# Contents

This is the Reserve Bank of New Zealand's submission to the Finance and Expenditure Committee's inquiry into the future monetary policy framework. We welcome the inquiry and are keen to contribute, and to assist the work of the Committee, in any way possible.

The package of papers is structured as follows. A main submission contains all the key propositions that the Reserve Bank wishes to make to the Committee. An additional 11 supporting papers provide more detailed material and background information. The supporting papers are as follows:



We wish to make an oral appearance before the Committee. We would also be happy to supply additional material, or to provide further clarification or elaboration of points raised in these papers.


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# Main submission
# by the Reserve Bank of New Zealand

## Executive summary

### Delivering price stability

The Reserve Bank is responsible for maintaining price stability, an objective set for it under the Reserve Bank of New Zealand Act (1989). As agreed under the Policy Targets Agreement (PTA) between the Governor and the Minister of Finance, the Reserve Bank seeks to keep future CPI inflation outcomes within a 1 to 3 percent target range, on average over the medium term.

*New Zealand operates a monetary policy framework that is now very conventional by international standards.*

New Zealand operates a monetary policy framework that is now very conventional by international standards. Following New Zealand's lead, inflation targeting has been widely adopted elsewhere, including by most small commodity-exporting developed countries.

High inflation can be extremely damaging for an economy. Monetary policy focuses on maintaining low inflation so as to assist in creating a stable environment that is conducive to economic growth. However, monetary policy is only one contributing factor to economic performance. Other economic policies and a host of other influences will have a bearing on whether the economy flourishes. Monetary policy has largely succeeded in delivering low inflation despite some substantial challenges. In the 17 years since the inception of the Reserve Bank Act, annual CPI inflation has averaged around $2^1/_2$ percent, far lower than in the previous few decades. People plan on the basis that inflation will remain low and relatively stable.

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### A growing economy

In many respects, the economy has performed well in recent years. The current expansion, which began in 1998, represents New Zealand's longest post-war expansion. GDP has expanded by an average of 3.0 percent per annum, while the unemployment rate has halved from 7.6 percent of the labour force to around 3.8 percent.

In some respects, however, the country's long-run economic performance remains less encouraging. GDP growth per capita has not been strong enough to materially close the gap on other OECD countries, the stock of capital equipment per worker remains low, and the country's export performance appears somewhat disappointing. There is no compelling evidence to suggest that these features result from the design of New Zealand's monetary policy framework, or from the way in which monetary policy has been operated. Policy solutions, to the extent that they exist, are likely to lie elsewhere.

Monetary policy does not operate in a vacuum. In practice, it has had to contend with a range of economic shocks arising from both global and local sources. It also has to operate in an environment influenced by many other economic policies. Overall, we believe the monetary policy framework provides us with sufficient flexibility to carry out our task. But monetary policy does not have a perfect set of tools at its disposal for anticipating, let alone responding to, each and every shock. Monetary policy is ultimately limited in its ability to cushion the economy when abnormal pressures arise. Most shocks involve real economic adjustments, benefiting some sectors but harming others.

*Monetary policy is ultimately limited in its ability to cushion the economy when abnormal pressures arise.*

New Zealand has faced some very large economic shocks in recent years. During the period from 2001 to 2003, there was an unexpected surge in net immigration which produced a sharp lift in the demand for housing and boosted economic activity and inflation pressures considerably. The doubling in house prices since then has been unprecedented for New Zealand. More recently, a marked rise in world oil prices added directly to inflation, whilst adversely affecting the level of spending elsewhere in the economy. And just in the past six months, we have seen an extremely sharp rise in world dairy prices, which is expected to boost economic activity over the coming year. Economic shocks pose real monetary policy challenges. Making sense of complex events unfolding in real-time is sometimes complicated by the fact that many key statistics come out with a delay and are subsequently revised.

Moreover, in recent years, we have been setting the Official Cash Rate (OCR) in a highly unusual world environment. The OCR has been raised significantly in response to strong domestic inflation pressures. However, interest rates in many other countries were unusually low for several years. Large global imbalances have developed, with some countries including the United States, Australia and New Zealand experiencing large current account deficits partly related to rapid increases in house prices. These current account deficits have been funded largely through capital inflows from Asia: the economies of that region have been generating large surpluses through strong export growth and high saving rates. These strong capital inflows have put significant upward pressure on some exchange rates, including New Zealand's.

## Household borrowing

*Inflation pressures in New Zealand over recent years have been fuelled by significant increases in borrowing by households.*

Inflation pressures in New Zealand over recent years have been fuelled by significant increases in borrowing by households. Critics of monetary policy often argue that the only reason the New Zealand dollar has been so high is that domestic interest rates have been set well above world levels. However, New Zealanders have been prepared to continue to borrow at interest rates that their overseas counterparts would consider very high. Quite why this is the case is not fully understood, but there seems little doubt that if the household sector's appetite for debt had been more muted, the conduct of monetary policy would have been easier and the exchange rate cycle less extreme.

## Exchange rate cycles

*The scope for operating monetary policy in a fashion that would materially dampen the exchange rate cycle without causing significant problems elsewhere in the economy – or generating damaging inflation cycles – appears very limited.*

It is commonly asserted that New Zealand's large exchange rate cycles may have contributed to the disappointing aspects of the country's economic performance noted earlier and that these cycles are being unnecessarily generated by monetary policy. Big swings in the exchange rate do seem likely to impose some costs on the export sector, although these are difficult to measure. The scope for operating monetary policy in a fashion that would materially dampen the exchange rate cycle without causing significant problems elsewhere in the economy – or generating damaging inflation cycles – appears very limited. The Reserve Bank's foreign exchange rate intervention framework provides a limited means of clipping the peaks and troughs but its impact is likely to be small.

There have been calls in some quarters to broaden the policy targets for monetary policy to require the Reserve Bank to pursue directly real sector objectives such as the promotion of external trade, growth or full employment. At issue is not whether these are worthy objectives but whether monetary policy is technically able to pursue them effectively. In the Reserve Bank's view, consistent with the international evidence, monetary policy is simply not able to directly boost the sustainable rate of real economic growth. Monetary policy must operate within the constraints of the economy's productive capacity, which in turn is determined by factors such as productivity, resource endowments and so forth. The best contribution monetary policy can make to macroeconomic wellbeing is to maintain stable prices over the medium term.

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## The OCR

The main tool of monetary policy is the OCR, a conventional monetary policy instrument of the type used by most central banks around the world. The OCR is an effective lever, but it works with a substantial lag and its impact on inflation is rather imprecise. This is partly a reflection of the predominance of fixed rate mortgages in New Zealand, but the OCR will always be a rather blunt instrument. In particular, it cannot be fine-tuned to affect different sectors of the economy differentially. The inherent limitations of tools like the OCR face other countries too.

## Other tools

*Some alternative tools that can be envisaged would be very difficult to use and would create collateral damage.*

Over the past two years, we have conducted research into whether there may be additional tools or policy approaches that could be used in order to assist in controlling inflation pressures. If such tools existed they could operate directly on inflation pressures whilst reducing the need to raise interest rates. That, in turn, would potentially reduce pressure on the exchange rate. However, this work has confirmed that there are no silver bullets or simple solutions. Some alternative tools that can be envisaged would be very difficult to use and would create collateral damage.

The Reserve Bank has, however, identified some areas that the Committee may wish to give further consideration. These are examined in the papers accompanying this submission. Faced with difficult international circumstances, monetary policy needs to operate within as neutral as possible a domestic environment. We do not currently have such an environment.

