



OutLook

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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.

The Association advocates a targeted tax approach to enhance and accelerate innovative behaviour in New Zealand firms. We draw on the analysis and experience of our membership, and other research, to substantiate and present our perspective on how New Zealand can increase the growth rate of productive innovation and enjoy a first world future.

This paper looks at the role of monetary policy in creating an environment where firms can invest in new technology. Innovation is of little use unless it is converted into a more productive process, so a stable environment where inflation, interest rates and exchange rates are managed is essential to give firms the confidence to invest in these new initiatives. The performance of current monetary policy settings will be assessed along with other supplementary measures.

Growth, Inflation Control and the RBNZ

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.

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.

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. As a result of the financial crisis and the global slowdown, inflation may be a non-issue right now, but the imperfections within New Zealand's policy settings should not be ignored. Remember merely a year ago, we were trying to deal with strong inflationary pressure, and the tradeable sector was under extreme pressure due to a record-high exchange rate. Without major policy adjustment, history will soon repeat itself.

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.

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Among other things, such as supervising and monitoring the banking system, the Reserve Bank of New Zealand (RBNZ) is required to maintain price stability under the Reserve Bank Act (1989). 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.

In order to influence economy activity, especially control inflation, the Act grants the RBNZ the right to operate monetary policy² without Government intervention. However, it also requires the RBNZ to publish a monetary policy statement every six months for Parliament's Finance and Expenditure Select Committee to review.

“the RBNZ simply prescribes the cost of money”

Monetary Policy and the Rational Behind the OCR

Monetary policy is essentially a process of managing money supply, which can either be an expansionary policy that increases the money supply in the economy or a contractionary policy that reduces the total money supply. Rather than directly injecting or withdrawing money from the monetary system, the RBNZ simply prescribes the cost of money (i.e. the interest rate), and lets the market run its course. So to increase the money supply, the Bank would lower the cost of borrowing, and vice versa. By increasing the cost of money, it indirectly reduces the quantity supplied.

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. The OCR determines these rates, and there is no limit on overnight borrowing. The OCR acts as a signal to high street banks; a lower rate indicates a loose monetary policy and encourages commercial banks to lend and take advantage of the low interest settlement account. A higher rate warns against reckless lending, as it is likely to result in expensive settlement payments.

“people tend to spend less and save more when the interest rate is high.”

The RBNZ also 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 produces a consequential reduction in demand and price pressure with a tendency for inflationary pressures to fall.

The Impact of Monetary Policy on the New Zealand Export Sector

When the Reserve Bank puts interest rates up to counter inflationary pressures this also drives the exchange rate up. As interest rates move up these become attractive to foreign investors, particularly from countries like Japan where interest rates are traditionally low. Investors have to buy New Zealand dollars to get access to these interest rates, pushing up the exchange rate.

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 our export sector with both higher costs from the change in 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 a major change in their business model, generally referred to as 'off-shoring', as firms move operations to other jurisdictions.

“an overvalued currency makes imports cheaper and increases the competitive tensions in the domestic market”

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 and higher local costs. These increases are never substantially offset by the reduction in the cost of offshore materials.

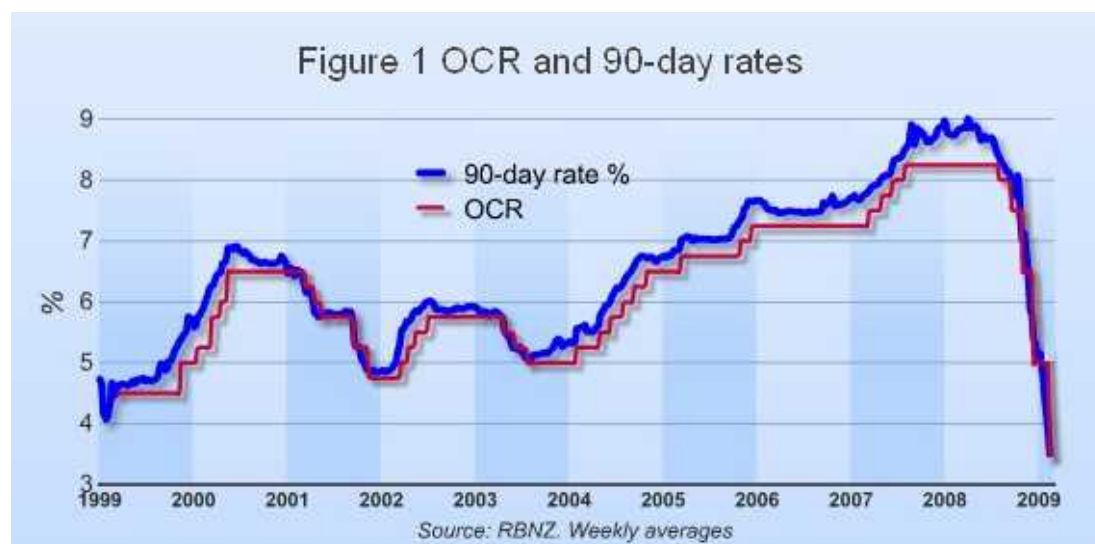
It is worth noting that 'fixed term' lending in the property market effectively slows the impact of the OCR on costs experienced by borrowers. This isolates the target of consumer spending from the intent of monetary policy, creating a chronic and persistent problem for the tradeable sector. In this way New Zealand's monetary policy is not isolated from the global economy. At times of low interest rates and therefore high liquidity in the rest of the world, there will be a substantial impact on the exchange rate.

