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SUBMISSION ON THE FUTURE MONETARY POLICY FRAMEWORK INQUIRY

To the Finance and Expenditure Committee

Introduction

This submission is from Roger J Kerr, Director of Asia-Pacific Risk Management Limited, Auckland (The Auckland one, not the NZ Business Roundtable one!)

I wish to appear before the committee to speak to my submission.

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Executive Summary & Recommendations

The central theme and recommendation of this submission is that tightening monetary policy, by way of official interest rate increases, has been ineffective in controlling inflation increases over this last economic expansion cycle (2002 to 2006) because the sources of price increases in the economy have not been demand driven, but related to supply-side and non-competitive factors.

Two particular factors, unique to this period and not so relevant in earlier economic expansion periods, have combined to stymie and frustrate the efforts of the Reserve Bank of New Zealand ("RBNZ") to moderate consumer demand in the economy by interest rate increases:-

- 80% of house mortgage borrowers fix their interest rates for 2 to 5 years (lowest rates and highly competitive market between bank lenders) resulting in no change of spending behaviour when short-term interest rates were increased. The time-lag from monetary tightening to expected changes in the economy is thus considerably prolonged. The RBNZ have recognised this factor.
- Higher interest rates automatically drive a higher New Zealand Dollar value, making imported consumer goods cheaper in the retail stores, in turn enticing a higher level of spending by consumers as they can afford to buy goods they could not afford previously. Easier access to consumer credit has compounded this factor. In my opinion, the RBNZ have failed to recognise this factor.

The domestic economy (housing, retail, services) continued at a robust pace from 2005 to March 2007, despite the higher interest rates and higher exchange rates, which were contracting the productive sectors (exporting, manufacturing, agriculture, fishing, forestry)

The inflation that has occurred in the economy over the last five years (as the analysis in this submission will highlight) has largely come from areas that are not influenced or affected by interest rates. The RBNZ have thus caused significant collateral damage to the export and manufacturing sectors through their “high interest rate/high exchange rate” policy, whilst failing to recognise and address the real root causes of inflation.

Nearly all of the inflation experienced in this time period has come from the following sources:-

- Fuel and transport cost increases due to global oil price rises.
- Energy costs (electricity) increases due to climatic conditions (low hydro dam water levels) and underinvestment in generation capacity (RMA impediments)
- Food price increases due to adverse weather and global influences (e.g. bread and chicken prices increasing as grain prices rise due to bio-fuel demand)
- Non-competitive sectors of the economy (monopoly providers, central government, local government, public-sector agencies, education institutions) increasing charges, fees, user-pays prices as there is no market discipline or controls to counter such behaviour.

The first three types of inflation are unable to be controlled by monetary policy or any other economic policy prescription in New Zealand. However consistent inflation from the non-competitive sector is controllable. Unfortunately the RBNZ has been either unable or unwilling to address this issue with Government.

My recommendations to improve the monetary policy framework to control the inflation we can control and provide flexibility around the inflation we cannot control (and should not attempt to control) are as follows:-

- **Review the Policy Target Agreements** (“PTA”) between the RBNZ and the Minister of Finance to return to accountability by the RBNZ to manage “underlying” or “core” inflation that excludes volatile food and energy prices and allows for certain exclusions of Government charges/fees. The change in 2000 to the PTA that stated headline inflation “must be maintained between 1% and 3% on average over the business cycle” has proven to be too inflexible and has unnecessarily caused increased volatility in interest rates and exchange rates that are detrimental to business investment/confidence and economic growth.
- As the growing **Government sector** does not have competitive market-related disciplines that control price increases, other financial mechanisms and controls must be introduced to curtail the problematic “cost-plus” price setting behaviour of the public sector. Many economic and political commentators have blamed increased Government spending for the inflation problem. It is not necessarily the level of Government spending that is the issue; it is the price-setting behaviour within the public sector that has caused the problem.
- It is debatable whether monetary policy should be applied to burst asset-price bubbles (the NZ residential property market). However, as the RBNZ has seen rising house prices as the biggest cause of inflationary risk through boosting consumer spending, the **taxation treatment around residential investment/rental properties** should be reviewed. The taxation purists would argue that it is poor tax policy and inconsistent to

abolish the use of tax losses from rental investment properties to offset other taxable income. However, the fact that residential rental properties are easily leveraged to high levels by aggressive bank mortgage lending practices, makes a special case for singling out rental properties to have no tax off-set. There is no question that tax-driven investment in residential property has distorted market values and frustrated the efficient workings of monetary policy in the economy.

