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I—REPORTS AND PROCEEDINGS OF SELECT COMMITTEES

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QUEEN ELIZABETH THE SECOND

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Inquiry into 21st century learning environments and digital literacy

Report of the Education and Science Committee

Fiftieth Parliament
(Nikki Kaye, Chairperson)
December 2012

Presented to the House of Representatives


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**Inquiry in 21st century learning environments and digital literacy**

**Summary of recommendations**

The Education and Science Committee makes the following recommendations to the Government:

- That it implement a system that collects, analyses, and disseminates better sector-wide data on digital literacy and 21st century skills to enable more evidence-based policy decisions. (p. 17)
- That it develop an improved research framework to ensure that educational policies are informed by current research thinking and future-focused thinking in the digital area. In developing the research framework, adequate consideration should be given to ensuring that New Zealand research is shared throughout the country and with international research programmes. (p. 17)
- That it consider whether it commissions an iterative best-evidence synthesis of digital learning and pedagogies. (p. 17)
- That it investigate the benefits and implications, along with any policy or legislative changes, of extending availability of school facilities and resources, including computer labs and Internet connections, to their communities. (p. 19)
- That it create best-practice design templates for school buildings so that newly-built schools and upgrades are more open, flexible, and networked. (p. 19)
- That it consider how school libraries can be 21st century learning environments. (p. 19)
- That it consider encouraging local government to ensure greater Internet access via public libraries for out-of-school learning as a valuable community resource. (p. 20)
- That it consider requiring all New Zealand teachers to demonstrate a defined standard of digital literacy and to undertake professional learning and development to maintain their digital literacy skills, knowledge, and understanding. (p. 22)
- That it consider requiring appropriate school leaders to demonstrate a defined standard of digital literacy, and to undertake professional learning and development to maintain their digital literacy skills, knowledge, and understanding. (p. 22)
- That it consider measuring and evaluating teacher training institutions on the quality of their digital literacy training. (p. 22)
- That it, in consultation with the education sector, consider whether there needs to be any policy changes to take into account potential workload changes as a result of online learning. (p. 23)
That it consider ensuring that all appropriate New Zealand video content produced for public consumption is licensed and funded under a single national contract, and made available to all schools. (p. 25)

That it ensure that policies and guidance are developed to help prevent cyber-bullying and inappropriate online content. (p. 26)

That it ensure that more local New Zealand content, including Māori and Pasifika content, is made available to all schools, either through the Network for Learning or by other means. (p. 26)

That it ensure that digital educational materials for learning Te Reo Māori are available to all students. (p. 26)

That it consider ensuring access to high-quality digital resources to support the New Zealand curriculum for all teachers and learners. (p. 26)

That it review the intellectual property framework for our education system to resolve copyright issues that have been raised, including considering Creative Commons policy. (p. 26)

That it consider the advantages and disadvantages of whether all documentation produced by the Ministry of Education for teaching and learning purposes should be released under a Creative Commons licence. (p. 26)

That it review the definitions of digital literacy to consider a common definition that can be used across the sector. (p. 28)

That it review 21st century skills in the context of digital literacy in our education system. (p. 28)

That it consider research and the potential for a greater role of educational games as part of digital learning environments for 21st century learning and skill development. (p. 28)

That it consider enhancing the role of information science in the education sector. (p. 28)

That it better position ICT skills, knowledge, and understanding as educational options that lead to high-value careers. (p. 28)

That it consider introducing policies and initiatives to ensure that every child at school in New Zealand has access to digital learning at school. (p. 31)

That it undertake research and consider policies in relation to digital literacy in early childhood education. (p. 31)

That it undertake to consider how digital learning material used in New Zealand schools can be accessible by people with disabilities, including those who cannot see graphics, cannot hear audio, or cannot operate a mouse. (p. 31)

That it review licensing arrangements for software, so that students have equity of access in schools and in homes, including the use of open-source software. (p. 31)

That it consider introducing a policy that every student have access to a digital device for learning, including the appropriate age for such a policy to apply. (p. 33)
• That it consider research and best practice to develop policies on device ownership and other arrangements to ensure students have access to a device. (p. 33)

• That it investigate the best bulk supply arrangements to enable possible purchase by families or schools of devices suitable for use by students at school. (p. 33)

• That it require schools to establish guidelines on the use of devices at school, based on Ministry of Education guidance, which recognises the value of digital devices for learning. (p. 33)

• That it consider how to ensure access to necessary technical support, to ensure the use of ICT in schools is effective. (p. 33)

• That it consider whether SNUP specifications should include high-quality wi-fi coverage in the upgrades provided to schools. (p. 35)

