Inquiry into Future Monetary Policy Framework

Manufacturers and Exporters Association

(formerly Canterbury Manufacturers' Association and NZ Engineering Federation)

"The MEA has been formed largely as a result of the massive pressure now being placed on New Zealand's tradeable sector. Today we are here to try and impart the feeling of the clear and present danger felt by New Zealand's exporters and manufacturers."

"I don't intend to speak to all the papers, the attachments (slide 10 onwards) are included for your information."

Introduction

- Scott Yates – Plankwall, Auckland
- John Heng – Click Clack, Palmerston North
- Gordon Sutherland – AW Fraser, Christchurch
- John Errington – EC Goughs, Christchurch
- John Walley – MEA
- Members have over $2b sales over 50% of which are exported – we see both economies - tradeables and non-tradeables, weighted to external tradeables.

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“The team today is as listed, Scott, John, Gordon, John and myself. I will outline the world as seen by manufacturers and exporters, and try to reinforce the comments made in our submission.”

“Monetary policy, in the context of fiscal and broader government policy is not working for all New Zealand. This is manifest in the emergence of two economies with negative impact to growth, productivity, capability development, and the retention of worthwhile activity.”

“This leaves us all vulnerable to external economic and political shocks, and many of us worried about the future.”

More than Monetary Policy….

- Causes of inflationary pressure:
  - Discussed elsewhere will not comment today.
- Effectiveness of monetary policy in controlling inflation:
  - Controlling inflation perhaps; killing the export sector certainly.
- Interaction of monetary policy and other parts of the economic policy framework including fiscal policy.
- The capacity for non-inflationary growth in the New Zealand economy.
- Productivity in the economy and associated constraints:
  - Most of our comments today will be in regard to these last three points.

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"We note the first two points have been well traversed by other submissions, particularly that of Brian Gould. We will focus our comments today on the last three issues before this Inquiry."

Economic policy framework has delivered….

- Two large companies (in New Zealand terms):
  - one a manufacturer of sophisticated capital products with almost 100% of sales to export markets.
  - the other a major supplier of processed materials to the building industry with roughly 80% of sales to the domestic market.
- One says "things have never been better for a generation". The other says "things have never been worse for a generation".
- Guess which is which?

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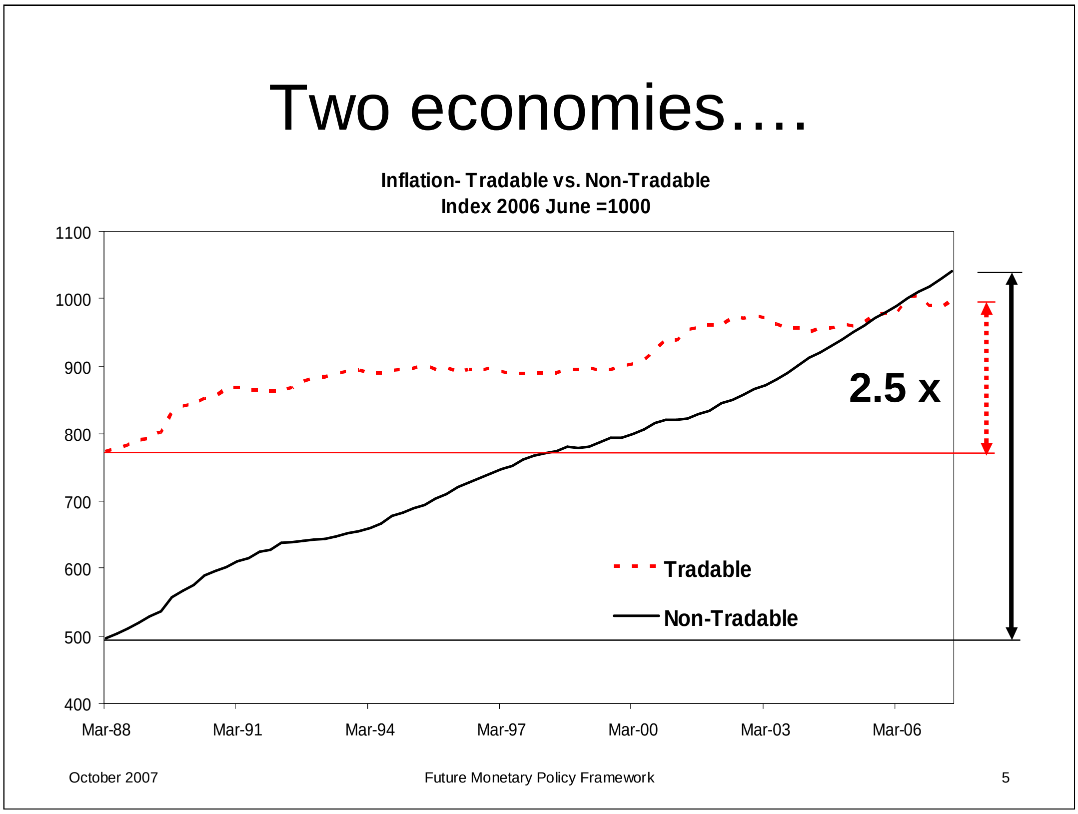
"There has to be a better way; two economies is no way to run a country."

