OCR: THE SHARPEST TOOL IN THE BOX?

GIVING INTEREST RATES SOME HELP TO CONTROL INFLATION

BusinessNZ

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FOREWORD

The Official Cash Rate (OCR) is often criticised for not packing enough punch against inflationary pressures.

The OCR effectively sets the price (interest rate) of borrowing money and is the Reserve Bank's main tool to keep inflation within the 1-3% target band.

However, the popularity of fixed interest rates has muted the OCR's ability to ease the cycle of rising house prices, rents, the Kiwi dollar, a serious account deficit and exporter unhappiness.

Indeed, a recent ACNielsen survey found changes to OCR rates could well have a minimal effect on households, with 94% of respondents saying a 0.5% lift would make little or no difference to their spending.

Finance Minister Michael Cullen highlighted these shortcomings when he mooted a mortgage levy in February. Although quickly doused with a torrent of opposition, the levy's short exposure was enough to show the Government is searching for new weapons to help the OCR curb inflation.

This booklet reviews recent research on monetary policy and outlines what some of these helpmates could be.

Instead of presenting short-term solutions, the focus is on those for the longer term.

In exploring the pros and cons of each, the intention is not to promote the views of Business NZ, but to contribute to the debate.

Phil O'Reilly
Chief Executive – Business NZ

SECTION ONE
The Reserve Bank Act

The Reserve Bank Act (1989) was introduced to deliver stability in the general level of prices. It requires the Governor of the Reserve Bank to keep average CPI inflation at between 1-3% in the medium term.

The Act also requires transparency from the Reserve Bank and the bank publishes a monetary policy statement at least every six months. Although Parliament's Finance & Expenditure Select Committee reviews the way the Reserve Bank handles monetary policy, the Act grants the bank independence from government intervention.

"The Reserve Bank Act of New Zealand (1989) recognises the limitations of monetary policy in achieving multiple objectives, and specifies that the best possible contribution that monetary policy can make to the economy is achieving price stability.

New Zealand's choice of inflation measure is the headline Consumer Price Inflation. Some central banks look at some core measures of inflation by excluding certain volatile items such as petrol and energy prices. This way, they focus on underlying inflation rather than short-term contributors of inflation volatility. The Policy Targets Agreement directs the Reserve Bank of New Zealand to focus on the headline CPI on average over the medium-term. This medium-term focus allows the Bank to look through any short-term volatility in inflation caused by oil prices, energy prices or any other one-off short-term variation. Therefore, with the medium-term focus, the difference between the headline and a core measure diminishes substantially." [1]

The Reserve Bank is also required to avoid unnecessary volatility in output, interest rates and the exchange rate – recognising this is detrimental to economic welfare and may have adverse impacts on economic growth. [2]

1 Reserve Bank of New Zealand "Inflation Targeting: The New Zealand Experience and Some Lessons". Allan Bollard and Ozer Karagedikli, (January 19, 2006).

2. Clause 4(b) of the Policy Targets Agreement.

SECTION TWO
Recent research on monetary policy

The two most significant pieces of research on monetary policy in New Zealand have been the *'Supplementary Stabilisation Instruments'* report to the Reserve Bank (February 2006), and proceedings from the macroeconomic policy forum of mid-2006, contained in the Reserve Bank publication: *'Testing stabilisation policy limits in a small open economy: Proceedings from a macroeconomic policy forum'* (October 2006).

In November 2005, a team of senior Reserve Bank and Treasury staff was tasked with finding useful tools, directly affecting the housing and residential mortgage credit markets, that could supplement the role of interest rates in managing inflation.

The rationale was that if instruments other than the OCR were available to target the housing sector, they might alleviate some of the pressures on the exchange rate that adversely affect the performance of the traded goods sector.

Their findings are in the *'Supplementary Stabilisation Instruments'* report.

Perhaps not surprisingly, the report concluded there were no simple or ready options that could be easily implemented and provide large payoffs in the near-term.

The Reserve Bank looked at the following six options:

1. A tax on property for resale
2. Ring-fencing (of losses)
3. Improving the responsiveness of housing supply
4. Linking bank capital to cyclical risk
5. A discretionary loan to value ratio limit
6. A discretionary mortgage interest levy

These options, as assessed by the Reserve Bank, are outlined in Appendix One.