• That it consider accelerating the SNUP programme. (p. 35)

• That it consider whether the Crown-owned company Network for Learning Ltd be required to actively seek New Zealand content and services for delivery to schools. (p. 37)

• That it consider whether the Network for Learning should be accessible not just from schools’ premises. (p. 37)

• That it consider how Network for Learning Ltd can provide affordable access to high-speed Internet connections with unlimited data to all schools. (p. 37)

• That it consider the benefits of implementing and operating a single system for core ICT services in schools, including identity and access management, a student management system, a learning management system, e-portfolio, e-asTTle and e-Admin systems such as ENROL. (p. 37)

• That it consider whether access to high-speed Internet and core ICT services should be funded nationally. (p. 37)

• That it recognise that 21st century learning will require significant change across the education sector, involving a wide range of stakeholders; and that the Government recognise achieving such a change needs government- and sector-wide leadership to develop and promote a vision, and to lead an integrated series of work programmes to implement that vision. (p. 39)

• That it consider reviewing the best institutional arrangements for providing the leadership to deliver both digital capability and 21st century learning environments. This review should include options such as, but not limited to, strengthening the Ministry of Education, extending the responsibility of Network for Learning Ltd, or establishing a new Crown entity. (p. 39)

• That it consider that the Education Review Office report on the digital capability of schools in its regular school reviews. (p. 41)

• That it consider that the Education Review Office reports include information on how well schools collaborate with other schools. (p. 41)
- That it seek input from the sector on barriers to collaboration, and then modify policy, funding, and operational processes to actively promote collaboration. (p. 41)
- That it review student assessment to ensure that more online assessment opportunities are realised. (p. 41)
- That it consider possible regulations regarding the use of school buildings to support the use of digital facilities by the community. (p. 41)
- That it assess the possible resource implications of our recommendations for ICT expenditure. (p. 41)
- That it assess possible legislative changes in response to the recommendations in this report. (p. 41)
1 Context

We are aware that the education sector is changing significantly as a result of new technologies and access to the Internet. This is an area of rapid change. We considered it necessary to examine the full implications of this rapid development for our education sector, and so resolved to initiate this inquiry. In this report, we use the term “21st century learning” to mean the changes to teaching and learning in schools that result from digital technology. However we acknowledge that many of our recommendations may be applicable beyond schools, in the wider education sector.

The term “learning environment” suggests traditional places of learning such as schools, classrooms, or libraries. However, while much of 21st century learning takes place in dedicated physical locations, in today’s technology-driven world a learning environment can also be virtual, online, or remote.

The purpose of this inquiry is to investigate and to make recommendations on the best structures, tools, and communities, in both rural and urban New Zealand, for enabling students and educators to attain the knowledge and skills, such as digital literacy, that the 21st century demands of us all.

The terms of reference for the inquiry are as follows:

- Investigate possible options for the best facilities that support teaching and learning in 21st century schools; in particular, investigate more flexible teaching spaces.
- Investigate possible changes to the timing of when learning can occur, given the spread of handheld devices.
- Investigate possible options for the best technological infrastructure that supports teaching and learning in 21st century schools.
- Consider how the rollout of ultra-fast broadband (UFB) will affect teaching techniques and processes, and whether additional resources or training may further enhance the positive effect of UFB on teaching and learning outcomes. In particular, investigate the role and efficiency of the Network for Learning.
- Consider whether current generations of learners more readily adopt new technology, and whether increasing base levels of technological proficiency may promote independent learning.
- Investigate the opportunities for technology to increase collaboration between neighbouring schools, and between distance learners.
- Investigate issues of equity of access to technology in New Zealand schools, which includes establishing the current extent of New Zealand’s digital divide.
- Investigate the impact of increased digital literacy on learning.
We received 90 submissions, and considered advice from the Ministry of Education and the Ministry of Business, Innovation and Employment, and from a specialist advisor, Laurence Millar.

**Defining digital literacy**

Within the broad areas of student competence there was discussion on digital literacy. There was substantial support for viewing digital literacy as more than just technical competence. One submitter recommended that the definition of digital literacy should be aligned to the skills that will equip the New Zealand workforce of the future. We are also aware that some definitions refer to three skill sets that individuals need to master in order to be digitally literate. To achieve Information, Media, and Technology Skills, the theory is that a person needs to achieve competency in these areas. We acknowledge that while there may be differing definitions of digital literacy, the basic premise is that students will be able to come through our education system with an ability to navigate new technologies, and have the skills that are required of them in the modern world.