"This theme is repeated constantly in many of the other submissions to this Inquiry. We hope the threat to productive activity has not been lost on you all."

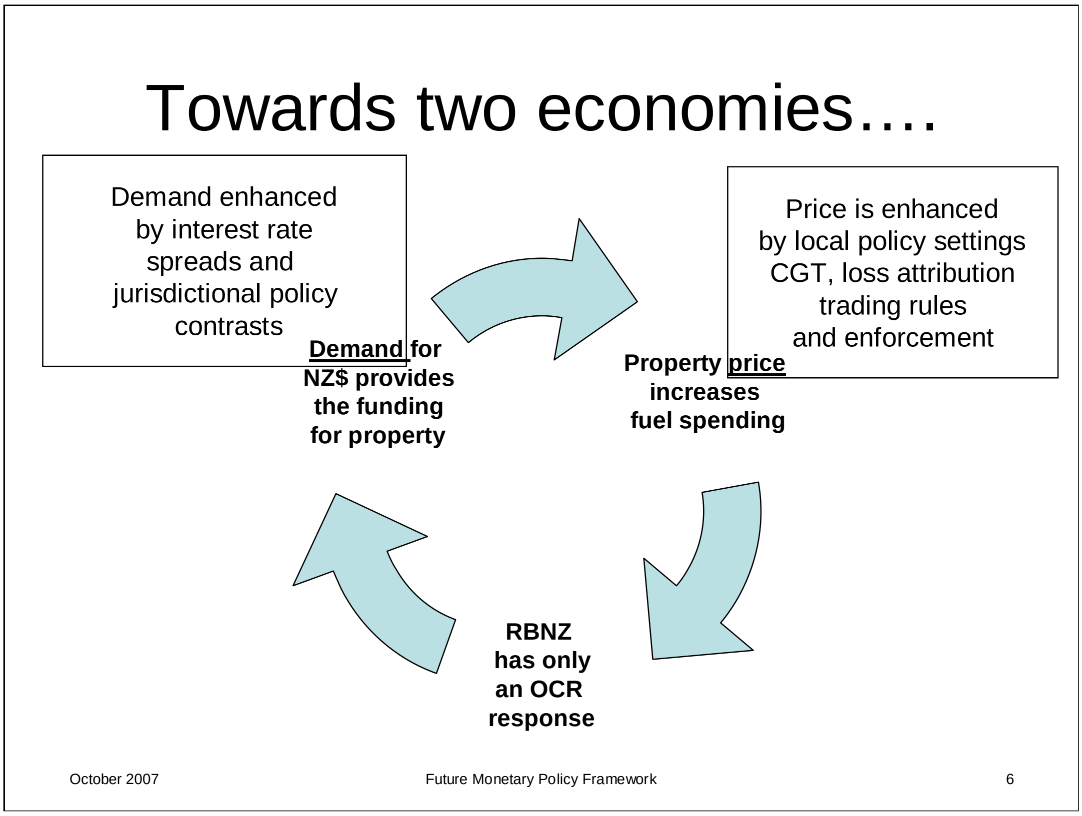
"There is a clear and present danger that the single goal, single tool approach will fatally deflate our producers and not, in a timeframe to be meaningful, impact existing asset holders."