Options 3 and 6 were considered to have the most potential, although the February 2007 report to the Reserve Bank and Treasury: *'Mortgage Interest Levy, a Detailed Option,'* showed there would be significant issues associated with the latter.

The other significant report also by the Reserve Bank: *'Testing stabilisation policy limits in a small open economy: Proceedings from a macroeconomic policy forum'*, states:

"The overall conclusion that emerged is that the essential elements of New Zealand's macroeconomic policy framework are still fundamentally sound and remain appropriate. Furthermore, some fluctuations in the current account and some volatility in the exchange rate and other relative prices are to be expected and are an important part of the process of adjustment to changing international and domestic events. Nevertheless, several suggestions to improve the way structural, fiscal and monetary policies interacted and impacted on the economy were raised and debated..."

SECTION THREE

What other policy mechanisms could work alongside interest rates to ease inflationary pressures?

There are a number of other measures that could potentially reduce pressure on interest rates and therefore, the exchange rate pressures on exporters.

Some measures support interest rate changes and would impact households directly. Others limit the need for an interest rate rise, for example, tighter control over government spending and regulation.

Some options are politically and economically unpalatable. Others have potential and are worthy of further investigation. However, as with the mortgage levy proposal, when one digs a little deeper, all have flaws. There is certainly no "silver bullet".

The options include:

- Put a lid on central and local government expenditure
- Improve the quality of regulation
- Adjust interest rates more decisively
- Increase competition in markets
- Improve productivity
- Improve communication with the public and key international markets
- Improve responsiveness of housing supply
- Adopt a common currency
- Intervene in currency exchange markets
- Lower interest rates
- Restrict use of fixed-rate mortgages
- Modify tax rates temporarily
- Introduce a capital gains tax
- Restrict bank credit lending
- Make immigrants pay

Put a lid on central and local government expenditure

Capping the growth rates of central and local government operating expenditure would help control the inflationary pressures generated through additional spending. Annual adjustments could be made to accommodate population growth and general inflation.

Although capping growth rates could impede the Government's ability to fund new infrastructure, provision could be made for Government to seek public support for expenditure beyond the cap if necessary.

Most government spending is on domestic goods and services and increased demand puts pressure on prices and costs. Poor quality expenditure, such as the introduction of interest-free student loans from April last year, further undermines competitiveness. The OECD, for example, has been critical of some aspects of the Working for Families package.

Increasing real government expenditure at a time when the economy is operating at close to full capacity brings further inflationary pressures. Local government rating increases have generally exceeded movements in the Consumer Price Index. Also, many central and local government services are not open to competition and are therefore not subject to normal market pressures or disciplines.

The Government states it has been a prudent fiscal manager – despite a strong increase in Crown expenses and NZSF contributions since 1999/2000 and projections of further substantial increases.

The strongly performing economy has helped by providing large increases in revenue to cover substantial spending increases. Although restraint in withstanding calls to increase spending by even greater amounts has been admirable, there has nevertheless been a large increase in spending – at least some of which is of dubious or unproven value.

The following examples could be considered areas of imprudent government expenditure:

1. **Increased spending on Working for Families ::** This effectively makes three-quarters of working families recipients of social welfare. This redistribution policy increases administration and bureaucracy and, some analysis suggests, creates poverty traps. Tax cuts would provide greater incentives for all families and individuals to work harder and retain earnings for investing or spending as they see fit.

2. **Interest free student loans ::** This effectively provides subsidies for students to spend beyond their means without incentives to retire the debts as quickly as possible when they graduate. Students are encouraged into debt in the knowledge they are not subject to the normal pressures of debt servicing other individuals face.

3. **Expanding local government rates rebates to low-income earners, irrespective of assets held ::** This will reduce incentives on local government to seriously examine current expenditure and determine whether or not it is necessary for the public good.

4. **Increasing superannuation payments ::** Superannuation is not currently targeted at those in greatest need, given that it is not subject to income or assets testing.

