
Supporting Paper A7

Other possible supporting policy initiatives

Introduction

Monetary policy generally acts to stabilise the overall economy. However, the Reserve Bank has little control over the interest rate/exchange rate mix and at times this mix may mean monetary policy is not bearing very heavily on the sector that is generating the most pressure on resources. In the last few years, for example, demand has been strongest in the household sector and the domestic economy, but the strength of the exchange rate has pushed much of the burden of adjustment onto the tradables sector.

If there were alternative tools that could assist macroeconomic stabilisation without undesired spillover onto the exchange rate, they could have been useful. That possibility is the subject of this paper.¹ In the 2006 Supplementary Stabilisation Instruments report the Reserve Bank and Treasury published some analysis of possible measures, targeted specifically at housing or housing finance. These options are summarised in supporting paper A6. This paper looks briefly at a broader range of possible options.

Each of them would need considerable further evaluation and development before they could be implemented. They should therefore be thought of primarily in terms of improving future cycles, although possible beneficial announcement and signalling effects in the late stages of the current extended cycle should not be overlooked. Throughout this paper, our focus is on the possible scope

for the measures in question to assist in easing the pressures monetary policy can sometimes face.

Fiscal and financial policy initiatives

Decisions about taxation

Taxes affect choices. This section considers the potential effects of the tax treatment of investment income, such as capital gains and interest, rules on interest deductibility, and provisions relating to interest paid to non-residents. The tax system is complex and serves multiple ends. We are not tax experts and recognise that any of the issues raised here need to be explored in depth and in light of the overall design and goals of the tax system.

Our focus has been on how different rules might make the job for monetary policy a bit easier. For example, if the housing sector in New Zealand is larger or more volatile as a result of the tax treatment of housing, that could make the job of monetary policy harder. This may be the case to some extent, although the distortions are probably not unusually severe by international standards.

How the tax system treats housing relative to other assets

The most important single feature of the tax system that is clearly favourable to housing is the treatment of owner-occupied housing. For those who live in their own home without a large mortgage, there is a considerable tax advantage. If those same people instead had their wealth

¹ This issue has been analysed in New Zealand previously. For example, after the big exchange rate cycle of the mid 1990s the Reserve Bank published assessments of a number of possible supplementary instruments in its submission to the Svensson review of monetary policy.

in a bank deposit and rented accommodation, the after-tax interest they earned would not normally be enough to cover the rent. Almost every country has some sort of tax bias towards owner-occupied housing.

More generally, liability for income tax is assessed, broadly, on the basis of aggregate individual income. Most investment income is captured in the definition of taxable income, but a significant proportion is not. In particular, while all interest is taxed, many capital gains are not.² Even moderate inflation means that long-lived assets rise in price over time, creating tax-based incentives to favour those assets. Ideally, the taxation treatment of capital gains would be more comparable to the tax treatment of interest.

For example, by allocating their wealth to property (or other real assets such as shares) rather than bank deposits, investors are able to avoid earning taxable interest. Over long periods of time, and even in the absence of big house price cycles, they would expect to earn untaxed capital gains, even if only because inflation slowly increases the prices of everything. Investors who do not have a lot of wealth can still benefit by borrowing and then deducting any resulting losses (if total costs exceed rental income) against labour income.

The tax advantage (of real assets over financial assets such as bank deposits) is not a gearing issue. An investor who shifts cash from a bank account to a rental property gets very similar tax benefits to a highly geared investor. Making that shift results in a reduction in interest income, but it also reduces tax payments on that income. That is exactly parallel, in principle, to a leveraged investor facing interest costs, which are written off, resulting in reduced taxes on total gross income. Gearing becomes particularly attractive at times, not because of any particular tax advantage, but because of stronger than usual expectations of future asset price increases. If a potential investor is very confident that prices will be rising, and can cope with the risk, then borrowing to the hilt has a certain logic almost regardless of the tax treatment.

