

Submission of the
National Distribution Union

To the
**Finance and Expenditure
Select Committee**

On the
**Inquiry into the Monetary
Policy Framework**

16 July 2007

***We seek leave to make
oral representations
on this submission***

Contact person

Joe Hendren

Researcher

Direct Dial (09) 622-8431

Email joe.hendren@ndu.org.nz

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Introduction

- 1) The National Distribution Union welcomes the opportunity to contribute to an inquiry into monetary policy. We believe such an investigation is long overdue.
- 2) The National Distribution Union has 20,000 members, and covers a wide range of industries. Workers organised by the Union include retail and supermarket workers, storeworkers, bus and truck drivers, butchers, clothing and textile workers, energy workers, sawmill and pulpmill workers, bakers, and ambulance officers.
- 3) Our members are affected by monetary policy on a number of levels.
 - a) As the New Zealand dollar has risen many manufacturing jobs have been lost, and others have felt uncertain about their continuing employment as the dollar remains high.
 - b) Our members are also affected at the household level as mortgage costs escalate in response to increases in the Official Cash Rate, and housing rentals rise.
- 4) The NDU believes a fundamental reconsideration of the operation of monetary policy is required.
- 5) Key points include:
 - a) A lack of evidence to support the translation of “inflationary pressures” into “inflation”
 - b) The combined negative impact on productivity of the treatment of wage increases as a risk and the use of interest rate increases as the primary tool of inflation-pressure control, thereby incentivising low productivity by keeping wages low and capital costs high
 - c) The demonstrably counter-productive raising of interest rates which in NZ conditions simply fuels inflationary pressure by attracting speculative “hot” money, raising the exchange rate and putting pressure on the productive sector
 - d) The damage done to both individuals and institutions by the uncertain environment for long-term productive investment in both physical and human capital
 - e) The need to tackle house price inflation through comprehensive policy measures and not through high interest rates

The Housing Market

- 6) The NDU believes there is something fundamentally wrong with a housing market that is structured to deliver untaxed capital gains to those who have capital, at the same time as denying the dream of home ownership to the upcoming generation.
- 7) **Speculative Investment in Property:** Speculation on secondary properties bought for investment purposes is driving up house price inflation.

- a) According to Treasury figures, 25 per cent of residential property sales in 2005 were for properties that had been owned for less than two years. This represents a significant increase from the 10 per cent of 2001¹. Many of these sales will have been motivated by a desire to acquire tax free capital gains.
 - b) Property investors are able to reduce their tax bill by writing off “losses” on the rental property against other taxable income. Tax data from 1994 shows a trend towards greater investment in loss-making properties, with more taxpayers now reporting tax losses rather than tax profits from property investments².
 - c) While the NDU welcomes the Budget 2007 initiative to provide the Inland Revenue Department with more resources to investigate such housing transactions, we believe it would be more effective to address the structural issues in the tax system that encourage these sorts of transactions in the first place. This would also assist monetary policy.
 - d) In the June 2007 Monetary Policy Statement the Reserve Bank noted that increasing overseas ownership of residential property is also driving up prices. “Overall, it seems that, in certain regions and for particular property types, overseas demand is likely to have been quite influential”³. This was based on Inland Revenue data on non-resident individuals claiming rental income or losses on rental property and Quotable Value Limited data on the addresses of property owners. The Reserve Bank noted these sets of data were likely to undercount the level of overseas ownership.
- 8) **Land Banking:** The NDU also notes the comments of the Minister of Housing, Chris Carter, who says Auckland’s growth is being strangled by developers who refuse to build on their land and wait for it to rise in value. “Speculators have been buying up land and sitting on it until prices rise through the roof... This is inhibiting supply and eventually hitting first-time buyers, and it is a problem that needs to be confronted”⁴. The Minister also blamed developers for almost exclusively building expensive large homes on large sections, again pricing first home buyers out of the market.
 - 9) **OCR Rises can lead to rent inflation:** While the recent rises in the Official Cash rate have sought to contain inflation, this could have a contrary effect in the residential rental market. Property investments are often highly geared with a substantial portion of the capital being sourced through a mortgage. As fixed term mortgages come up for renewal, most landlords will push rents up instead of selling their properties. Darren Gibbs, Deutsche Bank's chief economist doubts landlords will stage any “wholesale bailout” in response to interest rate rises⁵. He predicts it is more likely that rents will be hiked, stoking inflation, and therefore having precisely the reverse effect to that intended by the Reserve Bank.
 - 10) **Increased household debt levels:** Household debt as a proportion of annual disposable income has risen from around 74 per cent in 1992 to 160 per cent by 2006.
 - 11) **Fewer Mortgages:** While the amount of total household borrowing may have increased considerably the actual number of households making mortgage payments has fallen. In 2006 there were 405,267 households making mortgage payments, down from 448,374 in 1996.
 - 12) **Real Estate Agents:** The real estate industry conducts aggressive marketing campaigns to increase sales and prices. As most commissions are based on the sale price, real estate agents have a vested interest in creating a market where prices escalate. Many real estate agents are also key players in

¹ Reserve Bank and Treasury (10/2/06), “Supplementary Stabilisation Instruments: Initial Report”, p 14.