Improve the quality of regulation[3]

Most commentators consider the Public Finance Act to have lent support to the Reserve Bank in the sense that government spending and taxation policies have to operate within a relatively sound framework and focus on the medium term, rather than ad hoc pump priming of the economy in election years, which compounds inflationary pressures.

This requirement for tight controls on government spending may provide an incentive to shift more of the fiscal burden on to the private sector through regulation, thereby reducing the need for government to identify such expenditures in official budgetary processes.

This confirms the need for the Government to improve its regulatory processes through the adoption of a Regulatory Responsibility Act (or similar).

3 For a full explanation of Business NZ's views on regulatory policy, refer to the Regulation Perspectives publication, available online at www.businessnz.org.nz.

The risks of not having such an Act to complement government spending are:

1. Government may be encouraged to shift more and more of its fiscal burden on to the private sector through regulation (which is off-budget); and

2. There will be inappropriate regulation, which either raises costs or increases uncertainty for business (thereby impacting on investment and resulting in inflationary pressures).[4]

The following actions by government departments or agencies should be considered when contemplating future regulation:

- **Adopt a Regulatory Responsibility Act ::** Require adherence to a set of principles similar to those required by the Fiscal Responsibility Act, now part of the Public Finance Act, to promote discipline in decision making.

- **Define the problem ::** Require all proposals for regulation to include clear analysis of the problem to be addressed. Analysis should cover the scale and significance of the problem and consider options other than regulation for addressing it.

- **Carry out cost-benefit analysis ::** Require all proposals for regulations to include cost-benefit analysis by an independent agency providing a service similar to that of the Australian Productivity Commission.

- **Travel up the pyramid ::** Consider non-regulatory options first, moving 'up the pyramid' to generic, light-handed options, with more stringent options only if clearly warranted.

- **Keep it generic ::** Give preference to light-handed generic regulation, such as the Commerce Act and Fair Trading Act, instead of industry-specific regulation, unless exceptional circumstances require an industry-specific approach.

- **Regulate only when required ::** Introduce new regulations only when justified by clear cases of significant, not minor, market failure.

- **Self-regulation as a goal, not a pathway ::** Self-regulation should not be introduced as a precursor to future government-imposed regulation. Self-regulation should be allowed to stand on its merits and not viewed by officials or others as a process by which more heavy-handed regulation may be imposed in the future.

- **Review all regulations ::** Use an independent agency to regularly review all regulation to ensure it achieves original objectives and is still required.

- **Sunset clause ::** Include a sunset clause, with an expiry date such as 5 years, in new regulations where appropriate. The point at which the expiry date is reached would be the optimal time to review the regulation.

Adjust interest rates more decisively

There are a couple of lessons the Reserve Bank may learn from previous attempts at tightening monetary policy via interest rates.

First, given that the majority of homeowners are on fixed rate mortgages, attempts to tinker around the margins (i.e. increasing base rates by 0.25%) are unlikely to have any effect. This implies that changes in monetary policy need to be less frequent or all they will do is put added pressure on the exchange rate while having minimal impact on household consumption.

4 For example, credit rating agency Standard and Poors warned electricity and gas lines businesses face a weakening of their credit ratings. It said the split roles of the Electricity Commission and the Commerce Commission, in determining grid upgrades and the financial return that Transpower was entitled to, leave the door open for conflict and delays.

Second, when changes to monetary policy are necessary, the bank should be more decisive and adjust the rate by at least 0.5%.

It could be that monetary policy tightening during 2004 and 2005 was not too little but too late. Slow and gradual rises in the order of 0.25% do not seem to have the required impact on consumers. It is almost death by a thousand cuts – nobody notices it but the long-term consequences are bad, particularly for exporters who face higher exchange rates while households continue to spend like there is no tomorrow.

Increase competition in markets

Areas of the economy such as accident insurance and local government services such as rubbish and water services should be opened up to competition. Central government does not have to be a monopoly service provider to meet social and economic objectives, and local government would be able to reduce the rating burden through savings from contracting out services.

Privatising all the central and local government activities for which public sector ownership is not essential would ensure commercial disciplines are clearly imposed on enterprises, thus minimising the risk of a cost-plus mentality.