"Policy support for wealth creators is long overdue."



“Note the difference in the inflation rates of non-tradeables and tradeables: how to control the problem side of the economy without hitting tradeables with both interest and exchange rate impacts is the key issue.”

“If the policy response to domestic inflation does not become more sophisticated (beyond the OCR), at some point most of us will become "sub prime" as the export sector contracts and the property bubble bursts.”



"Monetary policy does not exist in isolation, it is difficult to imagine insufficient global liquidity to swamp New Zealand provided an interest rate spread exists."

The interest rate spread is driven by policy and performance contrasts between jurisdictions, having only the interest rate response, we create the "worst of times and the best of times".

"Internal settings bias investment towards property, further spinning up the problem."

Out-turn

- Policy contrasts between jurisdictions drive or damp the two economies outcome.
- Local policy can drive or damp elements of the same process.
- What has happened to the exchange rate and external sector speaks to the bias inherent in policy settings in comparative and absolute terms.
- Without change in a number of policy settings we can anticipate little change, and the continued contraction of our export sector.
- That contraction will reduce the capability of our economy and ultimately living standards for everyone.
- What you do next is really very, very important to us all.

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"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, are not viable options for exporters in the short term, and are not good for any of us in the longer term."

"What you do next is very, very important."

"Continued pressure on the tradeable economy (as a result of the exchange rate volatility) will see a reduction in diversity and complexity of our exports, that will increase our susceptibility to external political and economic shocks - cost of oil, carbon, credit crunches, commodity prices and the like.

Bias to low productivity….

- There is a bias (incentive) in our policy settings that favour land and buildings over productive investments and export growth:
  - *Absence of tax balance (income - profits - capital gains).*
  - *Inadequate depreciation on plant and equipment (*machines are not buildings*).*
  - Favourable loss attribution rules on property.
  - Property trading rules are not enforced.
  - *Exchange rate volatility weight against tradeables.*
  - *CPI methodology that "weights" towards property and property cost*.
- Investment flows to things at "are" rather than things that "do".
- Small companies struggle with investment, exchange rate risk (remember domestic market impacts), and the development of export markets.
- Such bias is not shared by other jurisdictions so structural comparative advantages develop and push back against our export growth.

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"More productivity flows from 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 is also worth keeping in mind that the vast majority of New Zealand's exporters are small companies without the balance sheet strength to push through multiyear adverse variations in exchange rates."

"As our export types dwindle we become increasingly exposed to problems impacting those that remain. Most critically, the reduction in skills and 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. In need not be so"

We all need mates…

- Monetary policy as others have said “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 (fix the issues on previous slide)
  - Create stability in the external economy (so export markets are attractive and worth the risk even to small firms):
    - Focus inflation control mechanisms on non-tradeables (where the inflation is).
    - Variable gst / mortgage levies.
    - Impose lender / borrower equity ratios.
    - Coordinate wider policy to exchange rate stability (immigration, government spending).
  - Minimise inter-jurisdictional policy contrasts and eliminate them where possible.
    - Holidays, compliance, regulation and taxation load.

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“If the current situation continues the tradeable sector with 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.”

“Before taking your questions I would like Scott, John, Gordon and John to make a comment.”

Appendix

Some information that might be useful.