² Reserve Bank and Treasury (10/2/06), “Supplementary Stabilisation Instruments: Initial Report”, p. 19

³ Reserve Bank (8/6/07), “Monetary Policy Statement: June 2007”, p. 14

⁴ Chris Carter (23/4/07), “Column on High Cost of Housing”, www.beehive.govt.nz

⁵ NZ Herald (23/6/07), “Squeeze on landlords”, Anne Gibson

the residential investment property game as property managers. In the Auckland and Northland regions Barfoot and Thompson undertake the property management for over 6,500 investment properties⁶. LJ Hooker Development Services, a real estate agency that sells many investment properties, entices investors with the claim that a new apartment can be bought “for just \$1000 down”⁷. The investor usually borrows the entire purchase price, plus a bit more, and secures the lot with a mortgage also covering their existing home. Not only do such schemes encourage escalation of house prices, they also carry risks largely not borne by the developer or the real estate company.

Wage increases should not be regarded as an economic problem

- 13) **Wage Rises remain low by International standards:** Despite record corporate profits, low levels of unemployment and high demand for staff, wage rises for workers in New Zealand have continued to lag behind the rest of the OCED in real terms. Over the 10 years between 1993 and 2003 the average annual change in real compensation per employee was 0.7 per cent, compared to the OCED average of 1.1 per cent and the Australian average of 1.3 per cent⁸.
- 14) New Zealand’s low wage levels represent a fundamental structural problem in the economy. Between 1980 and 2001, wages fell 6.5 per cent in real terms, at the same time workers in comparable countries saw significant increases in real wages. Real wages in Australia rose 28.8 per cent while Finnish workers saw a 68.2 per cent increase.
- 15) New Zealand’s low wage environment is not due to an inability of companies to pay more. A study by the Reserve Bank showed corporate profits rose 11 per cent between 2000 and 2004⁹. According to a NZ Herald survey in April 2007, the chief executives of New Zealand’s 56 largest companies got an average pay rise of 8 per cent last year, with an average pay packet of over \$1 million¹⁰.
- 16) **Full Employment policy needed:** The current policy of the Reserve Bank appears to continue to regard low unemployment as an 'inflationary pressure' in itself, despite wage levels remaining far more subdued than would be expected given the demand for labour. If it is the aim to transform New Zealand into a “high wage high value” economy, a 3.2% increase in private sector wages to the March 2007 should not be regarded as a threat to New Zealand's economic health. The NDU believes this aim would be assisted by the Reserve Bank adopting a full employment policy, as a means of clarifying that low levels of unemployment ought not to be regarded as a problem.
- 17) Wage increases have simply failed to rise as much as predominant economic theories would predict, particularly when wages have failed to keep up with key components in the cost of living. For example:
 - a) **Rents are rising faster than wages:** In 1993 rents were 26 per cent of the average wage. In 2006 rents had risen to 32 per cent of the average wage nationally and 37 per cent in Auckland¹¹. Between 1993 and the first quarter of 2007 rents rose by 86 per cent while wages only rose by 50 per cent.
 - b) **House prices are outstripping wages:** In the three years from 2004 to 2006 increases in house prices outstripped wage rises by 4 to 1. House prices increased by 38.5 per cent

⁶ As of 31 October 2006. Source <http://www.barfoot.co.nz/about/company.asp>

⁷ Sunday Star Times (17/6/07), “Tax trap in \$1000 down flats”, Greg Nines and Sunday Star Times (17/6/07), “A Wellington Deal from LJ Hooker”

⁸ OCED, “Employment Outlook” 2006

⁹ Khoon Goh, “Developments in New Zealand Corporate Sector”, Reserve Bank Bulletin, Vol 68 – No. 2, 2005.

¹⁰ NZ Herald (7/4/07), “Price of success – what our chief executives earn”.

