



New Zealand Chambers of Commerce (Inc)

Submission to the Finance and Expenditure Committee

Inquiry into the Future Monetary Policy Framework

July 2007

Introduction

The New Zealand Chambers of Commerce (Inc), NZCCI, is an umbrella organisation serving the interests of 34 Chambers of Commerce nationwide. These, in turn, represent over 24,000 businesses around the country. While many of our members are in the SME category our membership includes most of the largest corporations in New Zealand.

NZCCI is pleased to be able to make this submission on the Finance and Expenditure Committee's Inquiry into the Future Monetary Policy Framework.

We support the broad monetary policy framework and do not believe changes would be in the long term interests of the New Zealand economy. However we do propose some measures which we believe would enhance the effectiveness of monetary policy and thereby take pressure off interest and exchange rates.

The importance of price stability

Maintaining low inflation or price stability is crucial for the competitiveness of the New Zealand economy. Businesses and consumers are worse off if prices rise faster than incomes and inflation can reduce the value of an investment if the returns are insufficient to compensate. Sustained inflation also has longer-term effects. If money is losing its value, businesses and investors are less likely to enter into long-term contracts. This discourages investment in the nation's productive capacity.

As well as being crucial for maintaining international competitiveness, low inflation is also the best way to maintain low interest and exchange rates in the medium term.

New Zealand's monetary policy framework

The Reserve Bank of New Zealand Act (1989) gives the Reserve Bank political independence and specifies the achievement of price stability as its primary objective. There is a policy target agreement (PTA) between the Reserve Bank Governor and the Minister of Finance setting out specific targets for achieving and maintaining price stability¹.

¹ Currently this is set as an annual movement in the consumers price index (CPI) of 1 to 3% on average over the medium term.

We fully support this broad monetary policy framework including the Reserve Bank's independence and its single focus on price stability. We note that the 2001 independent review of monetary policy by Professor Lars Svensson found that the New Zealand framework was consistent with the best international practice of flexible inflation targeting. The best thing that the Reserve Bank can do to contribute to economic growth is to focus on price stability.

Effectiveness of monetary policy

Notwithstanding our support for the broad monetary policy framework, the interaction of monetary policy with other policy and economic settings is currently throwing up some detrimental impacts in the present economic environment.

This is because a combination of macroeconomic and government policy settings means monetary policy is having to work harder than it otherwise would to curb inflation. This is resulting in overly high interest and exchange rates.

Specifically, the Bank is having to lean against the following policy settings which are all pushing in the other direction, contributing to higher prices. This is not a complete list:

- Fiscal stimulus through increasing government expenditure
- Increased labour costs (from the Holidays Act, higher minimum wage, KiwiSaver etc)
- Higher costs from new regulation (banking, telecommunications, electricity, food safety etc)
- Increasing central and local government charges (The cpi shows these increased 27% in the last five years compared with 13% overall.)
- The RMA and Building Act increasing housing costs and prices.
- Increasing local government spending and rate rises

Monetary policy should focus on inflation but it needs support from other pillars of government policy to be effective. It must not operate in isolation.

In addition to these government policy settings, there are a couple of significant macroeconomic features which the Reserve Bank sees as a major driver of inflation and is responding to with a tightening of monetary policy.

Firstly, a positive output gap (where GDP exceeds the economy's capacity to produce goods and services without generating high rates of inflation) has opened up in recent years. This has generated pressure on available resources in the economy and led to a prolonged period of high non-tradables inflation. The key to addressing non-tradables inflation is by improving the economy's productive capacity.

Secondly, the "wealth effect" associated with the buoyant housing market has led to strong growth in consumer spending. The predominance of fixed rate mortgages (which slows the transmission to retail borrowers of increases in the OCR) means monetary policy has been slower in dampening the housing market and the consequential growth in consumer spending.

These factors mean monetary policy is having to work harder than it otherwise would - again resulting in overly high interest and exchange rates.