Consistent with the comprehensive approach to tax generally adopted in New Zealand, individuals borrowing to fund income-generating activities are able to deduct that interest against other income (including wage and salary income). That applies to borrowing undertaken to finance investment housing properties as much as to that undertaken to purchase equities, or to carry out other business activities.³ There is no tax policy bias towards housing in these deductibility provisions, although bank lending criteria mean that investment housing is able to be more heavily debt-financed than many other assets. Australia has a similar approach to deductibility of interest and other losses against labour income, but many other countries limit or prevent this offsetting of losses of investment property against other income.

Overall, it is difficult to tell what effect these features of the tax system have had on the housing sector as a whole. For example, the inflation-related distortions, while material and possibly growing over the last decade,⁴ are surely much less significant than it was in the 1970s and 1980s. From a cross-country perspective, it is not obvious that New Zealand house price cycles have been larger than those in other countries, and over recent decades as a whole, New Zealand has not invested a larger share of its GDP in housing construction than have other OECD countries. It is also important to recognise that the largest impact of any tax distortions on asset prices should occur around the time tax provisions are changed. A new bias in favour of a particular class of asset will become reflected in a higher price for that asset, but it does not then lead to permanently higher future returns.

Overall, our sense is that the effective tax advantages to owning housing have probably boosted the price of housing in New Zealand somewhat, and may have amplified the variability of house prices once some other shock, or set

² The exemption from tax on capital gains is reinforced by the recently introduced PIE regime under which capital gains on actively managed funds will now be exempt from any taxation.

³ And when the ability to deduct other losses against labour income was limited from 1982 to 1991, this restriction applied to all investment activities, not just to residential investment property.

⁴ The inflation target has been increased twice and more taxpayers have moved into the 33 and the (new) 39 percent tax brackets.

of circumstances, triggers a cycle.⁵ Tax biases in favour of housing may well have the same effect in other countries. However, since housing wealth is a larger portion of aggregate household wealth in New Zealand and as consumption growth here seems to be quite strongly correlated with house prices, consumption and business cycle variability in New Zealand might be reduced slightly by creating a more level playing field in the taxation of housing and investment assets. The recent (current) house price cycle clearly was not caused by tax policy, but the overall tax regime may have reinforced the strength and speculative aspects of the house price cycle after it was kicked off by other factors, such as an unexpected surge in migration.

Possible changes to the treatment of income on capital

Broadly, the tax treatment of capital gains and interest could be made more comparable by reducing the tax on interest (and the deductibility of interest expenses), or by making the taxation of capital gains more comprehensive. Capital gains taxes are common internationally, but are hard to design and implement in a way that works well. Capital gains taxes are generally only levied when a property is traded, usually exclude owner-occupied houses (already heavily tax-favoured), and create a substantial incentive to hold onto properties simply to delay tax (and hence materially reduce the effective cost of the tax). We strongly support the recent increase in funding for tax enforcement in respect of capital gains made on investment property, but we do not see capital gains taxes as the means to remove all systemic biases in favour of long-lived real assets such as housing. Countries with fuller capital gains tax regimes face all the sorts of practical issues discussed above, and have continued to experience substantial house price cycles.

⁵ The distortions have tended to make the value of housing (relative to national income) higher, making fluctuations in housing value of greater macroeconomic significance. The percentage fluctuations in house prices may also have been increased because the tax free nature of expected future capital appreciation means changes in the rate of expected future capital appreciation have a larger impact on today's price. For example, if people revise up the expected future growth rate of rents, prices will respond more today if the impact of that future rental growth on the price of the asset is tax free to the investor.

Some countries run "dual" taxation systems with lower tax rates on investment income. Indeed, the OECD (2007) recently made suggestions along exactly these lines for New Zealand. A few years ago, the McLeod committee went further and recommended a comprehensive reform where all taxes on actual investment income would be replaced by a "Risk Free Rate of Return" (RFRM) method of taxing investments. Essentially, the RFRM taxes assets on an assumed rate of return, rather than trying to calculate actual returns. Because the size and nature of actual returns do not affect tax under a RFRM, there would then be no tax-related reason to choose particular investments.⁶