Specific Comments

The following analysis and evidence is provided to support the conclusions and recommendations in the Executive Summary above.

My comments are centred on the following four terms of reference for the inquiry:-

- Causes of inflationary pressures.
- Effectiveness of current monetary policy in controlling inflation.
- Interaction of monetary policy with fiscal and general economic policies.
- Consideration of additional measures that could enhance monetary policy in New Zealand.

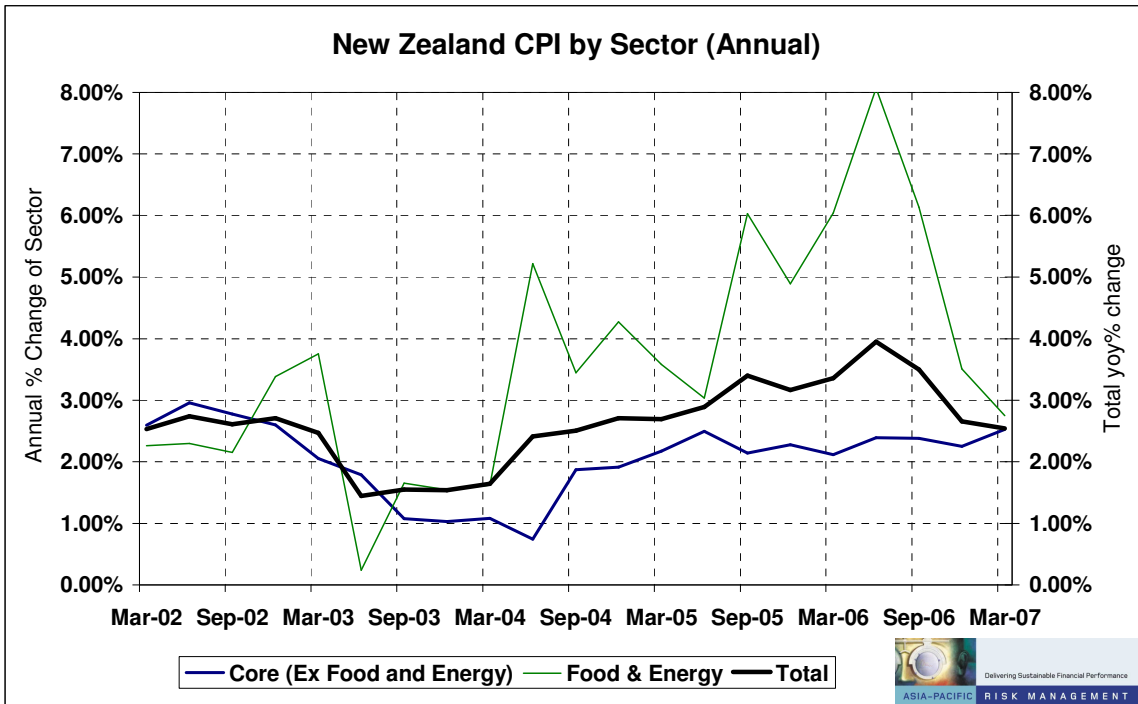
My observation and understanding of economic/inflation drivers and the interdependence of financial markets variables (interest rates and exchange rates) to the economy is based on 20-years experience of advising major New Zealand companies on foreign exchange and interest rate risks. I have analysed and dissected every one of the RBNZ's quarterly Monetary Policy Statements since they commenced in the early 1990's. There have been periods when I have agreed with and endorsed their forecast of the economy and therefore their monetary policy stance. There have also been many periods when I have strongly disagreed with their economic forecasts and monetary policy management. In particular, over the past two years I have been of the consistent view that their monetary tightening action would not control the supply-side generated inflation and would only lead to exchange rate appreciation that would hurt exports and GDP growth. Attached as an Appendix to this submission is a letter I wrote to the RBNZ Governor in October 2005 on precisely this point.