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 matter is too urgent to seek a solution via this sort of approach³.

The 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 five or so 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 generally high by international standards. In July 2007 the rate reached its cyclical high of 8.25%, an increase of 325 basis points since early 2004 (see Figure 1). Since July 2008, the RBNZ has reduced OCR by 475 basis points to 3.5 percent as at January 2009, a rate which is still considerably higher than our trading partners.



For most of 2007 and 2008 high commodity and oil prices meant that strong inflationary pressures persisted despite the OCR reaching a record-high level. This clearly demonstrates the weakness of our monetary policy. It was not until mid 2008, when the global financial turmoil and the fall in commodity prices reduced the inflationary pressures to a comfortable level, that the RBNZ was able to reduce the OCR.

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“the OCR has demonstrated clear limitations when applied to the New Zealand economy over recent years.”

Given the above comments, it is worth considering why the OCR has demonstrated clear limitations when applied to the New Zealand economy over recent years.

The Consumer Price Index

If inflation is to be our control parameter for the economy, it is important to have a clear view on how inflation is best measured and the biases that are inherent in the methodology selected. Most countries use a Consumer Price Index (CPI) as a measure of inflation. The index measures the percentage 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 weighting. 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. The expenditure approach excludes such transactions.

“This selection tends to increase the impact of house prices on New Zealand’s CPI.”

The New Zealand CPI includes the net purchase of owner-occupied dwellings by households in the reference base period⁴. 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 impact of house prices on New Zealand’s CPI.

The US Bureau of Labour Statistics adopted a rental equivalence variant of the consumption approach to home ownership in its CPI in 1983⁵. 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 isolates 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 since 2001 (see Figure 2), and the continued buoyancy in the housing market is proving to be one of the main drivers of domestic inflation.



“the same method is used in Australia but Australia has other constraining policies such as capital gains tax”

Using the expenditure approach, the US and the UK see 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 1⁸). 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 of capital gains⁶.

New Zealand does not have a Capital Gains Tax (CGT), with only certain “capital” gains classified as taxable income, and thus 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.

Table 1 Overview of methods⁷ 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.

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 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, indexing⁷ or discounting. Rollover provisions⁸ 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 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 - a stamp duty and a tax free period for superannuation payments⁹) is more specific than our own. Although capital gains are not the whole story (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 a lower inflation rate could be anticipated, and that would make the RBNZ's task much easier.

A phased introduction of CGT is not an opportunity to increase the tax take, rather it balances taxes allowing for reductions elsewhere in the tax system. Such a change would be a positive signal from Government in support of a productive investment framework.

In summary, the selection of the index methodology can make a difference to the reported CPI. An 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.

Supplementary Stabilisation Instruments

In recognition of these problems, a consultant group was formed between the RBNZ and Treasury in November 2005. It examined supplementary measures that would act directly on the housing market in order to lower inflationary pressure, and therefore decrease 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 a policy would be a compulsory reporting system for all sales of property held for less than two years, or to 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 from being used 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. It seeks 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.

The next 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: this policy suggests that bank capital requirements are better tailored to cyclical risks, maybe linking capital to loan-to-value ratios¹⁰. As the RBNZ sets the capital requirements for the registered banks, setting the proportion of total assets that a bank must hold in reserve with the central bank, the level of funds available to loan can be changed. Hence, the cost of borrowing can be influenced to provide counter-cyclical benefits.
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

"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"

"The problem is the market for land and buildings, and how that seems to drive domestic consumption"

property. It can also be triggered when inflationary pressure is high, and when the gap between New Zealand and foreign interest rates is unusually large.