¹¹ Professor Bob Hargreaves of Massey University quoted in NZ Herald (25/4/07), “House prices leave rents behind”

while wages went up by 8.7 per cent. House prices increased 9.7 per cent in the year ending December 2006. The Reserve Bank expects higher levels of house price inflation in 2007 as the average number of days taken to sell a house has fallen to “very low levels”¹². A March 2007 study showed almost three-quarters of the average take home pay is needed to service the mortgage on an average New Zealand house¹³. In Auckland a mortgage now takes up 92.8 per cent of the local average take home pay (up from 71.1 per cent two years ago), whereas in Central Otago the costs of a mortgage are now more than the average salary (105 per cent, up from 91 per cent in December 2004)

- c) **Rising Interest Rates:** The costs of servicing a mortgage at high interest rates is making home ownership less affordable for first home buyers. Those already with mortgages face significant rises in mortgage costs when their fixed rate mortgage comes up for renewal. Due to recent rises in the Official Cash Rate (OCR) some will face paying an additional \$200 a fortnight, despite being on a fixed income in real terms.

The role of productivity in the economy

- 18) **Lowering wages damages productivity:** Research has shown that not only did the Employment Contracts Act have a negative impact on wage levels, it also had a negative impact on productivity. A 2003 Treasury paper found that wages fell from roughly comparable to Australia in the 1980s to 60% of their level by 2002 and that “with labour relatively cheaper in relation to capital than in Australia, it appears that New Zealand firms have opted for a lower level of capital intensity”¹⁴. Between 1988 and 1993 capital per worker in New Zealand rose at a faster rate than Australia, but since then it has fallen significantly behind¹⁵.
- 19) **High Interest Rates harm productivity:** A monetary policy based upon low wages and high interest rates will not help New Zealand raise its levels of productivity. As interest rates rise, so does the cost of capital. New Zealand businesses are more likely to continue to hire ten low paid workers than buy new machinery, even if the capital expenditure would ultimately lead to higher levels of productivity.

Impact of Capital Flows

- 20) As interest rates rise in response to increases in the Official Cash Rate, foreign investors are attracted to higher rates of interest on offer. Many such investors take out loans in a country with low rates of interest, and invest these funds in New Zealand for higher returns. This raises the value of the New Zealand dollar, placing greater pressure on manufacturers and other exporters.
- 21) This ‘investment’ is absorbed into New Zealand through the buy-ups of companies and land, and through a build-up of foreign funding into the banking system.
- 22) Between the end of January 2001 and the end of September 2006 the banks housing lending has more than doubled, from \$66 billion to \$132.4 billion.
- 23) Much of these capital flows end up in the New Zealand housing market rather than into investment that contributes to the productive capacity of the New Zealand economy. The value of the housing stock increased from \$247 billion in 2001 to \$506 billion in 2005.

¹² Reserve Bank (8/6/07), “Monetary Policy Statement: June 2007”, p. 11
<http://www.reservebank.govt.nz/monpol/statements/jun07.pdf>

¹³ NZ Herald (28/3/07), “Survey shows crisis in home affordability”

¹⁴ Black, M., Guy, M. & McLellan, N. (June 2003), “Productivity in New Zealand 1988 to 2002 New Zealand”, NZ Treasury Working Paper 03/06

¹⁵ Treasury & Ministry of Economic Development (2005), “Economic Development Indicators 2005”

Banks stoke inflation

- 24) **Bank lending practices:** The banks, particularly the four major Australian-owned banks, have a strong bias towards the housing market. Economist Brian Gaynor observed in July 2006 that “residential mortgages now represent 50.5 per cent of total bank lending compared with 47.7% per cent at the end of 2004. By comparison, residential mortgages have fallen from 36.6 per cent to 35.2 per cent of total Australian bank lending over the same period.”¹⁶
- 25) In November 2005 Reserve Bank Governor Alan Bollard accused the banks of pressuring inflation through their lending practices, and urged them to look beyond short term profits and market share¹⁷.
- 26) The finance sector union Finsec have highlighted how performance pay targets for bank staff can place greater pressure on inflation and interest rates. Such targets provide a greater incentive for bank employees to sell mortgages, credit cards and other forms of lending, as such “sales” are rewarded more highly than savings products. Customers “walking into BNZ will meet staff who are under pressure from their employer to encourage them into debt...The economic effect of such large growth can be inflationary pressure.”¹⁸

Rises in Commodity/Dairy Prices

- 27) According to the June 2007 Reserve Bank Monetary Policy Statement “[W]hile high dairy prices will boost disposable incomes, they are unlikely to increase the productive capacity of the economy significantly, and therefore will put upward pressure on medium term inflation”. While the Reserve Bank cites the effect on the Consumer Price Index as world dairy prices are passed onto New Zealand consumers, they also state they expect this impact to be “small and short-lived”. Interestingly they also point to the negative effects of a higher exchange rate for the tradables sector and predict many dairy farmers will be likely to use the increase to repay debt, as they have recently experienced sizeable increases in debt and operating expenses. Yet both of these effects also could have been driven by the rises in the Official Cash Rate in the first place. A restrictive monetary policy in this context risks minimising the economic benefits to New Zealand of higher dairy prices.