Asset sales have a number of benefits, including the reduction of government debt and greater efficiency in general. Also, there are a number of problems with continued government ownership of resources, particularly the tendency for SOEs to be subject to increased political interference over time.

Corporatisation, as an initial step towards privatisation, can instill private sector management principles to help turn a government department around – thereby maximising the revenue obtainable from a future asset sale. However, the logic for its retention over the medium term is not clear.

Improve productivity

Productivity growth is fundamental to ensuring New Zealand's international competitiveness. If resources can be used more efficiently offshore, then they will be. This obviously has an impact on our standard of living. More importantly, in the context of monetary policy settings, strong productivity growth can significantly boost real incomes without imposing added (inflationary) costs on the economy.

The OECD *'Economic Survey of New Zealand' (2005)* was unequivocal about the need to lift productivity:

"The primary challenge is to raise productivity growth further, as this will become the more critical driver of growth in the future. Of course, no government can make productivity growth happen; the best it can do is to identify and remove obstacles to growth and provide an economic environment in which firms and individuals can flourish. Despite the extensive reforms already undertaken, some areas remain where further policy improvements could be made, including in the areas of product market competition, business taxation, infrastructure provision, labour markets, innovation and human capital formation."

It is important to be clear that there is no one way of achieving significant productivity improvements. Moreover, it is not solely the role of government, business or labour organisations to improve New Zealand's productivity record. Some issues are best addressed by business, some by government, and others must be pursued by individual employees (or collectively in cases where this makes sense).

The following market features [5] are essential to improve productivity:

- Competition – productivity grows best in a competitive environment;
- Secure and transparent property rights – without these, incentives to invest are limited;
- Regulatory policy – this should be free from unintended costs and regulatory uncertainties;
- Tax and expenditure policy – expenditure and tax should occur at levels that do not discourage investment;
- Infrastructure – ongoing investment in infrastructure assets that are important for travel, communication and doing business;
- Flexible and responsive labour markets – making it possible for resources to shift quickly to more productive uses as these occur;
- Human capital and managerial capability – since productivity improvement is now largely predicated on actions by knowledge workers and at governance and managerial level;
- Global connectedness through trade and immigration – since productivity improvements ensue from specialisation and international trade maximises the benefits of specialisation on a larger scale; and
- Innovation – this plays a key role in expanding a businesses output beyond the capacity of its existing inputs.

Improve communication with the public and key international markets

There is an argument that if markets are better informed (accepting that they will never be fully informed), domestic and foreign investors are more likely to make what the Reserve Bank would consider to be more "prudent" investment decisions, rather than over-investing in housing, with the potential to lift some of the pressure off interest rates.

There has been talk that some international investors appear naïve in evaluating the risk of investing in New Zealand and therefore tend to over-invest, putting upward pressure on the New Zealand dollar, without recognising that although high real interest rates will provide high returns, exchange rate risks also need to be factored in to such investments.

The independent *Svensson Report* to the Minister of Finance on New Zealand monetary policy (2001) states that effective communication is vital to the efficient operation of monetary policy.

It can therefore be argued that the Reserve Bank could do more in terms of informing offshore investors of the situation in New Zealand. However, this could be a two-edged sword.

Late in 2005, it is understood some Reserve Bank officials went overseas and shared their views on the New Zealand economy with international investors. This had little effect on markets but did prompt debate as to whether it was appropriate for the Reserve Bank to outline what it considered to be the significant risks of investing in New Zealand. On the one hand, the Reserve Bank's action could be seen as trying to minimise long-term risks to New Zealanders but on the other, it could be seen as selling New Zealand short – i.e discouraging investment here.

Although there will always be arguments over what is an optimal amount of information on monetary policy settings, there would appear to be room for greater education of overseas investors, particularly those who invest solely for high real interest rates without any apparent understanding of the associated exchange rate risks. Whether this is the role of the Reserve Bank, the government or private sector advisors is debatable. What is important is that any such investor briefings should be publicly known and ideally, set at regular intervals to allay concerns regarding motivation.

