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Inquiry into the Future of the
Monetary Policy Framework
Secretariat
Finance and Expenditure Committee
Parliament House
Wellington



SUBMISSION FROM THE
CANTERBURY MANUFACTURERS'
ASSOCIATION
FOR THE

Inquiry into the Future of the Monetary Policy Framework

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The Canterbury Manufacturers' Association is pleased to have this opportunity to provide feedback from our members. We have noted the terms of reference and have attempted to address them in this submission.

BACKGROUND

The Canterbury Manufacturers' Association represents manufacturers predominantly in Canterbury and Westland, with members from the rest of the South Island and Auckland. The numbers of staff employed by our members represent approximately 40% of those employed by the manufacturing sector in the Canterbury region. Locally the manufacturing sector is a significant contributor to the economy, representing about 13.2% of employment.

Elaborately transformed manufactures comprise over 30% of New Zealand tradeable exports, sector sales total over \$30 billion and total national employment numbers around 170,000. New Zealand manufacturers face the ever-increasing onslaught of the cost of local regulation and global competition from low cost countries, without any significant support. The Canterbury region has a disproportionately high number of high value elaborately transformed manufacturers who have significant export sales when compared with all the other regions of New Zealand.

The historical reliance that New Zealand has placed in the primary sector and basic manufactured goods has seen the position that New Zealand has in the rankings of the Organisation of Economic Co-operation and Development fall from 5th in 1950 to 21st in 2005, between Spain and Greece, well into the lower middle bracket of global income per capita. New Zealand has grown more slowly than other countries due to the dependence on the primary sector. The manufactured goods sector of the internationally traded economy has grown much faster.

Without economic development, based on elaborate transformation commanding high prices from global customers, we will increasingly see issues such as "health problems" correctly characterised as "wealth problems", recent headlines on our inability to fund state-of-the-art cancer chemotherapy drugs demonstrate this limitation.

The Canterbury Manufacturers' Association does wish to be heard on this submission. For completeness the terms of reference addressed are as follows:

- 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.

Inflation Control and RBNZ

Inflation is a sustained increase in the general price level for goods and services. It is an economics 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, less 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), which 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 the monetary policy¹ independently from government intervention. At the same time, it requires the Bank 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.

The central bank will pay interest on any positive settlement account balances, and charge interest on overnight borrowing, at rates related to the OCR. At such rates, there is no limit on overnight borrowing. The OCR is indirectly influencing the market interest rates for the whole economy. By setting the OCR level, the RBNZ indirectly prescribes the average market interest rates, and as a result, a contraction of the monetary supply can be achieved indirectly by increasing the OCR.

¹ Monetary policy is used to control the inflation, since the fiscal policy is ineffective in influencing the economy under the floating foreign exchange regime.

With the ability to influence the market interest rate, the RBNZ can seek to influence inflation via monetary policy on the expectation that people tend to spend less and save more, and spend less and borrow less when the interest rate is high. Lower 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 consumers. This essentially isolates the target of consumer spending from the intent of monetary policy, creating a chronic and persistent problem for the tradeable sector.

A second notable point is that 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 an impact on the exchange rate. This impact varies with the interest rate differential between countries and perceived risks associated with the economy in New Zealand.

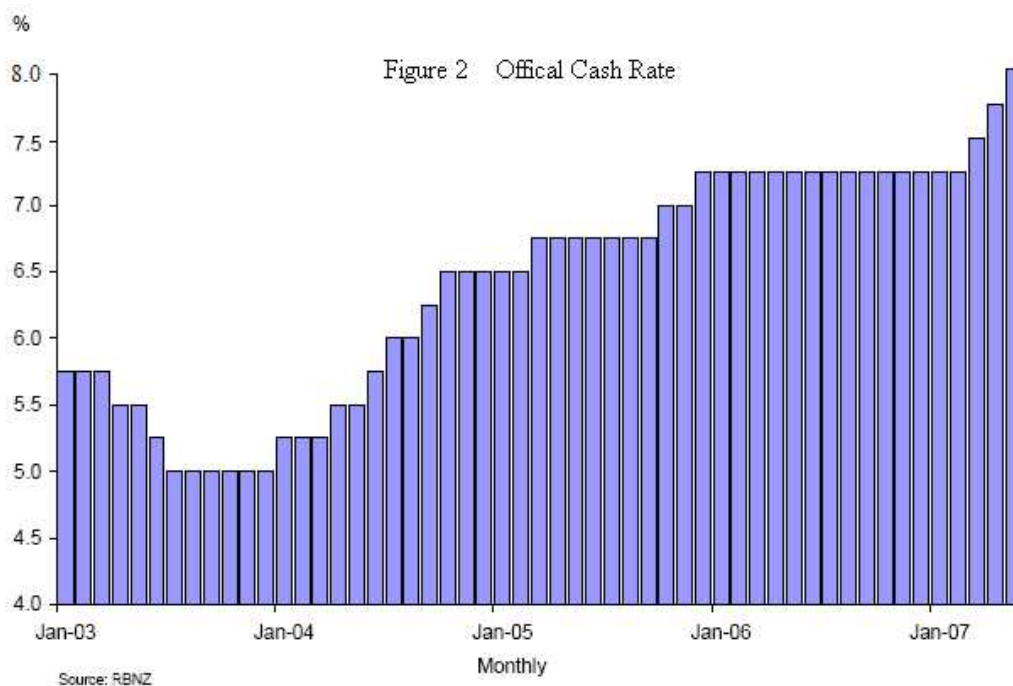
High interest rate spreads and confidence in New Zealand lead to an overvalued currency confronting the export sector with both higher costs, from the change in interest rates, and more significantly lower returns from export sales. If these conditions persist for any length of time, balance sheets come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