Recommendations from recent examinations of monetary policy including the joint Treasury and Reserve Bank of New Zealand’s report entitled Supplementary Stabilisation Instruments

- 28) **Increase capital adequacy requirements for Banks:** The NDU supports proposals to increase the capital adequacy requirements for banks, as we believe this would provide greater stability in the event of an economic downturn.
- a) The Reserve Bank is in the process of implementing the new Basel II international framework for assessing bank regulatory capital. This holds that regulatory capital requirements should be sensitive to risk, including risks associated with the business cycle.
 - b) The SSI report notes that New Zealand is unusual in that it imposes no additional capital requirements for housing mortgages with high loan to value (LVR) ratios.
 - c) While the SSI report focuses on residential mortgages with high LVR, the NDU also believes there are other types of highly geared loans, such as leveraged buyouts of

¹⁶ NZ Herald (8/7/06), “Profits for banks, loss for New Zealand”, Brian Gaynor

¹⁷ Dr Alan Bollard, 2/11/05, “Housing debt, inflation and the exchange rate”, speech to EMA AGM

¹⁸ Finsec, December 2005, “Submission to Reserve Bank on the effect of bank sales targets and performance management systems upon consumers and the economy”.

companies entirely financed by debt, should also be considered when assessing capital requirements for banks. Many companies who are taken over by private equity firms are loaded up with debt in order to repay the purchaser. In some cases these debt levels may well be unsustainable.

- d) When the carpet maker and iconic Kiwi manufacturer Feltex fell over last year, high debt levels were cited as among the reasons for his financial collapse. In particular some pointed to the acquisition of its competitor Shaw Industries in 2000, with ANZ Bank providing 100% of the funding¹⁹. When ANZ called in their loan in 2006 and forced Feltex into receivership many NDU members lost their jobs, and many ‘Mum and Dad’ investors lost their money thanks to irresponsible management. As a result the woven carpet plant in Christchurch closed, despite it representing, at least in some ways, the ‘high value’, ‘high skill’ manufacturing New Zealand ought to be encouraging.
 - e) Increasing the capital requirements for banks above the current 4% would not be particularly onerous, as the banks generally hold greater than the regulatory minimum as part of maintaining better external credit ratings. The major banks currently hold around 8% capital.
 - f) While there is a risk of disintermediation, where lenders attempt to go outside regulated financial institutions, this could be addressed by further reform of the financial sector. Such lenders are also likely to face a premium for seeking such loans.
 - g) With the New Zealand banking sector thoroughly dominated by the four major Australian owned banks there is a greater risk that difficulties in the banking sector in Australia are likely to also affect New Zealand. Increasing the capital requirements could also provide greater protection for New Zealand depositors, especially given that Australian law gives depositors in that country priority over other claimants.
- 29) Two types of borrowers likely to be affected by requiring greater capital requirements for high LVR mortgages and LVR limits are first home buyers and those buying investment properties.
- a) Given the current home affordability crisis where a great many New Zealanders are simply shut out of the property market the NDU would not like to see additional “stabilisation” instruments having a disproportionate effect on the ability of New Zealanders to make their first steps in the property market.
 - i) For this reason, and the mounting evidence that property speculators are buying up a greater proportion of the housing market, and therefore increasing prices, the NDU would like to see some investigation into the means by which greater restrictions could be placed on mortgages taken out for the purpose of property investments other than the family home. This could provide a means of cooling the housing market without further disadvantaging first home buyers.
 - ii) In 2007 ASB Bank reported that lending to existing homeowners had risen by a third in the past three years²⁰. Such properties are usually bought with 100% finance to claim the maximum tax deductions against wages or salaries. Even at high interest rates the payoffs can be considerable, as landlords gain tax breaks, rental income and the ability to reap the unrealised capital gain as they sell within a couple of years for a good profit.

¹⁹ NZ Herald ‘The Business’ Supplement (30/10/06)

