NEW ZEALAND BUSINESS ROUNDTABLE

Inquiry into the Future Monetary Policy Framework

July 2007

1. Introduction

1.1 This submission is made by the New Zealand Business Roundtable, an organisation comprising mainly chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The Business Roundtable supports the main features of the current monetary policy framework. It was one of the few business organisations to support the Reserve Bank Act at the time it was adopted by parliament. We endorse the price stability objective of the Act.

1.3 When the idea of a select committee inquiry was first mooted, our response was that it would be of little value if it focused only on monetary policy. Although we have a number of criticisms of the Reserve Bank's mandate (specifically the Policy Targets Agreement) and performance (discussed below), we believe other government policy settings are making its role unnecessarily difficult and exacerbating current economic imbalances. For that reason we were pleased that the Finance and Expenditure Committee (the 'Committee') adopted broader terms of reference, namely:

- To consider the causes of inflationary pressures.
- To consider the effectiveness of current monetary policy in controlling inflation.
- To examine the interaction of monetary policy with other elements of the economic policy framework including fiscal policy.
- To examine the New Zealand economy's capacity for non-inflationary growth, and how it can be improved.

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

- To examine the recommendations from recent examinations of monetary policy including the joint Treasury and Reserve Bank of New Zealand's report entitled Supplementary Stabilisation Instruments.

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

1.4 We believe there has been a great deal of confusion in public discussion about inflation and monetary policy, and that the Reserve Bank bears some responsibility for this confusion. It is likely to be reflected in submissions to the Committee. For that reason we have endeavoured to make this submission as simple and succinct as possible.

2. Inflation

2.1 One of the simplest explanations of inflation we have seen is by George Mason University professor of economics Walter Williams. He writes:

> First, let's decide what is and what is not inflation. One price or several prices rising is not inflation. When there's a general increase in prices, or alternatively, a reduction in the purchasing power of money, there's inflation. But just as in the case of diseases, describing a symptom doesn't necessarily give us a clue to a cause. Nobel Laureate and professor Milton Friedman says, "[I]nflation is always and everywhere a monetary phenomenon, in the sense that it cannot occur without a more rapid increase in the quantity of money than in output." Increases in money supply are what constitute inflation, and a general rise in prices is the symptom.
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> Let's look at that with a simple example. Pretend several of us gather to play a standard Monopoly game that contains $15,140 worth of money. The player who owns Boardwalk or any other property is free to sell it for any price he wishes. Given the money supply in the game, a general price level will emerge for all trades. If some property prices rise, others will fall, thereby maintaining that level.
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> Suppose unbeknownst to other players, I counterfeit $5,000 and introduce it into the game. Initially, that gives me tremendous purchasing power, whereby I can bid up property prices. After my $5,000 has circulated through the game, there will be a general rise in the prices – something that would have been impossible before I

> slipped money into the game. My example is a highly simplistic example of a real economy, but it permits us to make some basic assessments of inflation.
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> First, let's not let politicians deceive us, and escape culpability, by defining inflation as rising prices, which would allow them to make the pretence that inflation is caused by greedy businessmen, rapacious unions or Arab sheiks. Increases in money supply are what constitute inflation, and the general rise in the price level is the result. Who's in charge of the money supply? It's the government operating through the Federal Reserve.[1]

2.2 Key points to note from this statement are:

- inflation is an *ongoing* increase in the general level of prices
- inflation is caused by *money* (growing faster than output)
- the central bank has *full control* over the supply of money.

2.3 It follows that inflation should not be blamed on capacity constraints – general shortages of labour or available capital. Scarcity alone cannot cause inflation; labour and capital are always scarce, regardless of the level of inflation or how 'hot' the economy is running. The demand for labour and capital is a real demand that is related to real investment and consumption opportunities, real income and real wealth, including real cash balances. The short-term market response to an excess of domestic demand for domestic goods and services at full employment is to increase imports relative to exports. The longer-term response is to increase the domestic supply of tradable goods, or to reduce aggregate spending. None of these responses need involve inflation.

2.4 Similarly, inflation should not be blamed on the excess demand or spending that is associated with deficits in the current account of the balance of payments. For a start, a rise in the general price level that does not alter real incomes, output, demand, wealth or cash balances will have no effect on this real excess demand situation. Secondly, New Zealand is such a small country that it

[1] Walter Williams, http://www.townhall.com/opinion/columns/walterwilliams/2005/11/16/17524.html

cannot affect the world price of tradable goods and services. Indeed, there is no direct statistically significant relationship in practice between inflation and excess demand as measured by the balance of payments. In 1989 the CPI rose 7.2 percent when the current account deficit in the balance of payments was 3.7 percent of GDP. In 2006, CPI inflation was lower at 2.7 percent, yet excess demand according to this measure (the current account deficit) was 9 percent of GDP. Attached as Annex I is a chart that illustrates more comprehensively the lack of any close correlation between inflation and the current account balance. Instead, it is a non-market response – monetary policy settings – that determines whether periods of excess demand are associated with inflation. Within the economics profession, it was the 'stagflation' that many countries, including New Zealand, experienced in the 1970s that decisively refuted the earlier closed economy, 'demand pull', Keynesian proposition that inflation was caused by excess demand or an 'over-heated' real economy. Yet the minister of finance, Dr Michael Cullen, continues to talk in these discredited terms.

2.5 It also follows that inflation is not caused by cost-push inflation, let alone any 'unholy alliance' between labour and capital, whereby unions and employers agree to large wage increases that firms pass on in price increases. Unions and firms cannot print money. Firms exposed to international competition can't pass on such cost increases. It is true that a government monopoly (eg in health or education) can pay large wage increases not backed by productivity gains. However, they are effectively a tax on the exposed sectors of the economy; they can't by themselves cause economy-wide inflation.

2.6 It is also important to understand that, as the Reserve Bank states itself, a central bank cannot control inflation unless it can control its own balance sheet. In particular it must control the parts of its balance sheet that constitute the public's liquid claims on the central bank in the form of notes and coins, and the banking

system's liquid claims in the form of settlement balances at the central bank. This total is sometimes called base money. Base money can neither enter nor leave the banking system through the balance of payments as long as the Reserve Bank does not transact in foreign exchange. Provided it does not do so, all foreign exchange transactions merely see assets and liabilities change hands between private parties, with no change in the money base. This was an important reason for adopting a free float. Thus the Reserve Bank has full control over the supply of money.