## Tax favours housing

*Owning houses is favoured by New Zealand's tax system, and this may have been a factor in sustaining the recent housing cycle.*

Owning houses is favoured by New Zealand's tax system, and this may have been a factor in sustaining the recent housing cycle. The Reserve Bank believes that a relatively neutral environment for investment assets is important, to ensure that monetary policy does not end up fighting pressures that result from tax or regulatory distortions. However, tax policy is not the Reserve Bank's domain and we remain open-minded about the best way to achieve that neutrality. Tax policy is complex and has multiple objectives. However, we recommend that the Committee investigate the taxation of investment income in New Zealand and examine the scope for possible adjustments. At present, interest income is fully taxed (and interest costs are fully deductible), but capital gains (a different sort of investment income) are mostly not subject to tax. The Committee may wish to consider the case for limiting the ability to deduct income losses on investment activities against wage and salary income, and/or undertake a broader review of the taxation of investment income.

## Housing supply

*Regulatory and administrative constraints on the development of new subdivisions may have helped sustain the momentum in the housing market in recent years.*

As we noted in the Supplementary Stabilisation Instruments Report last year, and in our recent submission to the Commerce Select Committee inquiry into housing affordability, regulatory and administrative constraints on the development of new subdivisions may have helped sustain the momentum in the housing market in recent years. This, in turn, has contributed to the difficulty monetary policy has faced in containing inflation pressures. We encourage the Committee to recommend further work in this area by the relevant agencies to ensure that housing supply is not unduly restricted.

## Fiscal policy

*Over the past two years, despite continuing to run substantial surpluses, government fiscal policy has become more expansionary.*

The Reserve Bank is responsible for maintaining stable prices using monetary policy. The other main macro-economic policy instrument is fiscal policy. Fiscal policy has a broad range of objectives and is, of course, the responsibility of the government of the day. Adjustments to fiscal policy, undertaken for whatever reason, can have a powerful short-term impact on the economy. Increases in government spending or tax reductions have the potential to frustrate the efforts of monetary policy, especially at times when resource pressures in the economy are particularly intense. Over the past two years, despite continuing to run substantial surpluses, government fiscal policy has become more expansionary. Additional spending is adding to demand, and to overall inflation pressure, at a time when resources have been severely stretched for some time.

We believe the Committee should consider recommending the development of a framework in which higher thresholds are in place before discretionary expenditure is increased, or taxes are cut, especially in response to unexpected revenue increases, at times when overall pressure on the economy's resources is intense.

## Immigration

*In New Zealand, cycles in net immigration have been large and relatively volatile.*

In New Zealand, cycles in net immigration have been large and relatively volatile. The connections between these cycles, the housing market and economic activity more generally, have been well established. The Reserve Bank recognises that many of the components of net migration flows are not amenable to direct control. However, we believe the Committee should give consideration to whether variations in new migrant approvals could be used as a supplementary tool during periods in which demand pressures in the economy are becoming particularly intense.

There are many other economic policies that affect the environment in which monetary policy operates. The Reserve Bank believes that it is important that Parliament continues to monitor the broader economic policy environment in New Zealand with a view to ensuring the economy remains as flexible and responsive as possible in the face of future economic shocks.

## Capital adequacy rules

The Committee may wish to note some moves already underway that may be of moderate assistance to monetary policy in the future. The Reserve Bank is currently revising its capital adequacy rules to reflect the development of the new international framework, Basel II. This is expected to improve financial system soundness by making bank capital requirements more sensitive to risk and may provide some limited additional support for the stabilisation task of monetary policy.

In addition, the Reserve Bank endorses the moves in the 2007 Budget to increase the resources Inland Revenue has to enforce existing provisions around the taxation of profits on residential investment properties. Measures aimed at increasing household savings, such as Kiwisaver, could also be of some benefit to monetary policy over the longer haul if they prove successful in lifting national savings and diversifying household wealth across a broader range of assets.

## Recommendations to assist monetary policy in the future

*It is recommended that the Committee:*

*(a) encourages further work by the relevant agencies to ensure that housing land supply and the development of new subdivisions is not unduly restricted by regulatory or administrative constraints;*

*(b) reviews the taxation of investment income and the tax treatment of the financing of the purchase of investment assets. This should include examining the possibility of modifications to the existing provisions that allow any losses on investment activities to be fully offset against a taxpayer's other income at that taxpayer's marginal tax rate ("ring-fencing");*

*(c) encourages the development of a framework under which higher thresholds are in place before substantial increases in government spending (or tax reductions), especially those financed from unexpected revenue gains, occur at times when demand pressures in the economy are intense;*

*(d) considers whether variations in new migrant approvals could be used as a supplementary tool during periods in which demand pressures in the economy are becoming particularly intense; and*

*(e) recommends the allocation of additional resources to improve the overall range, quality, and timeliness of New Zealand's macroeconomic statistics.*

# Introduction

In this main submission, material is organised as follows. We first review the current institutions and goals set out for monetary policy in the Reserve Bank of New Zealand Act and the Policy Targets Agreement. We consider briefly several possible alternative approaches which some have advocated as means of reducing the size of exchange rate cycles. We then review economic developments since around 2000 and the role and effectiveness of monetary policy during that period. In the final main section, we move on to outline some areas the Committee might wish to focus on to provide support for monetary policy and to ease the sectoral stresses and imbalances that might arise in future if we are again faced with pressures of the scale and intensity of those seen this decade.

## Monetary policy goals and institutions

*(for more detail see supporting paper A1)*

Good monetary policy is intended, first and foremost, to stabilise the value of money - not hour by hour, or even month by month, but over the loosely-defined medium-term. Doing so provides as much predictability and certainty as possible about the overall level of prices in the economy. That means firms, households, and the Government can all make better decisions, leading to better economic outcomes.

High or unstable inflation, by contrast, is a corrosive force, which undermines a society's prospects for sustained growth in living standards. New Zealand's experience of high inflation in the 1970s and 1980s was a good example. The experience of persistently high inflation, and the costs of lowering inflation again once it has become entrenched, have provided the background against which legislation governing central banks and monetary policy around the developed world has been designed in recent decades.

A monetary policy regime focused on medium-term price stability, together with good management of the actual instruments of monetary policy, provides the best possible foundations to ensure that monetary policy supports, not undermines, medium-term prospects for growth in output, employment, trade and, ultimately, living standards for the population as a whole. But monetary policy works best not in isolation, but in the context of an overall framework for economic regulation and management that promotes a flexible and responsive economy.

### New Zealand's regime set firmly in the international mainstream

New Zealand's monetary policy regime, legislated for in the Reserve Bank of New Zealand Act 1989, and developed in practice since then, is set firmly within the mainstream of international practice. The inflation targeting approach to monetary policy was developed in New Zealand, and since then has been widely copied by a range of other countries, including most small commodity-exporting developed countries.

The details of each country's legislation, and especially the details of its governance arrangements, vary, reflecting the particularities of the period in which each country's law was enacted and/or the wider system of governance of public sector activities used in the country in question. Thus, the details of our Act look a little different than those in United Kingdom, which in turn look a little different from those in Canada or the United States or Australia or Sweden or the euro-area. From time to time it is worth looking again at those details to see whether refinements are appropriate.

But, in essence, the job that each of these central banks is trying to do is much the same: to deliver low and relatively stable inflation, and to do it in a way that avoids unnecessary short-run disruption to other aspects of the economy. Often (but not always) good monetary policy will be a stabilising influence, not just for inflation but for the economy as a whole. Interest rates will usually be lower than normal, providing some stimulus, when resources are underemployed. On the other hand, interest rates will typically be higher than normal, leaning against spending and rewarding savings, when resources have become scarce and the pace of spending growth exceeds the capacity of the economy to respond in a non-inflationary way. Across a wide range of countries, including New Zealand, the variability of GDP growth has moderated substantially in the last 15 to 20 years, the period in which monetary policy has been successfully focused on delivering low and stable inflation.