²⁰ NZ Herald (23/6/07), “Squeeze on landlords”, Anne Gibson

- iii) Identifying mortgages taken out for the purpose of property investments would also aid enforcement of the Income Tax Act 2004 that makes investments in housing for the purpose of making a capital gain taxable.
- 30) **Mortgage Interest Levy:** As a significant number of mortgages include a fixed term, there can be a significant delay before changes in the Official Cash Rate are felt in the housing market. It is argued that this may lead the Reserve Bank to push for higher interest rates than otherwise would have been necessary. One of the suggestions in the SSI report is that the Minister of Finance on advice from the Reserve Bank, or the Reserve Bank itself should have the authority to trigger a variable levy on mortgages, depending on monetary conditions. The effect of changes in the Official Cash Rate could be felt more immediately as the levy would increase the costs of fixed rate mortgages.
- 31) The SSI report contains some valuable discussion concerning the implications of the mortgage interest levy. In particular the report questions whether such a levy would be consistent with a long standing principle of Westminster parliamentary democracy that holds that taxes can only, and should only be levied by Parliament. The NDU believes these same questions could also be asked of the current structure of the Reserve Bank Act, as it could be argued movements in the OCR can have similar political effects to a tax. Does this show fiscal and monetary policy can not and should be separated, and question the whole notion of an 'independent' Reserve Bank? Does the concept of an 'independent' Reserve Bank actually mean independence from democracy?
- 32) The CTU suggests such a levy should only apply to mortgages for investment properties, or properties purchased at above the median local price.
- 33) The NDU agrees that any such levy should be only be applied in a way that tackles the problem of house price speculation, rather than further punishes those already struggling to fund house purchases. However we believe the more fundamental problem is the use of the interest rate/exchange rate mechanism and the single target of price stability. A progressive lowering of interest rates, and not their more uniform increase, is required.

Additional measures to enhance monetary policy in New Zealand

- 34) In 1964 the Reserve Bank of New Zealand Act gave a wide brief consistent with Keynesian principles of economic management. Its role was defined as “the maintenance of and promotion of economic and social welfare in New Zealand in having regard to the desirability of promoting the highest level of production and trade and full employment, and of maintaining a stable internal price level”²¹. Under the Reserve Bank Act of 1989 price stability was made the only performance indicator, under an assumption that other gains would arise from that. This assumption was challenged at the time by the Manufacturers’ Federation who called for ‘real sector objectives’ such as employment, trade and production to be included. Given the difficulties faced by the Reserve Bank the NDU believes it is high time the assumption that ‘inflation is the only ill’ is reconsidered, particularly when efforts to stamp out inflation are leading to negative consequences for other aspects of the economy.
- 35) Comparable central banks in Australia, the US and England all have a wider monetary focus.
 - a) New Zealand Reserve Bank only takes price stability/inflation into account when determining monetary policy. The Policy Targets Agreement with the Government sets out a task of keeping inflation within a 1% to 3% band on average over a medium term.

²¹ Kelsey, Jane (1993), “Rolling back the State”, p. 20

- b) The Reserve Bank of Australia has to consider “full employment and the economic prosperity and welfare of the people of Australia”.
 - c) The US Federal Reserve Board has “price stability, maximum employment and moderate long-term interest rates” as objectives.
 - d) Bank of England also has to “support the Government's economic objectives including those for growth and employment”²²
- 36) In June 2007, HSBC Chief Economist for Australia and New Zealand John Edwards made an interesting observation when he compared the operation of the New Zealand Reserve Bank (NZRB) with its counterpart in Australia (RBA). His comments regarding changing economic relationships could also apply to New Zealand.
- a) “According to RBNZ officials Aaron Drew and Rishab Sethi, “When aggregate output expands above the economy’s ‘supply capacity’...non tradeables inflation rises”. If that happens “a more than one-for-one monetary policy is required to return output to potential levels.” It sounds straightforward and as a general statement would be widely agreed among central banks including the RBA. But as an operating procedure it requires the central bank to estimate output growth over the next year or eighteen months, to estimate the relationship between expected output growth and the estimated supply capacity of the economy, and then to estimate the impact on price inflation of the estimated gap between estimated output and estimated capacity. It also, of course, requires the central bank to estimate the expected impact of a change in the cash rate on output growth. **Broadly speaking the RBA gives greater weight to the judgment and experience of its officials rather than the output of models in estimating these relationships.** The actual trajectory of contemporary core inflation is accordingly more important to the RBA and than the RBNZ, because in the RBA’s view the contemporary data may be signalling that past statistical relationships between output, capacity and inflation are changing. **The fact that core inflation has been falling when employment has been increasing quickly and the unemployment rate is at a three decade low, for example, tells us that some past economic relationships are no longer reliable.**”²³
(emphasis added)
- 37) These points are fundamental to our view. While the policy targets agreement was widened in 1996 to include the wording “so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy and in 1999 the words “shall seek to avoid unnecessary instability in output, interest rates, and the exchange rate”. As CTU economist Peter Conway has observed, despite these wording changes it is hard to detect a real change in the operation of monetary policy. The NDU believes change in the operation of the Reserve Bank can be best achieved by amending legislation so that monetary policy is influenced by a wider set of economic objectives, which would be more in line with its overseas equivalents.