Because the largest distortion in favour of real assets arises from the interaction of the tax system with a positive expected rate of inflation, another way to level the playing field between housing (and other assets) and bank deposits would be to directly tackle the tax treatment of the inflation compensation component of interest. Suppose the first 2 percentage points of interest could be made tax-free and non-deductible. Since the Reserve Bank acts to achieve 1 to 3 percent inflation over the medium term, this would simply correct for the fact that some portion of interest is simply compensation for inflation, not real income. Making this adjustment would substantially boost after-tax returns to saving and reduce the value of interest deductions. The incentives to invest in long-lived assets such as houses to avoid tax would be substantially diminished: the after-tax interest costs of doing so would have risen by around 0.8 percentage points per annum. There would still be tax advantages to investing in owner-occupied housing (avoiding paying rent out of after tax income) – as in most countries – although this incentive would be diminished by the improved real after-tax return on bank deposits.

Overall, in any future review of the basis of tax treatment of income earned on capital assets in New Zealand, the Reserve Bank supports further analysis of the way the investment income tax regime affects demand to own property.

⁶ The broad outline of this approach has since been applied to New Zealanders' (ex Australasia) foreign equity investments. But McLeod suggested it could apply to a broad asset base, potentially including owner-occupied housing, as an alternative to the current taxes on investment income.

Limiting the deduction of interest against investment assets

A more incremental change to the investment income tax regime might involve changing the rules on interest deductibility. As noted above, in many countries, (and in New Zealand for a brief period in earlier decades), losses on certain investments have been “ring fenced” so that they cannot be used (or used fully) to offset other (eg wage and salary) income. A ring-fence might apply only to residential property investment, or more generally.

A ring-fence that applied to property would make heavy gearing of rental properties uneconomic – and, hence, could have been particularly relevant when expectations of future capital gain were at their greatest. Over time, a ring-fence would lead to heavily geared investors scaling back their rental property investments, gradually being replaced by other buyers with more equity who were purchasing the properties as an alternative to having money in the bank. It is also possible that Australian investors would step up purchases of New Zealand housing, since in the absence of an Australian law on ring-fencing they could continue to deduct losses against labour income at home. Although a ring-fence effectively toughens the treatment of geared investors, if sufficient other investors become involved the effects of any ring fence on the demand to hold property and on the level of cyclical variability of house prices could be quite limited. However, the measure would tend to shift ownership of rental property towards less-heavily geared landlords, which might have some ancillary advantages in terms of macro-financial stability.

The economic rationale for some sort of ring-fencing of investment losses from labour income is strengthened by the fact that the tax rates on many forms of investment income are now quite a bit lower than the maximum personal marginal tax rate. Specifically, interest and other investment income will soon be able to be earned through the funds that meet the requirements to be Portfolio Investment Entities (PIEs) at a maximum 30 percent final tax rate. This is likely to become a popular way to earn interest.

The PIE structure creates elements of a “dual” tax system in New Zealand. To the extent it does so, it is arguably now not appropriate to allow investment losses (eg from a geared rental property) to be deducted against non-

investment income that would otherwise have been taxed at 39 percent. This could be prevented through a ring fence that limited the maximum applicable tax rate for deducting investment losses against other income to a rate of 30 percent, although this may be administratively complex and would probably have only a small impact.

We also believe that it would be worth considering in more detail the option of requiring all purchasers of investment property to make a choice at the time of purchase: if they chose to avail themselves of loss deductibility provisions they would be unambiguously subject to tax on any capital gain (at least to the extent of any past loss deductions), while those who did not claim losses against other income would not face tax on capital gains (or might face the existing “intent” tests).

Non-resident withholding tax

At present, most interest paid by New Zealanders to non-residents is effectively exempt from New Zealand tax. By contrast, interest paid to residents is fully taxed at the depositor's marginal personal tax rate. The situation is not quite as stark as this simple description suggests, because some foreign lenders will be liable for tax in their own country. However, after a cycle in which the ready availability of foreign capital has pushed the exchange rate to uncomfortable heights, we consider it could be timely to review the tax treatment of interest paid to non-residents.

