



NEW ZEALAND COUNCIL OF TRADE UNIONS  
*Te Kauae Kaimahi*

**New Zealand Council of Trade Unions  
Te Kauae Kaimahi**

Submission on the

**Inquiry into the future monetary policy  
framework**

to the

**the Finance and Expenditure Committee**

19<sup>th</sup> July 2007

## 1.0 Introduction

- 1.1 The New Zealand Council of Trade Unions - Te Kauae Kaimahi (CTU) is the internationally recognised trade union body in New Zealand. The CTU represents 39 affiliated unions with a membership of over 350,000 workers. The CTU acknowledges Te Tiriti o Waitangi as the founding document of Aotearoa New Zealand and formally acknowledges this through Te Runanga o Nga Kaimahi Maori o Aotearoa (Te Runanga) the Maori arm of Te Kauae Kaimahi (CTU) who represents approximately 60,000 Maori workers.
- 1.2 The CTU was not in favour of the narrow criteria for monetary policy as required by the Reserve Bank Act 1989, and has been a strong critic of the operation of monetary policy. The Act itself restricts the scope of monetary policy and the Policy Targets Agreement (PTA) also has a significant impact on the operation of policy. However, within those constraints, we have on many occasions argued that the application of monetary policy has been misguided and rigid.
- 1.3 The consistent CTU position has been to raise the need for a wider range of factors to be considered and for a longer time frame to apply in inflation targeting. For instance, Peter Harris argued in 1996<sup>1</sup> that monetary policy was “far too insensitive to the needs of the productive sector”. Ten years later, not a lot has changed.
- 1.4 There is a general perception that at the very least the “official cash rate” is a blunt tool that cannot on its own address inflationary pressures, and to the extent it can it does widespread collateral damage to the export sector via exchange rates. New Zealand has just 0.2% of global GDP yet as of December 2006 it has been estimated

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<sup>1</sup> Harris, Peter. *Controlling Inflation: A critique of the Reserve Bank and monetary policy*, New Zealand Council of Trade Unions, September 1996.

the New Zealand dollar was one of the eight most traded currencies in the world<sup>2</sup>.

- 1.5 The current account deficit for the year to March 2007 was \$13.9 billion. But \$11.8 billion (85%) of this deficit is from the income investment part of the current account. This decomposes into profits accruing to foreign investors and overseas funding of bank lending to flow through into household mortgages. Although the exchange rate naturally is impacted by the relative strength or weakness of other currencies, there is an additional margin that is due to currency speculation based on high interest rates.
- 1.6 In addition there is a major concern that property speculators are encouraging house price inflation and the resulting interest rate increases are affecting employment security and the survival of firms in the manufacturing export sector. In fact, the intensity of concern in the manufacturing sector is white hot.
- 1.7 Even if the recent spate of hikes in the OCR do manage to cool the housing market (or the bubble bursts), it is not desirable to see a repeat performance of what we have witnessed in the last 5 years with house prices far outstripping wage and salary increases and making it harder and harder for first home buyers.

## **2.0 Executive Summary**

- 2.1 The CTU has suggested a number of measures that can improve the operation of monetary policy. In particular, we emphasise the need for a measure or suite of measures to address house price inflation. The key submissions are:

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<sup>2</sup> See Investopedia.com.

- (a) Amend the Reserve Bank Act and reword the PTA by specific reference to the impact of a high exchange rate on export performance and employment.
- (b) Give Monetary Policy decisions to the Board of RBNZ
- (c) Enforce current tax rules on investment housing
- (d) Introduce a more comprehensive capital gains tax by reviewing current wording in the Income Tax Act
- (e) Introduce variable stamp duties
- (f) Remove ability to offset expenses in rental properties
- (g) Apply a variable mortgage levy to apply to investment housing and mortgages on houses above median price
- (h) Address supply side initiatives in respect of housing. This includes shared equity, increasing state housing stock, addressing zoning issues, more high density development, acquisition of land banked property
- (i) Consider a range of other housing initiatives such as developer levies, higher levels of trade training in construction, higher levels of restriction on foreign purchasers of property in New Zealand, targeted housing assistance, improved accommodation supplement policies, subsidised home lending, and enhancements to the KiwiSaver benefits for first home buyers.
- (j) Consider a transactions tax
- (k) Implement greater controls on bank lending practices

### **3.0 The Causes of Inflationary Pressures**

- 3.1 Unions and workers recognise the damage that can be caused by high inflation. The purchasing power of wages is easily eroded by rapidly rising consumer prices. Our criticism of the application of monetary policy due to the adverse effects on employment, output, and the exchange rate does not imply that we disagree with price stability. The issue is more that at low levels of inflation the costs of extracting the last bit of inflation out of the economy can outweigh the benefits.<sup>3</sup> Also, the rigid application of a target over too tight a timeframe can damage employment prospects for workers.
- 3.2 The CTU is concerned that a sense of perspective is however being lost in relation to inflation. During periods when inflation has been below 3%, we have nevertheless witnessed some economists warning of hyperinflation. The reality is that high inflation is a major issue in relation to house prices and we occasionally have a short term impact from rapidly rising oil prices. But overall, inflation in New Zealand has remained at modest levels.
- 3.3 This means that the commentary we hear on inflation and interest rates tends to overshadow other key economic issues such as the current account deficit, low productivity, embedded low wages, and wide gaps in income distribution. In fact there is now a huge imbalance in economic commentary. For instance, while a 1% quarterly increase in CPI is a valid issue for comment, the fact that annual inflation is 2% is almost completely ignored despite the fact that it is half of the level in July 2006. Fuel costs have had a variable impact on the annual and quarterly CPI statistics. Petrol prices were down by 8.4% over the year but up 8.0% in the quarter and the 1.0% quarterly increase in CPI would have been 0.6% if it were not for petrol price increases. This means that inflation factoring out the volatility of petrol prices is running

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<sup>3</sup> See Akerlof, G., Dickens, W., and Perry G. "The macroeconomics of low inflation", Brookings Papers

at more like 2.4%. A lot of the economic commentary asserts that New Zealand has a major problem with general inflation when the facts suggest we face a problem with house price inflation.