2.7 The Reserve Bank can use interest rates to influence the public's demand for base money, and it or the government can also change the level of base money directly through open-market operations that change the composition of the Reserve Bank's balance sheet. Currently the Reserve Bank exercises control by adjusting the Official Cash Rate. This increases or reduces the banking system's demand for settlement balances and has a 'chain reaction' effect on interest rates (within limits set by world interest rates), inflation expectations and exchange rate dynamics. Previously the Reserve Bank targeted settlement cash directly through open-market operations. Either mechanism should suffice to control inflation, but neither of them implies the rigid targeting of any particular monetary aggregate or interest rate level. Indeed, there is no tight, mechanistic relationship between increases in short-term interest rates or any particular aggregate and increases in prices, for well-understood reasons.[2] Whether policy focuses on setting the OCR and letting demand determine the quantity of base money, or vice versa, is much less important than the determination with which the price stability objective is seen to be pursued. Regardless of its choice of instrument, a central bank needs to look at all relevant information.

[2] Growth in output with unchanged transactions technology is one factor that increases demand for base money, but other factors also can alter the demand for the base. These are typically one-off, however, and lead to a permanent change in the price level rather than the inflation rate. This perspective also can explain why targeting the base growth rate is not alone sufficient to guarantee price stability.

2.8 The value of a given level of non-interest earning cash is determined by the volume of goods and services it can buy. This is obviously greater the lower the general price level. If the public has more cash than it requires, and it cannot reduce cash holdings through the balance of payments or by purchasing interest-bearing assets from the Reserve Bank or the Treasury, its only remaining option is to use the excess to buy more goods and services. In the absence of a sufficiently fast increase in production, the effect will be to raise the general level of prices, reducing the value of the public's cash holdings until it is happy to hold the real value that remains at the existing level of economic activity. Since a greater deficit in the current account of the balance of payments does not in itself increase domestic production and thereby the real demand for transaction balances, any such increase cannot reduce the inflationary effect of too much cash in the public's pockets in a lasting way. Hence the simple insight that inflation is a problem of 'too much money chasing too few goods'.[3]

2.9 The 'too few goods' aspect of this insight highlights the importance of relating monetary growth to economic growth. Other things being equal, the faster the rate of economic growth, the greater the rate of growth in the public's holdings of cash that is consistent with stability in the general level of prices. In turn economic growth depends fundamentally on growth in productivity (the output achieved from a given quantity of resources). The best contribution monetary policy can make to growth is to keep prices stable; it cannot otherwise contribute to the economy's long-run growth performance. New Zealand enjoyed years of strong growth and became one of the wealthiest countries in the world in the late 19th century and early 20th century at a time when the price level was essentially stable. Growth comes from real, supply-side economic factors, not monetary manipulation.

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[3] For a more technical discussion of the points made in paragraphs 2,5-2.7, see Section 5.1, 'What can the Reserve Bank control?', in Peter Hartley (2001) *Monetary Arrangements for New Zealand*, New Zealand Business Roundtable, Wellington.

As the *Australian Financial Review* recently commented in an article 'NZ needs to boost supply':

> … when every arm of policy has to be directed towards suppressing domestic demand, it is time to ask whether the Clark government has been doing enough to expand supply.
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> The answer has to be no. The government has been reluctant to face up to the lack of incentives, especially the impact of high income taxes on skilled labour and productivity and the impact of the regulatory burden on key businesses such as energy and telecoms.

2.10 The strength of the consensus about inflation today amongst economists was affirmed recently by Nobel laureate in economics, Edward Prescott, who wrote: "All respectable economists agree inflation is a monetary phenomenon".[4]

3. The misdirected debate about 'alternative instruments'

3.1 Much recent debate around monetary policy has lost sight of the fact that inflation is a monetary phenomenon.

3.2 For example, there have been suggestions that the tax treatment of housing should be changed to reduce house price increases. However, changing tax rules (by, say, imposing a capital gains tax on housing) would have only a one-off effect on house prices. Even if no other prices changed, it would have no effect on inflation (an ongoing increase in the general level of prices). Further, in theory at least, other prices would have to rise so as to keep the overall price level unchanged, otherwise the public's real cash balances would be too high. In short, while such proposals can be debated on their merits on tax policy grounds, they have nothing to do with monetary policy and inflation.[5]

3.3 Similarly, tax reductions do not cause inflation (provided the Reserve Bank does not allow the money supply to grow). As Federal Reserve governor Ben Bernanke has stated (in his well-

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[4] Personal communication, 22 May 2007.

[5] As far as investment in rental housing is concerned, the deputy commissioner of the Inland Revenue Department has advised the Finance and Expenditure Committee that it is not treated favourably relative to other investment. The 'ring fencing' debate is another distraction; changes in current rules would be bad tax policy.

known textbook co-authored with Andrew Abel): "… a cut in taxes causes only a one-time increase in aggregate demand … [not] a *sustained* increase in inflation." [6] Indeed, if tax cuts have the expected effect of increasing work effort, investment, and output for an unchanged level of cash in the economy, the overall price level should rise more slowly, if not fall, in order to keep the demand for cash in balance with the level of economic activity. Tax cuts in the United States and Australia in recent years have not caused problems for monetary authorities.

3.4 Changes in prudential requirements (eg to increase the risk weighting of housing assets in banks' portfolios) have also been mooted by the Reserve Bank. The same comment applies. This is an issue for prudential policy; it has nothing to do with monetary policy and inflation.

3.5 It follows that the entire debate about 'alternative instruments' has been misdirected and, not surprisingly, has led nowhere. As respected economist Willem Buiter noted at a macroeconomic policy forum sponsored by the Reserve Bank and the Treasury in 2006:

> The recent initial Report by the Governor, Reserve Bank of New Zealand and Secretary to the Treasury (2006), *Supplementary Stabilisation Instruments*, is "a little shop of horrors" of regulatory and fiscal interventions in asset and credit markets, that would fail to stabilise anything of value while creating massive distortions, disintermediation and rent-seeking behaviour.[7]

The Reserve Bank's tools for monetary control (notably interest rates) are standard among comparable central banks around the world. To our knowledge no other central bank is calling for 'alternative' monetary instruments'. The OCR is not a 'blunt instrument': it is a pervasive, non-distorting means of ensuring stable prices in general. We suggest the Committee recommends

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[6] Andrew B Abel and Ben S Bernanke, *Macroeconomics*, fifth edition, Pearson Addison Wesley, pp 589-590.

