MONETARY POLICY UPGRADE

HIGHLIGHTS

- **Maintain the Reserve Bank's independence and its inflation target.**
- **Broaden the objective of the Reserve Bank to include the external balance and allow it to use current tools to tackle our overvalued dollar.**
- **Give the Bank a new tool to adjust universal KiwiSaver savings rates as an alternative to raising interest rates. This would mean Kiwis would pay money to their retirement savings instead of higher mortgage payments to overseas banks.**

Independence Preserved

Labour is committed to preserving the independence of the Reserve Bank, but it's time to upgrade our monetary policy system for the 21st century.

We can't keep on undermining the productive sector of the economy with a high exchange rate and interest rates that are above international norms.

We need a more sophisticated approach that tackles the causes of inflation and recognises inflation-control as an important ingredient of a healthy economy – part of the means, not the end.

Labour's plan will give our businesses a fighting chance in international markets. That will mean more jobs, more export earnings, lower interest rates, less international debt and less foreign ownership of our land and companies.

Labour will update monetary policy by:

- Broadening the objectives of the Reserve Bank to creating the conditions for a healthy economy
- Taking the pressure off the Reserve Bank's OCR by using government policy to address the sources of inflation in the non-tradable sector
- Giving the Reserve Bank more weapons so that it doesn't have to turn to the blunt tool of the OCR every time.

THE ISSUE

New Zealand's monetary policy system was introduced in 1989 and has remained essentially untouched ever since. Like a 25 year-old computer system, it needs to be upgraded.

Our current monetary policy system was designed to deal with the most pressing issue of that time – inflation – as a reaction to the era of double-digit inflation under the National Muldoon Government.

This single minded focus on inflation, however, has had adverse consequences for the tradeable export sector.

New Zealand now has structurally high interest rates, and a persistently over-valued dollar. This contributes to a large current account deficit and high levels of international debt and foreign ownership.

The over-valued dollar and our high interest rates mean our businesses find themselves less able to compete abroad and undercut by imports at home. Our high interest rates also draw in foreign money, which fuels the housing market.

We have low general price inflation, a housing market which is inflating at rapid rates, while our tradable sector is in deflation.

The Reserve Bank attempts to stabilise house prices with higher interest rates. This strangles our exporters who, despite recent drops in commodity prices, face a rising currency.

That is one of the causes of New Zealand's long-term underperformance in growth and our high level of international debt.

Underinvestment in our export sector has meant fewer jobs and lower wages for Kiwis, and lower export earnings.

Our export base is narrowing, with manufacturers closing and a greater reliance on raw commodities and in particular dairy.

Further information is available at:
labour.org.nz/monetarypolicy

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BROADEN THE OBJECTIVE OF THE RESERVE BANK TO HELP ACHIEVE A POSITIVE EXTERNAL BALANCE

The existing objective of the Reserve Bank is

"To formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices."

Labour will amend the Reserve Bank Act to read:

"The primary function of the Bank with respect to monetary policy is to enhance New Zealand's economic welfare through maintaining stability in the general level of prices in a manner which best assists in achieving a positive external balance over the economic cycle, thereby having the most favourable impact on the stability of economic growth and the level of employment."

TAKE THE PRESSURE OFF THE RESERVE BANK'S OCR BY USING GOVERNMENT POLICY TO ADDRESS THE SOURCES OF INFLATION IN THE NON-TRADABLE SECTOR

Take the pressure off the Reserve Bank's OCR by using government policy to address the sources of inflation in the non-tradable sector

Government can ease inflationary pressures in the economy through its policy choices. Doing this, rather than leaving the job of tackling inflation entirely to the Reserve Bank, will result in lower interest rates and a lower exchange rate.

First, fiscal choices:

Labour is committed to running government surpluses and paying down National's record debt. The last Labour government ran surpluses every year, and will do so again.

This will reduce inflationary pressure.

Second, improve private savings:

We will improve savings. Labour introduced KiwiSaver. It is time to make it universal, like the Australian work based savings scheme. This will make us less reliant upon capital borrowed from overseas.

Thirdly, a range of other policy choices:

The tradeable sector in New Zealand is in deflation and is a major victim of OCR rises, while the sources of inflation are in the non-tradable sector.