The successful conduct of monetary policy is not a mechanical exercise, amenable to an engineering level of precision. Good judgement is at the heart of central bank decision making on monetary policy. Central banks around the world are constantly seeking to improve their performance. They seek to learn from each other and from newer and better research insights on how their own economy works, how the rest of the world is affecting their own economy, and about what works with monetary policy and what does not. Economies are constantly evolving and in conducting monetary policy central banks will always face huge amounts of uncertainty, across a whole range of dimensions. New shocks, old pressures manifesting themselves differently, and the interactions with a rapidly changing global marketplace, all mean that an excellent central bank will be constantly challenged to stay ahead of the game. There are limits to what monetary policy can achieve. Even within those limits, it is important to emphasise that in many respects monetary policy is more akin to an art than to a science.

We believe that the current legislative regime governing monetary policy in New Zealand provides what is needed to maintain medium-term price stability, and to do so in a way which produces good economic outcomes for New Zealanders. The overall framework and the policy mandate (section 8 of the Act, together with the Policy Targets Agreement) both keep us focused on the medium-term price stability objective and ensure an appropriate degree of flexibility to respond to new and unforeseen developments. The framework helps us make the choices and decisions that we believe are in the economic best interests of New Zealanders. Monetary policy is charged with delivering medium-term price stability, and the Reserve Bank has consistently succeeded in achieving that goal. However, there are many things monetary policy cannot do. As we will outline later in this submission, we believe that there are some other policy measures, which could alleviate some of the pressures and imbalances that successfully maintaining price stability in a turbulent and changing world can sometimes give rise to.

## The exchange rate and monetary policy: no easy alternatives

In an environment of low and stable inflation, the long-run competitive position of the New Zealand economy, and of its firms and workers, depends largely on things that monetary policy has little direct or sustained bearing on. Adjusting the OCR, or altering the Reserve Bank's approach to foreign exchange intervention, simply are not the big determinants of our ability as a nation to build sustained high living standards and generate the products and services that world markets will pay high prices for. Equally, however, in the short to medium term, the exchange rate is quite variable, often to an uncomfortable degree. Cyclical pressures and actual and expected interest rate adjustments are among the most important influences on the exchange rate. That is so for every developed country – from the United States at one end of the size spectrum, to Iceland at the other. Private capital flows, driven by changes in the attractiveness of (expected) returns offered in various countries, have become increasingly substantial and significant in recent decades.

Exchange rate cycles are typically large and in New Zealand the cycles have been a little larger than those experienced in most other comparable countries. The additional supplementary measures that we discuss later in the submission are typically designed to help dampen domestic demand-related pressures on inflation more directly. Doing so successfully might help to avoid unnecessarily large variability in the exchange rate and the concomitant pressure on the tradables sector of the economy. We – in common with authorities in most developed countries – believe that international capital flows provide many benefits, and (on average over time) help capital get to those who can make best use of it: New Zealand, after all, has been heavily dependent on foreign capital since the earliest days of European settlement. But that does not mean that we can overlook the challenges that capital flows can at times pose, for monetary policymakers and for firms and workers attempting to compete on an international stage.

We do not believe, however, that there are attractive alternative approaches that would substantially and systematically reduce the exchange rate cycles New Zealand has faced. For example, maintaining a fixed nominal exchange rate over the last four or five years would have required holding New Zealand interest rates down to the level of whichever country's currency we pegged to. Bank lending, house prices and consumer spending have increased rapidly in recent years even at the higher New Zealand interest rates. So a fixed nominal exchange rate, supported by lower interest rates, would almost certainly have resulted in much more rapid growth in domestic demand and an acceleration of inflation. That, in turn, would have worsened housing affordability, jeopardised financial stability, and as the cost and wage pressures accumulated would, in time, have seriously undermined the competitive position of the tradables sector. The more radical option of a currency union, usually considered only as part of a move towards closer political union, would have had similar problems.

There are no easy or costless ways in which the substantial pressures New Zealand has faced in the last few years could have been absorbed. There are, of course, some Asian countries (notably Singapore and Malaysia) which have, for the time being, managed the tantalisingly attractive combination of the stable real exchange rate and low and stable domestic inflation. For reasons outlined in supporting paper A1, we do not believe that their success could be replicated in New Zealand or other similar countries with a strong appetite for borrowing.

## The current business cycle in perspective

*(for more detail see supporting paper A2)*

### Background and introduction

In many respects the last decade or so has been a period of good economic times for New Zealand. Economic growth has been strong, incomes have grown considerably, consumer spending has been buoyant, inflation has been kept broadly in check, interest rates have fallen, and the number of people unemployed has fallen to the lowest level in decades. Unlike much of the rest of the developed world, we have not experienced a marked economic slowdown during that period. Indeed, there has been consistent pressure on resources for much of this decade.

The last recession in New Zealand was in 1998, triggered by a severe drought and the fallout from the Asian financial and economic crisis. After that recession, the economy rebounded quite quickly. Substantial falls in both interest rates and the exchange rate, and a gradual recovery in international prices for our export commodities, supported the recovery. Since 1998 New Zealand has chalked up a sustained period of growth, probably unparalleled in per capita terms in our modern history.

By around 2000, spare resources and productive capacity were already becoming scarce. The unemployment rate had fallen further, and firms were reporting increasing pressure on capacity and increasing difficulty in finding staff. The Reserve Bank concluded that a rise in inflation was becoming an increasing risk.

However, global events that began in 2001 changed the picture considerably. Those events have played an important role in shaping the way in which the economic cycle has unfolded throughout this decade.

### Low international interest rates

First, the economies of the United States and Europe slowed substantially as the IT/dotcom boom came to an end and investment spending fell markedly. That slowing ushered in half a decade of unusually low interest rates. In the United States, the Federal Reserve cut its target interest rate quite quickly, from 6.5 percent at the start of 2001, eventually reaching 1 percent, a level at which it remained until mid-2004. The European Central Bank progressively cut interest rates in the world's second-biggest economy to 2 percent and Japanese interest rates had already been at or near zero for a number of years. Elsewhere, increasingly large current account surpluses (and accumulations of foreign reserves) were beginning to develop around Asia. These surpluses, partly reflected sustained weakness in investment in most of east Asia (outside China). In combination, these factors left the stage set for a period of surprisingly low interest rates. Long-term interest rates in the United States reached a decades-long low of 3.6 percent as late as mid-2003.

Global interest rates were able to remain very low for some considerable time because investment spending (demand for funds) had fallen away unexpectedly rapidly in the world's largest economies, and because savings (supply of funds) were rising very rapidly in some others. However, the period of unusually low interest rates has had consequences, some of which are still being worked through.

First, the period of such low interest rates in other countries probably influenced, at the margin, every central bank's perspective on what a normal or reasonable interest rate might be for their own economy.

Second, lower interest rates worked, offsetting the influence of weak corporate investment on overall economic activity, by making access to household credit considerably cheaper than it normally had been. That, in turn, fuelled rapid increases in house prices in many countries. In the United States, for example, house prices rose very rapidly for several years while interest rates were unusually low. Now that official interest rates have returned to more normal levels, there is a substantial overhang in the housing market and house prices are falling.

Finally, a period of very low global interest rates eventually prompted more and more households and institutions to begin to search the world for better returns on their savings. As the world economy strengthened, and investors' appetite for risk returned, large flows began into a range of high-yielding assets. Margins on risky assets have narrowed rapidly over the decade, credit growth has picked up markedly, and currencies of countries with relatively high interest rates have been the flavour of the last half-decade.

Overall, our sense is that having cut interest rates markedly earlier in the decade the central banks in a range of developed countries have been persistently surprised by the resilience of demand and have had to revise up, sometimes on several occasions, their sense of the level of interest rates now needed to keep inflation pressures and credit demand in check. Indeed, in several countries at least, there is reason to think that this process may yet have further to go.

## Challenges and constraints for monetary policy

Turning back to New Zealand, in early-mid 2001 the Reserve Bank prudently took the position that, as a small open economy, New Zealand was likely to be adversely affected by the global slowdown. We began to cut the OCR accordingly. The Reserve Bank of Australia reacted very similarly. The terrorist attacks of 9/11 compounded the sense that global economic and financial risks were skewed to the downside. We (and a variety of other central banks) cut official interest rates further. The OCR was at 4.75 percent at the end of 2001.