[7] Willem Buiter, 'Stabilisation Policy in New Zealand: Counting your blessings, one by one', in Bob Buckle and Aaron Drew (eds), *Testing stabilisation policy limits in a small open economy*, Reserve Bank and the Treasury, 2006, p 69.

that no further resources should be wasted on the search for 'alternative instruments'.

3.6 It is important to emphasise at this point that we are not saying there are no issues around such things as house price increases, tax rules and other policies that may be creating economic distortions and making the Reserve Bank's job harder. To the contrary, 'monetary policy needs mates', and we come back to such issues later. However, the prime effect of other dysfunctional policies is on resource allocation and growth. The Reserve Bank can still achieve price stability despite them provided it establishes appropriate monetary conditions. This is not a sound policy mix, however; a better mix would result in better overall economic performance and less need for monetary restraint.

4. Sources of recent inflation problems

4.1 In June 2007 the Consumers Price Index was 20 percent (rounded) higher than in June 2000, representing an average compounded annual rate of inflation of 2.7 percent. This is inconsistent with the Bank's primary legislated function which is "to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices".

4.2 The foregoing discussion has explained why the starting point for exploring the source of a problem with inflation must be the Reserve Bank's conduct of monetary policy, not households or the private sector. Looking back, the Reserve Bank started presiding over higher inflation and rising inflation expectations from 1999-2000. It has shown an unwillingness to persist with a high ORC until inflation tracks the mid-point of the target range; indeed it reduced the OCR significantly during two periods when it was still well above the mid-point (see Annex II). As a result, inflation and inflation expectations have become entrenched at well above the (increased) mid-point of the target range. Inflation expectations

rose from under 2 percent in 1999 to around 2.5 percent in 2003 and then to around 3.5 percent in 2006, according to the National Bank's survey. The unwillingness to tackle this problem with greater determination is likely to have contributed to house price inflation, although many other factors were also operating. In addition, the Reserve Bank seems to have paid too little attention to inflation in the domestic (non-traded) sector of the economy, where it has been generally running above 4 percent since 2003. Its tolerance of excessive inflation has been described as a misguided 'go for growth' strategy: it has contributed to the ongoing momentum of the economy, masking the deteriorating productivity performance (see below) while aggravating inflationary and balance of payments pressures.

4.3 These problems seem likely to have been exacerbated by changes in the Policy Targets Agreement, in particular the move in the target band to 1-3 percent a year and the requirement for monetary policy to have regard to output and the exchange rate. These have arguably confused and blurred the Reserve Bank's focus. No convincing case was made for the changes. In our view they have served to raise and entrench inflation expectations and reduce policy predictability and credibility.[8] Partly as a consequence the Reserve Bank seems to have drifted well away from its price stability mandate. It gives the impression of being satisfied with inflation running at around 2.5 percent annually, on the basis that such a rate is not far out of line with other countries and that its interest rate policy has been rigorous. Over 10 years a 2.5 percent inflation rate results in an increase in the price level of nearly 30 percent. In no way can this be regarded as price stability.

[8] These concerns are widely shared. See, for example, 'Monetary faults point at wider inflation target', *National Business Review*, 6 July 2007, p 4: [Inflation] expectations have tended, after a bit of a lag, to move up whenever the target band is moved upward."

5. Confused communications

5.1 The Reserve Bank also seems to us to be responsible for some confused communications and ill-judged actions in recent years. These have included:

- a lack of clarity about the basic source of an inflation problem. An example is the document *Explaining Monetary Policy* on its website where it states that the underlying cause of inflation "is usually that too much money is available to purchase too few goods and services, or that demand in the economy is outpacing supply". However, as explained above, these two things are not the same. Only the first of them is consistent with the consensus of professional opinion on the matter as reported by economists such as Williams and Prescott;

- an excessive focus on the housing market. House price increases are just one component of the CPI and have occurred in other countries during a period of low real interest rates worldwide. Immigration, a strong labour market and rises in other asset prices, as well as increased regulation and central and local government fees and charges, have been other factors affecting the New Zealand housing market. It is valid to ascertain what factors are contributing to rising prices, but monetary policy should not be directed at a subgroup of the CPI. The emphasis on housing is adding to the uncertainty concerning what monetary policy is aiming to achieve;

- criticism of banks' lending policies, despite a lack of evidence that banks have been acting irrationally or putting the stability of the financial system at risk. Reports (which to our knowledge have not been denied) have even suggested that the Reserve Bank has urged banks to (collusively) increase interest margins;

- expressions of concern about New Zealanders' spending and saving habits, when such decisions cannot cause inflation and are not the Bank's business. Annex III demonstrates that there has been no significant relationship between real consumer spending and inflation during 1988-2007 – beliefs to the contrary are another relic of Keynesian economics. In any case there is little evidence that New Zealanders are poor savers (as the Bank's own data on increases in household net worth, Treasury research and OECD statistics on gross national saving demonstrate);

- suggestions that monetary policy has become ineffective, partly because of the growth of fixed rate mortgages. Fixed rate contracts merely assign risk between borrowers and lenders. Borrowers are shielded from the impact of interest rate rises during the terms of such mortgages but lenders aren't. Both are exposed to the higher interest rates where it counts – at the margin. In the final analysis the mix of fixed and floating rate mortgages is just another factor for the Reserve Bank to take into account in judging monetary conditions. As a participant in the 2006 macroeconomic policy forum noted, "The empirical work suggests that the strength and nature of the monetary policy transmission process in New Zealand is not significantly different to the group of comparable economies (Australia, Canada, Norway, Sweden and Chile).[9] Monetary policy is in fact a powerful instrument, and its mismanagement can easily lead to recessions or depressions and severe economic imbalances. Interest rate increases in the current tightening cycle seem likely to depress economic activity for an extended period of time;

- the impression the Reserve Bank has created that it needs to engineer a slowdown in economic activity in order to curb