5 For a full description of these issues and their importance in improving productivity and economic growth – refer to "Productivity Perspectives" (Business NZ, December 2005).

Improve responsiveness of housing supply

The *'Supplementary Stabilisation Instruments'* report to the Reserve Bank outlines improvements to the responsiveness of housing supply as a crucial mechanism to reduce inflationary pressures in this sector.

There appears to be a range of issues surrounding housing supply that would warrant further investigation.

These include:

1. Artificially restricting the amount of land available for new housing can result in artificial price increases as households compete for the strictly limited availability of new sub-divisions;

2. Potential time delays in getting resource consents and building permits which could add to overall housing costs;

3. Issues surrounding requirements for building materials and standards which may add unnecessary costs.

All the above issues would need to be considered in-depth to determine whether provision should be made for greater flexibility, provided basic public safety standards are met.

Common currency

Forming a common currency with Australia or the United States has been advocated as a way to overcome some of the problems associated with high real interest rates and exchange rate fluctuations.

However, it's unlikely to be a panacea.

Adopting Australia's currency would facilitate trade and be of major benefit to exporters and Business NZ believes this option should be investigated. A common currency would certainly lower the transaction costs of doing business across the Tasman and would appear to make sense, given that about 25 per cent of New Zealand's trade is with Australia.

Nevertheless, New Zealand also has significant trade relations with many other countries and with much trade based in US dollars; there would potentially be greater savings if New Zealand adopted the US currency.

However, tying New Zealand's fortunes to a new currency could also result in monetary policy driven from Sydney, Melbourne, New York or Washington – and this may not always be appropriate for New Zealand.

Our economy is also fundamentally different from other countries, for example, Australia has a much greater focus on mining resources. Merging the two currencies would mean currency movements and interest rates would be likely to reflect the situation in Australia's main metropolitan centres, rather than what was happening in the wider New Zealand economy. Where economies have divergent business cycles, the costs of currency union would be greater.

It must also be remembered there are many factors other than monetary policy that impact on interest and exchange rates. The degree of openness of an economy, regulatory policies and overall transparency in government spending and decision making all play a part.

Support for currency union is likely to be driven by the assumption New Zealand can somehow attain the success of another country's economy – in terms of growth and real income levels – without fundamental changes to current policy settings. However, it is productivity growth – or increased output for the same or fewer resources – that is the fundamental driver of improved living standards.

A second factor supporting common currency is that it may provide a buffer against currency volatility.

Contrary to popular belief, the New Zealand dollar has not been particularly volatile over the long-run compared to many other countries, although it is likely to have been more so over recent years. Research by the Reserve Bank found that for most of the period between 1988 and 2000, the volatility of the New Zealand dollar against the US dollar was less than that of the Australian dollar, the British pound and the Japanese yen. In comparing the exchange rate appreciation from trough to peak of those same currencies over the same period, the Reserve Bank found the New Zealand dollar compared reasonably favourably.

Despite this, it should be noted that the period analysed by the Reserve Bank does not include the significant general appreciation of the New Zealand dollar relative to the US dollar over the last few years. So it is possible the New Zealand dollar may have been more volatile in more recent times.

Intervene in currency exchange markets

The Government, via the Reserve Bank, could trade in foreign exchange and sell New Zealand dollars in a bid to drive the dollar down. However, it must be noted that New Zealand is a very small player in the world economy and could get taken advantage of by larger, sharper financial institutions overseas.

Government intervention would expose New Zealand taxpayers to considerable risk and if market participants thought the government was going to intervene the expectation could arise that government will come to the rescue every time the dollar is considered artificially high. Businesses would then see no reason to take appropriate action to minimise their currency exposure, such as hedging against adverse currency movements.

This option could also lead to greater Reserve Bank intervention and eventually reduce confidence in the bank and in the country's monetary policy. For this reason it is not recommended.

Lower interest rates

The Reserve Bank could lower the OCR to reduce the country's attractiveness as an investment destination. However, to have any meaningful impact the OCR would need to be lowered substantially – by two or three percentage points.

As interest rates in most other major countries are already very low compared to New Zealand, the margin between New Zealand and the rest of the world would have to drop substantially to have any real effect.