1. Dissecting Inflation Sources (2002 to 2007)

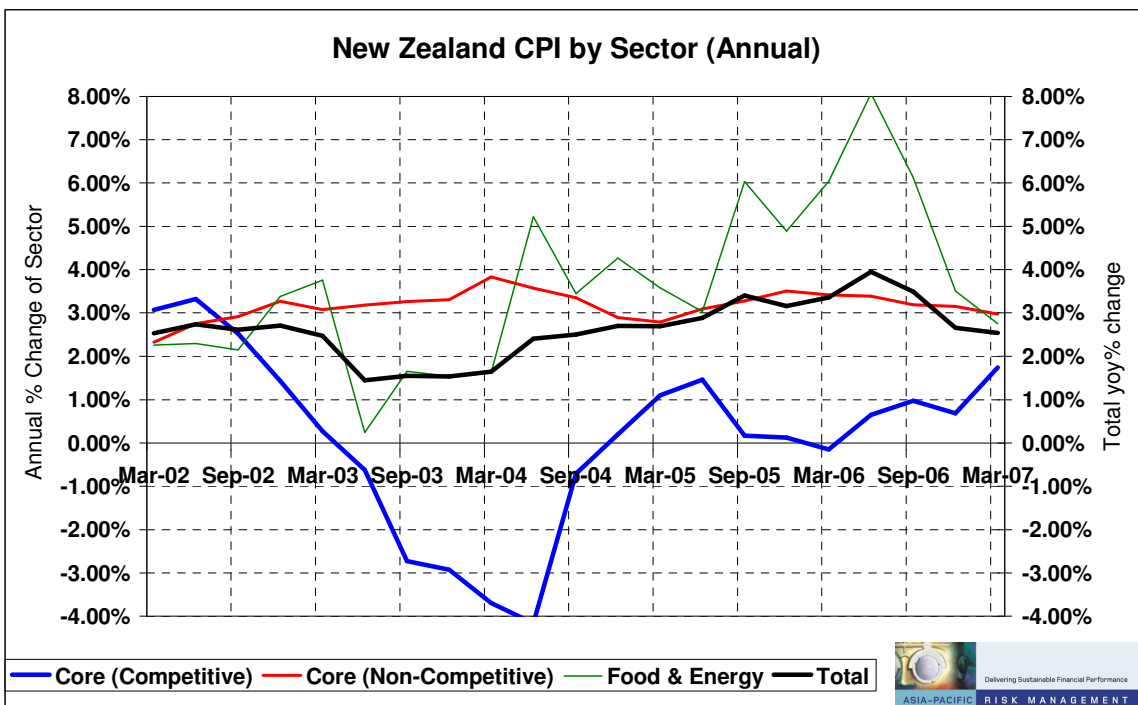
Efficient and proficient monetary policy management to combat increases in inflation must be directed at the causes of "core" inflation, to diffuse demand pressures and change price-setting behaviour. Changes to interest rates will not control or change the forces that drive food and energy prices, therefore this is why most central banks around the world strip-out the volatile food and energy prices from the headline inflation rate to produce a "core" inflation measure. This is what they target to keep within prescribed bounds and adjust monetary conditions accordingly.

The risk in stripping-out food and energy is that participants in the economy observe the high headline inflation rates and adjust their own inflationary expectations accordingly. However there is no evidence in the NZ economy over the past five years that elevated inflationary expectations has been a dominant driver of private-sector price setting behaviour. Similarly, a high headline inflation rate caused by petrol/diesel price increases, that we saw in mid-2006 and which the RBNZ must "look through", may lead to second-round general price increases in the economy i.e. business firms increasing prices because their transport/freight costs have increased. However, again there is no evidence in the economy over the last nine months since the mid-2006 oil price spike that these second-round price increases have materialised. Competitive pressures within the demand-side of the economy have kept these second round prices increases at bay.

If food and energy are excluded from the annual headline CPI inflation rate to produce a core inflation measure, the core inflation has not moved above 2.5% since 2002:-



Moving a step further to break down the core inflation between prices that are determined by the competitive part of the economy and prices that are set from the non-competitive sector, reveals more about the real sources of inflation in the NZ economy over the past five years:-



“Food and Energy Sectors” (food, electricity and petrol) consists of Food (economy wide weighting of 17.5%), Household Electricity and Energy (3.8%) and Private Transport Supplies and Services (9.3%). Total “Food and Energy Sectors” weighting of 30.5%.