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[9] Klaus Schmidt-Hebbel (Central Bank of Chile), Buckle and Drew, *op cit*, p 8.

inflation. As explained above, economies can grow strongly without generating inflation. Indeed economic growth, other things being equal, is helpful in reducing inflationary pressures. Certainly the Reserve Bank needs to assess the balance between money growth and output growth, but a better emphasis would be on the supply side of the economy and ways to overcome the problem of ‘too few goods’;

- the bizarre (and apparently fruitless) visit by Reserve Bank and Treasury officials to Japan to highlight the risks associated with a strong dollar and discourage investment in New Zealand; and

- the recent intervention in the foreign exchange market. In effect the Reserve Bank loosened monetary policy only a few days after it tightened it, causing confusion about its intentions. Predictably, there has been no obvious ongoing effect on the level of the exchange rate. The Bank has also unconvincingly argued that the intervention was costless; an article by the deputy governor neglected the risk-related funding costs of the reserves needed to support it.

Recent talk by the minister of finance and other politicians about overriding the price stability objective has added to this catalogue of erratic behaviour, which has not been seen since the Muldoon era. This can only damage hard-won domestic and international investor confidence.

5.2 In summary, while the overall monetary policy framework is sound, we see the operation of monetary policy as being in a state of confusion and considerable disarray. We believe the Committee should form a view on the Reserve Bank’s recent performance and its accountabilities. It should also consider the role of changes to the Policy Targets Agreement in contributing to recent inflationary problems.

6. 'Monetary policy needs mates'

6.1 Monetary policy does not operate in isolation from other policy influences on the economy. These can be benign or malign from the perspective of inflation control. In the early 1990s disinflation was facilitated by measures such as reductions in the growth of government spending and the freeing up of the labour market. In more recent years a range of policy settings have made inflation control harder.

6.2 Foremost among these has been the massive increase in central government spending – up $21 billion since 2000, including $3.8 billion in the current fiscal year alone. Government spending is mainly on non-traded goods and services, and has been a major factor in the movements in the CPI in that sector, as shown in the following box:

Inflation in government-dominated industries or activities relative to housing and total CPI

	Average Annual Compounded Rate of Inflation June 2000-2007	Multiple of CPI Inflation
CPI	2.7%	100%
Tradables	1.3%	48%
Non-tradables	3.7%	140%
Components of CPI related to dominant government Industries or activities		
CPI: New Zealand: central & local government charges	3.3%	124%
CPI: Electricity	5.8%	219%
CPI: Hospital services	5.8%	219%
CPI: Tertiary & other post school education	5.8%	219%
CPI: Health insurance	5.6%	210%
Some components of central & local government charges:		
CPI: New Zealand: Housing & h'hold utilities: property rates & rel servs	6.1%	230%
CPI: Local authority rates & payments	6.0%	225%
(The following series only has data from June 2002, so this is the 5-year compounded rate)		
CPI: Refuse disposal & recycling	16.1%	608%
Housing-related components of the CPI		
CPI: New Zealand: Housing & h'hold htilities: total	4.2%	159%
CPI: New Zealand: Housing & t'hold Utilities: actual rentals	0.8%	29%
CPI: New Zealand: Housing & h'hold utilities: home ownership	5.4%	205%
CPI: New Zealand: Housing & h'hold utilities: property maintenance	3.7%	138%

The ratio of the prices of non-traded goods to traded goods is the economy's real exchange rate. Government spending has accordingly been responsible in part for the rise in the real exchange rate, with the result that imports have increased, the current account deficit has risen, and export industries have been

squeezed. The Reserve Bank has had to battle against these influences. However, there is no way monetary policy can shield internationally exposed industries from fiscal mismanagement. In this context, it should be noted that the key issue is government spending, not the operating balance or movements in it. Unless the rate of growth of government spending is reduced, the pressure on the export sector is likely to continue unabated. The Reserve Bank should be far more outspoken on this issue.

6.3 In addition, there is a long list of other government actions that have been unhelpful from a stabilisation perspective. It includes:

- increases in taxation that have driven the ratio of taxation to GDP to around 43 percent, according to the OECD, putting New Zealand up with countries like Germany in the high tax category, and reducing incentives for productive activity;

- the encouragement to local authorities in the Local Government Act 2002 to expand their role and functions, which has seen high growth in council spending and rates and in other fees and charges. Research commissioned by Fletcher Building has found that those are the main explanation of higher house costs in New Zealand relative to Australia;

- the increase in labour market regulation through the Employment Relations Act, changes to the Holidays Act, minimum wage increases and other moves;

- cost-raising regulations in areas such as accident insurance, telecommunications, electricity and banking;

- cost increases arising from the Resource Management Act and changes to the Building Act that have pushed up house prices. A particular problem is council restrictions on land supply for housing; and

- the failure to press on with reforms in areas such as roading, water and other infrastructure to reap the benefits of potential efficiency gains and cost reductions.

6.4 In general, government action that increases a cost and therefore a price must be matched by a reduction in some other price in the economy if monetary policy is maintaining price stability. If other non-tradeables prices do not fall to offset such increases, the only way the offsetting reduction can occur is through an increase in the exchange rate which reduces the New Zealand dollar price of exportables and imports. Thus producers exposed to world prices suffer the consequences of government-induced price increases.

6.5 A final item in the category of unhelpful supporting factors is the problem of 'too few goods'. There has been a startling slump in productivity in recent years. Statistics New Zealand figures for the measured sector of the economy – essentially the business sector – show labour productivity declining from a trend growth rate of 2.7 percent in 1992-2000 to 1.3 percent in 2000-2006. The trend annual growth rate in multi-factor productivity is estimated to have declined from 2.3 percent to 0.7 percent – a reduction of two-thirds. Estimates prepared for the Business Roundtable for the most recent year (to March 2007) suggest that labour productivity did not grow at all in that period (see Annex IV). All the factors mentioned in paragraphs 6.2 and 6.3 are likely to have contributed to this trend.

