

OutLook

(1 December 2007)

Monetary Policy and Productivity

Foreword

This series of papers has been developed to underpin the policy advocated by the New Zealand Manufacturers and Exporters Association (MEA)¹. We draw on our analysis, the experience of our membership, and other research to substantiate the targeted taxation approach. With the right policy approach New Zealand can increase innovation and productivity and enjoy a first world future. Our OutLook papers include the tax treatment of productive assets, research and development, among others.

Innovation is inherently risky for any company to undertake, yet chance alone dictates that the more innovation our companies undertake, the greater the pay-off for the wider economy in the future. Only those economies that succeed in the innovation race will have a place in the world of rich nations. Consequently, creating an environment that effectively encourages naturally occurring innovative behaviours is perhaps the greatest policy challenge faced by governments today.

New Zealand needs a range of policy settings that supports and encourages innovation. We contend that this support is best delivered through the tax system, whereby those actually generating wealth are encouraged to re-invest in further wealth producing activity. Support for research and development (R&D) is helpful, yet our firms require further support for the downstream R&D commercialisation: expensing plant, equipment, patent costs, early stage investment deductibility, and tax credits for skills development. These, or similar taxation measures, would form the start of a coherent framework that would stimulate and encourage a diverse range of innovation across our entire economy, arrest our comparative economic decline, and begin our climb back up the ranks of rich nations.

¹ Formed by the Canterbury Manufacturers' Association (CMA) and the New Zealand Engineering Federation (NZEf) in August 2007.

Growth and Policy Settings

Economic growth, expressed in the long-term trend of Gross Domestic Product (GDP) per capita, is a general indicator of a country's standard of living. Strong economic growth demonstrates that overall, New Zealanders are making the right investment choices, making the best use of the resources under their control, and maximising productivity.

Over the medium term, there are considerable costs associated with inflation that can have a negative impact on economic growth. Therefore, price stability is essential to maintain growth that can only be achieved by a credible and sound monetary policy. However, in order to achieve non-inflationary growth, a comprehensive strategy is required to combine stability-oriented macroeconomic policies that have a balanced impact across the economy. Currently, New Zealand's system settings are some way from such a balance, as demonstrated by the strength of the domestic economy, and a tradable sector that is buckling under exchange rate pressures.

As a starting point, the Government's fiscal policies need to be in line with the goal of maintaining non-inflationary growth. In the Budget 2007 statement, the Government said that it expects to move from cash surpluses to deficits beyond 2006/07. With the election year proximity, it is important that Government spending does not inject further inflationary stimulus into the economy.

Secondly, policy settings should create a favourable environment for technological progress by promoting development and exploitation of intellectual assets, which is one of the most important drivers for long run per capita GDP growth. A productive economy flows from an environment that encourages and supports innovative productive investments. The more innovation an economy produces, on balance, the greater the economic pay off will be. As innovation comes with risk, encouraging and supporting more innovation in the economy is the greatest policy challenge faced by all governments today.

In the 2007 Budget, the Government announced changes in the tax treatment for R&D investment to encourage innovation. As a result, R&D in New Zealand will be eligible for a tax credit of 15% of allowable expenditure from the 2008/09 income year². This is a significant step in supporting higher levels of innovation that finally places New Zealand on par with most OECD countries in terms of R&D policy, and can be expected to have wider benefits for the economy boosting productivity and international competitiveness.

² For more information, please refer to MEA Outlook - Research and Development.

More generally, policy settings aimed at creating a favourable environment for productive investments will be associated with higher levels of productivity. Tax policy is one of government's most powerful tools. Tax can change the returns from a given investment and can influence the investments made. For a small, capital-importing country like New Zealand, a tax system that biases behaviour towards the more productive areas of economy, and those which maximise spill over benefits, would best sustain long term growth. An investment friendly atmosphere that promotes productive and export orientated activity is desirable, while policy that offers incentives to more passive investments, property for example, should be avoided³.