Double taxation treaties cap the rates of withholding tax that can be charged on interest paid to non-residents (currently to a rate of 10 to 15 percent). These provisions exist for good reasons, and effectively govern the distribution of tax revenue between the country of the lender and the country of the borrower. However, these non-resident withholding tax (NRWT) rates are not typically the binding rates at present, in respect of most of the borrowing from non-residents undertaken to finance activities in New Zealand. In lieu of NRWT, issuers are able to use the Approved Issuer Levy (AIL) system to replace NRWT obligations with a payment equal to 2 percent of the interest payment on a loan. Additionally, we understand over recent years an increasingly large share of the borrowing undertaken to finance spending and demand in New Zealand is undertaken using offshore structures that completely (and legally) avoid

the obligation to pay AIL.

The current system also has the undesirable effect of encouraging the use of offshore structures, and may reduce the range of financial instruments trading in New Zealand markets (including reducing the size and liquidity of the corporate bond market). Current practices also slightly lowers the cost of funds to borrowers (including banks), meaning that the OCR needs to be a little higher than otherwise to get the same overall cost to borrowers. Bringing all borrowing undertaken to finance New Zealand business activity back within the AIL tax net would tend to raise interest rates here slightly, and would do so without boosting the exchange rate. Indeed, had such a regime been in place in recent years, the peaks of the exchange rate might have been dampened a little.

Macro-fiscal policy

Because big changes in the Government's spending and taxation policy have a large influence on fluctuations in aggregate demand and inflation pressure, we pay a lot of attention to developments in this area. Fiscal policy is, of course, aimed primarily at things other than stabilising the business cycle: the Government's main focus is to take in tax revenue to pay for services like hospitals and schools, and also meet to superannuation and other transfer payment commitments. We do not have a view on what the Government should spend its money on, or on what average tax or spending rates should be, but we do think it is vital that the way discretionary changes in spending and tax policies affect demand is well understood. As the largest single participant in the economy, government choices can materially add to, or relieve, pressures on resources. This can be particularly important when the overall resources of the economy are severely stretched. In those circumstances, any additional demand tends to add to pressure on real interest and exchange rates, and any reduction in demand can ease those pressures.

Automatic stabilisers

Many government tax and spending systems tend to have an automatic offsetting effect on macroeconomic cycles. In a strong economic cycle, roughly a third of all additional

earned income flows directly to the Crown in additional tax, while transfers such as unemployment benefit will be paid to fewer people. The extent of these automatic fiscal stabilisers varies across countries, depending on factors such as the overall size of government.

In virtually every case, the design of a fiscal policy is unlikely to be based primarily around its automatic stabilisation effects. For example, a more progressive tax system may increase the automatic stabilisers by making bracket shifts more prevalent as the economy goes through upswings and downswings. However, the progressivity of the tax system is generally set with efficiency and equity considerations in mind, rather than fiscal stabilisation objectives.

Internationally, in analysis undertaken by the United Kingdom Treasury (2003), it was noted that if Britain adopted the euro, it could be worth paying more attention to the effect that any changes to fiscal policy would have on the automatic stabilisers. This reflected the fact that Britain would no longer have a domestic interest rate instrument to manage the UK economy. Even with an independent monetary policy, we are sometimes discomforted with the balance of cyclical pressures that result from the OCR when responding to macroeconomic cycles. Stronger automatic stabilisers could tend to reduce, at least by a little, the need for interest rates to respond to macroeconomic shocks.

Avoiding fiscal policy exacerbating cycles

New Zealand's macroeconomic arrangements provide for the independence of monetary and fiscal policy. Fiscal policy is set by the Government in accordance with the Public Finance Act 2005. The Public Finance Act requires the Government to set long term fiscal objectives and assess short-term intentions against those objectives. This helps to provide stable policy by anchoring decisions to a longer-term context.

The Public Finance Act provides for economic stabilisation to be taken into account in the setting of fiscal policy, as one of a range of objectives: "decisions are made with a view to goals such as the optimal allocation of resources, economic stabilisation, and the longer-term stability of public finances" (Treasury 2005). If anything, in the last 15 to 20 years, discretionary fiscal policy has often ended

up being pro-cyclical - exacerbating pressure on resources, and exacerbating slowdowns - rather than assisting in the stabilisation task. In the early 1990s, this probably reflected constraints created by substantial public debt. In the mid-1990s and again in the current cycle it was partly a consequence of the duration of the macroeconomic cycle, which surprised most commentators (including the Reserve Bank) both times.