- 3.4 The statistics in this respect are alarming. The 2007 Demographia Survey found that the median house price in Australia and New Zealand was 6.6 times the median household income, compared with 5.7 times in Ireland, 5.5 in the United Kingdom, 3.7 in the United States and 3.2 in Canada. Within New Zealand, the median house price in Auckland was 6.9 times median household income, Christchurch 6.0 times and Wellington 5.4. The home ownership rate has been falling. It was 73.8% in 1991, 67.8% in 2001, and 66.9% in 2006.
- 3.5 In the three years from 2004 to 2006, house prices increased by 38.5% while at the same time wages went up by 8.7%, meaning that house prices are outstripping wages by 4 to 1. According to one estimate<sup>4</sup>, median weekly take-home pay rose \$28.79 in the past twelve months, while weekly mortgage payments for a median-priced house has risen a \$107.12.
- 3.6 In the two years to February 2007, there was a 38% drop in the number of intending first home buyers with income of less than \$45,000. While the amount of borrowing may be way up – the actual number of households making mortgage payments has fallen although the average household size has barely changed in a decade - it was 2.7 people in 2006 and 2.8 people in 1996. In 2006 there were 405,267 households making mortgage payments, down from 448,374 in 1996. But there were 388,272 households making rental payments in 2006 compared with 290,124 in 1996. Massey University's Home

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<sup>4</sup> on Economic Activity, 1, 1996.  
[www.interest.co.nz](http://www.interest.co.nz).

Affordability Report<sup>5</sup>, released in February 2007 also confirms that house prices have significantly outstripped wages.

- 3.7 According to one source<sup>6</sup>, as at June 2007, it takes at least 81.2% of the average take-home pay to afford a standard mortgage payment of a median-priced house. In June 2002, it took a much lower 45.3% of take-home pay to make a mortgage payment on a median house and in May 2006 the figure was 68.2%.
- 3.8 Rents are also rising faster than wages. In 1993 rents were 26% of the average wage. In 2006 rents had risen to 32% of the average wage nationally. In Auckland rents rose by 37%<sup>7</sup>. Between 1993 and the first quarter of 2007 rents rose by 86% while wages only rose by 50%.
- 3.9 A key issue is land prices. In 2005, The Centre for Housing Research, Aotearoa New Zealand (CHRANZ) released research that investigated changes in regional housing markets in New Zealand between 1981 and 2004. They found that land prices increased at a significantly faster rate than housing prices, with a wide regional variation. Between 1981 and 2004, the real price of vacant residential sections rose by 286% on average across New Zealand and in Auckland City by 700%.
- 3.10 The CTU is extremely concerned by the levels of debt New Zealanders are having to manage, and the wide ranging ramifications of this. By mid-2006 the outstanding debt of households had increased around 5 times in dollar terms since 1990 and household debt as a proportion of annual disposable income has gone from around 74% in 1992 to 100% in 2000 to 160% by 2006. Servicing costs for debt as a proportion of income rose from 7.8% in the year to March 2001 to 13.1% in the March 2006 year.

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<sup>5</sup> Hargreaves, B. and Histen, S. (2007), Home Affordability Report, Quarterly Survey, February 2007, Volume 17, Number 1, Department of Finance, Banking and Property, Massey University.

<sup>6</sup> [www.interest.co.nz](http://www.interest.co.nz)

<sup>7</sup> Professor Bob Hargreaves of Massey University quoted in NZ Herald (25/4/07), "House prices leave

- 3.11 The valuation of overall housing stock relative to overall household disposable income surged from 3.7 in the March 2001 year to 6.7 in the March 2006 year. Borrowing from New Zealand households has doubled since 2001 whereas gross disposable household income rose by 23% in that period. Around 90% of household debt is accounted for by residential mortgages, and total household debt grew by 14% in the year to June 2006.
- 3.12 It has been estimated that housing equity withdrawal in 2006 amounted to 5.3% of disposable income for households. This implies that some people at least are using the rising value of their housing equity to fund current consumption. This is another indication of the problem that wages are not rising adequately. The CTU would much prefer to see consumption funded by rising real wages due to the combined effect of higher labour productivity and better distribution of income through collective bargaining than see consumption funded in part through equity withdrawal from an overheated housing market.
- 3.13 In September 1990, total non-resident funding of the New Zealand banking system was \$10.3 billion. By September 2004 it was \$43.4 billion and by September 2006, this figure had reached \$88.8 billion, which represented 31.8% of total banking system funding. In that two year period, bank lending for housing increased by \$32.4 billion<sup>8</sup>.
- 3.14 In addition there is added pressure from overseas investment in residential housing. The June 2007 Monetary Policy Statement commented that increasing overseas ownership of residential property is also driving up prices. The RBNZ<sup>9</sup> said that:

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rents behind”

<sup>8</sup> David Tripe, *Housing Boom: Banks' lending surge fuels distortions*, The Independent Financial Review - 24 Jan 2007, p 8.