“Core Competitive Sectors” consists of Alcohol and Beverages (7.2%), Clothing and Footwear (4.8%), Household Contents and Services (5.5%) and Transport excluding private supplies and services, 8.0%. Total “Core Competitive Sectors” weighting of 25.4%

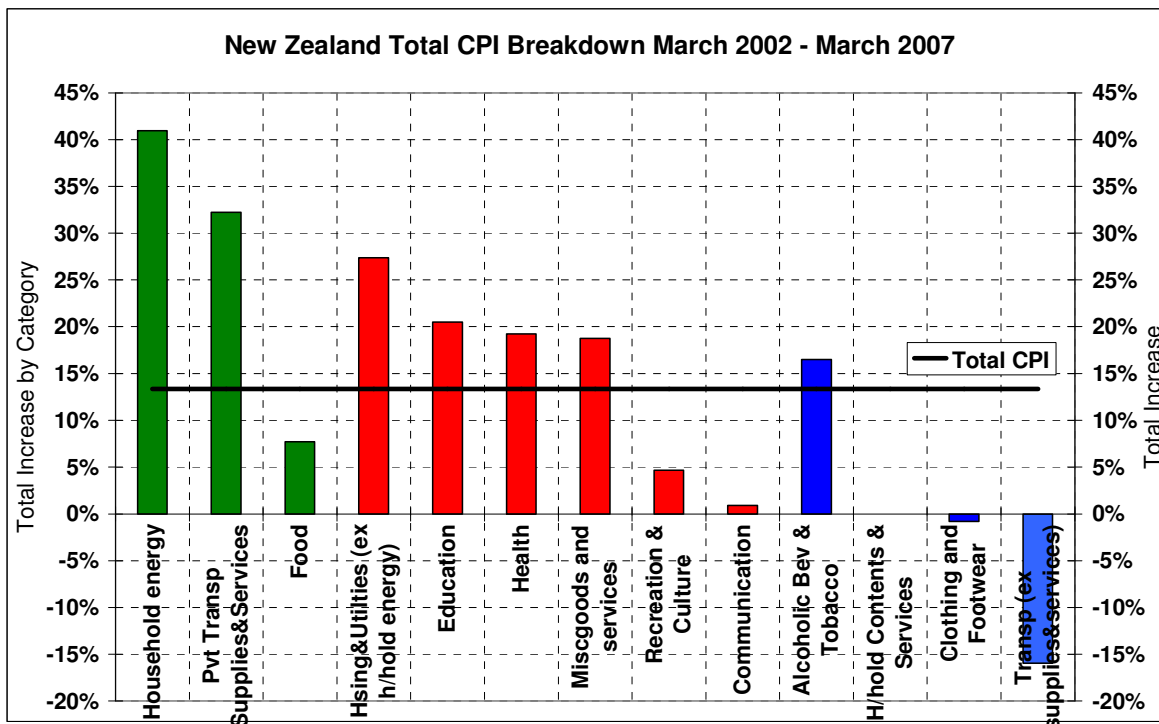
“Core Non-Competitive Sectors” consists of Housing and Utilities excluding household electricity and energy (16.2%), Recreation & Culture (10.2%), Education (2.1%), Health (5.2%), Miscellaneous Goods & Services (7.1%) and Communication (3.3%). Total “Non-Competitive Sector” weighting of 44.1%.

The sum of the sector contributions to CPI may not always add up to the total owing to rounding of Statistics New Zealand data.

The non-competitive part of the economy (chart red-line above - consisting of monopoly providers, central government, local government and public sector agencies) has consistently produced annual inflation of between 3% and 4% each year for five years. It is therefore, no wonder that the application of tight monetary policy has not worked to control inflation! The non-competitive sector is unresponsive to changes in interest rates, exchange rates and demand conditions.

The RBNZ may well argue that they have only one weapon at their disposal to combat inflation (interest rates) and if that does not influence a big part of the economy, they cannot help that. Therefore they could feel justified in tightening monetary policy to generate deflation in the competitive part of the economy that they can influence, to offset the inflation in the non-competitive part of the economy they cannot influence. The problem with this rationale is that mobile productive capital and export businesses are forced out of New Zealand due to the resultant overvaluation of the NZ Dollar, never to return. This would seem a very high cost for the economy to pay just to allow the inflationary behaviour in the non-competitive sector to continue unchecked.

The following inflation breakdown by CPI component part underlines the problem and exposes the industry sectors who are the perpetrators of inflation:-



Green code = Food and Energy

Red code = Non-Competitive Sector

Blue code = Competitive Sector

Note: All %'s in the note below pertain to the overall CPI index.