We would be keen to see whether better outcomes could be achieved in future cycles. We understand the Treasury is currently looking at the international literature on fiscal policy rules and its potential applicability in New Zealand. We are sceptical of the scope for formal rules, which would inevitably need to be rather complex, but would encourage the Committee to give consideration to how to minimise the extent to which fiscal policy choices reinforce, perhaps often inadvertently, cyclical pressures and imbalances.

One goal in this would be to ensure that a greater proportion of revenue surprises were saved. One of the major challenges facing any government, here and abroad, in the late stages of a long and strong economic upswing, is avoiding the tendency to increase spending, or cut tax rates, too far – overestimating the proportion of the observed revenue gains that really are permanent. Of course, public expectations of fiscal easings can become intense in the face of large and growing surpluses, and those expectations may themselves lead to additional private sector spending. Devices such as the New Zealand Superannuation Fund and Kiwisaver offer scope to relieve some of that pressure without involving actual fiscal injections.

In periods of particularly intense pressure on resources, particularly when the exchange rate is coming under extreme pressure, it would be desirable in principle for fiscal policy to play a more active counter-cyclical role. We recognise the severe practical limitations on this as an option.

Discretionary counter-cyclical instruments

We have discussed in other places the option of an additional discretionary tool such as the Mortgage Interest Levy (MIL), which uses a variable levy (revenue from which would accrue to the Crown) to help ease cyclical pressures and imbalances. Such an instrument might be able to be used to reduce domestic demand pressures without putting

additional upward pressure on the exchange rate.

One other option might be a variable rate of GST. Specifically, without altering the average rate of GST over time, the GST rate could be raised during periods of intense pressures on resources and lowered when inflationary pressures were very weak. Such a countercyclical GST rate could supplement the OCR in such periods.

An increase in the GST rate, during a period of intense pressure on resources, would help to dampen consumer demand. A higher GST rate would raise the price of consuming today relative to the price of consuming in the future. By doing so, it would encourage households to delay some of their consumption until the GST rate is lowered again. This **substitution effect** is much the same channel as that through which higher interest rates reduce consumption.

The difference is that GST affects everyone's consumption quite directly, whether or not they are material borrowers or savers. The reduction in demand would alleviate resource pressures and lower the ex-GST rate of inflation. By doing so, using a countercyclical GST tool might lead to a lower peak in both interest rates and, hence, the exchange rate. New Zealand consumers would face an additional incentive to delay spending, without providing a matching boost to the returns available to foreign savers. The Crown would receive (and set aside) additional revenue which could later be spent by temporarily reducing the GST rate during a particularly weak period.

Adjustments to the rate of GST would have a one-off effect on the (GST-inclusive) CPI inflation rate. Experience in New Zealand and other countries is that these one-off changes do not tend to upset firms' and households' expectations of medium-term inflation trends, although as with all CPI shocks that is something we would have to keep under review. The higher CPI would provide a compensating boost to the income of those on welfare benefits that are indexed to inflation, easing any short-term distributional concerns about the impact of such an instrument.

Changing the rate of GST for a period to influence consumer demand and thereby enhance stability is likely to be more effective than temporarily changing the rates of income tax. Many consumers would recognise that the change in the income tax rate is temporary and would likely

run down their savings a little to sustain current consumption levels during the period when tax rates were higher than usual. A rise in either tax cuts disposable incomes, but a rise in the GST rate also creates an effective incentive to delay consumption.

The effectiveness of the counter-cyclical GST rate, as a tool to maintain stability, will depend in part on the speed with which the tool could be deployed. Three types of delays associated with using the tool have been identified.

The first is the **recognition delay**. This is the length of time it takes to realise that a change in the GST rate would help to maintain economic stability. In the case of a cyclical upturn, if the recognition delay is too long, the eventual increase in the GST rate may have little impact on the peak of demand and may only exacerbate the slowdown that follows. The recognition delay for a change in the GST rate is unlikely to be significantly different from the recognition delay associated with a change in the OCR.