<sup>9</sup> RBNZ. “Monetary Policy Statement: June 2007”, p. 14.

“Overall, it seems that, in certain regions and for particular property types, overseas demand is likely to have been quite influential.”

- 3.15 The statistics discussed above reveal the extent to which the key issue is house price inflation rather than general inflation. The additional problem is that monetary policy has been attempting to shoulder the entire burden of addressing this inflation when it should be more focused on general inflation.
- 3.16 This is why some of the key measures which the CTU is proposing are focused on the housing market.
- 3.17 The need for additional tools to control housing speculation is not a new issue. For instance, Don Brash in an April 1998 RBNZ publication<sup>10</sup> noted that:
- “...the absence of a capital gains tax, and the over-taxation of many types of productive investment (largely because of depreciation allowances based on historical cost), together mean that inflation creates a strong bias in favour of real estate investment and against investment in plant and equipment”.
- 3.18 Depreciation rates have been partially addressed since that comment was made, but the absence of a robust capital gains tax has not.
- 3.19 In terms of other inflationary pressures, there has also been a clear trend for non-tradables inflation to outpace inflation in the tradables sector. This gives rise to a concern that there may need to be other controls on pricing by some utilities and others in the non-tradables sector. It also tends to reflect inflation in the construction sector which is a result of high demand for housing as well as non-residential construction.
- 3.20 An additional source of inflation is the extent to which consumers are encouraged to take on high levels of debt. In 2005, Finsec<sup>11</sup> noted that

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<sup>10</sup> RBNZ, *The Impact of Monetary Policy on the Economy*, April 1998.

in Westpac, staff “who used to make the bank an average of \$146,000 operating income per year, now each need to make the bank \$340,000 operating income per year. Staff have been forced to become more than twice as profitable for their bank. The bank forces its profits up by setting sales targets for staff to meet. Those targets grow each year to match the bank’s desire for larger profits, but the number of people employed to meet those targets falls”.

3.21 Finsec believes that one of the pressures on interest rates is banks, such as BNZ and Westpac, using sales targets to compel their staff to sell higher and higher levels of debt to customers. Those targets reward bank employees who sell mortgages, credit cards and other forms of lending at much higher levels than the rewards for savings products (see above figures). The banks consistently raise the targets on their employees as they seek to take market share off each other.

3.22 This means that a customer who walks into such a bank will be meeting staff who will be under pressure from their employer to encourage them into debt. The economic effect of such large growth in consumer debt can be inflationary pressure. Finsec notes that stress is widespread among workers in the bank because of serious understaffing and unreasonable demands placed upon those staff in the form of sales targets. This is creating an ethical dilemma for staff who are pressured to encourage customers into debt or to buy more banking products so that staff can reach their targets.

3.23 It should also be noted that in the New Zealand banking sector around \$2.6 billion profits each year accrues overseas.

3.24 Alan Bollard<sup>12</sup> has warned that:

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<sup>11</sup> <http://www.finsec.org.nz/submissions/targets.aspx>

<sup>12</sup> An address by Dr Alan Bollard, Governor of the Reserve Bank, Speech notes for an address to the Employers and Manufacturers Association (Northern) AGM, 2 November 2005

“banks need to focus on their long-term interests, not just their one-year profit growth or market share target. In New Zealand, the banking sector is also responsible for the bulk of credit allocation. This task is an important determinant of New Zealand's long-term economic growth and hence banks' future profits, and must be considered carefully. The larger banks' shareholder interests, which are intrinsically linked to the health of the New Zealand economy, will not be achieved if they promote loans to people who cannot afford them”.

- 3.25 We note also the comments of some that Government spending is a source of inflation. Certainly some spending, such as Working for Families, is likely to add to consumption spending as it is aimed at families which are to a large extent struggling to make ends meet. To some extent, this spending will replace consumption based on more debt. But with persistence evidence of income disparity and the extent of child poverty it is vital for Government to invest in families.
- 3.26 Core government spending as a proportion of GDP is at similar levels to 1999 of around 33%. The Government has also been running strong surpluses, pre-funding an element of future requirements for NZ Superannuation, shifting spending to some extent into education and infrastructure, and is also providing tax incentives for retirement savings, research and development as well as lowering company tax and assisting with export market development.
- 3.27 There are huge pressures that drive government spending. For instance, health spending accounted in 1993/94 for around 15.5% of government expenditure whereas today the figures is closer to 21%. The increases in expenditure are clearly justified, the quality of spending is always an issue, but it is not credible to criticise government spending one day and the next day call for more spending in the big ticket areas. And business leaders that criticise government spending also need to recognise that when they call for bold action on roading, or bigger tax cuts for business<sup>13</sup>, there are potential effects on inflation from these measures also.

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<sup>13</sup> It is accepted that corporate tax is a withholding tax but depending on how firms use the tax savings, there can be effects on inflation.

3.28 The CTU view is that there is always a case for examining the quality of government spending, but we do not believe that increased government spending is having a major impact on inflation. In addition, to the extent such government spending is having an effect on inflation, the spending is needed to address vital economic, social and environmental issues and therefore reductions in such expenditure would have harmful consequences.