Measures to tackle inflation in the housing market

- 38) With inflation in house prices continuing to outstrip general levels of inflation, attempts to cool the housing market with rises in the OCR have met with limited success, yet have left significant other parts of the economy under severe strain. The NDU believes specific and significant measures

²² Quoted in NZ Herald (16/06/07), “Brian Gaynor: What goes up must come down”

²³ HSBC (9 July 2007), “Australia & New Zealand Weekly”, John Edwards Chief Economist

need to be taken to dampen inflation in the housing market, and this would create greater scope for lower interest rates. Suggested measures include:

- 39) **Capital Gains Tax:** The NDU supports the introduction of a comprehensive capital gains tax on all properties apart from the family home.
- a) Such a tax could have significant downstream benefits for the New Zealand economy as more locally based capital would become available to finance local businesses. This would allow greater investment in staff through higher wages and greater spending on research and development.
 - b) The sharemarket would get a boost, and less overseas ownership of New Zealand companies would help to reduce the current account deficit.
 - c) Between 1989 and 2005 the residential property market provided investors and owners with a tax free gain of 319%²⁴.
 - d) The NDU challenges the assumption that a capital gains tax would be unpopular. The SSI report notes that developed Asian economies had used a variety of measures to curtail booming property markets, including adjustments to capital gains tax thresholds: “It is worth emphasising that, in these cases, rapid house price inflation had become highly unpopular (as housing affordability had come under such strain), which meant that there was considerable public support for actions to tackle house prices (indeed, in some cases, competition to generate the most politically attractive measures)”²⁵.
 - e) As a measure to stabilise rampant house price inflation a capital gains tax is likely to have more impact in the medium to long term, as investors redirect their capital into more productive assets. Even if a capital gains tax resulted in only a small improvement in home affordability, the NDU believe this step is still a worthwhile step as part of a wider policy mix.
- 40) **Land Tax:** A tax on undeveloped land should also be considered as a way to encourage the development of unutilised land within Metropolitan Urban Limits and to discourage “land banking” in times of high inflation of land values.
- 41) **Tax Loss Claims:** Treasury and the Reserve Bank²⁶ have considered restricting the operating losses that could be claimed on residential properties. While it may be tempting given that the current arrangements are used by some taxpayers to avoid paying their fair share, measures would need to be put in place to ensure those modest incomes did not face sharp rent increases as landlords seek to recover “losses”, such as strengthening tenants legal rights to long term secure tenure.
- 42) **Stamp Duties:** The introduction of stamp duties, on a progressive basis, could help to slow demand and act as a revenue source for affordable housing measures. Many Australian states have a transfer/mortgage or stamp duties applying to residential housing, with rebates available for those purchasing their first home.

Monetary Policy and the NZ dollar

- 43) The current account deficit for the year to March 2007 was \$13.9 billion, with total liabilities of \$145 billion to the rest of the world. While there has been a small drop in expatriated profits to

²⁴ Figures collated by economist and Infometrics Director Gareth Morgan, quoted in Sunday Star Times (17/6/07), “The Rent Trap”, Jenni McManus.

²⁵ Reserve Bank and Treasury (10/2/06), “Supplementary Stabilisation Instruments: Initial Report”, p 11

²⁶ Reserve Bank and Treasury (10/2/06), “Supplementary Stabilisation Instruments: Initial Report”

- foreign owned firms, \$11.8 billion (85%) of the \$13.9 billion dollar deficit is due to income accruing to foreign investors and the carry trade funding household mortgages.
- 44) It really ought to be questioned whether New Zealand can afford to pay the rest of the world the high rates of interest that are currently on offer. If, as it seems likely, these interest payments cannot be serviced by increased output in New Zealand, they must come from additional inflows to our Capital Account. This is called Ponzi Finance. As with the case of credit cards being used to pay interest on other credit cards, this risks ultimate financial disaster.
- 45) While most economic commentators regard the New Zealand currency as overvalued, particularly given New Zealand's large current account deficit, the dollar has continued to rise. If the global economy was working as it should, and was following the 'law' of supply and demand, high interest rates in New Zealand should lead to greater capital flows, which should then lead to lower interest rates.
- 46) Yet New Zealanders have always been over spenders, and since the float of the Kiwi in 1985 the currency has swung all over the place.
- 47) Short term speculative currency markets do not follow the rules of supply and demand. Speculators buy into a rising currency market, forcing the dollar higher, and bail out at the slightest hint of a drop in the value of a currency. Speculators make the global economy more unstable for their own private gains.
- 48) Economist James Tobin explained how volatile the currency markets can be. "Evidentially, 80% of foreign exchange transactions involve round trips of seven days or less. Most occur within one day. An undergraduate student of mine, upon graduating, got a job in the Chicago mercantile exchange and became assistant and apprentice to an active trader who had been an economics professor. After a few weeks the young man made bold to ask his mentor about the long-run calculations that must – necessarily he thought- govern his trades. The reply was "Sonny, my long-run is the next ten minutes."²⁷
- 49) As of December 2006 the New Zealand dollar was one of the eight most traded currencies in the world²⁸.
- 50) Interest Rates will not fall if investors believe the Reserve Bank will artificially keep them high in pursuit of its 1-3% inflation target. The money from overseas will keep coming, leading the exchange rate to rise or remain stable instead of falling.
- 51) In 1996 Reserve Bank Governor Don Brash raised interest rates in response to Government encouragement of Asian immigration, and 'interest sensitive' growth in housing and construction. At the time, this move was widely derided as an overreaction. Economist Adrian Orr, later an employee at the Reserve Bank, was scathing. Orr said that between 1994 and 1996 the Bank had pursued an inflexible high interest rate policy, irrespective of its effect on the currency, guaranteeing a healthy return to investors as it effectively removed the exchange rate risk. According to Bruce Jesson, the Reserve Bank had created a one way bet, and there was only direction the currency could go – up²⁹. The current situation is not unlike the situation in 1996 described by Jesson and Orr.