The second type of lag is the **implementation delay**. We do not know what the reasonable minimum period for a GST adjustment would be – the 1989 increase to 12.5 percent was done with about three months advance notice. A lengthy implementation delay could worsen macroeconomic stability. For example, if consumers expect the GST rate to rise in the near future they may bring forward substantial amounts of spending, particularly on durables. A spike in demand occurred in advance of the implementation of GST in 1986 (at 10 percent) and a further spike occurred just before the GST rate was raised to 12.5 percent in 1989.

Lastly, there is likely to be an **impact delay**, which is the length of time between changing the GST rate and observing the impact from this change on consumer demand. This delay will typically be shorter than the impact delay from a change in the OCR – fixed mortgage rates and exchange rate hedges slow the impact of OCR changes on those with existing financial exposures.

Changing the rate of GST in either direction would mean some increase in firms' costs. The advertised price of each product would need to be adjusted and accounting procedures may need to be amended. If such an instrument were to be adopted the GST rate would be changed only infrequently, and in periods of particularly severe pressures, but the scale of the price adjustment costs would have to be

investigated further in any comprehensive evaluation of a variable GST option.

There are a number of other practical issues associated with changing the GST rate. These would need to be resolved via further work and consultation with Inland Revenue.

There is little direct international precedent for using a counter-cyclical GST rate as a stabilisation tool. However, the United Kingdom Treasury (2003) considered changes to expenditure taxes alongside a range of other fiscal stabilisation measures that could be used if the United Kingdom adopted the euro. They concluded that evidence from macroeconomic models suggests that "changes in expenditure taxes could have a significant impact on demand for a relatively small change in the tax rate" (page 88).

There would be significant governance issues with an instrument of this sort. These would relate both to the constitutional conventions around setting and adjusting tax rates, and to the operational independence and accountability of the Reserve Bank. These issues are similar to those we addressed in exploring the possibility of a Mortgage Interest Levy. If a counter-cyclical GST tool was adopted, we believe that these issues should be addressed using the same approach outlined in the MIL proposal.⁷ Under that model, the decision to change the GST rate would be made by the Minister of Finance, on the recommendation of the Reserve Bank, which in turn would be bound to make such a recommendation only when certain broad statutory criteria had been met. The decision would operate on a double-veto process. That is, the Minister of Finance would approve the change, but could do so only on the recommendation of the Reserve Bank. The Reserve Bank would be required to explain publicly any recommendation to change the rate of GST. The Minister of Finance would need to explain publicly a decision that turned down a recommended change.

If the Committee considers that it is important to provide additional support to monetary policy in periods of unusual pressures, further consideration of a counter-cyclical GST instrument could be warranted.⁸ On some occasions, having

⁷ Available at <http://www.rbnz.govt.nz/monpol/about/2950448.html>.

⁸ Other possible instruments may also arise in that investigation, such as cyclical changes in the rules for depreciating business capital to encourage or discourage investment in particular periods.

the option of using such an instrument could provide some valuable flexibility, and might in turn reduce, at the margin, the size of the exchange rate cycles New Zealand has tended to face at such times.

Choices about financial policy

The New Zealand Government has (in the last 15 years or so, until recently) chosen to adopt a hedged foreign exchange position where the government balance sheet is not materially exposed to fluctuations in the value of the New Zealand dollar. It could be worth the Government considering carrying a substantial net long foreign exchange position, which is explicitly designed to rise in value during periods when the New Zealand economy is weak (and vice versa). Unrealised losses in good times, might help to restrain tendencies to increase spending markedly at just the time when overall pressure on resources is at its greatest. Unrealised gains during weak times, and cyclical troughs in the exchange rate, might help provide a buffer that discouraged substantial cuts in spending at the bottom of an economic cycle.

This idea was raised during last year's Macroeconomic Policy Forum by Klaus Schmidt-Hebbel (2006), chief economist of the Chilean central bank. He wrote that "the objective of counter-cyclical financial policy is to implement a government investment management policy geared at reducing the domestic costs of idiosyncratic shocks (including excessive exchange rate misalignments)".