In fact, the global slowdown had very little direct adverse impact on New Zealand and Australia. International prices for our export commodities remained quite buoyant, and the very low exchange rates provided a lot of support to those firms in the tradables sector that were exposed to slowing international demand.

More significantly, after the 9/11 attacks, migration flows to New Zealand reversed sharply. For several years, New Zealand had been experiencing a modest net migration outflow. This reversed very quickly, and by 2003 there was a net annual inflow (of both permanent and long-term migrants and students) of in excess of 80,000 people. That represented an enormous economic stimulus. Even if all migrants went straight into the workforce – and many, students in particular, do not – all of them need to be housed immediately. Even a quite basic house costs far more than the average annual income, so short-run big changes in migration (especially unforeseen ones) affect spending more acutely and immediately than they do the sustainable level of production in the economy. Average net migration to New Zealand is not extraordinarily high by international standards, but net flows in and out of New Zealand are much more volatile than those in most other countries. That variability complicates monetary policy.

The effects of the 2 percent population "shock" were most immediately apparent in the housing market, which had been in the doldrums – with flat or falling prices – for several years. Activity picked up very quickly - the average number of days it took to sell a house dropped from around 55 to around 35 within 11 months – and as activity picked up prices followed. Annual house price inflation reached 25 percent in 2003. As actual house price inflation rose sharply it appears that expectations of future price rises also increased.

With the benefit of hindsight, the Reserve Bank (and virtually every other forecaster and commentator) underestimated the significance of the huge net migration inflow and was relatively slow to reverse the precautionary OCR cuts of 2001. The Reserve Bank recognised the increase in migrant numbers, but expected that the effects would prove to be relatively short-lived and that within a year or two the economy would have adjusted to the higher population. Indeed, by 2004 net migrant inflows were dropping away very rapidly, contributing to a slowing in GDP growth over the following 12-18 months. But the willingness of house buyers, buoyed by strong income and employment growth and the initial large rise in house prices, to push prices ever higher did not drop away commensurately.

The migration shock came at a time when overall resources in the economy were already quite stretched. If the full significance of the shocks, and the spillover into the housing market, had been recognised, the OCR would probably have been raised quite quickly. However, at the time, most observers were more intently focused on the continuing sluggish world economy, rising oil prices, and the possible impact of the rising exchange rate. Raising the OCR quite materially in 2002 and 2003 would have gone against the clear consensus of forecaster and commentator opinion, and would probably have materially exacerbated the already-substantial upward pressure on the exchange rate.

Even with the view of the economy we held at the time, a couple of further considerations led us to raise the OCR more slowly than we might otherwise have done. Most importantly, the exchange rate was already rising quite rapidly in 2002 and 2003. New Zealand interest rates were relatively low but interest rates were much lower still in other countries. Well aware of our obligation to seek to avoid unnecessary instability in the exchange rate, and of the potential lagged impact that large changes in the exchange rate can have on the economy, we were left a little more cautious than we might have been if domestic considerations had been the only factor on our minds.

At times it was also quite hard to get a sure sense of just how much interest rate pressure was enough. New Zealand data are quite "noisy" and the lags in the production of official statistics can, at the margin, complicate things for us and other forecasters. For example, in the first half of 2003, GDP growth slowed very markedly and confidence indicators suggested that a sustained slowing might be getting underway. The uncertainty induced by SARS and by the invasion of Iraq, together with concerns about the possibility of a serious drought and electricity shortages, all pointed to a plausible case that any momentum that had built up in the domestic economy might soon dissipate. At the time, many other central banks were still cutting interest rates.

Of course, the momentum in the domestic economy did not dissipate, and since the start of 2004 we have progressively increased the OCR, by a total of 300 basis points, to the current level of 8 percent (well below mid 1990s peaks). We have typically moved quite cautiously throughout this period. In addition to exchange rate considerations, there have been quite sustained periods when it appeared that the economy might have been slowing quite markedly and that, as a result, spending and inflation pressures would soon be back under control. As just one example, there was no GDP growth at all in the second half of 2005 and business confidence indicators were very weak in early 2006.

Finally, and by no means least important, we have been conscious that for most of the cycle our own view of the level of monetary policy pressure that was likely to be required has been well ahead of that of almost all other observers and market participants. This gap between market views and our own had real consequences. The Reserve Bank sets the overnight Official Cash Rate, but if markets are sceptical of our story then longer-term interest rates (which affect the pricing of products such as fixed rate mortgages) are likely to move into line with the OCR only slowly. There was a material gap between our view and that of markets for much of 2005 and 2006. Only in the last six months or so have longer-term wholesale interest rates moved more consistently into line with the OCR.

## A perspective on the housing market

We had expected that the initial burst of house price inflation, prompted by the sharp upsurge in migration inflows, would prove short-lived. We and most others expected that quite modest increases in interest rates would be sufficient to dampen housing demand and that the higher prices would increase the supply of new housing. These expectations proved to be misplaced and the size and persistence of the house price boom proved much greater than had been expected.

New Zealand house prices have doubled in the last five years, among the larger increases during that period in any country that sets its own monetary policy. House prices have risen markedly in most of the developed world - Japan, Germany, and Switzerland are the main exceptions. In some cases, the reasons were obvious. In the United States, for example, the sharp slump in business investment led to big cuts in borrowing costs across the economy, and households responded predictably to the very cheap cost of funds. House prices rose sharply, and since interest rates have returned to more normal levels, are now falling. But in New Zealand and Australia there was no such period of surplus resources – we never needed to provide stimulus to the housing market to offset weakness elsewhere in the economy.

The Reserve Bank does not target house prices. The Policy Targets Agreement sets a target range for overall CPI inflation. But what happens in the housing sector affects CPI inflation for several reasons. First, the price of newly constructed houses enters the CPI directly, and second, because houses make up such a large share of total household wealth in New Zealand, increasing house prices tend to prompt quite large increases in overall consumer spending, putting pressure on resources. Both factors have been relevant this cycle. Building costs in the CPI have risen by around 30 percent since 2002, while the household savings rate, already low, has fallen substantially further. New Zealand households are estimated to have spent around 13 percent more than they earned last year. In addition, of course, the high house prices, if sustained, may lead to upward pressure on rents, which also have a large weight in the CPI.

There is a range of explanations for why house prices have risen so much in New Zealand in recent years. Our overall assessment is the same as the one we reached in the Supplementary Stabilisation Instruments report last year. The increase in house prices is largely due to cyclical macroeconomic factors. The big migration inflow was the initial trigger, supported by continuing strong employment and income growth, all reinforced by an increase in expectations (and fears) about what house prices might do in the future. The pressures have been exacerbated by intense competition, and narrowing margins, in the market for retail mortgages. With the benefit of hindsight, interest rates have not been high enough to counter fully those higher expectations – indeed, mortgage rates have been less than annual house price inflation for five successive years. Overall, our sense is that house prices have now moved well beyond what can be sustained by medium-term fundamentals.

Private rental properties make up around a quarter of the total stock of houses in New Zealand. Investment property purchases have no doubt exacerbated cyclical pressures in the housing market. There appear to be an increasing number of negatively-geared private landlords whose only prospect of making a positive return rests on possible future capital gains, and the rate of home ownership has continued to drop – although no faster than previously – in the last few years. To a considerable extent, the contribution of investment property purchases is probably both typical and unsurprising. When the price of an asset starts rising rapidly and is expected to continue doing so, it is not surprising that investors are keen to buy more of that asset, and ready to borrow heavily to do so. Those purchases will, of course, accentuate the upward pressure on prices. There is, however, little evidence that house prices in portions of the market dominated by rental properties have increased more than those in other portions of the market, suggesting that broader macroeconomic factors have been the dominant influence on house prices.