²⁷ Tobin, James (1996), "Prologue" in Mahbub ul Haq, Inge Kaul & Isabelle Grunberg (eds), "The Tobin Tax: Coping with Financial Volatility", http://cowles.econ.yale.edu/news/tobin/jt_96_tobin-tax.pdf

²⁸ Investopedia.com. (Accessed 16 July 2007), <http://www.investopedia.com/ask/answers/06/maincurrencypairs.asp>. While Investopedia do not rank the currencies in their top eight, based on other sources it is likely that the Kiwi would be ranked either 7 or 8.

²⁹ Adrian Orr's views are included in Jesson, Bruce (1999), "Only their purpose is mad", p. 99.

- 52) The combination of a tight monetary policy and a floating exchange rate is undermining the essential role of money – to facilitate the flow of goods and services through the international economy.

Monetary policy and the Manufacturing Sector

- 53) Current monetary policy, based on high interest rates and a high exchange rate are leading to significant job losses in the manufacturing sector. Over the past year, Electrolux, Dynamic Controls, GL Bowon and Gale Pacific have packed up their machines for Asia. Canterbury Manufacturers Association Chief Executive John Walley likened the flight of these offshore owned companies to canaries in the coal mine³⁰, and said New Zealand ignored at its peril a shrinking manufacturing sector. The continuing march of tariff reductions is also placing the manufacturing sector, and the jobs of our members at risk.
- 54) Policy increases both the cost of exporting and the insecurity surrounding investment in both human skill and equipment, plant and technology essential to “economic transformation.”

Consider Financial Transactions Taxes

- 55) In 1972 the James Tobin proposed a tax on foreign currency transactions as a means of dissuading speculation in international currency transactions. The rate would be set low, between 0.1% and 0.25% of volume. In an interview with Der Spiegel in 2001 Tobin noted that many of these transactions aimed for short term gains, but the sudden withdrawal of such ‘investment’ could have a substantial effect on national economies, “as countries have to drastically increase interest rates for their currency to still be attractive. But high interest is often disastrous for a national economy, as the nineties’ crises in Mexico, South East Asia and Russia have proven. My tax would return some margin of manoeuvre to issuing banks in small countries and would be a measure of opposition to the dictate of the financial markets.”³¹
- 56) The Association for the Taxation of financial Transactions for the Aid of Citizens (ATTAC) has been a strong proponent of a Tobin tax in recent years. Such a tax could provide an independent source of funding for international organisations, and provide a source of revenue for development projects in the poorer parts of the world.
- 57) While a Tobin Tax would be difficult for a single country to adopt on its own, countries such as Belgium and Canada have made legislative and parliamentary statements in support. On 15 June 2004 the Commission of Finance and Budget in the Belgian Federal Parliament passed a bill implementing the Spahn version of the Tobin Tax, committing Belgium to introduce a tax once all countries in the Eurozone introduce a similar law³². On the 24 March 1999 the Canadian House of Commons passed a resolution directing the government to “enact a tax on financial transactions in concert with the international community.”³³
- 58) The NDU would also like to see some investigation into the use of Financial Transactions Taxes in other countries to see if a tax could be implemented locally with the aim of placing a penalty on short term investments. While such measures may lead to a drop off in capital flows involving the New Zealand dollar, this could be a blessing in disguise as quality long term investment is likely to be attracted to an environment less prone to risks associated with a volatile exchange rate. Greater

³⁰ NZ Herald (4/7/07), “Only a matter of time before it’s US80c?”, Christopher Niesche

³¹ Der Spiegel (3/9/01), http://www.jubileeresearch.org/worldnews/lamerica/james_tobin_030901_english.htm

³² <http://www.diplomatie.be/en/policy/policynotedetail.asp?TEXTID=40795>

³³ Tobin Tax Motion passes in Canada’s Parliament, <http://www.ceedweb.org/iirp/canadames.htm>. It passed 164 votes to 83.

stability the value of the Kiwi would make it easier for New Zealand businesses to expand their export operations.