Besides running a net long foreign exchange position, other academic economists have argued that governments could consider developing other financial instruments that help hedge against macroeconomic risks, and encourage households to hold such instruments to hedge their personal risks.

At present, both New Zealand and Australia are experiencing commodity export price booms. The Australian boom is much larger, but the macroeconomic effects do not seem that much greater than those in New Zealand. It is plausible that this partly reflects the fact that the commodity producing sector in Australia has substantial foreign ownership. There is also a high degree of foreign

ownership of New Zealand businesses generally, but this is much less true of the commodity sectors. That means New Zealanders more fully capture the substantial income gains when international prices of our export commodities rise sharply, but are also more heavily exposed to the losses when prices fall.

We would not want to overstate the importance of this area, particularly when thinking about the stabilisation of non-extreme business cycles. However, at the margin, a better diversified mix of investments (for the same level of net dependence on foreign financing) held by the New Zealand Government or by New Zealanders more generally might make currency and economic cycles a bit milder and easier to manage. Awareness of the benefits of diversification is an important part of strengthening financial literacy among the wider community.

We think these issues deserve attention in any longer-term review of the structure of the overall balance sheet of the Crown and the way in which that balance sheet might support stabilisation objectives.

Other regulatory policy initiatives

Besides taxation and spending, other government policy initiatives can clearly affect the business cycle. In general, regulatory policies that limit bottlenecks and make it easier to shift resources between sectors are likely to reduce the required monetary policy adjustments in response to shocks.

Regulatory changes in New Zealand generally require the preparation of a Regulatory Impact Statement (RIS). Restrictions that inhibit economic activity and involve compliance costs need to be justified in this document. However, it could be that more explicit consideration of the potential implications of proposed regulatory initiatives for macroeconomic flexibility, and sectoral pressures in the face of shocks, should be factored into policy formulation more generally.

We focus in this section on the potential role of policies surrounding immigration and housing supply. Supporting paper A8 discusses the potential role of prudential regulatory policy.

Debt management and the slope of the yield curve

Other papers in this submission have noted that at times the slope of the interest rate yield curve can create difficulties for monetary policy. Unusually low longer-term international interest rates may tend to put downward pressure on domestic long-term rates. Using conventional monetary policy instruments, the only way to push domestic term interest rates higher would be to increase the OCR even further.

The Government, through the Debt Management Office of the Treasury, is a reasonably significant participant in wholesale financial markets. It has been suggested that perhaps government financing activities could be altered in an attempt to modify the shape of the yield curve. In particular, if the Government issued materially more long-term debt (and either significantly reduced its short-term debt issuance or invested the proceeds in short-term instruments), this might raise long-term interest rates relative to short-term ones, and assist monetary policy at the margin.

There are some classes of investors in government securities with a natural interest in short-term securities and others with a natural interest in long-term securities, and the two are not perfectly substitutable. So, a change in government debt issuance patterns might be able to engender some, modest, change in the shape of the government yield curve. However, government securities yields are not the prices banks face when determining interest rates on mortgages. Rates on interest rate swaps are what matters for mortgage pricing. That market is much deeper and more liquid (more volume transacted and a much larger underlying stock of assets) than the market in government securities. We think it is unlikely that changes in government financing patterns would materially alter the wholesale yield curve in the interest rate swaps market.

Labour and migration policy

The steep unexpected increases in migration seen over 2002 contributed substantially to triggering the housing cycle and more generally exacerbating the pressures on demand experienced in the earlier part of this economic cycle. Permanent migrants boost the New Zealand labour supply, but in the short run there is usually a significantly larger impact on demand. This is mainly because migrants boost demand for housing and stimulate new construction. As businesses hire the new workers they may need to invest in additional plant and equipment as well.

Migration tends to be inherently pro-cyclical: people choose to come to New Zealand (or choose not to leave) when the economy is strong.⁹ Thus these demand-side effects of migration have often tended to accentuate economic cycles. Migration can also “kick off” a housing price and demand cycle when some outside event (eg an international crisis like 9/11 or a change of New Zealand migration policy) alters the rate of net migration significantly. Unexpected

fluctuations pose the biggest challenges for macroeconomic management.