We are also aware of a wider term used by some of “digital citizenship”. Drawing from the Key Competencies and Values in the New Zealand Curriculum and a growing body of research knowledge, NetSafe in consultation with some New Zealand teachers has produced a definition of a New Zealand digital citizen. NetSafe advocates that digital literacy or the ability to understand and fully participate in the digital world is fundamental to digital citizenship. It is the combination of technical and social skills that enable a person to be successful and safe in the information age.

NetSafe also proposes that just like literacy and numeracy initiatives, which provide people with the skills to participate in the work force, digital literacy has become an essential skill to be a confident, connected, and actively involved lifelong learner. In chapter 6 we set out recommendations for the development of digital literacy and 21st century skills.

**Past and current initiatives**


In the area of technological capability, Project PROBE brought the first broadband access to almost all schools in 2003, and research showed the distribution of laptops for principals and teachers through the TELA scheme at a similar time provided a substantial change in the use of information and communication technology (ICT) in schools. We are aware that there has been some interest from Australian politicians and officials regarding our rural broadband rollout and our investment in e-learning, the Virtual Learning Network, the Virtual Kura project, and particularly in building teacher capability.

We had advice from the Ministry of Business, Innovation and Employment that the Government is investing $1.5 billion in ultra-fast broadband. We had advice that the Government’s target is for 97.7 percent of schools and 99.9 percent of students to have
access to ultra-fast broadband. We heard from the Ministry of Education that it is ensuring (in partnership with the Ministry of Business, Innovation and Employment and Crown Fibre Holdings) that all schools will be connected to fibre or an alternative technology by 2016, and that over the next few years all schools will have completed internal network upgrades. We heard that the government has invested in Network for Learning Ltd, and its aim is to ensure all schools have access to affordable, safe, reliable, ultra-fast connectivity and content and services from 2013, to enhance school administration and student learning outcomes.

**Articulating a 21st century vision**

Throughout the submissions, we were presented with a clear consensus on the potential features of the New Zealand education sector in the future. We heard there could be enhanced personalised learning, rather than a one-size-fits-all approach, allowing learners to proceed at their own pace. This could allow more student-led inquiry, where students have more control over their learning, and allow them to focus on their own interests, with support from teachers. In such an environment, we heard that digital literacy would be an essential skill to enable and enhance both teaching and learning.

We heard that the current education system does not always meet the individual needs of students. Using the Internet, each student can learn in a more personalised way, and access information in a way that reflects their individual learning needs and style. A number of student submitters said that they valued the individual learning that their schools offer, which is made possible by the use of Internet-sourced resources. We believe major changes in the way students learn are inevitable, and it is essential that the Ministry of Education and teachers be responsive to the shift. We also heard that parents would have more opportunities to be involved in their children’s education, and that their own digital literacy could be enhanced and supported by their children.

We understand that there are many schools that have developed positive 21st century learning environments. We heard of education networks, loops, and clusters throughout New Zealand that are at the cutting edge of best practice. Innovation is happening in urban and rural areas, and students from higher and lower income backgrounds are benefitting. Students and teachers from these communities made enthusiastic submissions to the inquiry, and were confident that the rest of the education sector could benefit from some of their innovations. In particular, we were impressed with the school students who submitted to our select committee from Amesbury School, Tawa Intermediate, and the Computer Clubhouse Trust. We were encouraged by their depth of understanding and their desire for e-learning.

**Fostering innovation and collaboration**

More innovations are needed beyond the existing community of education enthusiasts and clusters. The networks and loops in question do not just connect schools within a local area. Some of the most innovative uses of the connections between schools involve using networks and loops to allow teachers to collaborate around the country, and to reach more students in a targeted way. For example, we heard from a submitter who leads a regular digital discussion group with the teachers who have been tasked with leading innovation and development in their schools towards a 21st century learning environment. Another submitter had founded a voluntary group of biology teachers, which holds regular
discussions of methods that they have used successfully with their students. This subject
teacher example is particularly interesting, as it shows leadership by teachers as well as an
innovative approach to professional development. These teachers are using the resources
available to them to collaborate with their fellow teachers, and to share their innovations so
that their students are receiving the best education in biology that the combined group of
teachers can offer.

We heard from several submitters about the Manaiakalani project, which has been
operating for 19 years. One submitter specifically said that the project succeeds because of
leadership, time, and dedication. Another submitter said that before the Manaiakalani
cluster proved it possible, he would not have believed that a school could install wi-fi for
its community, support the provision of devices for their students, and lift educational
outcomes without leaving the school in debt. The Manaiakalani cluster of schools
submitted that their students are making exceptional progress.