Nonetheless, we believe that the tax treatment of housing, and of investment properties in particular should be explored further. At present, the tax system has some features which favour the purchase of houses, and there is certainly a widespread perception that the system is particularly favourable to leveraged investors. In this respect, we were encouraged by the provision of additional funding in the recent Budget to enable Inland Revenue to strengthen the enforcement of the existing provisions of the Income Tax Act governing taxation of capital gains made on property purchased with the intention of resale. Moreover, we believe that some useful structural changes to the tax system (outlined below) might, at the margin, dampen the size of future housing cycles.

## Commodity prices

International prices for New Zealand's export commodities have boosted incomes and employment this decade but until recently the impact has probably been secondary. New Zealand's export commodity prices have been reasonably strong throughout this decade (in world price terms) and, despite rising oil prices, New Zealand's terms of trade (the ratio of export to import prices) has been strong.

The sharp and surprisingly sustained increases in the world price of oil this decade has acted as a drag on disposable incomes, business margins, and business and consumer confidence. The risk that the sharp increases in oil prices might have led to a marked slowing in economic growth made us more cautious than otherwise about raising the OCR at times. We, and central banks in other countries, have been a little surprised at the apparent resilience of the world economy in the face of such high real prices for oil.

More recently, the very sharp increase in world dairy prices, which began less than a year ago, which was totally unforeseen (even by Fonterra), and which is continuing, has changed the picture. Dairy products make up around 15 percent of New Zealand's total exports. Higher dairy prices make New Zealand as a whole materially better off. But higher interest rates and a rising exchange rate are part of the way in which the gains are distributed around the community and overall pressure on resources is kept in check. When dairy prices rise, incomes rise too, but in the near-term at least no more real resources (goods or workers) are available to meet the increased demand.

## Fiscal policy

Until quite recently, fiscal policy has played a relatively limited role in the cycle. In the early years of this decade, overall government consumption and investment spending was little changed as a share of total GDP. The Government has run relatively large surpluses and the overall Crown financial position has improved to the point where New Zealand is one of the few OECD countries with no net debt and growing net financial assets.

However, our analysis suggests that in the last couple of years, discretionary fiscal policy has begun to be materially stimulatory. What matters for the overall pressure on resources, and hence the pressures on monetary policy, is not the level of the overall budgetary surplus or deficit, but discretionary choices to utilise the surplus. As a result of fiscal policy choices, government consumption and investment spending have been increasing quite rapidly, government-related employment has also increased rapidly, and some measures such as the Working for Families package have put a large amount of additional income directly into the hands of households. By historical standards, the extent to which discretionary fiscal policy stimulates demand is not extreme. Instead, what makes the current fiscal stimulus unusual is that it comes at a time when the economy's productive capacity has been severely stretched for several years. To cope with additional government spending without adding to inflation, some other spending must be crowded out. Higher real interest rates and a higher exchange rate are part of the mechanism for making that happen.

To be quite clear, the Reserve Bank does not have a view on the appropriate level or composition of government revenue or expenditure. We do not have a view on the merits of particular fiscal initiatives. But if the economy faces additional demand pressure, from whatever source, when resources are already severely stretched, then monetary policy has to be tighter than otherwise if inflation is to be kept in check. Even measures that improve the economy's long-term growth potential can exacerbate excess demand pressures in the near-term – roading expenditure is perhaps a good example.

## Effectiveness of monetary policy

In recent years, there has been some debate as to whether monetary policy has lost its "bite"; its ability to influence demand and spending conditions effectively.

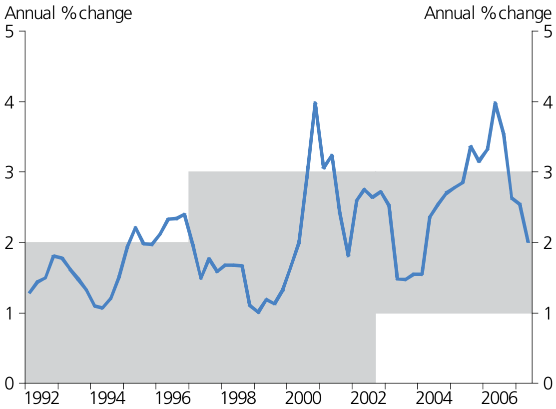
In an open economy such as New Zealand, whenever our economic cycle is at a different stage than those in other countries (as it has been this decade), much of the impact of tighter monetary policy will always come through the response of the exchange rate to higher interest rates, rather than as a direct effect of the interest rates themselves. That will be uncomfortable at times. At present, for example, trade-weighted measures of the exchange rate are reaching levels even higher than those at the peak of the previous cycle a decade ago. Low global interest rates have, no doubt, tended to push down longer-term New Zealand interest rates, exacerbating the difficulties we have sometimes faced in raising the cost of credit to new borrowers.

There has also been concern in some quarters that the growing use of fixed rate mortgage products has undermined monetary policy. Fixed rate mortgages have desirable features – they provide greater certainty for households, and mean that any particular interest rate a household contracts to is locked in for some time. However, in recent years the intense competition among mortgage lenders has been concentrated on fixed mortgage rates. As a result, there has been an unusually large gap between traditional variable mortgage rates and fixed rates: a difference much larger than that between wholesale rates for the same terms. The aggressive competition complicated our efforts at times, although we could have chosen to offset the impact on the overall cost of credit by raising the OCR further. The prevalence of fixed rate mortgages means changes in interest rates affect existing borrowers more slowly than if everyone had a floating rate loan. On the other hand, the prevalence of fixed rate mortgages might in time provide greater short-term impact on the housing market itself – someone taking a five-year fixed rate mortgage at a newly-increased interest rate knows that they are locked in to that rate for the next five years.

When markets and commentators do not share a central bank's view that inflation pressures are not being adequately contained, that will – at least until the difference is resolved – affect the central bank's ability to keep fixed term rates up. As noted earlier, there was such a divergence of view for a period in 2005 and 2006. On that occasion the balance of market opinion gradually shifted into line with our view that interest rates needed to stay higher for longer than had previously seemed likely.

This decade has posed challenges. Low global interest rates, aggressive competition in the fixed rate market, and differences of view between us and the balance of market opinion, have all at times complicated the job of getting on top of demand pressures. Overall, the way in which monetary policy affects spending has changed, and the lag between increases in the OCR and any impact on general consumer spending has probably slowed a little. Over time, conventional monetary policy, expressed through adjustments to the OCR, remains an effective tool, sufficient to deliver medium-term price stability, but it will no doubt face very substantial headwinds again at times in the future.

### Figure 1
### CPI inflation and target*




Source: Statistics New Zealand.

* CPI inflation here refers to the target inflation measure at the time. As supporting paper A1 explains, this was not the unadjusted CPI itself during the early part of the period.

## Assessment

The Reserve Bank is charged, first and foremost, with delivering and maintaining medium-term price stability. That job is being done successfully. Core measures of inflation have remained broadly within the medium-term target range throughout the period, and commentators expect inflation to remain within that range in the years ahead. There is no sign that firms and households are acting as if they fear that future CPI inflation rates will settle outside the target range. In the face of some very large shocks, some intense pressures, and a difficult international environment, inflation has been kept broadly in check. That is the first and most important job for any central bank.

However, monetary policy is not one of those activities in which every judgement will prove to have been correct. At several times during the most recent cycle there was good reason to believe – and outside commentators certainly did believe – that demand pressures were slowing and that the cumulative impact of a relatively high exchange rate and rising real interest rates would soon do the job. With hindsight, we would probably have raised the OCR a little faster a little sooner than we actually did. However, it is equally true that if it had not been for the increasing fiscal boost to demand and the recent very large jump in dairy prices, both of which have boosted incomes and confidence about the future, the situation today would be looking much more comfortable.