6.6 The relevance of productivity growth to monetary policy was recently noted by ANZ National Bank economists. As they put it:

> Weak productivity growth has heightened capacity pressure and kept inflation high despite sub-trend growth … It is folly to say such a deterioration is completely cyclical given the sheer magnitude of the fall and the period it extends over. If labour productivity growth had been a mere 0.2 percentage points per year higher for the past 5 years, thereby raising the supply side capacity of the economy, the output gap would be negative, interest rates would be at least 50 basis points lower, and the NZD/USD well south of 0.70.

We are pleased that the terms of reference of the Committee require it to "examine the role of productivity in the economy, how

it can be improved and the constraints upon it." With minor exceptions such as the announced cut in company tax in the recent budget, this decade has seen few pro-productivity, pro-competition reforms and many additional constraints on productivity. While firms obviously are the vehicle for productivity improvements in the business sector, and management performance has a role to play, research indicates that institutions and policies are predominantly responsible for productivity improvements and hence differences in per capita incomes. There is no likelihood that with present policy settings the government will achieve its former 'top priority' goal of lifting average per capita income in New Zealand to the top half of the OECD range. On present trends the country is likely to resume its fall in the OECD rankings after arresting the decline with the economic reforms of the 1980s and early 1990s.

7. Conclusion

7.1 We have suggested in this submission that monetary policy has become confused and incoherent. Combined with the dramatic fall in productivity growth, economic management in recent years seems likely to be seen in retrospect as seriously wanting. Major imbalances have been allowed to build up in the economy, there is a risk of sharp and painful adjustments, and interest rates are likely to remain high for some time, with depressing effects on the economy. These problems cannot be put down to capacity or demand pressures resulting from economic growth. The economy grew by only 2.2 percent in calendar 2005 and 1.5 percent in calendar 2006 and looks likely to continue to grow slowly this year and next. This sluggish growth performance is occurring at a time when New Zealand should be doing far better. Our terms of trade and some commodity prices are at high levels; Australia is growing strongly, and world growth this year is expected to be around 5 percent in real terms

7.2 We see the main reasons for these poor outcomes as being the government's departure from well-recognised and orthodox

principles of economic management. After fiscal and monetary credibility was established in the early 1990s, New Zealand enjoyed strong, non-inflationary growth. Australia has continued with more orthodox policies including expenditure discipline that has not threatened monetary policy, tax cuts and ongoing moves towards greater economic freedom, to the point where it is now rated above New Zealand in one index of economic freedom. Meanwhile, the government's moves to more interventionist policies and its reluctance to reduce taxes (indeed, as noted earlier, the overall tax burden as measured by the tax to GDP ratio has risen sharply) have reduced economic freedom and the flexibility of the economy. There is little prospect of New Zealand matching Australia's non-inflationary growth performance in the period ahead. We have been making these points for some time and believe there is now overwhelming evidence to justify them and warrant major changes in policy directions.

7.3 In our view the first contribution the Committee could make in the interests of better policy is to produce a high quality report which helps to improve public understanding of inflation as a monetary issue and the role of monetary policy in maintaining a stable price level. Suggestions that the price stability objective should be changed and that monetary policy should be used to target the exchange rate or other goals should be firmly rejected.

7.4 We think the Committee should recommend that the most important step the government could take to reduce current pressures on monetary policy and the exchange rate would be to rein in the growth of government spending. This does not necessarily require cuts in any programmes, although in our view there is ample evidence of wasteful and badly targeted spending. We suggest that the government should bring down a mini-budget as quickly as possible which reduces or defers spending plans, and establishes a rigorous review of base spending.

7.5 In addition to recommending stronger expenditure discipline, we submit that the Committee should:

- examine the relationship between successive changes to the Policy Target Agreements and the rise in inflation expectations;

- propose that a competent statistician (such as former government statistician Len Cook) be commissioned to consider the rate of increase in measured price levels that would be consistent with stability in the general level of prices, abstracting from quality changes. Our understanding of relevant international research is that a stable price level may be represented by 'drift' of around 1 percent in relevant price indexes (due to quality changes, index lags and the like). However, there is a need to conduct such a study specifically for New Zealand. Meanwhile it is a concern that measured inflation is much higher;

- suggest that in the light of such an investigation consideration should be given to changing the Policy Targets Agreement to provide a focus on price stability. This could take the form, for example, of a point target or a range, such as the former New Zealand and current European Central Bank range of 0-2 percent. (Currently Euro area countries are experiencing an economic upturn with inflation and inflation expectations firmly anchored.);

- consider whether the Reserve Bank's board should be required to determine whether a Policy Targets Agreement accords with the legislated price stability goal of the Reserve Bank Act;

- evaluate the performance of the Reserve Bank in recent years in conducting and communicating about monetary policy. The quid pro quo for granting the Bank independence was to ensure accountability for its

performance. Current sanctions for inadequate performance appear to be weak, and options for strengthening them should be explored;

- propose that the ability of the Reserve Bank to intervene in the foreign exchange market should be curtailed by a reduction in its reserves and by restricting its mandate to intervene only in the event of disorderly market conditions (as was the case in the past);

- discourage any further investigation of 'alternative monetary instruments';

- identify policy settings (in addition to government spending) that are making the Reserve Bank's job harder, notably areas such as taxation, local government, regulation, state ownership and infrastructure, and propose remedies; and