#### **4.0 The Effectiveness of Current Monetary Policy in Controlling Inflation**

4.1 The CTU is concerned about the operation of monetary policy. For example, in Australia, the current rate of inflation is 2.4% and their cash rate is 6.25%. John Edwards of HSBC noted recently<sup>14</sup> that the “RBNZ style is quite different from its Australian cousin.”

4.2 As if to emphasise the degree of estimation involved in output gap models, John Edwards goes on to say that the operating procedure used by the RBNZ “requires the central bank to estimate the output growth over the next year or eighteen months, to estimate the relationship between expected output growth and the estimated supply capacity of the economy, and then to estimate the impact on price inflation of the estimated gap between estimated output and estimated capacity”.

4.3 He notes that in contrast the RBA gives greater weight to the judgment and experience of its officials than the output of models. This means that the RBA by putting more emphasis on an analysis of current core inflation is better placed to interpret changing factors – such as declining core inflation despite rising employment and historically low unemployment.

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<sup>14</sup> HSBC. “Australia and New Zealand Weekly”, 9 July, 2007.

4.4 And Steve Burrell in the Sydney Morning Herald<sup>15</sup> has noted:

“The stylistic difference between the Australian and New Zealand approaches is most evident when, as is the case now, you have both strengthening demand and moderating inflation. RBA governor Glenn Stevens has taken a more flexible stance, taking into account a wider range of factors and giving more weight to actual inflation outcomes than his counterpart, Alan Bollard. The New Zealand approach not only means higher rates for new home borrowers and business. Higher rates also drive up a country's currency, making it tougher for exporters and companies competing with imports”.

4.5 The RBNZ<sup>16</sup> of course say that “a calibrated forecasting and policy system, incorporating both forward- and backward-looking behaviour, has successfully supported policy-making over the past nine years”.

4.6 However, we are now in the situation where the extent to which a lower exchange rate can occur (given that the impact of monetary policy is at the margin given the influence of international factors affecting exchange rates) is predicated on the economy slowing to a considerable extent, loss of jobs, a major drop in manufactured exports, with the result that overseas confidence in both high economic returns and higher interest rates evaporates.

4.7 In this scenario, a credible alternative would be to actually drop interest rates so that currency speculators are not presented with a one way bet and the exchange rate falls. This is more likely to occur if the RBNZ had confidence that there are other instruments that can address inflation in the housing market.

4.8 There is another concern that some economic commentators and forecasters are attempting to unduly influence OCR decisions. They

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<sup>15</sup> 21 June 2007, *What a difference a ditch makes*.

<sup>16</sup> Spencer, Grant and Ozer Karagedikli. “Modelling for monetary policy: the New Zealand experience”. Reserve Bank Bulletin, Vol 69, No. 2 page 24.

argue strongly for an increase in the OCR, and then they observe that markets are “pricing in” such a decision. And then they suggest that the OCR should increase because it was already priced in. For instance, on Monday 16<sup>th</sup> July, Cameron Bagrie from ANZ was quoted as saying “if the market is pricing in the chance of an interest rate increase at 65 percent, it might encourage Governor Alan Bollard to deliver it”.

## **5.0 The Interaction of Monetary Policy with other elements of the Economic Policy Framework, including Fiscal Policy**

- 5.1 It is difficult for there to be precise co-ordination between monetary policy and fiscal policy given the independence of the Reserve Bank. In general, the fiscal stance should be countercyclical in addition to the operation of automatic stabilisers.
- 5.2 Clearly a Government has to consider a range of objectives and has a number of “policy targets”, rather than one.
- 5.3 For instance the National Party during the last election promised \$3.3 billion worth of tax cuts, mainly aimed at those on higher incomes. This of course would have been disastrous for monetary policy as it would have been highly inflationary and inevitably would have led to much more significant and earlier increases in the official cash rate than what we have seen in 2006 and 2007. What is important therefore, whether the debate is about tax cuts or government spending, is to ensure that the monetary policy consequences of such policies are analysed in the context of broader economic and social considerations, rather than elevate inflation considerations above all others – such as income adequacy, economic development, export success and so on.
- 5.4 The CTU obviously supports co-ordination between the operation of monetary policy and fiscal policy. But if we as a country persist with an

independent Reserve Bank using only one indicator and one lever, then there are very real limits to such co-ordination. And a Government clearly has a large number of important objectives to consider, even though stable prices will always be one those.

## **6.0 The Economy's Capacity for Non-inflationary Growth and how it can be Improved**

- 6.1 One of the major concerns about monetary policy is its impact on growth. This is not helped by some very conservative assumptions about non-inflationary growth. For instance, in February 2000, Westpac described the level of 6.3% unemployment as "worryingly low".<sup>17</sup> Since then it has fallen and now appears to be anchored below 4%. Yet inflation has remained at relatively low levels and it does not appear that low unemployment is a major factor. Of course, some argue that confidence in the housing market is underpinned by low unemployment. But clearly we have seen that unemployment can go a lot lower than the worry point for Westpac of 6.3% without adding to inflationary pressures.
- 6.2 The CTU supports economic transformation to a high wage, high skill, economy based on an increasing value margin in goods and services. This requires an investment approach. It requires collective investments in infrastructure and education to create a sound basis for high productivity and non-inflationary growth.
- 6.3 While this is a medium and long-term approach, it cannot lead to continuous improvement if growth is choked off whenever it creates pressures in the economy.