The official cash rate (OCR) is a blunt instrument in the sense that it can not specifically target the sectors where price pressures are predominant. In the current cycle inflation is mainly being driven by the non-tradable sector but tight monetary policy is putting pressure on the export sector which is more exposed to exchange rates. As well as being inequitable this is inefficient.

Don't alter the monetary policy framework

We caution against altering the monetary policy framework as a quick fix to increasing interest and exchange rates. This would address the symptoms rather than the cause of some fundamental problems facing the New Zealand economy.

Rather than change the monetary policy framework we need to rectify the policy settings and implement policies which support monetary policy. This is elaborated on later in the submission.

There have been calls for the Reserve Bank's inflation target to be made wider and for the Bank to be required to have regard for other variables or be given alternative targets (eg economic growth and exchange rates.)

We do not support these. Undermining the Bank's focus on price stability by relaxing the inflation target would ultimately result in higher exchange and interest rates in the medium term.

Giving the Bank additional targets would distract it from its primary focus of price stability. The best possible contribution that monetary policy can make to the economy is achieving low inflation.

There have already been significant adjustments to the monetary policy framework in recent years - including relaxing the target from 0-2% to 1-3% on average over the medium term, and requiring monetary policy to have regard to economic growth and the exchange rate. These have not resulted in better outcomes. Allowing higher inflation has not resulted in lower interest rates – if anything it has exacerbated the problem, and a further softening of the target would make things worse.

Low inflation does not require low economic growth

It is concerning that many commentators, and possibly even the Reserve Bank, believe that strong economic growth and inflation go hand in hand and that a slowdown in economic activity is needed to control inflation. This is not always true as was highlighted in a recent Melbourne Age article, reproduced in the [Dominion Post](#), about the difference between the operating styles of the Australian and New Zealand central banks.

Rather than slow demand, more attention needs to be given to the supply side of the economy to increase capacity so that economic growth is not inflationary. This is an area of investigation we would like the committee to pursue.

Housing taxation

There has been a lot of comment about whether or not tax policy has contributed to the current housing boom and whether or not changes should be introduced to address it.

If it could be demonstrated that rental properties enjoy a tax advantage over other investment, we would support a levelling of the playing field. However, there is no evidence that they do. We are opposed to biasing the tax system against housing (although proper enforcement of existing laws, eg capital gain applied to on-selling for a profit etc, should apply). Either way this is a tax policy issue and should not be used to address monetary policy.

It seems that the perceived advantage of rental properties is due to the ability in the current environment for home-buyers to borrow 100% of the purchase price of a house whereas banks are less likely to lend 100% for other investments meaning interest deductions are greater for housing investors than other investors. This is not a tax issue and so doesn't need addressing as such but it does raise questions about the capital adequacy ratios which may be encouraging banks to weight their portfolios heavily in favour of residential mortgages.

Mortgage interest levy

A mortgage interest levy to supplement the OCR has been raised, particularly on fixed rate mortgages, to address the buoyant housing market. We oppose this proposal. As well as going well beyond mainstream international thinking, such a levy would pose several practical difficulties. The idea has as much merit as a variable gst to manage consumer demand (which we would also oppose.)

Ten Point Plan to Support Monetary Policy

Other than strengthen the Reserve Bank's focus on price stability, we doubt there are any changes to the broad monetary policy framework that can by themselves rectify the current imbalances and negative impact of high interest and exchange rates. However this does not mean there are no solutions to these problems.

We offer the following ten-point plan which is designed to support monetary policy. Implementation of these proposals would help contain inflation and take pressure off interest and exchange rates in the process.

The ten policy measures are:

1. Slow the growth in government expenditure
2. Enhance New Zealand's competitive economic environment
3. Encourage the spread of migrant settlement throughout New Zealand
4. Reconsider banks' capital adequacy ratios
5. Improve New Zealand savings culture
6. Invest in infrastructure to ease capacity constraints
7. Improve responsiveness of housing supply
8. Improve productivity
9. Cap local government rates
10. Rewrite the Policy Targets Agreement to focus on price stability

These are elaborated on here.