**Evaluation of best practice and research**

Throughout this report, there is much reference to anecdotal evidence. We heard there is a
lack of research in the area of education. That is why we have recommended that the
Government consider improving the research framework to ensure that educational
policies are informed by current research thinking and future-focused thinking in the digital
area. In considering the research framework, adequate consideration should be given to
ensuring that New Zealand research is shared throughout the country and with
international research programmes. We believe that one of the most important steps that
the Ministry of Education can take to improve learning in New Zealand is to invest more
in pedagogic research; other ministries could conduct neuro-biological research. Sir Peter
Gluckman noted that we are entering an age of technological change and have little idea of
what impact this will have on brain development. The pace of technological development
is such that teaching and learning approaches are going to need to be much more flexible
to respond to these and future changes.

We heard from one submitter that educational research is poorly funded, particularly
compared with economic research, and that there is a lack of professional assessment of
the quality and the impact of programmes in New Zealand.

**Addressing equity issues**

The learning and teaching environment needs to support more involvement of family and
whānau in the education of their children. Throughout our hearings, we heard examples of
inequity between rural and urban communities, between and within schools, in access to
devices, and resulting from the variable digital literacy of individuals. We heard that both
the home and the school environment affect students’ ability to become digitally literate. In
chapter 7, these issues are outlined and we have proposed recommendations.

We recognise that buildings and classroom design in many schools reflect a 20th century
model. Many submitters described their desire for a more innovative and flexible physical
environment for teaching and learning.

Submitters repeatedly told us that they would like to see changes to further enhance the
education system to better reflect 21st century learning, skills, and competencies. The
current system (legislation, policy, leadership, and measurement) can be seen as a barrier by schools, principals, and teachers who are achieving 21st century learning; the system needs to change to support the vision, and create incentives to realise it.

**The future of learning and teaching**

We heard that changes in the methods of teaching are being driven largely by students. The increasing access that students have to online and blended learning has provided them with a more diverse range of sources of information and enhanced inquiry learning.

We heard that there may be better opportunities for certain areas of the school system such as teaching in isolated areas or the provision of tuition in languages. We heard that there will also be more opportunities for students to access content from around the world, or a teacher in another New Zealand location.

There is a need to up-skill current teachers to offer such new ways of learning. We heard that this could require big changes to the professional learning and development that are available to teachers, as well as initial teacher training, and this will be discussed in detail in chapter 4. We heard from a number of different submitters about possible models to deliver teacher support and professional development.

In order for teachers to facilitate digital literacy, they must themselves be digitally literate. Teachers who do not embrace e-learning are at risk of not being able to maximise learning opportunities for their students. Inconsistent policies in the device policy area have the potential to establish a digital divide within schools.

We believe that the future of learning will be blended; students will combine learning from on-line and video technology with group work and individual study. The skills of a teacher will need to reflect this new blended learning environment.

We received a number of submissions urging us to ensure that the needs of students with disability are considered. We also heard of one school that redesigned a classroom around the needs of a disabled student. We were interested to hear that the school found that all students benefitted from the redesigned classroom. We recognise that under the current education system, disabled students can be marginalised, and we must ensure such students are accommodated in planning for education.

We heard that progress has been made by some individual schools in adopting new methods of teaching. Schools throughout the country have begun to collaborate more by creating networks. The move to networking of schools was motivated in part by a recognition that this approach can help address the challenges that face small schools, especially rural schools. We feel that there is an opportunity for schools to learn from the experience of others that have developed virtual networks.

**Potential barriers to progress**

New Zealand can boast examples of exceptional 21st century learning in the digital environment. The biggest challenge the New Zealand education system faces is scaling these successes so that every school uses digital devices and access to Internet content and services to maximise learning opportunities. While we heard many submissions describing individual success stories, we would like to have been presented with research that analyses
the common characteristics of these successes. However, we acknowledge in chapter 2 that there is a lack of research focussed in this area both in New Zealand and overseas.

We heard that a major factor in the success of a school is leadership. Leadership within schools is offered by principals, individual teachers, and boards of trustees. We heard from a number of teachers who had established leadership roles to progress 21st century learning. We heard that there are opportunities for teachers to become online leaders, via access to the Internet, for example by hosting a discussion forum on their particular subject. We heard from the leader of a “digital citizenship group” of teachers from a range of schools throughout the country, who regularly conference call to collaborate and share ideas about what is working for them. This group shows what can be achieved. We recognise what can be achieved by the leadership of dedicated educational professionals, and in chapter 11, we propose initiatives to support them more.