## Medium-term economic performance and monetary policy

***(for more detail see supporting papers A4 and A5)***

Although this decade has, in many respects, been a good one for New Zealand's economy, there are a number of surprising, and somewhat disappointing, aspects of our longer-term economic performance. The sense of disappointment is all the more real when the overall New Zealand policy framework is highly regarded internationally. The surprising features include the following:

- the lack of any substantial convergence between our living standards and those of the rest of the OECD;
- weak longer-term export volume growth (among the lowest in the OECD);
- a stock of capital equipment per worker which remains well below the OECD average; and
- real interest rates which average persistently higher than those in any other OECD country (with the possible exception of Iceland).

There is no single easy and convincing explanation to reconcile all of these observations. We do not believe, however, that the way New Zealand's monetary policy is designed or conducted is an important part of the explanation.

As noted earlier, the broad framework within which we conduct monetary policy is conventional by international standards – this includes both the inflation target midpoint and the degree to which inflation fluctuates around that midpoint. There is no obvious reason to suggest that achieving a conventional inflation target is more difficult in New Zealand than in other developed countries. And as supporting paper A3 illustrates, the Reserve Bank has tended to respond to shocks in a way fairly similar to that of our peers in the United States and Australia.

The Reserve Bank, of course, sets the OCR directly. In that mechanical sense, our policy rate has been, on average, higher than those of other countries because of decisions we have made. However, the Reserve Bank does not set interest rates on a whim. We use projections about the outlook for inflation and these are put together using evidence about the willingness of New Zealand firms and households to borrow at any particular interest rate, or to save at that interest rate.

For some combination of reasons, New Zealanders have, on average, been willing to borrow heavily (and unwilling to save) even at real interest rates that would have had a much more contractionary effect in most other developed economies. The inflation record provides further direct evidence. Over the 17 years of the current regime, inflation has consistently averaged in the upper half of successive target ranges. If, for example, the OCR had consistently been set too high, we would have expected to see inflation average in the lower half of the target range, even falling at times below the bottom of the range.

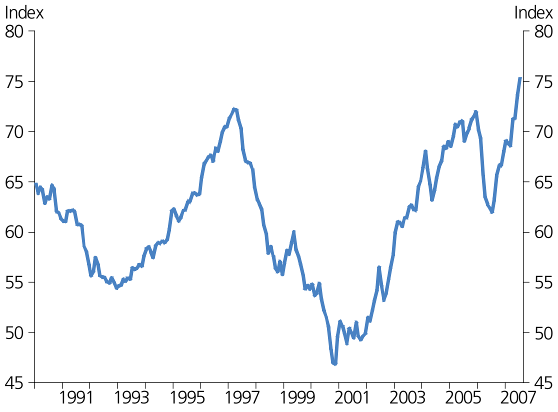
We do not have a fully convincing explanation for the borrowing and savings preferences of New Zealanders. Our interest rates might be expected to be higher than those in other countries if we were investing very heavily and rapidly catching up with the per capita incomes in other developed countries. But we are not. Over decades, our investment share of GDP has averaged no higher than the OECD average – even though we have a faster growing population than most countries, and hence probably have more infrastructure and housing needs than most. Indeed, the high cost of capital is probably one of the factors holding back investment growth.

Our relatively low rate of national savings appears to be the main factor explaining persistently high New Zealand interest rates. It is easy to document that phenomenon, but hard to explain it convincingly. The tax treatment of savings may have played some role and it will be interesting to assess the overall impact of recent policy changes in this area, including the introduction of Kiwisaver, to see whether they result in a material overall improvement in national savings.

And what of exports? It would be surprising if the considerable cyclical swings in the exchange rate that New Zealand experiences were not detrimentally affecting our export performance. But, equally, it is hard to demonstrate such an effect formally. In a nation of small export producers, often without the benefits of the global diversification that many large export producers in other developed countries might have, it is difficult to believe that there are no adverse effects of the large swings in the exchange rate that New Zealand has experienced. On the other hand, it is worth bearing in mind that Australia has achieved a consistently strong economic performance, and is now an upper income OECD country, even without much growth in export volumes.

Our judgement is, however, that the extent of the exchange rate cycles New Zealand has faced cannot be ascribed to problems in the way monetary policy is designed or conducted. In particular, there is no evidence that monetary policy has been conducted in an overly assertive fashion, which might have exacerbated the cycles. Further research may shed fresh light on this issue, but, overall, it is difficult not to conclude that New Zealand's exchange rate will probably remain quite volatile, perhaps especially while our appetite for debt is so voracious. In making OCR decisions, we may remain torn between two unpleasant choices. On the one hand, to minimise near-term pressures on the exchange rate as a tightening cycle gets underway we can adjust the OCR slowly in the hope that we will not need to raise it very far in total. But if we are wrong this approach might lengthen the exchange rate cycle. On the other hand, we could adjust the OCR more aggressively, which would almost certainly exacerbate the initial exchange rate fluctuations, some of which might later prove to have been unnecessary.

### Figure 2
### Trade-weighted exchange rate*




Source: RBNZ.

* This is an analytical series applying the methodology that has been used to construct the official TWI since 1999 all the way back to 1990.

## Supporting measures

The Official Cash Rate, or some similar policy interest rate, will remain the centrepiece of any market-based system of running monetary policy – in New Zealand and other similar countries. On its own, the OCR is sufficient to deliver medium-term price stability. However, the OCR can at times be a rather blunt instrument and is not well-attuned to dealing with concerns and imbalances that arise when inflationary pressures are very different across different sectors of the economy. We believe there are some modifications to structural polices, and some supplementary tools and instruments, which might enable pressures arising in the domestic economy to be managed with less severe spillover onto the tradables sector. Most of these would require legislation.

### Existing Reserve Bank instruments

*(for more detail see supporting papers A8 and A9)*

The option of undertaking foreign exchange intervention for monetary policy purposes has been in our toolkit since 2004. Intervention has a limited role to play, but can at times be helpful in signalling the central bank's sense that the exchange rate is very out of line with medium-term fundamentals. Done well, it may also have a role to play in engendering some additional uncertainty among market participants. If intervention does that it may make some market participants slower than otherwise to jump on a trend carrying the exchange rate further away from levels justified by medium-term fundamentals. Foreign exchange intervention on the scale undertaken in developed countries is not a silver bullet – it will not change the broad character of the exchange rate cycle, but may make a difference (although a hard to measure one) at the margin around the peaks and troughs of the cycle. The Reserve Bank's intervention framework, including new refinements announced recently, typically provides for intervention for monetary policy purposes only when the exchange rate is well away from a level that is warranted by the medium-term fundamentals. Intervention is undertaken for policy reasons, but we would also expect it to be profitable over the medium-term.

The Reserve Bank's prudential supervision powers are exercised, by statute, to promote a sound and efficient financial system. Provisions such as capital adequacy requirements on banks may, however, also have macroeconomic implications. A badly-designed capital regime can result in incentives which lead banks to take on additional risk at the top of economic and asset market cycles; just the time when a greater degree of caution should probably be at play. A new system for managing the capital adequacy of banks (the international Basel II standard) is being introduced in New Zealand next year. We are actively working to minimise any risk that the way the new regime is applied could lead to larger credit cycles, which would exacerbate the challenges facing monetary policy. It may be possible to introduce some counter-cyclical aspects to the regime, but we would not expect any measures in this area to have a significant dampening impact on future credit cycles.

The Committee will be aware that banking competition in the retail mortgage market has been particularly intense in recent years. Intense competition is a good thing, but we have also been concerned to ensure that banks are confident that business is being done in a way that adequately allows for the longer-term risks, including the risk of a possible future sharp downturn in the housing market. We have been actively monitoring bank lending standards and although we have observed some increases in loan-to-value ratios, these are not at a point that would give rise to major concerns. Discussions with banks on these sorts of issues are an occasional part of a prudential regulator's role. They can be expected to make a small, but useful, contribution to supporting the stabilisation work of monetary policy, especially during periods of very rapid credit growth and strong asset price inflation.