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. By June 2007 the rate was at 8.00%, an increase of 300 basis points since early 2004 (see Figure 2). Even at this high rate, "domestic inflation pressures have remained strong and widespread" as reported by the RBNZ in their Monetary Policy Statement (June 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 the OCR works in other countries, but has demonstrated clear limitations when applied to the New Zealand economy over recent years.

Consumer Price Index

It might be obvious to say, but the 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, where the consumption approach includes notional or non-market transactions, the expenditure approach excludes such transactions.

The New Zealand CPI includes the net purchase of owner-occupied dwelling by household in the reference base period². The acquisitions variant of the expenditure approach has been adopted. This was changed from the consumption-based approach in the 1974 revision. This selection tends to increase the impact of house prices on the New Zealand CPI.

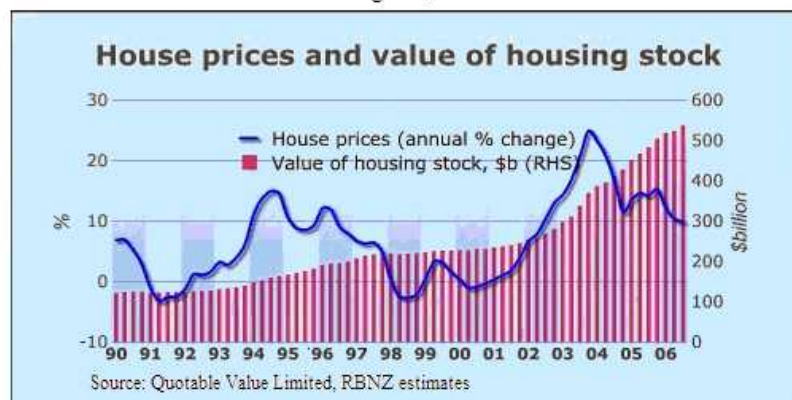
² The period in which the expenditure required to purchase the index commodity selection of goods and services is equated to the index base number (1000). The expression base (sometimes referred to as the reference base) for the current CPI is the June 1999 quarter.

The US Bureau of Labour Statistics has adopted a rental equivalence variant of the consumption approach to home ownership in its CPI since 1983³. 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 therefore 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 has been constant increase in the house prices for the past five years (see Figure 3), and the continued buoyancy in the housing market is proven to be one of the main drivers of domestic inflation.

Figure 3



³ An acquisitions approach was adopted prior to 1983.

Many factors effect a country's inflation rate, although comparing the country's inflation rate and their interest 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.

Table 1 Country Comparison		
Country	Inflation rate (2006 est.)	Interest rate
US	2.50%	5.25%
UK	3.00%	5.5%
Aus	3.80%	6.25%
NZ	3.80%	8.00%

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 set a lower OCR.

The OECD reports that New Zealand and Australia are the only two countries to use the acquisitions approach (see Table 2). 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 gains⁴.

⁴ 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 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, indexing⁵ or discounting. Rollover provisions⁶ 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 payments⁷) is more specific than our own, and while 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 much 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 productive investments.

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.

⁵ 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.

⁶ 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.

⁷ 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.

The last 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 ratios⁸. 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.

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 took no action on this report and consequentially, significant inflation pressures 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; decimating the export sector.

⁸ Loan to value ratio is the loan amount expressed as a percent of either the purchase price or the appraised value of the property.

New Zealand's Capacity for Non-Inflationary Growth

Economic growth, expressed in the long-term trend of GDP per capita, is the national measure of productivity. Strong economic growth demonstrates that New Zealanders are making the right investment choices, making the best use of the resources under its control, and being productive. Growth for its own sake is pointless, economic growth enables choice in public policy and generally determines living standards. Whatever the aspirations, eventually, the bill has to be paid.

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.

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.