Summary

To consider the causes of inflationary pressures.

- The first question must be whether “inflationary pressure” is the same problem as “inflation”. Even were we to accept that price stability should be the sole concern of the operation of monetary policy (which we don’t), raising interest rates on the basis of an increasingly questionable relationship between “inflationary pressure” and “inflation” should stop. We do know that there are a number of “pressures” that could be managed through more comprehensive policies, and others (like wage increases) which are desirable:
 - Investment Properties: Speculation on secondary properties bought for investment purposes is driving up house price inflation.
 - Banking: Banks create inflationary pressure through their lending practices. Capital flows are attracted by our high interest rates, and the banks funnel much of this money into the housing market.
 - Wages are too low: If we are to reach the goal of becoming a high value, high wage economy, wage inflation should not be regarded as a threat to New Zealand’s economic health. In real terms, wage rises for workers have lagged behind the rest of the OCED, and actually fell 6.5% between 1980 and 2001. This demonstrates that low wages are a fundamental structural problem in the economy.

To consider the effectiveness of current monetary policy in controlling inflation.

- Clearly, the current policy is failing. Rising interest rates attract money into the country, increasing liquidity and inflationary pressure
- Having said that this question can not be easily answered. The evidence does not prove in our recent experience a relationship between pressures like skill shortages and low unemployment and inflation
- More tools required: Instead of using the Official Cash Rate as the only means to control inflation, the NDU call for specific policy measures to address inflation in particular sectors where prices are rising well above general levels of inflation. This could allow lower overall interest rates.
- High interest rates can be counterproductive: Increases in mortgage costs are likely be passed on as rent increases. High interest rates encourage greater capital flows, encouraging inflation in the housing market.

To examine the interaction of monetary policy with other elements of the economic policy framework including fiscal policy.

- Change the current upward cycle: Current monetary policy is leading to an upward cycle of increasing interest rates and a higher New Zealand dollar. By adopting specific measures to cool house price inflation, this cycle could then be broken by adopting significantly lower interest rates. Currency speculators would not be given a one-way bet, and the exchange rate will fall.
- To blame government spending when we have the most fiscally conservative government in a generation and one which has redirected vast amounts of revenue into debt repayment and savings would be absurd

To examine the New Zealand economy’s capacity for non- inflationary growth, and how it can be improved.

- Adopt a wider monetary focus: The NDU believes current monetary policy places too much emphasis on price stability, and that New Zealand would experience greater levels of growth if it adopted a policy including ‘real sector objectives’. This would be more in line with the focus of central banks in Australia, the US and England.
- Short term considerations to lower inflation are causing long term damage to the manufacturing sector.
- A restrictive monetary policy risks minimising the benefits to New Zealand of higher dairy prices.

To examine the role of productivity in the economy, how it can be improved, and the constraints upon it.

- High interest rates increase capital costs: This discourages businesses from increasing the kinds of capital investment that would be likely to result in productivity gains. Private sector employers have relied too much on a flexible labour market and low paid workers, rather than investing more capital per worker to increase productivity. Current monetary policy has been exacerbating this problem.
- Low wages incentivise low productivity: means to increase wages through collective bargaining and direct government measures (eg the minimum wage) are required

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.

- Increase capital requirements for banks.
- Interest rates should be lowered, not made more universally higher through a levy on fixed rate mortgages
- While the NDU welcomes the Budget 2007 initiative to provide the Inland Revenue Department with more resources to investigate such housing transactions, we believe it would be more effective to address the structural issues in the tax system that encourage these sorts of transactions in the first place. This would also assist monetary policy.
- For this reason we support a comprehensive capital gains tax on all but the family home. A tax on undeveloped land and stamp duties could also play a useful role in dampening demand.

To consider additional measures that could enhance monetary policy in New Zealand.

- Adopt a wider monetary focus: The NDU believes current monetary policy places too much emphasis on price stability, and that New Zealand would experience greater levels of growth if it adopted a policy including 'real sector objectives'. This would be more in line with the focus of central banks in Australia, the US and England.
- Instead of using the Official Cash Rate as the only means to control inflation, the NDU call for specific policy measures to address inflation in particular sectors where prices are rising well above general levels of inflation.
- New Zealand should advocate internationally for measures to discourage the short term speculative trade in currencies, such as the introduction of a comprehensive global Tobin Tax.
- New Zealand should follow the example of Belgium and pass enabling legislation for a Tobin tax