Given the buoyant property sector and growth in real incomes (despite high levels of household debt), a lower OCR is likely to send the already overheated property market into a frenzy as competition for property and other goods and services would increase, diminishing confidence in the Reserve Bank.

Also, as there are a number of other factors influencing the exchange rate, lowering the OCR may not necessarily lead to substantial long-term falls in the value of the New Zealand dollar relative to other currencies.

Under this scenario, the whole credibility of the Reserve Bank as an institution would be brought into question given that its primary purpose is to control inflation. Therefore, Business NZ does not recommend this option.

Restrict use of fixed rate mortgages

The OCR's power to influence economic growth and inflation has diminished somewhat with the availability of low fixed interest rates. Two years ago, about two-thirds of people had mortgages on fixed rates. Now the proportion is about 85%.

One way to minimise this problem, and to ensure households respond to movements in the OCR, would be to restrict the use of fixed rate mortgages – either limiting them to one-year terms or restricting the proportion of a mortgage that can be on a fixed rate.

More draconian measures could see fixed rate mortgages banned completely.[6] While this might have a desirable effect on immediate household behaviour, it poses significant risks to borrowers. Just as many exporters hedge against adverse movements in the exchange rate, households also hedge against adverse interest rate movements as part of good prudent financial management.

Restricting the ability of households to fix their mortgages for a particular period could harm those least able to manage that risk – for example, those on relatively low fixed incomes. This would also be somewhat ironic at a time when the Government and industry groups have actively encouraged businesses to adopt hedging policies in respect to exchange rates and other significant business inputs such as energy. Reducing household options to manage risk in a cost-effective manner seems undesirable.

Such a ban could also act counter to the Government's goal of improving access to the housing market for first-home buyers, and is not supported by Business NZ.

Temporary modification of tax rates

An option to quickly modify household spending and support movements in interest rates would be to temporarily raise or decrease taxes – primarily the Goods and Services Tax (GST). Changes to GST would be felt immediately given that it is largely impossible to evade.

However, the associated risks and administrative costs make doing so undesirable. Some are outlined below:

1. Who would determine whether a rise or decline in GST is justified – the Government, the Reserve Bank or a third party of independent "experts"?
2. How would the tax changes be implemented in a timely fashion?
3. What impacts would a rise have on future consumer inflationary expectations?
4. GST fluctuations would make business planning more difficult.

Business NZ does not support this option.

Introduce a capital gains tax

A capital gains tax could be used to weaken housing inflation by reducing the financial gains to be made through property and thereby reducing the attractiveness of real estate as an investment. This could take some pressure off interest rates, given that housing has been a significant contributor to inflation in recent years.

But although it looks to be an attractive option, a capital gains tax would have fundamental weaknesses.

- Capital gains would probably have to be taxed on 'realised' gains, particularly for those on low fixed incomes. This could encourage some to lock themselves into holding particular assets.
- There could be difficulties determining accurate valuations.

6 Just how effective interest rate rises are in reducing expenditure is somewhat debatable given that a recent ACNielson survey found a staggering 95% of respondents who had floating mortgages said that an increase in the OCR would have little or no effect on their spending habits.

- A capital gains tax would involve the ability to write off capital losses which, on the margin at least, could encourage riskier investments.
- Politics would likely rule out taxing the family home so there would arguably be incentives to over-invest in this area.
- A capital gains tax would need to be all encompassing in order to be effective or it would simply encourage distortions in the market with households changing to non-taxed assets. It may also need to be implied annually based on the real price of rents in order to influence behaviour.

Business NZ does not support this option.

Restricting banks credit lending

The Reserve Bank has overall control of the prudential supervision of New Zealand's banking system. One way to reduce demand for credit would be to require banks to have greater security (deposits) over money lent, potentially restricting the total amount loaned.

While this option might hold some superficial appeal, individuals and companies would probably find ways around such restrictions by sourcing funds from overseas or from financial institutions not affected by the controls. Business NZ does not endorse it because it would be likely to encourage this sort of avoidance and be difficult to introduce.