- 1) Household energy has a 3.8% weighting of which Electricity is 3.3%. This is out of the total 20.0% Housing and Utilities group weighting.
- 2) Private Transport Supplies and Services have a 9.3% weighting of which 5.4% is Petrol. This is out of the total 17.2% Transport group weighting.
- 3) Food group weighting is 17.5% of which Grocery is 6.7%, Restaurants 4.0%, Meat 2.8% and Fruit & Veg 2.2%.
- 4) Housing and utilities (excluding household energy) has a 16.2% weighting. Of this the major components are Rentals (6.9%), Purchase of New Housing, i.e. construction costs (4.7%) and Local Authority Rates (2.2%).
- 5) Education group weighting is 2.0%.
- 6) Health group weighting is 5.2% of which Outpatient Services is 3.4%.
- 7) Miscellaneous goods and services has a 7.1% weighting. Personal care is 2.1%, Insurance 1.7%.
- 8) Recreation & Culture has a 10.2% weighting.
- 9) Communication has a 3.3% weighting of which Telecommunication Services is 3.0%.
- 10) Alcoholic Beverages and Tobacco has a 7.2% weighting.
- 11) Household Contents and Services has a 5.5% weighting of which Furniture, Furnishings and Floor Cover is 2.1% and Household Appliances is 1.2%.
- 12) Clothing and Footwear has a 4.8% weighting.
- 13) Transport (excluding supplies and services) has a 8.0% weight of which Vehicle Purchases is 5.2% and Passenger Transport Services is 2.7%.

Conclusions:

- The lack of competition to control price setting behaviour in significant parts of the economy is the largest cause of inflation in New Zealand over the past five years.
- Government, local government and public sector agencies have expanded their activities due to regulatory and legislative requirements (e.g. Building Act 2004) passing through these cost increases into higher fees, prices and charges to end-users.
- Consistent and substantial electricity price increases to residential users have been a major contributor to inflation, yet wholesale electricity prices have not increased markedly.
- House construction costs is the only identifiable “demand-push” area of significant price increase, however its weighting in the CPI is quite minor.
- The PTA requirements imposed on the RBNZ make it far too tough for them (and too tough on the wider economy) to control inflation in areas they cannot influence. Monetary policy needs friends to work effectively, unfortunately over the past five years it has not had those friends.
- The Government and public sector need to take a leadership role to get their own house in order on price setting behaviour, before casting off the inflation responsibility and cost to the RBNZ, business sector and consumers/households.
- The fact that the Government has to resort to Parliamentary Select Committee Inquiries to understand why inflation control is not working and the RBNZ have to resort to NZD/USD currency market intervention to “trim the gains” of an over-valued exchange rate caused by their own high interest rates, is indeed a sad commentary on where monetary policy management has degenerated to in New Zealand.

2. RBNZ: Inflation and Economic Forecasting Accountability

In interpreting and forecasting the economy to ascertain and measure future inflation risks, the RBNZ model and analyse a plethora of economic statistics and indicators. What has been very surprising to me in recent years is their seemingly lack of focus on drilling down into the specific details of:-

- What individual prices in the economy have increased?
- What has caused those individual prices to increase?
- Will those individual prices continue to increase in the future, or were they one-off in nature and thus will not repeat?
- Were the prices that increased the particular prices the RBNZ expected to increase?
- Were the causes of the price increases the particular causes the RBNZ identified 12 months ago as drivers of higher inflation?
- Were there new inflationary pressures from sources the RBNZ did not anticipate 12 months ago?

This type of detailed analysis and regular benchmarking of the accuracy of previous inflation/economic forecasts must lead to a far better understanding by the RBNZ of the drivers of inflation and whether monetary policy responses are appropriate or not.

Such analysis would have revealed the considerable inflationary pressures stemming from the non-competitive sector at an earlier date. In my view it is not good enough for the RBNZ to ignore these inflationary sources because they themselves cannot do anything directly about them. They have a responsibility to identify and address all sources of inflation in the economy. If the Governor is indeed independent, he has a responsibility to bring the Government sector to task about their price setting behaviour. The current Governor, from my observation, has failed to do this

The quarterly Monetary Policy Statements do not include this form of analysis and accountability, instead they have become exercises in macro-economic theory that state "strong consumer demand + low unemployment = rising inflation in the future".

The breakdown of inflation in section 1.1 above clearly illustrates that over the last five years the sources of inflation have not been consumer spending and wages increasing. It is surprising that the words "competition" and "business profits" completely fail to make it into the RBNZ's recent Monetary Policy Statements, as these are the two most important aspects of inflation and pricing trend indicators. The quality of their economic analysis has reduced considerably in recent years, in my humble opinion.