Whatever the tax rules, there is a question mark as to the effectiveness of Inland Revenue's audit activities. Most of New Zealand's inflation is caused by non-tradable goods, such as houses, although in order to cool aspects of the housing market, Budget 2007 added a further \$14.6 million to Inland Revenue over 2007/08 to 2009/10 to strengthen its auditing of property transactions. If the actions were effective then there could be some change of incentives within the housing market. In any event, other disincentives, which will be discussed in the later section, could better balance investment incentives that would encourage productive investment, and relieve the massive pressure on the tradeable sector.

This paper will focus on New Zealand's monetary policy settings and some supplementary measures, which could encourage more productivity from our economy.

Inflation Control and RBNZ

Inflation is a sustained increase in the general price level for goods and services. It is an economic phenomenon that has very important implications for both individuals and the whole economy, but is relatively invisible in the short run. From an average consumer's point of view, inflation implies buying less with the same amount of money, or in other words, lower purchasing power.

Among other things, such as supervising and monitoring the banking system, the Reserve Bank of New Zealand (RBNZ) is required to maintain price stability. The Reserve Bank Act (1989) defines price stability in a specific and public contract. The Policy Target Agreement (PTA) is negotiated between the Minister of Finance and the RBNZ. According to the current PTA, one of the mandates of the RBNZ is to keep inflation between one and three percent, on average, over the medium term.

³ For more information, please refer to MEA Outlook – Assets, Taxes and Productivity.

In order to influence economy activity, especially control inflation, the Act grants the RBNZ the right to operate the monetary policy⁴ independently from government intervention. At the same time, it requires the RBNZ to publish a monetary policy statement every six months for Parliament's Finance and Expenditure Select Committee to review.

Monetary Policy and the Rational Behind the OCR

Monetary policy is essentially a process of managing money supply that is either an expansionary policy that increases the total money supply in the economy, or a contractionary policy that decreases the total money supply.

The conventional way of implementing monetary policy is via the Official Cash Rate (OCR). The RBNZ creates settlement accounts for registered banks to settle inter-bank transactions at the end of the day and will pay interest on any positive settlement account balances, and charge interest on overnight borrowing, at rates related to the OCR. There is no limit on overnight borrowing.

The RBNZ indirectly prescribes the average market interest rates via the OCR, indirectly influencing the market interest rates for the whole economy. As a result, a contraction of the monetary supply can be achieved indirectly by increasing the OCR, and the RBNZ can seek to influence inflation via monetary policy on the expectation that people tend to spend less and save more when the interest rate is high. Reduced spending has a consequential reduction demand and price pressure with a tendency for inflation pressures to fall.

The Impact of Monetary Policy on the New Zealand Export Sector

It is worth noting that 'fixed term' lending in the property market effectively slows the impact of the OCR on costs experienced by borrowers. This isolates the target of consumer spending from the intent of monetary policy, creating a persistent problem for the tradeable sector as increases in exchange rate quickly follow increases in the OCR, as international money flows into New Zealand chasing higher interest rates. In this way New Zealand's monetary policy is not isolated from the global economy. At times of low interest rates in the rest of the world, and the liquidity implied by those low interest rates, there will be a significant impact on the exchange rate.

⁴ Monetary policy is used to control the inflation, since the fiscal policy is ineffective in influencing the economy under the floating foreign exchange regime.

This impact varies with the interest rate differential between countries and perceived risks associated with the economy in New Zealand.

High interest rate spreads and confidence in New Zealand lead to an overvalued currency, confronting the export sector with both higher costs from increased interest rates, and more significantly, lower returns from export sales. If these conditions persist for any length of time, balance sheets come under extreme pressure, leading to company failure, withdrawal from export markets, or the major change in business model, generally referred to as 'off-shoring'.

At the same time, an overvalued currency makes imports cheaper and increases the competitive tensions in the domestic market. As a result, manufacturers and exporters face a raft of coinciding adverse pressures, including greater competition in the domestic market, lower returns from export markets, higher local costs, and perhaps a helpful reduction in the cost of offshore materials. It should be noted that the helpful reductions never come close to offsetting the adverse changes.

