They make judgements about their expected returns but you want a capital regime to reflect real economic risks and some lending on property—for example, lending 90 percent or 100 percent of loan to value ratio is high risk, because house prices can fall. If you're lending 20 percent of the loan to value ratio, that's an extremely low-risk operation. If you're lending to a very safe, rock-solid, triple A corporate, that's probably a very low-risk credit. If you're lending to someone who's very highly leveraged, totally unsecured, that's very highly leveraged. So what we're looking for in the whole Basel II regime—it's been designed this way internationally—is to be more responsive to actual differences in risk characteristics.

Chauvel Thank you very much. It's much appreciated.

conclusion of evidence