Make immigrants pay

Immigration, like foreign investment, plays an important part in New Zealand's overall development and is critical to economic expansion. Given the country's size and limited resource base, isolation from global markets is not a realistic option even if we wanted it.

Despite this, net migration can impose significant pressures on the New Zealand economy and on individual sectors in particular. For example, it boosts demand for new housing which ultimately flows through into the entire housing market, fuelling inflation in general.

Net migration is generally a good indicator of economic performance. When the economy is booming, the number of people entering New Zealand typically increases and the number leaving decreases. When the economy falters the opposite occurs. Net migration inflows have increased from 6,000 in October 2006 to around 14,000 today. Note that net migration exceeded 40,000 per annum at its peak in 2002/03 – a significant number given that New Zealand's population sits at just over 4 million.

One option would be to impose a charge on people migrating to New Zealand during periods of strong inflows (assuming these coincided with strong domestic pressures), as a way to smooth the flows or recognise some of the costs added migration places on the economy. To some extent, coming to New Zealand would become a valuable property right, entitling recipients to significant rights and privileges recognised by an appropriate rationing (price) mechanism.

The difficulty with trying to introduce this or other rationing devices such as the old points system is that New Zealand, and many other countries, are desperate to recruit skilled migrants who can make positive contributions to the economy. Changing the rules, even slightly, could deflect would-be migrants to more attractive destinations where rules are stable and well understood.

Given that markets are generally faster at self-correcting than any government intervention, attempts to modify migration flows may well exacerbate the problem rather than cure perceived market failure – in other words, replacing perceived market failure with government failure. Business NZ believes this would not be in the country's long-term economic interests, and therefore does not support this option.

Conclusions

There are a number of options to reduce the pressure on interest rates (and therefore exchange rate pressures on exporters) as the sole tool for influencing monetary policy.

Most entail significant risks and certainly, there are no silver bullets.

Effective policy solutions must ensure that markets are competitive (i.e. by removing monopoly status from the provision of goods and services), must reduce regulatory burdens which place unnecessary costs on businesses and individuals, and must avoid government spending stimulus by maintaining a tight control on government spending and keeping it targeted at clear cases of market failure.

Issues surrounding land availability and housing supply would clearly warrant further investigation.

Greater provision of information from the Reserve Bank to the general public and overseas markets also appears to be crucial in improving investor understanding of monetary policy. Current financial literacy among New Zealanders appears to be sub-standard, as evidenced by what could be considered largely irrational responses to the recent ACNielsen survey on the implications of increases in the OCR for household expenditure.

Crucially, moves to muddy the waters over who is responsible for monetary policy could reduce confidence in New Zealand's political and financial institutions. In this respect, any supplementary tools to support monetary policy should ensure control is retained within the Reserve Bank to maintain international credibility. The current Reserve Bank Act provides for independence from government intervention, ensuring transparency in monetary policy settings.

Recommendations

Recommendations

Business NZ recommends the following as the best options for consideration:

- Improve responsiveness of housing supply
- Improve the quality of regulation
- Put a lid on central and local government expenditure
- Improve the quality of government expenditure
- Increase competition in markets
- Improve productivity
- Adjust interest rates more decisively

APPENDIX ONE
'Supplementary Stabilisation Instruments'