House prices are the major driver of inflation in New Zealand, both directly and through the so-called 'wealth effect', which encourages households to realise gains from rising house prices by taking on higher debt for consumption.

If house prices were stable, there would be less call on the Reserve Bank to maintain relatively high interest rates, which would, in turn, allow the currency to return to a fair level.

Just as importantly, stable house prices would make it more affordable for families to buy a home and service a mortgage. This would stem the rapid decline in homeownership rates.

The property market is marked by under-supply of affordably priced homes, with property developers preferring higher-profit, more expensive homes. This, along with the tax advantages for housing investment (see below), has driven the price of houses higher.

Labour's KiwiBuild programme is designed to build 100,000 affordable homes over 10 years and sell them to families. This will help to stabilise the market, and significantly reduce a major driver of inflation in our economy.

Another step to encourage NZ savings, and investment in the export and import substituting real economy, would be to remove the tax bias which currently favours investment in land based investments by introducing a tax on capital gains from property, excluding the family home.

The current tax bias is unusual in western countries and contributes to underinvestment in the productive economy, and savings.

The tax advantages drive asset prices, and demand for mortgage borrowing, to higher levels than would otherwise be sustained. This increases demand for imported borrowings, which puts pressure on the exchange rate.

This distortion in the tax system also pushes up house and other property prices beyond the reach of many, while enabling wealthier New Zealanders to pay lower rates of tax on their economic income.

Labour will also ring fence losses on property investments, and stop them being offset against other income.

To further cool speculative demand in the housing sector, Labour will ban non-resident foreigners from buying existing New Zealand housing and farm land.

After housing, electricity was the largest source of inflation in the past year (excepting the excise increases on tobacco products).

Electricity prices are rising rapidly, despite low and stable production costs for most of our electricity, as a result of the market rules set up by the 'Bradford reforms' implemented by National.

Labour's NZ Power plan will bring down electricity costs. It will break the market power of the generator/retailer oligopoly, stop over-charging for our lost-cost hydro power. This will reduce power costs to businesses and residential users.

A range of other complimentary measures are discussed in the longer paper released today.

RESERVE BANK TOOLS THAT WILL MAKE IT LESS RELIANT ON THE BLUNT TOOL OF THE OCR

Varied use of existing tools:

The existing tools of the Reserve Bank include adjusting the interest rate, foreign exchange purchases, and so-called macro-prudential tools such as capital ratios, and loan to valuation restrictions.

Broadening the objective of the Reserve Bank to include the external balance objective will require the Reserve Bank to consider whether the broadened objective can be advanced through a varied use of the Bank's existing tools.

Macro-prudential ratios were used sparingly prior to the GFC. While their use has expanded since the GFC, they are still notionally deployed for prudential purposes, rather than monetary policy objectives.
For example, changes to capital requirements set by the Reserve Bank for different classes of lending are currently motivated by financial stability considerations. Under a broadened objective, the Bank may deploy these to limit credit growth and demand for currency even when prudential standards are already met, so as to achieve its broader objective.

The Bank would provide advice as to the knock on effects on interest rates and capital availability.

New tool to be investigated – variable savings rate:

Labour intends to make KiwiSaver universal. Those in the workplace and not in KiwiSaver will be transitioned in at the current 6% (3% from the employee, and 3% from the employer). Thereafter, there will be a slow increase at ½ or 1% pa towards the intended total of 9% of earnings.

Rather than increasing or decreasing interest rates, the Reserve Bank could ask the government to vary Kiwisaver contribution rates, within a defined range. Alternatively, the policy targets agreement could delegate to the Reserve Bank the power to vary Kiwisaver contribution rates within a defined range.

Increasing the Kiwisaver contribution rate instead of raising the OCR would have the same effect as an interest rate increase in terms of reducing inflationary pressure and increasing savings.

Instead of mortgagors and other borrowers handing more money over to the bank (much of which is exported off shore), they would be increasing their savings for the future.

CONCLUSION

This proposal is part of the across-government approach proposed by the New Zealand Labour Party to address New Zealand's external position, build the net wealth of the country and improve the job opportunities and incomes of those who work here.