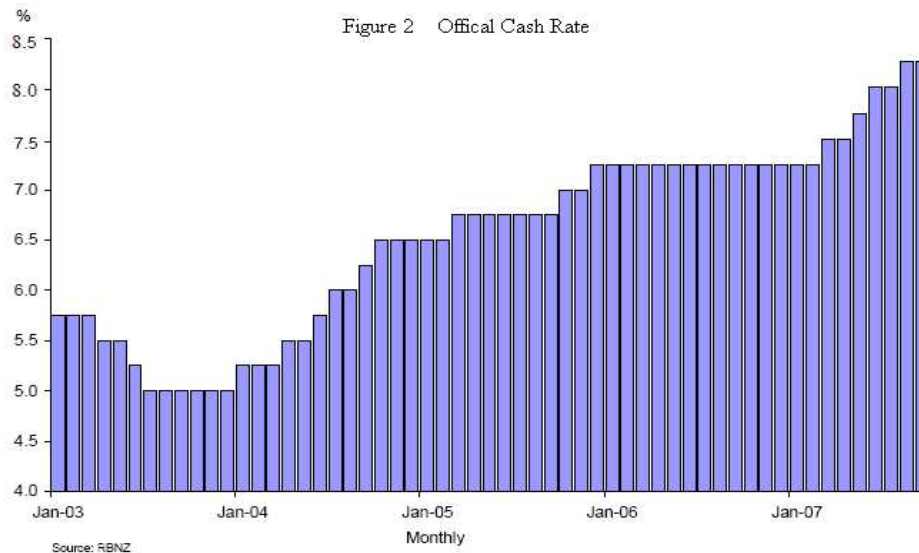
It has been suggested that one way to solve the problem of high interest spreads and volatility is to form a currency union with one of our trading partners (i.e. Australia). However, there is no all upside choice, and any move in this regard will be complex and protracted, and the MEA believes the matter is too urgent to seek a solution via this sort of approach⁵.

Official Cash Rate

Following its introduction in March 1999, the RBNZ reviews the OCR eight times each year. These reviews receive a high degree of media attention and comment by interested parties. Often comments are in the form of technical analysis and forecast, and the self-interest associated with much of the commentary is not overt. Conditions over the past three years have shown the OCR to be a blunt and ineffective tool in controlling domestic inflationary pressure. Therefore, there is a need to consider and implement alternative or supplementary methods in addition to the OCR, targeted at inflation control.

Looking at New Zealand's current situation, the OCR level is very high by international standards. In November 2007 the rate was at 8.25%, an increase of 325 basis points since early 2004 (see Figure 2).

⁵ For more detail, please refer to MEA Outlook – Monetary Union Discussion.



Even at this high rate, inflation is likely to rise in the short term due to higher food prices, as reported by the RBNZ in their Monetary Policy Statement (September 2007); a clear demonstration that the OCR has simply not worked. Favourable international commodity prices, high dairy payouts in 2007 and those forecast for 2008, will continue to drive inflation pressure in the economy and it is unlikely that the RBNZ will reduce the OCR in the medium term. Given the above comments, it is worth considering why inflation control via monetary policy seems to work in other countries, but has demonstrated clear limitations when applied to the New Zealand economy over recent years.

Consumer Price Index

Control of inflation is fundamentally dependent on how it is measured. Most countries use a Consumer Price Index (CPI) as a measure of inflation. It is the percentage change of the index numbers that measures the average change over time in the price paid by a 'typical consumer' for a basket of goods and services. Different goods might be in the basket, and goods in the basket are given different weights. Recently Statistics New Zealand changed the content and weighting of the New Zealand basket in an attempt to better represent inflation in the economy.

Some countries measure their CPI on a different conceptual basis, particularly when dealing with owner-occupied housing. There are two distinct concepts used internationally, namely the consumption, or the expenditure approach. The consumption approach includes notional or non-market transactions, for example depreciation, appreciation and opportunity cost, while the expenditure approach excludes such transactions.

The New Zealand CPI includes the net purchase of owner-occupied dwelling by household in the reference base period⁶. The acquisitions variant of the expenditure approach has been adopted. This changed from the consumption-based approach in the 1974 revision. This selection tends to increase the weight of house prices in the measured New Zealand CPI.