## Possible additional instruments

*(for more detail see supporting paper A7)*

Any number of possible measures could be introduced to attempt to influence demand, or activity in a particular sector of the economy. We are generally wary of ad hoc solutions and have tried to frame our comments and suggestions below in a more general context. In other words, we have tried to look for measures which, if enacted, would improve the overall performance of the New Zealand economy in coping with cyclical pressures, without undue longer-term distortions or costs. Several of our observations below relate to the tax system. The tax system is complex and needs to serve multiple ends. We are not tax experts and any proposed modifications to the tax system to assist macroeconomic stability would need to be carefully considered in light of the overall design of the tax framework.

More generally, we believe that policymakers should give considerable weight in designing policy to the importance of ensuring that the New Zealand economy is flexible and responsive. Flexibility is likely to be particularly important in a small economy like New Zealand's, prone to being buffeted by shocks and apparently exposed to exchange rate cycles even larger than those experienced in most other developed countries.

### *Immigration*

As we noted earlier in this submission, net migration flows to and from New Zealand are large and, by OECD standards, are quite volatile. We do not have a view on the appropriate long-term average level of net migration. However, large changes, especially unexpected ones, in net migration numbers materially complicate monetary policy. Most new migrants take up jobs and help ease labour market pressures, but in the first 12-18 months the demand effects typically dominate, especially in the housing market. We recognise that many of the migrant flows are not subject to government influence (in particular, the choices of New Zealanders resident here and abroad), and that there is a legitimate interest in promoting a reasonably stable approach to approving new foreign migrants. Nonetheless, there are real consequences for New Zealanders from the current degree of variability in net migration flows. Large fluctuations in house prices, and in real interest and exchange rates, also have costs.

Accordingly, **we believe that consideration should be given to whether there is scope for using variations in the number of new migrants approved as a supplementary tool**, at least in periods when excess demand pressures are building up to particularly intense levels. Net migration inflows are now quite small and the issue is not pressing now. However, periods of pressure will no doubt occur again, and it would be helpful if all government agencies recognise the role that volatility in migrant flows plays in exaggerating economic cycles in New Zealand, and take that into account in planning and in the design of regulatory and policy frameworks.

### *Housing supply*

In the Supplementary Stabilisation Instruments Report last year, and in our recent submission[1] to the Commerce Select Committee inquiry into housing affordability, the Reserve Bank highlighted the possibility that regulatory and administrative constraints on development of new subdivisions may have accentuated the house price cycle, by dampening the supply response to an increase in demand. There is suggestive evidence in New Zealand and abroad that these factors can play an important role - not so much in triggering price increases in the first place, but in allowing momentum to develop.

We are not experts in this area, and have not done detailed work on the subject, but **we would encourage the Committee to recommend that further work be undertaken by relevant government agencies to ensure that housing and land supply responses are not unduly constricted by regulatory and administrative constraints**. Reforms in this area would be likely to take some time, but would leave New Zealand better positioned to absorb pressures that might result in future housing cycles. This issue could be of greater than usual importance in New Zealand in view of the substantial fluctuations in net migrant flows that are likely, from time to time, to recur.

[1] Available at: http://www.rbnz.govt.nz/monpol/about/2989594.html.

### *Fiscal policy*

Discretionary fiscal policy can be a major influence on the overall demand pressures the economy is experiencing at any particular time. Current practice is built around the separation of fiscal and monetary policy, with each area of policy having its own governing framework. In the case of fiscal policy, the medium-term goal that anchors policy is a gross government debt target of 20 percent of GDP. Automatic stabilisers – the built-in features of the tax system that means revenue rises and spending falls as activity increases (and vice versa) – provide a useful buffer in the face of surprising strong or weak demand.

That approach is likely to produce broadly sensible medium-term results. However, in periods when the overall pressure on resources is already intense, when government revenues are likely to be increasing strongly, it is always difficult to judge which revenue increases are likely to be permanent and which will, with the passage of time and the turning of the cycle, prove to be transitory. Many countries have erred in the direction of treating too large a proportion of the revenue increases as permanent, and have increased spending (or cut tax rates) accordingly. Doing so exacerbates the pressures facing the central bank, and also creates future fiscal risks. These pressures are manifested in higher (than otherwise) interest and exchange rates. In New Zealand, discretionary fiscal policy over the last 15 to 20 years has quite frequently ended up accentuating economic cycles, rather than helping dampen them – with concomitant effects on the exchange rate.

We are hesitant about proposing mechanical or invariant rules, but **we believe the Committee should consider recommending the development of a framework in which higher thresholds are established before spending is substantially increased, or tax rates cut, in periods of prolonged cyclical strength**.

### *Tax treatment of housing*

Housing is favoured by the tax system. The biggest advantage is to those who live in their own home with little or no mortgage debt. In addition, investment in houses and other long-lived assets is also favoured by the tax system when there is even a moderate level of inflation in an economy. This is so because the compensation for inflation on financial instruments takes the form of higher interest rates (which are taxed and deductible), whereas on real assets the compensation for inflation takes the form of capital gains (which mostly are not taxed in New Zealand).

We welcome the move in the recent Budget to increase the resources Inland Revenue has available to enforce the existing provisions governing the taxation of profits on properties purchased with the intention of resale. As noted above, we do not believe that any biases in the tax system have been the prime cause of the current housing cycle. Housing price cycles are recurrent features in all market economies, and the overall tax treatment of housing has not changed very much in recent years. However, at the margin, once expectations of high house price inflation became established it is possible that the overall tax treatment of housing may have exacerbated upward pressures on house prices. Certainly, many of those purchasing investment properties in recent years have done so under the impression that the tax system favours them.

The New Zealand tax system is also relatively unusual in treating income (gains and losses) from all sources similarly. Thus losses on business investment activities, such as (but not limited to) residential property investment, can be offset against income from other sources, whether wages and salaries or other investment income. This comprehensive approach to the tax system has generally been highly regarded internationally. Nonetheless, **the Committee may wish to consider whether limiting the ability to deduct investment losses against wage and salary income might help dampen, at least a little, future asset market cycles.** We note that from 1982 to 1991, the ability to deduct such losses, from any investment activity, was limited to $10,000 (around $20,000 in today's dollars). Measures in this area may have little direct impact at this late stage of the current cycle, but the possible beneficial announcement and signalling effects of active consideration of the issue should not be underestimated.

### *Tax treatment of general investment income*

We believe that there is a strong case for a more consistent tax treatment of income earned on investment assets. At present, income tax is levied on all interest earned, even though some portion is not real income but simply compensation for inflation. And for those able to deduct interest (investors and firms) all interest can be deducted, even though some interest is not a real cost but simply compensation for inflation. By contrast, on real assets the compensation for inflation takes the form of capital gains. New Zealand has no capital gains tax, so that the inflation component of the return to real assets (eg houses) goes untaxed. This difference is quite material: for an expected inflation rate of 2 percent, the current tax treatment overtaxes depositors by 0.8 percentage points (2 percent inflation, at a 39 percent maximum marginal tax rate), and lowers the cost of borrowing for investment purposes by the same amount.

Moreover, there are now some quite significant gaps in the way the tax system treats even very similar forms of income on investments. For example, funds invested through a portfolio investment entity face a maximum final tax rate of 30 percent (with no tax on capital gains), while someone actively managing their own funds faces a maximum tax rate of 39 percent and is liable for taxation on capital gains made on active trading.

Correcting these anomalies would not be easy, and in particular comprehensively adjusting the tax system for inflation would involve some administrative complexities. But these challenges would have to be set against the real distortions created by the current practice, which, over the long-term, skews savers' choices towards real assets and encourages a greater degree of indebtedness than otherwise. Other comparable countries treat inflation in a broadly similar manner, but in most of those systems the actual size of the distortion is somewhat smaller. This is because most taxation systems are more generous towards savings and because most other countries have a capital gains tax in place. In some countries in Europe, tax reform has resulted in a markedly lower tax rate adopted on all income earned from capital (interest, profits, rent). Indeed, the recent OECD report recommended that New Zealand consider this approach, in view of our low overall savings rate, persistently high interest rates, and highly-leveraged economy.