Some of these options might be preferable to others, but none of the proposals provided immediate answers capable of providing a large payoff in the short term.

The Government has continued to talk about this problem. In September 2008 the Finance and Expenditure Select Committee released their findings from the inquiry into the monetary policy framework, claiming that there is no better way to control inflation than what we have. Yet again no major action was recommended.

New Zealand still has the highest interest rates in the developed world. Once the financial crisis is over, the vicious cycle will start again. 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 sets ever more post-float highs decimating the export sector. An inflation mechanism that disengages exchange rate from domestic interest rate is needed to counteract this problem.

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 good 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. Governments have failed to act on the recommendations that present a political, as much as an economic problem. Now in 2009, in times of global recession, inflation and monetary policy become minor issues for most governments. However, the timing is perfect for the system to be reformed. New Zealand does not exist in isolation, so if the existing policy settings continue, interest rates will go up again once the crisis is over.

As things are, the measurement of the CPI and the focus on land and buildings due to the absence of capital gains tax will mean that New Zealand will always see greater inflationary pressure. If that results in higher interest rates than our trading partners (or they simply opt for more expansionary monetary settings) we will see greater pressure on our exchange rate as funds flow into New Zealand to match the demands of the asset market.

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
- Reserve Capital Ratio (RCR)¹¹ controlled by the RBNZ.
- Variable and compulsory superannuation savings schemes controlled by 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 the price of land and buildings) that is threatening the life of the tradeable sector; a sector that is necessary to support our future as a first world economy.

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Overall Policy Position

The New Zealand Manufacturers and Exporters Association see policy as an interconnected framework, doing some things but not all is helpful but misses the opportunity to fully leverage one policy on another. The creation of high added value activity offers the best hope for future growth in the New Zealand economy.

Encouraging more investment in productive activity:

- A balanced taxation regime across income, profits and realised capital gains¹².
- Isolate our exchange rate from our inflation control methods.¹³
- Extended deductibility on early stage investment for R&D based firms¹⁴.
- Remove housing from the measure of CPI.¹⁵

More R&D based commercial out-turns in firms:

- Tax credit for R&D (see our R&D Outlook).
- Expense all productive equipment and patents.
- Tax credit for people and skills development targeted at new products and process.

A range of policy settings is required to support innovation. Expensing plant, equipment and patent costs, early stage investment deductibility, and tax credits for skills development, would provide a commercialisation framework for the R&D Tax credits for R&D would level the playing field for New Zealand firms with regard to the rest of the world, the other policy changes provide a coherent approach to encourage a diverse range of innovation across our entire economy.

Members of the New Zealand Manufacturers and Exporters Association make nearly \$2.0 billion in sales and have an export value of around \$1.0 billion. Our organisation can trace its existence back to the early history of New Zealand. As a legacy of the hard work and careful financial management of the past, we have a significant asset base that enables our independence and extends our activity. Subscriptions fund only a very small part of our current operating costs.

Membership is open to all manufacturers and exporters and others at the discretion of our Council. Enquiries should be directed to mea@mea.org.nz

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

² Monetary policy is used to control the inflation, since the fiscal policy is ineffective in influencing the economy under the floating foreign exchange regime.

³ For more detail, please refer to MEA Outlook – Monetary Union Discussion.

⁴ 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.

⁵ An acquisitions approach was adopted prior to 1983.

⁶ The proceeds of an asset sold less its 'cost base' (the original cost plus add-ons over time) are the capital gain.

⁷ 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.

⁸ 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.

⁹ Also note the impact Individual Retirement Accounts have in the USA regarding a broader linkage across the economy to the Federal Reserve base rate.

¹⁰ Loan to value ratio is the loan amount expressed as a percent of either the purchase price or the appraised value of the property.

¹¹ For more information on RCR, please refer to MEA Outlook- Exchange rate, a Trade Orientated Approach.

¹² 'Assets, Tax and Productivity', <http://www.mea.org.nz/document.ashx?id=442>

¹³ 'Monetary Policy and Productivity', <http://www.mea.org.nz/document.ashx?id=454>

¹⁴ 'Research and Development', <http://www.mea.org.nz/document.ashx?id=411>

¹⁵ 'Monetary Policy and Productivity', <http://www.mea.org.nz/document.ashx?id=454>