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<sup>17</sup> Westpac Trust Economic Overview Vol. 8, February 2000, p.1.

6.4 In addition, the CTU believes that additional tools to address house price inflation will make it more likely that there is a period of non-inflationary growth as this has been a major source of inflation.

## **7.0 The Role of Productivity in the Economy, how it can be Improved, and Constraints on Productivity**

7.1 The CTU recognises that many cyclical and structural problems in the economy can be addressed in the context of rising productivity. As Paul Krugman said in 1992<sup>18</sup>:

"Productivity isn't everything, but in the long run, it is almost everything. A country's ability to raise its standard of living over time depends almost entirely on its ability to raise its output per worker".

7.2 Lifting levels of productivity is about continuous improvement. And it is about many factors coming together. For instance, it requires modern infrastructure, high levels of investment in skills, and rising levels of capital per worker. But the CTU also believes that we cannot have high productivity without enhanced performance at a workplace level.

7.3 The CTU has had an active involvement in productivity issues for several years. In 2002, we set out in a paper to a Growth and Innovation Advisory Board/Government workshop a CTU perspective on productivity. We have published papers on "Unions, Innovation and Sustainable Development" and also "Your Job, Your Industry, Your Future" to illustrate the vital role of workers in innovation and industry development. In 2003 and 2004, we met regularly with Business NZ and the Treasury to discuss productivity issues both at the workplace level and in terms of infrastructural requirements for a lift in both the level and rate of growth of multifactor productivity (MFP) and labour productivity. And we

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<sup>18</sup> Krugman, Paul. *Age of Diminished Expectations: US Economic Policy in the 1980s*. MIT Press, Cambridge, page 9.

participated in the Workplace Productivity Working Group which released a report in late 2004.

- 7.4 Since that time we have been more focused at an operational level, in the Workplace Productivity Reference Group and now, with the support of the Labour Department, the CTU has a new project called "Workplace Productivity Education Project" (WPEP). In addition, the CTU has promoted an innovative project on Māori economic development in the context of Hui Taumata and this includes a strong component on workplace productivity.
- 7.5 The CTU is acutely aware that union involvement in productivity can be controversial for a number of reasons. The evidence of real benefits for workers can be hard to detect, union engagement on productivity can affect the way unions operate, worker experiences of productivity initiatives are often negative, and employers are sometimes ambivalent about union involvement, and so on. Disturbingly, it is hard to detect a relationship based on New Zealand data between lifts in labour productivity, and an improvement in real wages. But the CTU also knows that if we are to lay firm foundations for the high wage, high skill economy that we have advocated for many, many years, then continuous improvements in labour productivity will play a vital part.
- 7.6 We also believe that we are in catch-up mode. Research on the effects of the Employment Contracts Act on productivity also shows that a lot of damage was done to not only wages but the ability to lift productivity on a continuous basis. According to a NZ Treasury paper<sup>19</sup> wage levels fell from roughly comparable to Australia in the 1980s to 60% of their level by 2002 and that "with labour relatively cheaper in relation to capital than in Australia, it appears that New

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<sup>19</sup> Melleny Black, Melody Guy and Nathan McLellan. "Productivity in New Zealand 1988 to 2002 New Zealand". NZ Treasury Working Paper 03/06 June 2003.

Zealand firms have opted for a lower level of capital intensity". In fact between 1992 and 1996, the relative price of labour to capital fell by 22%. This was not the way to increase productivity.

- 7.7 Low wages have become embedded. Over the 10 years between 1993 and 2003 the average annual change in real compensation per employee was 0.7%, compared to the OCED average of 1.1% and the Australian average of 1.3%<sup>20</sup>. Between 1980 and 2001, wages fell 6.5% in real terms, at the same time workers in comparable countries saw significant increases in real wages. Real wages in Australia rose 28.8% while Finnish workers saw a 68.2% increase.
- 7.8 There are distributional issues also. A study by the Reserve Bank showed corporate profits rose 11% between 2000 and 2004<sup>21</sup>. And a recent survey<sup>22</sup> showed that the chief executives of New Zealand's 56 largest companies got an average pay rise of 8% last year, with an average pay packet of over \$1 million.
- 7.9 A recent Treasury and Ministry of Economic Development Report on *Economic Development Indicators 2005* also showed that capital per worker in New Zealand had been rising at a faster rate than Australia from 1988 to 1993 but since then it has slipped significantly behind.
- 7.10 In essence this means that New Zealand has low capital per worker, but high labour market participation. NZ is 4<sup>th</sup> highest in the OECD in terms of hours worked per person. There is not much that can be done to lift GDP by simply adding to hours worked. So increasing the value of output is more likely to come from innovation and

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<sup>20</sup> OCED, "Employment Outlook" 2006

<sup>21</sup> Khoon Goh, "Developments in New Zealand Corporate Sector", Reserve Bank Bulletin, Vol 68 – No. 2, 2005.

<sup>22</sup> NZ Herald (7/4/07), "Price of success – what our chief executives earn".

working smarter, rather than from more people in the labour force and more hours per person.

7.11 Some of the research looking at union effects on productivity point to a positive effect on productivity from both employee involvement and unionism, especially when combined with technology. The “low road” of cost minimisation, low wages, low investment, casual labour might produce a very short-term advantage for some employers but it cannot underpin sustainable productivity improvements and results in a legacy of low investment in capital, and negative workplace relationships. By contrast, higher unionisation can lead to higher wages, more investment in capital and higher productivity. And higher levels of unionisation combined with high employee involvement can lead to higher rates of productivity growth than in situations of non-unionisation and high involvement. However, it is the nature of union involvement rather than the presence of a union that is important in respect of productivity.