There is a range of important longer-term issues here and each of them is complex. They have the potential to improve both the overall tax regime, and to improve a little the cyclical response of asset prices. We believe that **these are issues that should be considered when the overall framework for the taxation of income earned on investment and capital assets is next reviewed.**

*Taxation of interest paid to non-residents*

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, it could be timely to review the tax treatment of interest paid to non-residents.

In particular, the current Approved Issuer Levy (AIL) system, under which issuers are able to replace non-resident withholding tax obligations with a payment equal to 2 percent of the interest payment on a loan, should be modified. We understand that 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 even AIL. This both slightly lowers the cost of funds to borrowers (including banks) and also has the undesirable effect of discouraging the issuance of securities in New Zealand. We recommend that all borrowing undertaken abroad to finance New Zealand business activity be brought back within the tax net. This would tend to raise interest rates here slightly and would do so without boosting the exchange rate. Had such a regime been in place in recent years, the peaks of the exchange rate might have been dampened a little.

*Mortgage Interest Levy*

In the Supplementary Stabilisation Instruments project, we identified a discretionary Mortgage Interest Levy as one possible supplementary tool that might allow the cost of finance to domestic borrowers to be increased without increasing the returns to foreign savers. If so, the peaks in the exchange rate cycles might be a little lower than otherwise.

At the request of the Minister of Finance, the Reserve Bank and the Treasury undertook further work on this option late last year and early this year. This work was ended in February and a fuller model of a Mortgage Interest Levy developed as part of that work was published.[2]

The Mortgage Interest Levy had various problems, including longer-term enforcement issues and questions around the appropriate governance framework for what was, in essence, a tax measure. It would, moreover, have been unconventional by international standards. Nonetheless, in circumstances where housing market pressures were the major factor putting pressure on monetary policy, it could at times have offered a useful addition to the tool kit. At present, of course, lending to the business sector is growing as rapidly as lending to the household sector, and the largest additional boosts to domestic demand are coming from fiscal policy and the increase in dairy prices. One alternative model would involve a levy on all credit extended to domestic residents, enforced by limiting interest deductibility to those loans on which the levy had been paid. We have not explored that option in depth.

*Counter-cyclical adjustment to GST*

When the Mortgage Interest Levy option was developed, as part of a project that focused solely on housing-related instruments, officials noted that such an instrument should be evaluated against other possible discretionary fiscal instruments. One such instrument, which was advocated by one of the speakers at our Macroeconomic Policy Forum last year, was the possibility of a counter-cyclical adjustment to the rate of GST.

Increasing GST for a period – say, 12 months at a time – when demand pressures were particularly intense

[2] This report is available at http://www.rbnz.govt.nz/monpol/about/2950448.html

would have some attractive features. Consumers would be encouraged to delay purchases until the rate of GST had dropped back to the normal level. In that sense the instrument would function a little like an interest rate (raising the attractiveness of consuming next year rather than this), but without the exchange rate consequences of raising interest rates. Indeed, GST applies to almost all consumption spending, and immediately, whereas interest rates only materially and immediately affect those making large financing or investment decisions at the time.

However, any alternative instrument would have its own difficulties and costs. Constitutional conventions rightly constrain the scope for delegating tax adjustments, and yet a model that relied on parliamentary approval would raise a number of conflicts, and could be seen as undermining the operational autonomy of the Reserve Bank. Moreover, the flipside of the fact that GST affects all consumer spending is that any increase would hit low income consumers quite immediately. Welfare benefits are indexed, but only with a lag, and there is no formal indexation for low income wage-earners. And adjusting prices when the rate of GST changed would create added costs for retailers. As with any possible alternative or supplementary instruments, these costs would need to be weighed against those that arise from the size of the cycles in the exchange rate.

## Improving statistics

*(for more detail see supporting paper A10)*

New Zealand's official economic statistics are broadly adequate for our purposes. However, there are material weaknesses in the statistical framework (which mean that in some areas New Zealand is well away from international best practice). Accordingly, we consider that the Committee should recommend the allocation of additional resources to improve the overall range, quality, and timeliness of New Zealand's macroeconomic statistics. Globalisation also continues to pose fresh challenges to statisticians and we need to invest in the best possible statistics that will help us effectively understand and respond to the growing economic and financial linkages between New Zealand and the rest of the world.

There are two broad areas where material payoffs could be achieved. The first is to improve the range of longer-term economic statistics (income-based measure of GDP, better measures of savings etc). The second is around the frequency and timeliness of the sort of data we use each and every quarter to update our sense of where the economy is at right now. For example, the first reading on GDP is not available until the very end of the following quarter, the longest lag in any OECD country. New Zealand is also one of the few OECD countries without any official monthly data on the labour market or key production sectors. The significance of individual data deficiencies and delays should not be overstated, but the cumulative impact can become quite significant. Over time, better data should lead to better policy, and to better commentary and research from those who observe and monitor us.

## Conclusion and specific recommendations

Monetary policy in New Zealand – design and conduct – is firmly within the mainstream of approaches adopted by countries of our type around the world. Indeed, many developed countries have followed our lead in developing an inflation targeting regime. Over time, we have successfully delivered inflation rates that have averaged within the target range.

The framework provides us with ample flexibility to cope with emerging issues, data surprises and pressures. The framework works well but it works best when monetary policy is supported by other aspects of economic policy and by the design and operation of the regulatory and tax systems. Even a good framework does not necessarily mean an easy life, for us or for the tradables sector. Variability, in the economy and in the exchange rate, is a fact of life.

Over the most recent cycle we have been grappling with surprisingly strong and robust inflation pressures, apparent most immediately in the housing market. These pressures arose at a time when global interest rates were unusually and persistently low, meaning that any OCR increases were reflected disproportionately in the exchange rate. We were, with hindsight, slow to recognise fully the strength of the demand and housing market pressures on inflation and, hence, the monetary policy stance that would be required. We have, however, been distinctly and consistently closer to the mark than the consensus of private commentators and market participants.

There is a range of supplementary measures or tools which we believe the Committee should consider to improve the overall responsiveness and flexibility of the economy, and to mitigate likely pressures on the exchange rate in future cycles. We do not believe that these have very much, other than signalling and announcement effects, to offer at this late stage of the current cycle – almost all of them would require months to implement. However, it is important to look to the future – the focus of this inquiry – and to focus on ensuring that we have in place frameworks which give us the maximum chance of keeping future inflation pressures in check with minimal transitional distortion, especially to the tradables sector. If there were panaceas they would already have been adopted, but there are probably several useful refinements which could, at the margin, improve the overall functioning of the economy and ease the specific burdens that monetary policy adjustments at times place on specific sectors of the economy. In particular, we recommend that the Committee:

(a) encourages further work by the relevant agencies to ensure that housing land supply and the development of new subdivisions is not unduly restricted by regulatory or administrative constraints;

(b) reviews the taxation of investment income and the tax treatment of the financing of the purchase of investment assets. This should include examining the possibility of modifications to the existing provisions that allow any losses on investment activities to be fully offset against a taxpayer's other income at that taxpayer's marginal tax rate ("ring-fencing");

(c) encourages the development of a framework under which higher thresholds are in place before substantial increases in government spending (or tax reductions), especially those financed from unexpected revenue gains, occur at times when demand pressures in the economy are intense;

(d) considers whether variations in new migrant approvals could be used as a supplementary tool during periods in which demand pressures in the economy are becoming particularly intense; and

(e) recommends the allocation of additional resources to improve the overall range, quality, and timeliness of New Zealand's macroeconomic statistics.