At the margin, the “excess demand” implications of migration can be somewhat reduced if new migrants are able and willing to quickly enter the workforce and have skills that relieve shortages. A migration policy designed to admit skilled workers is thus relatively helpful to monetary policy. Innovations such as seasonal work schemes (which do not put pressure on housing markets) are also relatively useful. The surge and subsequent decline of international students entering the New Zealand market was less helpful, considered from this perspective only, as these students would typically have added more to demand than supply.

Besides the composition of migrants, policies that reduce the cyclical nature of migration are useful to monetary policy. Little can be done on the New Zealand policy side to stabilise outward migration numbers or returning New Zealanders. The policy of maintaining a target band for the number of incoming migrants which prevents sharp upward swings is useful. Because some people will miss out when there is heavy demand to migrate but be able to reapply and

⁹ For example, recent Reserve Bank work by Coleman and Landon-Lane (2007) demonstrates this effect.

potentially come in later years, the target cap policy is likely to help stabilise inflows relative to a policy that was based around a fixed set of entry criteria.

We believe it would be worth examining whether, in periods when peak demand pressures are beginning to accumulate, it might be sensible to formalise a system in which the level of new migrant approvals could be reduced, to ease excess demand pressures. Migration is not a major issue right now. More generally, and looking to the future, we believe it is critical that policymakers recognise the strong impact that big fluctuations in net migration, especially unexpected ones, have on economic conditions in New Zealand.

Residential housing supply

As discussed in more detail in our recent submission to the inquiry into housing affordability in New Zealand,¹⁰ the Reserve Bank believes that government policies could usefully focus on increasing the responsiveness of housing supply to changes in demand. Looking at supply issues might involve a review of planning practices, with a view to possibly relaxing “urban fences” and encouraging medium-density redevelopment in existing areas. We encourage further work in this area. Besides improving affordability, greater responsiveness from the supply side will help to limit price fluctuations, particularly during upswings. This is because the value of existing houses is unlikely to rise far above the price of comparable new housing. If rising prices stimulate a lot of construction activity, those new houses will soak up the demand for housing and should push prices back towards the cost of construction. As people recognise this constraint on prices, they may cease developing such extrapolative expectations of future house prices.

New Zealand is not a densely populated country and it seems that there should be sufficient land to meet demand for new housing. Research in New Zealand and overseas, however, suggests that regulatory constraints can powerfully inhibit development. For example, the work of Edward Glaeser (2004) and co-authors has shown that house prices have risen most dramatically in certain United States

counties where regulatory constraints have been particularly tight, even if the county is sparsely populated.

The size of the construction sector in New Zealand has expanded strongly in recent years. But new housing (eg on the outskirts of cities) can never fully substitute for existing housing in premium areas, except perhaps in the long run as tastes gradually change and new urban areas form. Regulatory constraints on the location of new developments exacerbate this difference between new and existing homes. These constraints are generally there for good reasons but we would support continuing analysis of the process by which they are enacted. As Glaeser notes, existing inhabitants of an area may often try to limit further development of the area. Prospective new residents of an area have the opposite incentives but it may be hard for them to coordinate compelling submissions in support of development.

Conclusions

In our main submission we have noted that the institutional arrangements for monetary policy in New Zealand have been adopted in their essentials by a wide range of other countries over the last 15 years, a period which has seen inflation largely brought under control across the developed world. If anything, economists have probably been surprised by the effectiveness of central banks in controlling inflation, and reducing variability in both output and inflation. However, there is clearly disquiet about the extent to which exchange rates (between major economies such as the United States and Japan, as well as smaller currencies like the New Zealand dollar) have fluctuated.

This is not a problem that other developed economies have solved, and it seems unlikely that there are comprehensive solutions that would substantially and reliably reduce future exchange rate fluctuations. However, we think that, at the margin, fiscal and regulatory initiatives might offer some ways to reduce the accumulation of pressures that monetary policy has to respond to, and thus perhaps mitigate the more marked exchange rate cycles.

¹⁰ <http://www.rbnz.govt.nz/monpol/about/2989594.html>.

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