7.12 We have therefore welcomed the growing opportunities to work with Business New Zealand and other employer groups and organisations, in both the private and public sector on a range of initiatives to raise awareness about productivity, promote the use of tools that can address productivity issues including consideration of seven identified drivers across management capability, workplace culture, work organisation, skills and education, innovation and technology, networks, and measurement.

7.13 But this process has to be seen as beneficial by workers. If we are to promote engagement on productivity, this has to be based on the real benefits to members who will often see the point of arguing for a decent wage rise this year, but be more sceptical about a process that, if the distributional mechanisms existed, could lift real wages by perhaps 20% over a 5 year period.

- 7.14 Workers will also be very suspicious of a continued internationalisation of production with global supply chains. In a small open economy, almost entirely tariff free and a long way from markets, the continuous announcements of relocation to various Asian countries and especially China, is creating huge concerns.
- 7.15 Adding to these pressures is the operation of monetary policy. High interest rates add to the cost of capital and therefore encourages employers to rely on low cost labour. It magnifies the problems we already have with low capital per worker.
- 7.16 In addition it worsens the exchange rate making it harder for NZ firms to export. In this sense, the operation of monetary policy is undermining productivity improvements.
- 7.17 This is not the place to go into a high level of detail on additional steps required to increase productivity.
- 7.18 The CTU has argued consistently for an investment strategy – in roads, ports, rail, in skills and education, in regional and industry development, and in improved workplace practices.
- 7.19 What we are doing well in New Zealand is building a greater sense of trust and shared purpose along the high wage, high skill pathway. In particular, despite persistent differences on a narrow range of industrial relations issues, and some disagreement on the extent of Government involvement, there is general support by the business community for an investment approach.
- 7.20 However, the CTU believes that now is the time for improvements in the scale, integration, level of commitment and extent of participation in respect to workplace productivity initiatives so that we can pick up the pace of economic transformation, and also promote better means of diffusion of best practice.

- 7.21 Our concern is that higher levels of investment in infrastructure, research and development, and skills, will get sub-optimal results if the drivers of workplace productivity at an industry, organisation and workplace level are not recognised.
- 7.22 So we want to see the effort being put into productivity issues scaled up.
- 7.23 This is made so much harder if monetary policy operates in such a way as to reinforce a low wage, low capital per worker and therefore low productivity economy. In addition, there is a very real risk of despondency in many parts of the export sector due to high exchange and interest rates, and this will militate against investment.

## **8.0 Comment on Treasury and RBNZ Report on Supplementary Stabilisation Instruments**

- 8.1 The Supplementary Stabilisation Instruments Report in February 2006 discussed a number of options: tax on property purchased for resale; ring-fencing losses on investment properties; easing regulatory constraints to improve housing supply; linking bank capital requirement more closely to risk; discretionary limit on loan to value ratio, and; mortgage interest levy.
- 8.2 The report also notes some other options including stamp duties; land tax; housing income tax on the basis of implicit rental income; limit on term of mortgage finance; a ban on pre-selling houses or apartments; housing credit auction; a required liquidity ratio; quantitative restrictions on lending secured against residential property; a requirement for banks to undertake dynamic provisioning for loan losses, and; guidelines on bank housing lending.

- 8.3 The CTU has supported some of these measures including a form of capital gains tax, ring fencing, mortgage levies in some circumstances, and stamp duties.
- 8.4 One of the difficulties with any of these measures is that any attempt to discourage investment housing can also make it harder for those on lower incomes to purchase a house and could also impact in other ways on those already at a disadvantage in the housing market. For instance, ring fencing losses on investment properties is a sensible proposal but could in the short run lead to higher rents as landlords lose their tax advantage and countenance less capital gain.
- 8.5 What is important in any consideration of alternative measures is that we already know something about the counterfactual. We know that it is difficult with current instruments including the OCR to cool house price inflation without doing serious damage to the export sector. So it is not that alternative measures will not carry some risk and even some perverse consequences. But the magnitude of that risk or the perverse effects needs to be considered alongside the existing risks of continued reliance on the OCR.

## **9.0 Additional Measures that could Enhance Monetary Policy**

- 9.1 The CTU wishes to suggest a number of additional measures that could enhance monetary policy. These are discussed in the remaining sections of this submission.

## **10.0 Amend the Reserve Bank Act and reword the PTA**

- 10.1 The wording in the PTA was changed in 1996 to widen the band to 0-3%, and add to the wording “so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy”. In 1999 the words “and shall seek to avoid unnecessary instability in

output, interest rates, and the exchange rate” were added. But it is hard to detect a real change in the operation of monetary policy as a consequence of the changed wording.