	Option 1. **Tax on property for resale**	**Option 2.** **Ring-fencing**	**Option 3.** **Improve responsiveness of housing supply**
Description	Increased publicity and increased enforcement of current law (making gains on non owner-occupied properties purchased with the intention of resale liable for income tax). Other options: Require reporting of all sales of property held for less than two years, or remove the exemption for owner-occupied property held for less than two years.	Prevent operating losses on investment properties being offset against other income.	Measures to increases the speed at which new land and houses are able to be brought onto the market in response to evidence of rising demand.
Effects on cycle	Limited positive effects are possible (the more so, the more far-reaching the measures).	Likely to be quite limited (little evidence that cycles are more muted in countries that ring-fence).	Favourable, but hard to predict reliably how strong the effects would be. Any impact in dampening house price cycles would be offset, to some extent, by intensified pressure in the construction sector.
Other impacts (efficiency, stability, distribution)	Increased publicity and enforcement of existing law would have low efficiency costs. More far-reaching measures would involve greater administrative, compliance, and avoidance costs. Unlikely to be material adverse distributional impacts.	Immediate impact likely to be greatest on smaller and highly leveraged participants in (and often new entrants to) the investment property market. Ongoing enforcement challenges and costs, and perhaps at the margin a reduction in the supply of rental properties. Represents a departure from the principle of treating similar investment activities similarly.	Should be generally favourable and, by improving affordability, should also have positive distributional impacts.
Implementation (enforcement, timing, legislation)	Heightening awareness of existing rules could be done quickly, although the legislative basis for any increased enforcement would need to be determined. A more extensive reporting framework would require legislation. Long-term effectiveness would be a challenge, with strong incentives to avoid any two year reporting threshold.	Would require new legislation. Longer-term enforcement challenges, especially for more sophisticated and diversified investors.	Significant lags, because many constraints are likely to involve a wide variety of local authority rules. Understanding these and securing changes would take considerable further time and effort.
Initial assessment	Could be merit in encouraging IRD to factor in broader cyclical considerations when allocating audit resources. Impact on cycle likely to be limited. Before taking the other options above any further, additional work would be needed to understand better the role of speculative factors in housing cycles.	Not favored. Little evidence that housing cycles are less marked in those countries that ring-fence than in those that do not.	Work in this area, building on what has already been commissioned, appears likely to be promising in the longer-term.

Report to the Reserve Bank, February 2006, pages 3 and 4.

Option 4. **Linking bank capital to cyclical risk**	Option 5. **Discretionary loan to value ratio limit**	Option 6. **Discretionary mortgage interest levy**
Ensuring that bank capital requirements, under Basel II are better tailored to cyclical risks. Possible earlier modifications to Basel I, to link capital to loan to value ratios.	Comprehensive limit on loan to value ratio, imposed on all lenders and all loans secured by residential property. Able to be triggered at the discretion of the Reserve Bank, in response to periods of particular stress in the housing market.	Levy imposed on all loans, by all lenders, secured by residential property. Able to be triggered in response to periods of particular pressure in the housing market and when the gap between NZ and foreign interest rates is unusually large.
Likely to be quite limited. Main aim of the framework would be to ensure that banks have sufficient capital to cope with downturns rather than to dampen lending cycles.	Could be material, although would depend on correctly calibrating the scheme.	Could be material, by establishing a wedge between domestic mortgage borrowing costs and returns available to depositors.
Limited adverse effects, as any changes would be designed to better align capital requirements with risk.	Poorly targeted and would impinge most directly on lower income and first homebuyers. Could also constrain small and medium enterprise borrowing. Ongoing efficiency costs, heightened because it is a direct control.	Real resources costs devoted to implementing and maintaining the regime. Raises price of residential mortgage credit relative to other forms of credit, irrespective of relative risk considerations. Lowers returns to savers. Any increases in mortgages rates would fall most heavily on lower income borrowers and highly geared new entrants to the housing market.
Basel II regime will not be in force for some time. Modifications to the existing requirements could be implemented quite quickly. If such measures had much effect on bank housing lending, disintermediation would be a concern because the existing powers affect registered banks only.	Would require new legislation. Long-term enforcement would rest with the Reserve Bank and would be a major challenge (especially for an instrument used infrequently). Particular difficulties may arise in avoiding offshore disintermediation.	Would require new legislation (with significant issues around ability to delegate authority to trigger the levy). Longer-term enforcement by IRD would face considerable ongoing challenges.
Shift to Basel II should ensure that over time capital requirements are better tailored to risk. Limited ancillary counter-cyclical benefits are also possible. Weaker case for changes to Basel I, although might have positive signaling benefits.	A direct control instrument and one that is relatively poorly targeted. This, together with the likely ongoing enforcement problems, suggests this instrument should not be developed further.	Better-targeted and with the advantage of being explicitly price-based. Enforcement would be a continuing challenge. Further work would be needed in a number of areas. In any overall assessment other discretionary demand management tools (including tax ones) beyond the scope of this review would desirably be considered.

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