The US Bureau of Labour Statistics has adopted a rental equivalence variant of the consumption approach to home ownership in its CPI since 1983⁷. This variant assumes that the sum of the component costs associated with the consumption of shelter services is equivalent to the rent charged for the property, if rented by the household occupying it. It is argued that the cost of shelter from an owner-occupied dwelling can be imputed from the rent that is being paid in the rental housing market place for an equivalent dwelling. To some extent this approach dislocates rises in house prices and costs from the inflation measure.

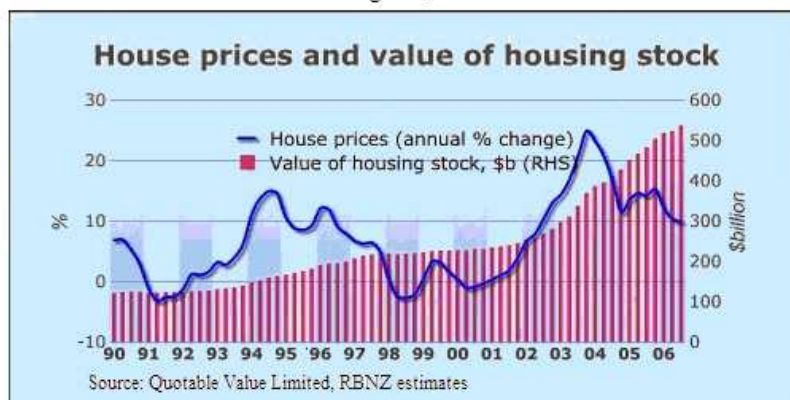
The United Kingdom Central Statistical Office excludes the owner occupied dwelling costs from the CPI, which was previously called the UK Harmonised Index of Consumer Price (HICP). The owner-occupied dwelling costs are included in its Retail Price Index (RPI). In 1995 a variant of the consumption approach, Economic Cost of Use, was adopted for the treatment of owner-occupied housing that included mortgage interest payment and depreciation.

As mentioned before, the CPI is used as a measure of inflation. Therefore, by adopting the acquisition variant approach, the country is likely to have a higher inflation rate at times of rising house prices in the domestic market. Looking at New Zealand's housing market, there have been constant increases in the house prices for the past five years (see Figure 3), and the continued buoyancy in the housing market is proving to be one of the main drivers of domestic inflation.

⁶ The period in which the expenditure required to purchase the index commodity selection of goods and services is equated to the index base number (1000). The expression base (sometimes referred to as the reference base) for the current CPI is the June 1999 quarter.

⁷ An acquisitions approach was adopted prior to 1983.

Figure 3



Many factors affect a country's inflation rate, although comparing the country's inflation rate and their interest rate level offers a useful indication. As shown in Table 1, both the US and the UK have lower inflation rates, as well as lower interest rates, as does Australia, given the fact it manages to maintain the same inflation rate with an interest rate that is 175 basis points lower than New Zealand.

Country	Inflation rate (2006 est.)	Interest rate
US	2.50%	4.75%
UK	3.00%	5.75%
Aus	3.80%	6.50%
NZ	3.80%	8.25%

Source: CIA world Book 2006

Using the expenditure approach, the US and UK see a lower inflationary pressure (than they otherwise would via an acquisitions approach) and consequently they appear, all other things being equal, to tolerate a lower OCR.

The OECD reports that New Zealand and Australia are the only two countries to use the acquisitions approach (see Table 2⁸). The important question is: why is Australia doing a better job than New Zealand, given Australia has the same inflation measure approach as New Zealand? It is important to look for wider policy settings that are driving higher levels of inflation pressure in New Zealand than Australia; one obvious difference is the different tax treatment to capital gains⁸.

⁸ The proceeds of an asset sold less its 'cost base' (the original cost plus add-ons over time) are the capital gain.

Table 2: Overview of methods* to estimate OOH in the CPI

	Rental equivalents	User cost	Net acquisitions	Payments	Exclusion of OOH
Canada		X			
Mexico	X				
United States	X				
Australia			X		
Japan	X				
Korea	X				
New-Zealand			X		
Austria ¹					
Belgium					X
Czech Republic	X				
Denmark	X				
Finland		X			
France					X
Germany	X				
Greece					X
Hungary	X				
Iceland		X			
Ireland ²				X	
Italy					X
Luxembourg					X
Netherlands	X				
Norway	X				
Poland					X
Portugal					X
Slovak Republic	X				
Spain					X
Sweden		X			
Switzerland	X				
Turkey	X				
United Kingdom		X		X	
Euro area (HICP)					X

* For a discussion of methods see section 2. Minor repairs and maintenance as well as property taxes are included in all countries.