1. *Slow the growth in government expenditure*

The substantial increases in government expenditure over recent years have made a significant contribution to inflationary pressures over the period. The Reserve Bank is not alone in repeatedly drawing attention to this. Slowing the growth in government expenditure to below the growth rate of the wider economy would take a great deal of

pressure off monetary policy. Unfortunately, under the 2007 budget the ratio of Government spending to GDP continues to grow.

In the context of the current debate about the inflationary nature of expansionary fiscal policy, it is worth noting that tax cuts are not inflationary if they are accompanied by a reduction in government expenditure. Corresponding reductions in taxes would provide incentives for improved productivity growth which is a key condition for non-inflationary growth.

2. Enhance the competitive environment

Competition has an important role to playing maintaining downward pressure on prices. New Zealand's economic environment is quite competitive by international standards but there are some areas where improvements are possible. The delivery of local government services and telecommunications are particular candidates for this.

3. Spread migrant settlement throughout New Zealand

We welcome increased migration for the economic and cultural benefits it brings. Notwithstanding this, the demands on infrastructure resulting from the significant population boost when net inward migration is concentrated on small geographic areas (eg Auckland) are contributing to pricing pressures. Other parts of New Zealand would welcome the settlement of new and returning New Zealanders.

4. Reconsider capital adequacy ratios

Capital adequacy ratios based on the Basel agreement influence banks' lending policies by dictating how much capital backing they have to hold for mortgage vis a vis business loans. The ratios are a prudential tool based on risk and should not be seen as a monetary policy tool. Nevertheless, based on an assumption of lower risk, proposed changes internationally will make it easier for banks to lend to the housing sector. Because of the point New Zealand is at in its current housing cycle this assumed low relative risk may not be applicable and so we recommend the committee research this issue.

5. Improve New Zealand savings culture

Significant growth in consumer spending in recent years, partly fuelled by the wealth effect of the housing boom and increased job security has made a significant contribution to inflationary pressures. While not wanting to undermine the importance of consumer choice in saving/ spending decisions, an increase in household savings would dampen such pressures. We support the KiwiSaver as a means of changing New Zealand savings culture.

6. Invest in infrastructure to ease capacity constraints

A major driver of inflationary pressure in the New Zealand economy is from what is known as the positive output gap. This is due to GDP growth exceeding the natural rate of growth due to capacity constraints. Increased investment is the key to alleviating these constraints. The government has a major role here in the facilitation of infrastructural investment.

7. Increase the responsiveness of the supply of land and housing

One contributing factor to the buoyant housing market is the slow speed at which new land and houses are able to be brought onto the market in response to evidence of rising demand. Amendments should be made to local government and other rules to increase the responsiveness of housing supply. This was one of the six measures the Reserve Bank and Treasury considered favourably in the February 2006 supplementary stabilisation instruments work.

8. Improve productivity

Improved productivity growth in the New Zealand economy will improve the economies capacity for non-inflationary growth. This is particularly important in the current environment where there are capacity constraints. Investment and training are crucial drivers of productivity and tax cuts would provide valuable incentives to improve productivity.

9. Cap local government rates

Local government rates and charges have far exceeded the rate of inflation and population growth. Mechanisms need to be introduced to improve local government accountability with a view to constraining growth in expenditure and rates.

10. Rewrite the Policy Targets Agreement to focus on price stability

Finally, a crucial way to support monetary policy is to give the Reserve Bank clearer goals. The relaxing of the PTA to 1-3%, introducing the concept of the medium term, and requiring monetary policy to have regard to economic growth and the exchange rate have not resulted in better inflation outcomes or lower interest rates – if anything it has exacerbated the problem. Monetary policy should be focussed on what it does best, achieving price stability, and the PTA should be rewritten accordingly.

Conclusion

We support the broad monetary policy framework and do not believe major changes would be in the long term interests of the New Zealand economy. However we do propose some measures which we believe will enhance the effectiveness of monetary policy and thereby take pressure off interest and exchange rates. These proposals and research areas would make a real difference and should be carried out as soon as possible.