On the subject of enforcing the taxation rules, there is a question as to the effectiveness of the Inland Revenue's audit activities. Most of New Zealand's inflation is caused by non-tradable goods, such as houses. In order to cool the housing market, Budget 2007 provides 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 incentives within the housing market. In any event, other disincentives (ring-fenced losses, capital gain tax) could better balance investment incentives that would encourage productive investment, and relieve the massive pressure on the tradeable sector.

The Role of Productivity in the Economy

While low unemployment rates and high participation rates enhance the quantity of employment, they are not the full story. The question, from the productivity standpoint, is whether New Zealanders are working smarter or are working longer in order to make their way in the world, and meet the ever-growing costs of compliance and government aspirations. Between 1989 and 2006, the total number of jobs in the economy increased by 42.9%; the total number of manufacturing jobs contracted by 8.75%, a reduction in absolute terms and a greater loss in share. Reduced manufacturing content in the economy provides fewer innovation carriers⁹; fewer innovation carriers result in a lower growth rate. This leads to a discussion on the question of productivity.

Productivity is used to describe various characteristics that affect the relationship between input and output. Labour productivity (things made per person hour), and capital productivity (measured by the return on investment and multifactor productivity) seek to capture the things that simple labour and capital inputs fail to take into consideration - innovation and technical changes. Productivity is improved as a result of these technical changes and changes in efficiency. At the microeconomic level, the choices a firm might make on machines, working practices, the products that are developed, the way products are distributed and sold, all impact the financial performance (a general productivity measure) of the firm. These choices add up to macroeconomic performance, and the quality of each individual decision; public, monetary and fiscal policy, all have a bearing on the outcome – the productivity of the economy, economic growth and the associated improvement in living standards.

Innovation can be defined as the process of reallocating resources in the anticipation of an improved return. The definition contains the need to choose and the predictive risk inherent in that choice. Innovation requires creativity, involves risk, and investment. The predominance of small firms in New Zealand is a result of our small population. This has many implications because few companies can conduct significant research and development. Those that do, would not justify such spending without anticipating revenue from overseas markets, and the small domestic base also means that New Zealand's exporters start exporting much earlier in the firm's growth cycle than would be seen in larger economies.

⁹ Products capture invention and innovation and make those qualities tradable.

As living standards depend on growth, and growth depends on exports, it would seem wise to try to provide local exporters with a stable and supportive environment. Unfortunately, this is not the case and the turnout in terms of GDP growth and multifactor productivity is evident.

As an Association representing manufacturers and exporters, the CMA was happy to see the budget announcement of the tax credit for R&D, however, our fear is it might be too little too late. Our members find it difficult to understand why they do not get the support enjoyed by their competitors in other jurisdictions. They find it hard to understand why productive investments are so disadvantaged by public policy in New Zealand compared with property, and they are scared that their balance sheets will be empty before the policy driven, bloated exchange rate returns to fair value.

Those that choose or must remain in New Zealand fear that those who can, and do, “offshore” their operations or business will leave supply chains bereft of critical mass, further sacrificing the innovative capacity of the New Zealand economy.

Productivity is driven by innovation; innovation captured in products (device + service) drives growth. Growth in New Zealand depends on exports, public policy does not support exports, and achieving non-inflationary growth is difficult. The solution lies in policy settings that do not drive a wedge between local interest rates and those of the other countries. External stability is more important to the long run growth of New Zealand than internal stability, and we need policy support for the productive sector: R&D credits, first year write off for productive plant, skill development incentives and early stage investment incentives. These are a set of coherent, mutually supportive policies that would encourage more risk taking, higher levels of innovation, productivity and growth than would otherwise have been the case.

It is worth noting that whatever happens on traded goods and services, returns on sales fall over time. The milk, meat and fibre produced by New Zealand essentially have a finite volume and falling value in the long run – the people of this country cannot rely on fish, farms and forestry to return the standard of living that they have previously experienced. We have to do more than we have done in the past.

Elaborately transformed manufactured goods, of all kinds, are innovation carriers, they are 30% of New Zealand's exports and 10% of employment, yet current policy settings are laying waste to our manufacturing capability. What sort of place will New Zealand have in the developed world without its manufacturers and exporters?

Put aside the idea that manufacturing does not matter in New Zealand, because New Zealand without manufacturers will not have a place in the first world.

Conclusion

It is no longer sufficient for any government to claim "the RBNZ is independent" and therefore, the "consequences of inflation are nothing to do with us" approach. The abdication of the responsibility for balance in the economy is not leadership or 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 measures 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 need to 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.
- 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 a first world economy.

Solutions will be complex and politically hard to do, but the alternative is worse, and for some in the export sector the worst continues to happen. The entire spectrum of tradable activity, food processors, sawmills and high tech manufacturers are quitting New Zealand. Policy can address the problem that firmly resides in the property market, and exporters need to see the Select Committee establish a coherent cross-party solution. Exporters are collapsing at the moment, and sooner or later, so will the rest of our economy.

John Walley