1) House construction commodities only

2) Mortgage interest payments only

Source: OECD (2002) and national sources.

New Zealand does not have a Capital Gains Tax (CGT), with only certain 'capital' gains classified as taxable income, and thus are subject to income tax. These are profits on the sale of patent rights, and profits in the trade of property (land and buildings). Generally, the gains from ordinary sales of a person's private residence, business, or farm property are exempt from tax.

Australia introduced a capital gains tax on 20 September 1985, with only realised capital gains being eligible for taxation. The tax is not separate in its own right, but forms part of the income tax system. It operates by having net gains treated as taxable income in the tax year an asset is sold, or otherwise disposed of.

From 21 September 1999, any gain on an asset is discounted by 50% for individual taxpayers, or by 33 1/3% for superannuation funds if held after a year. Net losses in a tax year may be carried forward, but not offset against income.

For assets acquired before that date, the taxpayer can choose between two methods of calculating a capital gain; indexing⁹ or discounting. Rollover provisions¹⁰ apply to some disposals, and one of the most significant is transfers to beneficiaries on death, so that the CGT is not a quasi death duty. The law is framed as to apply to all assets, except those specifically exempted. It applies both to assets owned outright and to a partial interest in an asset, and to both tangible and intangible assets. One of the main exemptions is the house or unit which is the taxpayer's main residence and up to the first two hectares of adjacent land used for domestic purposes.

In short, Australia's capital gains tax (and other policies designed to press back on house price inflation; stamp duty and a tax free period for superannuation payments¹¹) is more specific than our own, although capital gains tax is not the whole story, for example, land supply, immigration and relocations, national and local planning rules - all have an impact. On balance, investors see less attraction in the property market. In adopting a similar approach, a cooler housing market and lower inflation rate could be anticipated, and that would make the RBNZ's task easier.

A phased introduction of CGT is not an opportunity to increase the tax take, rather it is a tax balancing where increases have corresponding reductions elsewhere. Such a change would be a positive signal from government in support of a productive investment framework.

In summary, the issue is inflation, as measured by a cost price index of some form. The selection of the index methodology can make a difference to the reported CPI. Expenditure based index will be more sensitive to gains in the value of housing, land and buildings, and broader policy can weight investment towards the property market. On this basis, it should not be a surprise that New Zealand has higher inflation, the highest interest rates in the developed world, and consequently an overvalued currency.

⁹ The elements of the cost base each indexed by changes in the CPI (consumer price index). Each element is indexed according to the date the cost was incurred.

¹⁰ Special provisions for deferring capital gains tax liability, either by letting a new owner keep the previous owner's cost base, or by letting an owner switch to a new similar asset and keep the old cost base.

¹¹ Also note the impact Individual Retirement Accounts have in the USA regarding a broader linkage across the economy to the Federal Reserve base rate.

Supplementary Stabilisation Instruments

In recognition of these problems, a consultant group was formed with the RBNZ and Treasury in November 2005 with the aim of examining supplementary measures that would act directly on the housing market in order to lower inflation pressure, and the need for an ever increasing OCR. Four months later, the group published the research report titled “*Supplementary Stabilisation Instruments*”, and presented six different options for consideration. The first three options directly focused on the housing market.

1. *A tax on property for resale*: this policy tries to cool the housing market by reducing the potential profitability of non owner-occupied properties purchased with the intention of resale, since all gains will be liable for income tax. A variation of such policy will be a compulsory reporting system for all sales of property held for less than two years, or remove the exemption for owner-occupied property held for less than two years.
2. *Ring-fencing*: this policy increases the potential risk of property investment, since operating losses on investment properties will be prevented to offset against other income.
3. *Improving the responsiveness of housing supply*: this policy tries to influence the property price by manipulating market demand and supply, which is to increase the speed at which new land and houses are able to be brought onto the market in response to evidence of rising demand.