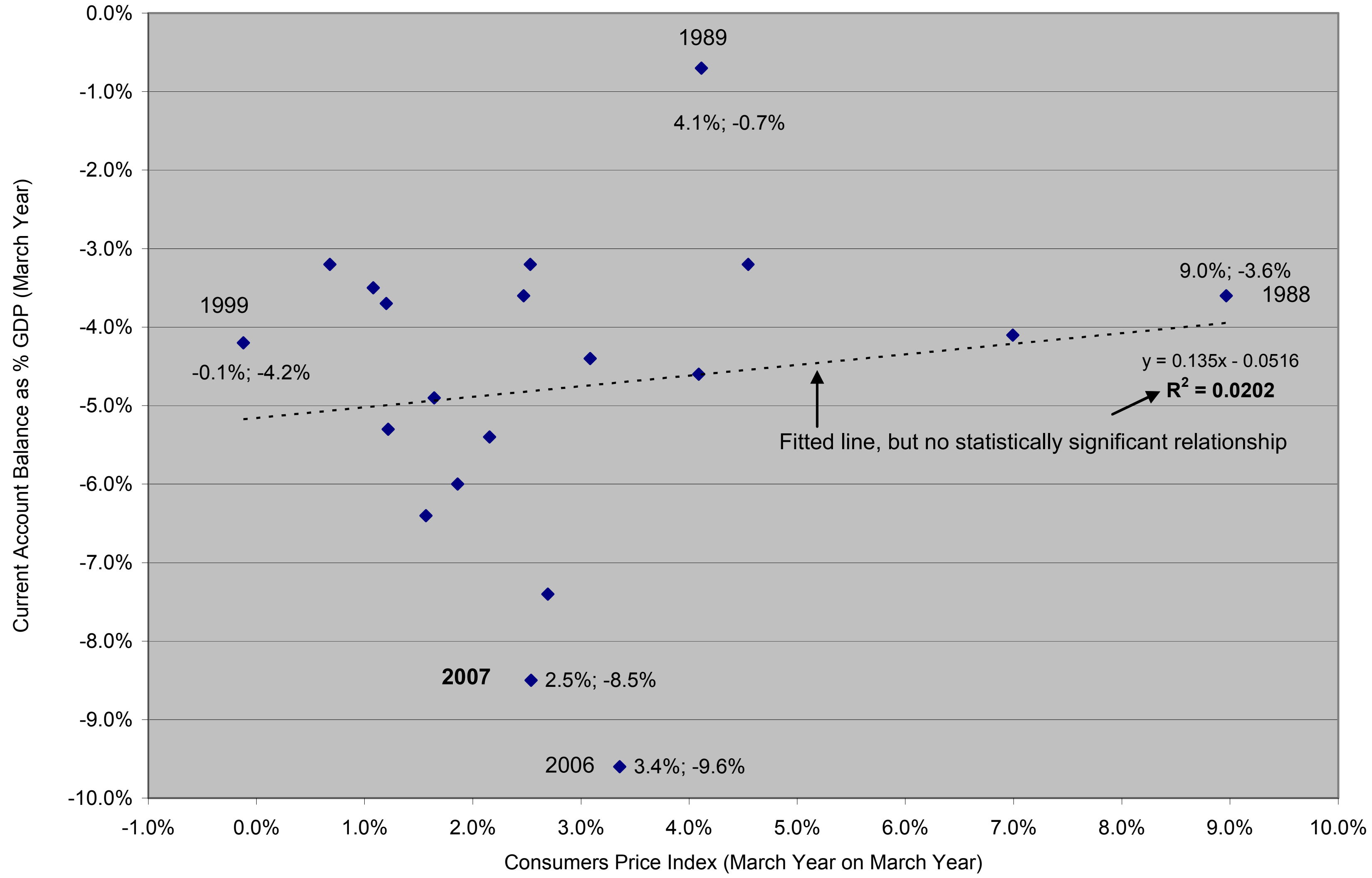
- emphasise the need to reverse the recent productivity slump through economic freedom-enhancing reforms to encourage entrepreneurship, investment and skill development.

7.6 Beyond these suggestions we see no current grounds for basic changes to the monetary policy framework. Our 2001 study *Monetary Arrangements for New Zealand* (copy enclosed) found that "a low and stable inflation rate is the only reasonable ultimate goal for a central bank". Likewise the Finance and Expenditure Committee stated in a 1989 report, "Monetary policy at the end of the day can only hope to achieve one objective, that is, price stability." The review of monetary policy conducted by Swedish economist Lars Svensson found that New Zealand's monetary policy framework is consistent with world best practice. In a recent paper Svensson has stated, "There is no evidence that inflation targeting has been detrimental to growth, productivity, employment or other measures of economic performance." [10]

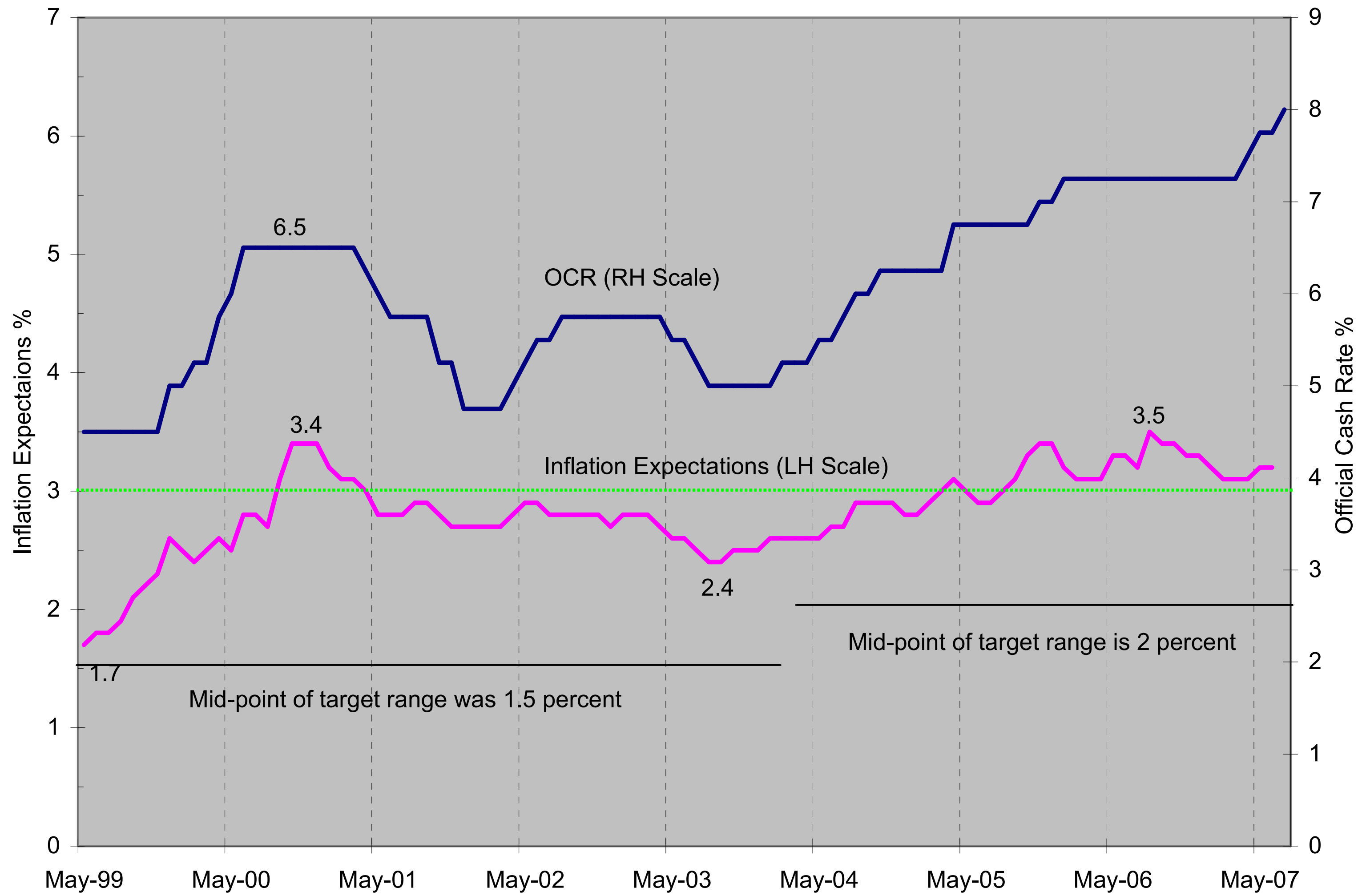
[10] Lars Svensson, for *The New Palgrave Dictionary of Economics*, 2nd edition, edited by Larry Blum and Steven Durlauf.