The transparency and openness we have in New Zealand with the RBNZ required to front up regularly to Parliamentary Select Committees, the markets and the public with their prognosis of the economy, interpretation of inflation risks and monetary policy responses is highly commendable. However, with that disclosure and transparency, must come a responsibility and accountability for their past forecasts and actions. Rather than a continuous look forward on the economy, my view is that the RBNZ would do a better monetary policy management job if they critically examined their past forecasts and explained the differences between what was expected and what actually happened. Any successful business or public entity would employ this discipline. I am sure the RBNZ undertake such a self-examination process internally, but they do not report the conclusions in the Monetary Policy Statement.

Authored by: Roger J Kerr, Director, Asia-Pacific Risk Management Limited



APPENDIX

Delivering Sustainable Financial Performance

ASIA-PACIFIC RISK MANAGEMENT

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3 October 2005

Mr Alan Bollard
Governor
Reserve Bank of New Zealand
PO Box 2498
WELLINGTON

Dear Alan

Recent developments in the economy and interest rate market pricing have prompted me to write to you with our firm's current views on the outlook for inflation, monetary policy and the economy following the discussion we had at our offices back in June. At that time, you were of the view that the domestic demand side of the economy would remain stronger this year than we thought likely, whereas we saw the export/productive sector being weaker than RBNZ expectations and forecasts. I guess time may have proven us both correct!

I understand the considerable pressures and challenges in front of the Governor of New Zealand's central bank when circumstances conspire to deliver a two-speed economy as well as inflation increases from uncontrollable external forces (oil), and you only have judgement calls with a very blunt instrument at your disposal.

In considering your monetary policy responses over coming weeks to the current and future economic environment, I would implore you to take a deep breath and stand back somewhat from the current knee-jerk reaction of the moneymarkets and rapidly changing views of a few bank economists. Our very strong view is that further hikes in the OCR at this time would be a grave monetary policy miscalculation, with the only impact being a substantial increase in the risk of sending the economy into recession. As has been seen over the last 12 months, increasing interest rates to temper domestic demand has not been effective in curbing inflationary pressures and risks, as this sector is not the source of upwards price pressures. Current and future inflation pressures are all coming from the supply side of the economy, not the demand side.

It may appear to be an easy decision (in the short-term) to satisfy the interest rate market's pricing of now more than one further 0.25% increase in the OCR. However such a decision would do nothing to reduce inflation risks or control the inflation rate in 12 to 18 months time. Any official increase in rates would certainly send the NZ dollar value higher and further damage exporter's incomes, investment and confidence. I am sure the strong historical correlations between export performance and the overall direction of the New

Zealand economy are well known to you, and there is nothing to suggest that these linkages have fundamentally altered.

We would contend that the following factors make any further tightening of monetary policy both unnecessary and potentially dangerous to the economy in the medium to longer term:-

- Current and future inflationary pressures are only coming from three very narrow sources that are not influenced by monetary policy/interest rates:-
 - Transport and energy due to global oil price increases.
 - Residential construction costs due to past supply and resource constraints. The new Building Act has also swung the compliance pendulum too far the other way now, adding 10%-20% to the cost of building a new house.
 - Government taxes and Local Government rates.
- Falling business confidence reflects concerns about the economy going forward and the inability to pass through cost increases (energy and some wages) into selling prices i.e. profit margin compression.
- Recent Merchandise Trade and GDP growth data may have prompted the financial markets to price in further monetary tightening, but a closer understanding of the underlying trends (i.e. stock building and low price deflator outcomes) would suggest that inflation risks have not increased at all.
- The continuation of reasonably robust retail sales appears to be more due to deflation in many consumer items and very easy credit terms. However we expect to see sharp decreases in consumer confidence from here as higher transport costs, interest rates and past "spending on credit" bills hit household budgets.
- Due to the very high level of fixed-rate mortgage borrowing, the full impact of earlier 2004/2005 interest rate increases is only now starting to influence behaviour as increased loan rate re-sets take affect.

Alan, if at all possible, we encourage you to direct your warnings about inflation to the real sources of that inflation (Government being one major source) and not to be pushed into a decision you will regret by hawkish economists who seem more motivated by interest rate and exchange rate volatility than anything else. Further OCR increases from here would cause a serious hard-landing for the economy and make the subsequent adjustment and recovery period so much more painful.

Our advisory client base covers all sectors of the economy, particularly export and import. We are close to the business affairs of our clients and can inform you that exporters are now contracting their businesses at an alarming clip.

Yours sincerely



Roger J Kerr
Director
Asia-Pacific Risk Management Limited