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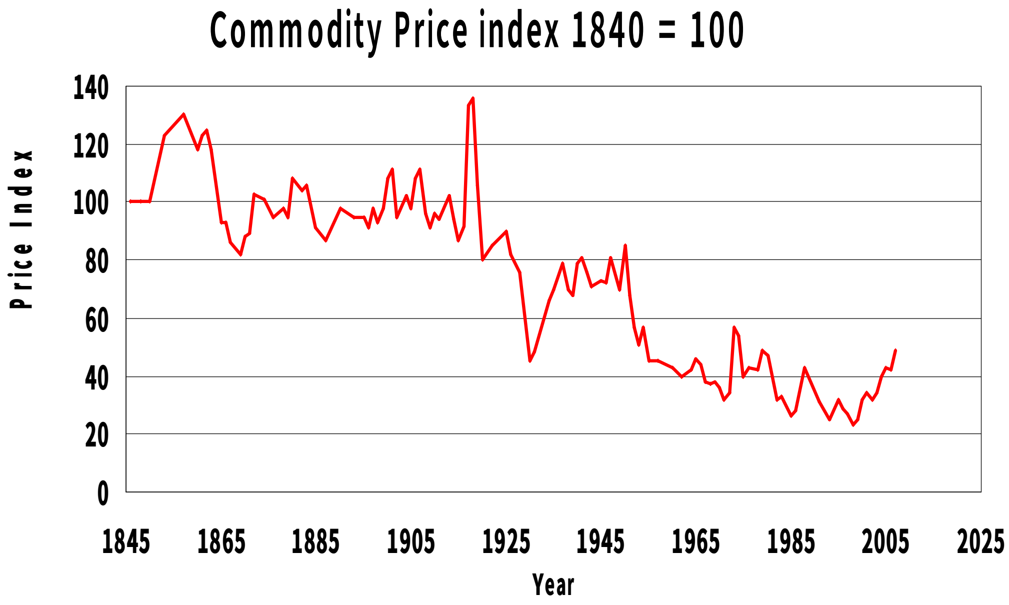
Falling(?) for a more than a century



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The global decline in commodities is not new, this graph indicates it has been with us for a century, in fact even the huge events of the first and second world wars hardly impacted the slide. Commodities are not doing badly, simply the value added by transformation is doing better.

In the end there is only so much we will pay for an apple, organic or not, but what is the limit you will pay for the new and glittering man-made “necessities” of life?

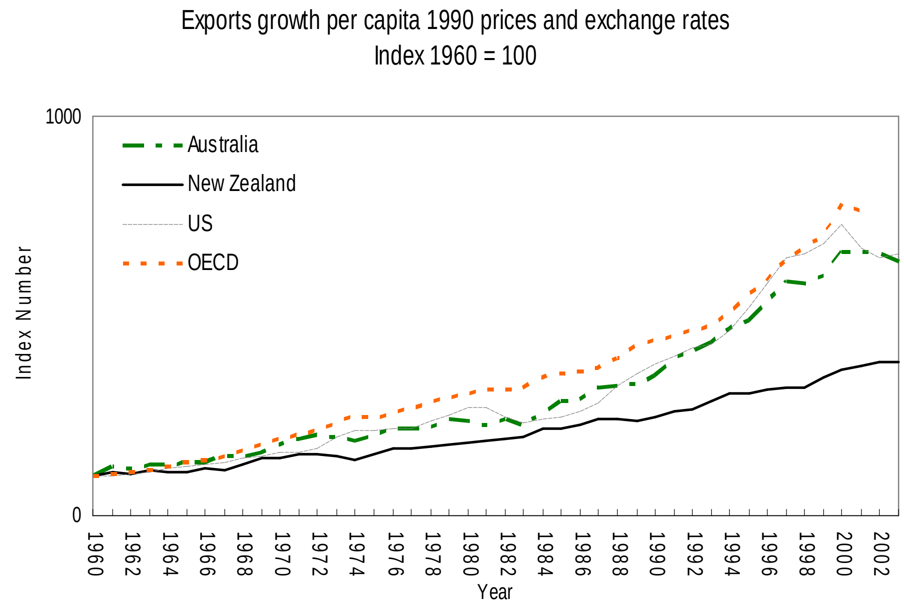
The dairy payout has been good but what of the future – less than \$6/kg but costs are rising at \$0.25/kg/year.

What's it worth

- Milk fat:
  - 1950 ~ 1kg ~ 4% of national average wage
  - 2007 ~ 1kg ~ 1% of national average wage
- Job changes
  - 1989 ~ 1.2m jobs, 260k in manufacturing
  - 2007 ~ 1.7m jobs, 240k in manufacturing
- Latest
  - Exports commercial services ~ $8b
  - Primary exports ~ $22b (50 / 50 processed / unprocessed)
  - Manufactured exports ~ $12b
  - Cumulative current account deficit ~ 83% GDP

Productivity follows productive investment, the contrary is also true.