These three options target the housing market via the cost of borrowing. Since most property investment involves some form of financing arrangement, when the cost of borrowing increases, the demand for the investment decreases.

4. *Link bank capital to cyclical risk*: the policy suggests that bank capital requirements are better tailored to cyclical risks, maybe link capital to loan-to-value ratios¹². As the RBNZ sets the capital requirements for the registered banks, which is changing the proportion of total assets that a bank must hold in reserve with the central bank, the level of funds available to loan is changed. Hence, the cost of borrowing can be influenced to provide counter-cyclical benefits.

¹² Loan to value ratio is the loan amount expressed as a percent of either the purchase price or the appraised value of the property.

5. *A discretionary loan to value ratio limit:* compared with the previous option, this policy directly restricts the loan to value ratio imposed on all lenders and all loans secured by residential property. It can be triggered at the direction of the RBNZ in response to periods of particular stress in the housing market.

6. *A discretionary mortgage interest levy:* instead of focusing on the supply side of the story, the levy will influence the lenders' decision, secured by residential property. It can also be triggered under high inflation pressure, and when the gap between New Zealand and foreign interest rates is unusually large.

Some of these options might be preferred more than others, but none of the proposals provided immediate answers, capable of providing a large payoff in the near term.

The Government has continued to talk around this problem, but no action has been taken at this point. Significant inflation pressures continue and are generating the highest interest rates in the developed world. Broader policy driving an overheated property market, and interest rate spreads are attracting off-shore money into New Zealand. Those funds are driving the property market as the high street banks compete for more and more property backed loans, while at the same time, the New Zealand dollar set ever higher post-float highs; more than decimating the export sector.

Conclusion

It is no longer sufficient for any government to claim "the RBNZ is independent" and therefore adopt the "consequences of inflation are nothing to do with us" approach to monetary policy. The abdication of the responsibility for balance in the economy is not leadership or good governance.

Treasury and the RBNZ recognised the problem of strong domestic inflationary pressure in late 2005 and reported the findings of their study in 2006. The Government has failed to act on the recommendations that present a political, as much as an economic problem. New Zealand does not exist in isolation, if the existing policy settings continue, interest rates will always tend to be higher here than in the rest of the world due to the way New Zealand chooses to measure inflation, the expenditure approach and emphasis on housing values, (unlike the US method which represent rents).

Under the status quo, New Zealand will always see more pressure on the exchange rates and see global liquidity find its way into our domestic housing market; a market where broader fiscal policy enhances that demand. The problem is the housing market, and how that seems to drive domestic consumption. These problems can be addressed by some or all of the following:

- Mortgage levies controlled by the RBNZ.
- Capital gains tax on property transactions (family home excluded).
- Ring-fenced losses on property investments.
- Variable GST controlled by the RBNZ.
- Variable and compulsory superannuation savings schemes controlled by the RBNZ.
- Government spending and immigration stance when inflation pressures are high.

House price driven inflation is the most critical threat to the future of New Zealand. Property market distortions have created a positive feedback system (**house prices directly drive inflation, inflation drives the OCR, the OCR drives the currency and provides the funds to drive house prices**) that is threatening the life of the tradable sector. A sector that is necessary to support our future as a first world economy.

Only those economies that succeed in the innovation race will have a place in the world of rich nations. The policy position of the Manufacturers and Exporters Association (MEA) is that it is best to create an environment for innovation in elaborately transformed or complex products:

Encouraging more investment in productive activity:

- A balanced taxation regime across income, profits and realised capital gains¹³.
- Extended deductibility on early stage investment for R&D based firms.

More R&D based commercial out-turns in complex products:

- Tax credit for R&D¹⁴
- Expense all productive equipment and patents¹⁵
- Tax credit for people and skills development targeted at new products and process.

¹³ The family home should be exempt from capital tax.

¹⁴ MEA Outlook – Research and Development.

¹⁵ MEA Outlook – Assets, Tax and Productivity.

A range of policy settings are required to support innovation, expanding the R&D tax credit introduction to commercialisation costs around plant, equipment patents and early stage investment deductibility, and tax credits for skills development, forming broader, more coherent support framework, to encourage innovation at the firm level, where it really matters.

[End]