Svensson's comments could be invited on any suggestions by the minister of finance and New Zealand First to override the price stability goal or target the exchange rate.

7.7 Our study also recommended that in a longer-term perspective the possibility of adopting a common currency should be kept under review, in tandem with improvements to fiscal and labour market policies. It also suggested consideration of base money targeting as a supplement to current inflation targeting, and other ideas for moving towards a more passive monetary policy regime. We commend the study to the Committee's attention.



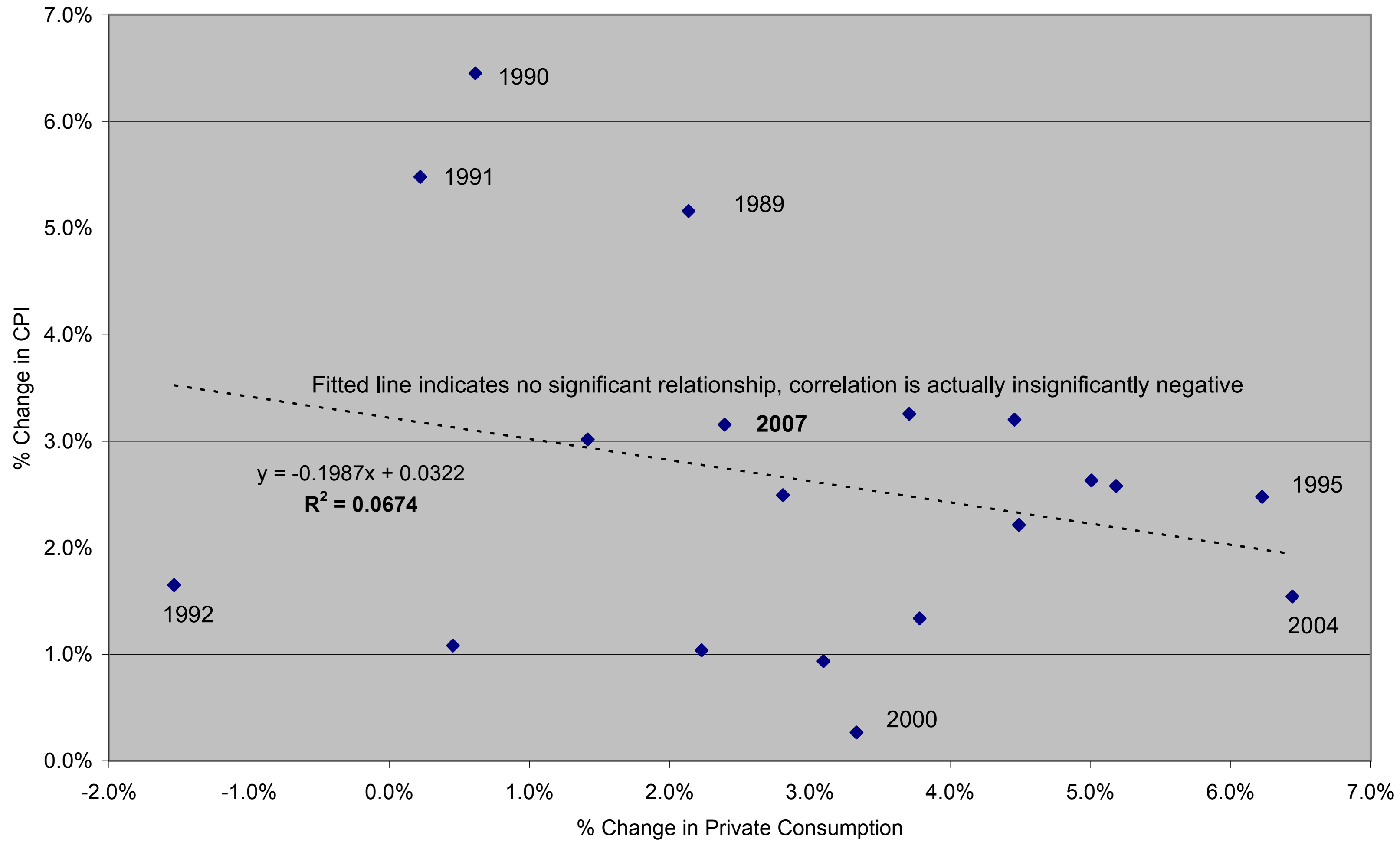
Annex I



Annex II

Inflation and Rate of Increase in Real Consumer Spending: No Significant Relationship during 1988-2007

March Year on March Year Percentage Changes



Annex III

Media Release

NEW ZEALAND BusinessROUNDTABLE
PROMOTING POLICIES FOR A BETTER NEW ZEALAND

Labour Productivity Growth Grinds to a Halt

Annex IV

"The deterioration in New Zealand's productivity growth performance in recent years looks likely to have continued in the year ended March 2007", Roger Kerr, executive director of the New Zealand Business Roundtable, said today.