Export Growth



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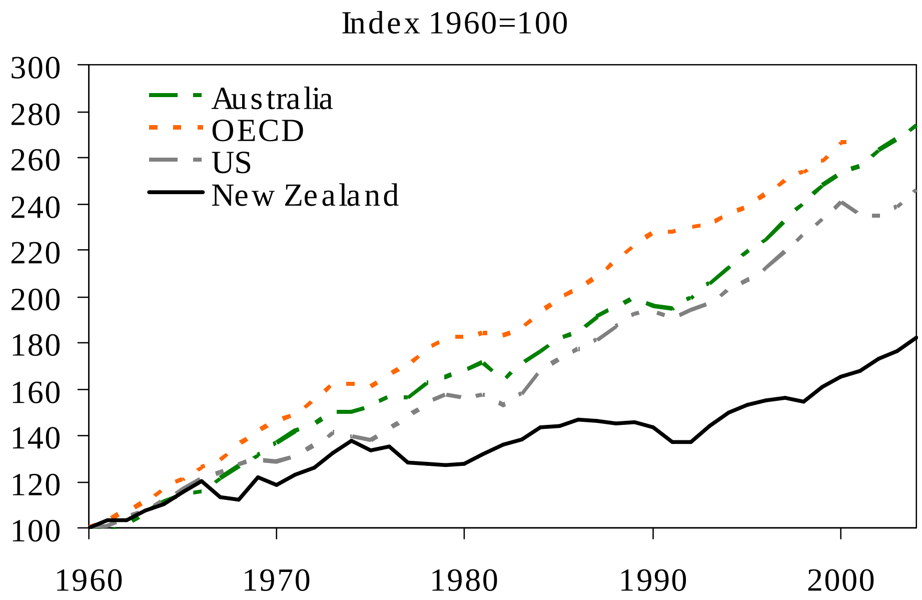
You can see the growth of exports from the New Zealand economy is growing less that that of our trading competitors; OECD average, Australia, and USA.