- 10.2 The Reserve Bank of Australia has to consider “full employment and the economic prosperity and welfare of the people of Australia”. The US Federal Reserve Board has “price stability, maximum employment and moderate long-term interest rates” as objectives. And the Bank of England also has to “support the Government's economic objectives including those for growth and employment”.<sup>23</sup>
- 10.3 Prior to the Reserve Bank Act of 1989, the Act from 1964 defined the role of the Bank as “the maintenance of and promotion of economic and social welfare in New Zealand in having regard to the desirability of promoting the highest level of production and trade and full employment, and of maintaining a stable internal price level”<sup>24</sup>. If that criterion was genuinely applied today, it is likely that interest rates and the New Zealand dollar value would be at lower levels.
- 10.4 The CTU would like to see the PTA wording strengthened further by specific reference to the impact of a high exchange rate on export performance and employment. Our preference is for such a statement to be embedded in the Act, rather than the PTA.
- 10.5 We note that Section 12 of the Reserve Bank Act permits the Bank to be directed by an Order in Council to formulate and implement monetary policy for any economic objective, other than the economic objective specified in section 8 of the Act. While this is a useful measure to have as a last resort, it is no substitute for a change in the PTA wording and the wording in the Act.

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<sup>23</sup> Brian Gaynor. NZ Herald (16/06/07). “What goes up must come down.”

<sup>24</sup> Kelsey, Jane (1993), “Rolling back the State”, p. 20

10.6 In the 1980s the major issue in monetary policy was seen to be unacceptably high inflation. Today, the key issue is unacceptably high NZ dollar. In both cases, there are domestic and international factors. It now makes sense to reword the Act. This should not be seen as a signal that inflation no longer matters. It should be a signal that it matters in the context of a broader set of objectives.

## **11.0 Give Monetary Policy decisions to the Board of RBNZ**

11.1 Current policy decision-making process does not allow adequate breadth of input. This is significantly different from the situation in Australia, USA, and the United Kingdom.

11.2 In 1996, former Governor of the Reserve bank of Australia, Bernie Fraser<sup>25</sup>, commented on the role of the Board of the Bank as:

“an important part of the present framework: it helps to keep the Bank team honest; it brings a real world dimension to policy discussions, consistent with the charter’s emphasis on employment as well as inflation; and it adds to the authority of the eventual decisions”.

He described Board members as:

“competent decent people committed to ensuring that the Bank did all it could to promote, not sectional interests, but, in the words of the Act, the economic prosperity and welfare of the people of Australia”.

11.3 A former official of the Reserve Bank, David Mayes<sup>26</sup>, has also noted that:

“other countries have been rather more concerned to have a structure of responsibility for monetary policy that is clearly both technically competent and representative of a wide range of views. In that way both the independence from party politics and the general acceptance to society - legitimacy - of the decisions is heightened. New Zealand is largely alone in placing all the responsibility personally on the governor”.

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<sup>25</sup> Fraser, B. (1996), “Reserve Bank Independence”, Reserve Bank Bulletin, September.

<sup>26</sup> Mayes, D. (1999), “New Zealand not alone in quest for stable prices”, NZ Herald, 13 January.

- 11.4 There could be a significant improvement in governance if there was a similar structure in New Zealand that allowed for a Board or Committee with some external representation which, along with the Governor, was involved in the policy decision-making process. This is somewhat similar to the situation in other countries such as United Kingdom (Monetary Policy Committee), Australia (Reserve Bank Board) and USA (Federal Open Market Committee).
- 11.5 We note also that Professor Svenssen in his review of monetary policy released in 2001 recommended the establishment of a formal Monetary Policy Committee of the Reserve Bank, responsible for monetary policy. This Committee was to be of five people including the Governor as chair (with the casting vote), the two Deputy Governors, and two other senior Bank officials.

## **12.0 Specific measures to address house price inflation**

- 12.1 **Enforce current tax rules** - Housing markets have been described as ‘powerful engines of inequality’ which take income from the renters, and give it to owners through tax exemptions, tax deductions, and subsidies<sup>27</sup>. The CTU hopes that the Budget announcement that Inland Revenue is to expand its audit activity to ensure property speculators pay a fairer share of tax will have some impact. Under the “intention test”, if a housing property is not lived in by the owner, and was acquired with the purpose or intention of resale, then any capital gain on that property is taxable. This of course excludes residential property from the definition of income, provided the house or property was occupied mainly as a residence by the person, their family, or under certain trust arrangements. However the exclusion explicitly does not apply to a person who has engaged in a regular pattern of acquiring

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<sup>27</sup> Dunn, James R., ‘Housing as a Socio-Economic Determinant of Health: Assessing Research Needs’ Centre for Urban and Community Studies A summary of a paper prepared for the Canadian Institutes of Health Research, April 2003, <http://www.urbancentre.utoronto.ca/pdfs/researchbulletins/15.pdf>

and disposing, or erecting and disposing of dwelling houses. We note that when the IRD focused on property investment in some parts of Auckland as well as Queenstown and Wanaka they generated an extra \$106.6 million in tax from those investigations, including \$52.9 million from Auckland. It appears that tax revenue of around \$113 million was collected last year through auditing property transactions.

**12.2 Capital gains tax** – This must be part of any package to cool the housing market. A recent editorial in the Dominion Post<sup>28</sup> said that the situation requires “politicians brave enough to impose a capital gains tax on homes other than the family home”. They said that while such a move “would not prove popular how many jobs have to go and how many times does the economy have to have the life choked out of it before politicians face up to the fact that New Zealand cannot afford to indulge property investors at the expense of those who create jobs and generate overseas earnings”? It has been estimated that about 19% of couples and 8% of individuals own some form of secondary residential property. About 25% of residential property sales in 2005 were of properties that had been owned for less than 2 years - up from 10% in 2001<sup>29</sup>. Such a high rate of sales in a short period implies that a significant portion of residential property was acquired with the intention of resale. Between 1989 and 2005 the residential property market provided investors and owners with a tax free gain of 319%<sup>30</sup>. There is the ability to enforce current rules more vigorously as discussed, but an additional measure could be to review the wording in the Income Tax Act in order to more effectively tax capital gains on investment housing. This is not materially different from the above submission, but indicates a starting place for such a change given the current wording on “intentions test”.