"Indeed labour productivity in what Statistics New Zealand calls the measured sector of the economy – essentially the business sector – may have been static in the latest year."

Mr Kerr said that the recent release by Statistics New Zealand on growth in real gross domestic product for the year ended March 2007 allowed estimates of productivity growth for that year to be made. The official, more sophisticated, Statistics New Zealand productivity figures will not be available until March 2008. The official figure for labour productivity growth for the year to March 2006 was 0.7 percent, one of the lowest on record.

With real GDP growth of only 1.7 percent in the year to March 2007 and positive economy-wide employment growth, it is clear that labour productivity growth in that year was weak. A regression-based projection suggests a decline in measured sector labour productivity of -0.1 percent for the year, an essentially static outcome.

Capital productivity growth and multifactor productivity growth for 2006-07 are also likely to be poor.

"From any perspective, New Zealand's recent productivity trend has been abysmal", Mr Kerr said.

"As the attached chart shows, there was strong trend growth in measured sector labour productivity of 2.7 percent a year on average in 1992-2000, the period following the reforms of the 1980s and early 1990s.

"During the present government's term of office, that trend rate of growth has been only 1.3 percent in 2000-06 and looks likely to fall further when the series is updated. A similar fall is apparent in the rate of growth of multifactor productivity."

Mr Kerr said that these trends were strong evidence that government policies of high spending and taxation, a less flexible labour market, increasing regulation and other policies that have reduced economic freedom were damaging productivity in the business sector and reducing the country's growth outlook. The productivity performance of the public sector may have been even worse.

“While there is still some scope to increase labour utilisation, labour productivity growth is almost the only thing that matters for growth in output per capita and hence living standards in the long run”, Mr Kerr said. “Annual productivity growth rates of 3 percent or more on average are needed for fast economic growth.

“Present trends indicate that New Zealand is falling well behind the productivity performance of the United States and Australia, and there is no prospect that it will regain a place in the top half of the OECD income rankings with present policy settings.

“Despite Australia’s superior performance, a lively debate about productivity is occurring in that country in the run-up to this year’s Australian election. Our productivity trend should be a high profile issue for the government, other political parties and the media in this country too”, Mr Kerr concluded.

10 July 2007

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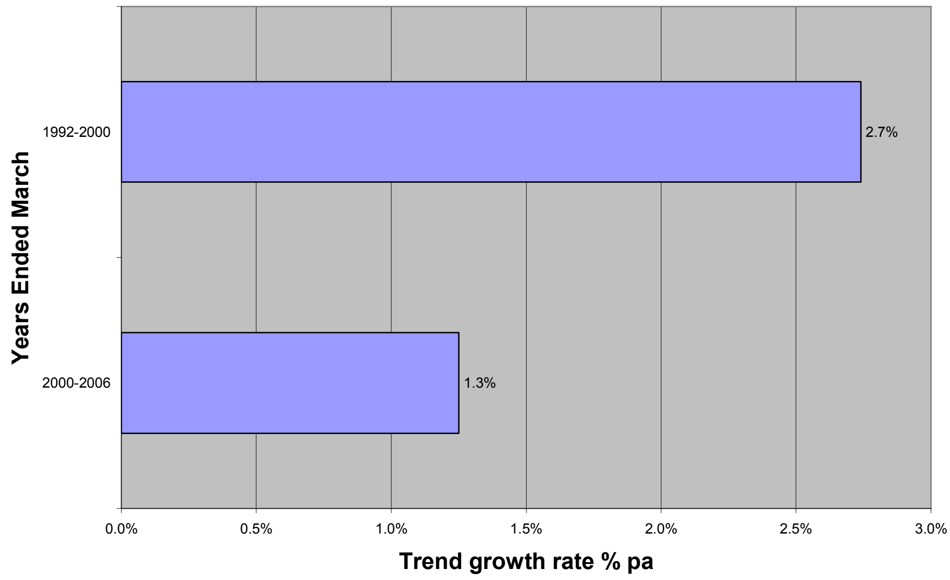
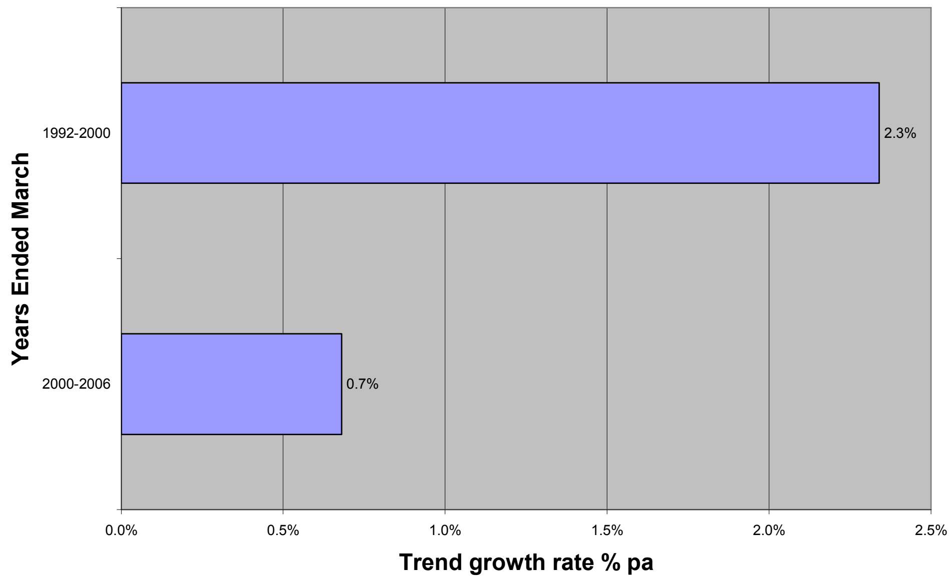

Labour Productivity - Measured Sector
Years Ended March
1992-2000
2000-2006
2.7%
1.3%
0.0%
0.5%
1.0%
1.5%
2.0%
2.5%
3.0%
Trend growth rate % pa


Multi-Factor Productivity - Measured Sector
Years Ended March
1992-2000
2000-2006
2.3%
0.7%
0.0%
0.5%
1.0%
1.5%
2.0%
2.5%
Trend growth rate % pa