Real GDP per Capita



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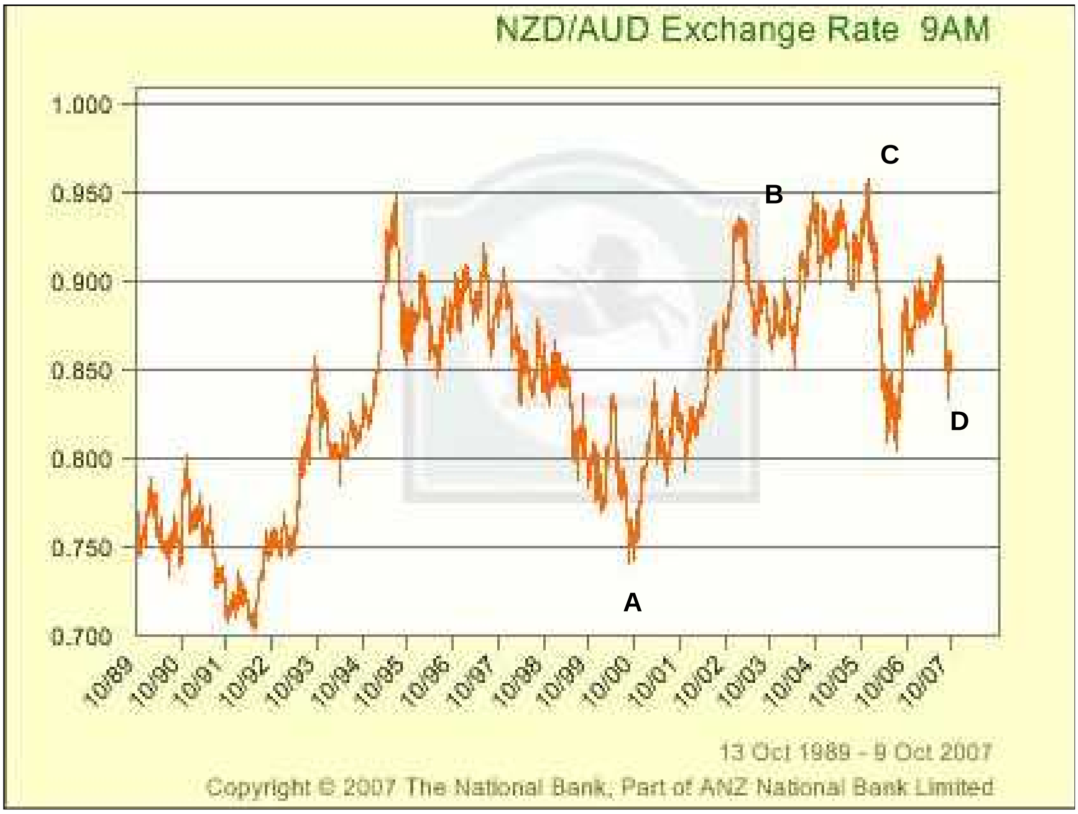
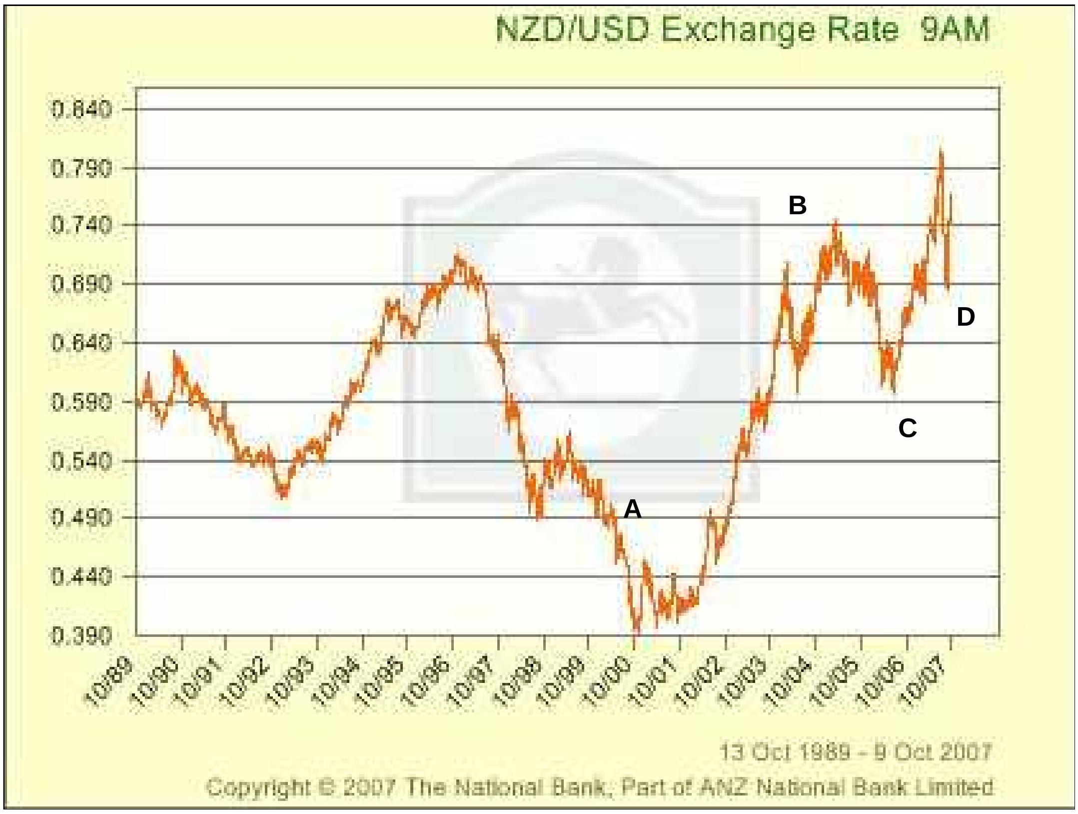
In the end GDP is not everything, but it serves as a good proxy for productivity, the net out-turn of all our decisions and efforts – we are doing less well than our competitors and the gap is growing.



The rate of change kills either the will or the capability to export. It is difficult to deal with these fluctuations, even accurate "price to market" decisions by competent firms offer little choice: sacrifice share or margin. Volatile and rapid changes suggest there is great risk in export efforts particularly for small firms.

The Australian dollar is perhaps the most important to ETMs in New Zealand. The fall to around the long run average is helpful but it has been painful for the majority of the past 5 years.

Imagine trying to make decisions at times A, B, C and D – how might the decisions have changed had the future been known.



The US and Australian (usually the first export market for ETMs) each have wild cross swings.