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<sup>28</sup> The Dominion Post Wednesday, 13 June 2007.

<sup>29</sup> Van Zijll de Jong, Mark and Grant M. Scobie “Housing: An Analysis of Ownership and Investment based on the Household Savings Survey”, New Zealand Treasury, Working Paper, #06, p.23.

<sup>30</sup> Jenni McManus quoting Gareth Morgan in Sunday Star Times (17/6/07), “The Rent Trap”.

- 12.3 **Establish stamp duties** – Variable stamp duties could be introduced, particularly on higher priced housing to both slow demand and act as a revenue source for affordable housing. For instance, given that entitlements to the first home buyer benefits of KiwiSaver will apply to the purchase of a lower-quartile priced home, then it would not make sense to have a stamp duty on lower quartile homes even if it was not a first home buyer, but it could apply to upper quartile purchases. The borrower could be partially exempt if refinancing a loan of a particular property.
- 12.4 **Remove ability to offset expenses in rental properties** – The ability to fully deduct rental income losses against other income has encouraged quite a number of people to take on higher levels of debt in order to purchase investment property. An option therefore is to ring-fence operating losses on residential properties in order to remove the ability to apply such losses to reduce a landlord's taxable income. A similar approach would be to allow those who buy an investment property to operate in a way similar to any other business where there is depreciation, an ability to offset expenses, but taxes are paid on any profits.
- 12.5 **Variable Mortgage Levy to apply in some circumstances** – The Treasury and RBNZ discussion of supplementary measures included the suggestion of a mortgage levy that could be imposed as an effective tax. However one of the concerns this raises is the impact on lower income borrowers. Therefore the CTU suggest that such a levy would only apply to mortgages on property that was purchased at above the median price or is an investment property. It is recognised that there would be some complications in implementing such a levy that is targeted to those able to afford more expensive houses. However it would act in a way to cool the housing market.
- 12.6 The CTU has also supported a number of supply side initiatives in respect of housing. This includes shared equity, increasing state

housing stock, addressing zoning issues, more high density development, and acquisition of land banked property.

12.7 We have suggested other measures also in respect of housing such as developer levies, higher levels of trade training in construction, higher levels of restriction on foreign purchasers of property in New Zealand, targeted housing assistance, improved accommodation supplement policies, subsidized home lending, and enhancements to the KiwiSaver benefits for first home buyers.

12.8 As noted above, the Supplementary Stabilisation Instruments Report also examined a number of options in respect of housing including tax issues and improvements in the responsiveness of housing supply to demand conditions.

### **13.0 Consider a Transactions Tax**

13.1 It would be difficult for one country to implement a Tobin tax on international currency transactions. Chile and Malaysia have, as noted above, used such measures with limited effects. Other countries such as Belgium and Canada have supported such an approach if it was on a concerted basis with a number of countries.

13.2 There is no doubt that New Zealand is being targeted by currency speculators and a little bit of currency trading by the RBNZ is not much of a deterrent thus far. This means more fundamental measures need to be considered.

### **14.0 Implement Greater Controls on Bank Lending Practices**

14.1 It would be difficult to reinstitute reserve ratios given the ability of banks to raise funds in wholesale markets. But there still could be some base requirements in the form of such a ratio.

14.2 A discretionary loan to value limit was considered as part of the Treasury and RBNZ discussion of supplementary measures. It did not find much favour. However it does make sense to have some limit on the extent to which people can borrow and take on a huge level of debt. It is recognised that some of those struggling to get into the housing market would be affected, but one of the drivers of house price inflation has been the extent to which people are encouraged to take on a high level of debt.

14.3 But there is mounting concern that banks are now prepared to give 100% mortgages to people when they are at a heightened risk of house prices dropping and therefore could end up in a negative equity situation. There should be an increase in capital requirements for banks.

14.4 There also needs to be an investigation of the lending practices of banks. Specifically, the pay systems and disciplinary processes that incentivise staff to maximise customer lending need to be addressed.

14.5 In addition there needs to be more stringent criteria around access to credit cards and increases to limits without proven capacity to repay. Of course, it would not be desirable to drive such borrowers into the arms of loan sharks but this does not excuse the need for a greater level of bank responsibility.

## **15.0 Summary**

15.1 The CTU urges this Committee to make some clear recommendations on future monetary policy. A lot is at stake. In particular, we hope that a solution can be found for the problem caused by overwhelming house price inflation. Another tool or a new suite of tools is required. In an MMP environment, we are looking for a practical way forward.

- 15.2 It is likely that any solution will have a downside. But this should be considered alongside the damage being done now – thousands more New Zealanders every year being priced out of decent housing, manufacturers laying off workers due to the twin effect of interest and exchange rates, and a long run cycle where the currency appears to settle even at the bottom of the cycle at a higher level each time.
- 15.3 Controlling inflation needs to remain a key imperative. Workers do not want to see the value of their pay packet eroded by high and persistent inflation. But the damage being done to the economy as interest rates rise to dampen house price inflation is too high a cost. Another tool and a more appropriate approach are needed.