We heard from some rural schools that geographical location is preventing them from giving their students the best learning experience. Teachers in these schools cannot help their students reap the full benefits of individual and collaborative learning methods based on Internet-sourced content for lack of high-speed Internet access. A number of submitters to the inquiry also said that wireless access throughout schools is an important asset for learning. If students and teachers are to be encouraged to source information from the Internet, then they must be able to access the content quickly and efficiently. The issue of the availability of technology is covered in detail in chapter 7.

Another barrier to teachers realising the full potential of blended learning using digital devices is the time needed to master the new technology, according to submitters. A high percentage of current teachers were not taught skills in information and communication technology when they were at teachers’ college. These teachers are required to find the time to take professional development courses to gain the necessary skills. Submitters suggested that changes are needed to the way that professional development is run, so that these issues can be tackled. Again, this will be addressed in chapter 4.

We heard from teachers who are leading their schools in digital literacy about how they use a wide range of tools in communicating with their students. Their students can learn at a time that best suits them, and we heard of examples of teachers seeing their primary-school-aged students uploading documents late at night. Teachers may then feel they are expected to facilitate learning at the time which best suits the student. When the school day is over, instead of being able to prepare for the next day, teachers now find themselves communicating with students, and continuing to help them learn.

Teachers who made submissions to the inquiry were asked how they maintained a work–life balance, and many replied that they find it difficult. If technology is designed to make the teachers available more often, teachers’ work–life balance issues should be considered.

Throughout this inquiry we have been aware of the rapidly changing environment, and the need for greater data and research. For this reason we have taken an approach throughout the report whereby we have endeavoured to identify the challenges and emerging trends, then we have identified key work streams that the Government should consider as a result of those issues and challenges.
We are pleased that we have been able to present a substantive report with significant cross-party agreement by the four political parties on this committee.
2 Improving data and research to create an evidence base

We understand that the area of digital literacy is an emerging policy area in education. One of the challenges that we had in this inquiry was that there were certain areas where there was a lack of data and research to inform our inquiry. However, we do believe that we have been able to identify throughout this report some policy issues that need addressing and some general areas of work. In each area we have been careful to examine the available evidence base for our recommendations.

We are encouraged that the Ministry of Education recognises that 21st century learning requires many technology components to be in place in schools including fibre Internet connection, in-school networks, equipment, schools software and hardware (including computers, laptops, tablets, printers, and other “end-user devices”), as well as the content and services used for teaching and learning. We asked questions about the presence and use of technology in schools. While we understand this is still an emerging area around the world, we believe it is crucial that government agencies are able to provide more comprehensive data in the future. For example, we were provided with data on which schools had access to fibre, but not on which schools were making use of the fibre for teaching and learning purposes. This reflects a particular point in time in the deployment of fibre to schools.

We also received advice about schools that had received an internal network upgrade, but not whether these schools had access to fibre. Other examples of areas where we would have liked more comprehensive information were the extent to which wi-fi access was used in schools, the adequacy of technical support, the variety of policies on devices in schools, the use of school ICT facilities by the community, access to ICT by students outside school (for example in the home), the software in use in schools, the extent of e-learning and the use of digital content resources by students, and the ICT capacity and capability of teachers in schools. There does not appear to be a sector-wide view of the digital state of each school. We understand that under current policy settings in the sector, operational decisions are made by individual boards of trustees; however, we consider that the absence of a comprehensive integrated view of the digital readiness of all schools makes it difficult to plan for 21st century learning. We consider it important that there be robust nation-wide data on the use of ICT in schools to enable sector-wide planning for 21st century learning.

Many submitters suggested that more research is needed into the impact of digital technology on teaching and learning and the resultant outcomes. One area of research raised by Sir Peter Gluckman was the relationship between digital technology and neurobiology. In his submission, Sir Peter Gluckman noted that current research on the relationship between technology and learning is inconclusive. In his submission, he noted that some studies show that technology-based training can improve working memory and provide mental stimulation, but some applications can be a distraction, and parental
monitoring of younger students’ use of technology may improve learning outcomes. He also submitted that research into the risks and potential benefits for healthy development presented by new technologies will enable educational professionals and parents to access clearer independent information.

We heard from a submitter that they believe that educational research is poorly funded compared with economic research. We heard that research is being conducted by postgraduate students in New Zealand into the role of the “e-principal”, blended learning, and initial teacher education, and we believe that such research will be invaluable for the development of 21st century learning environments.

We accept that one major reason that the research is limited is because this is an emerging policy area. We feel the need for a sense of urgency to ensure there is better data and research as more schools are using more technology and shifting towards a 21st century learning environment.

Research identified as necessary by submitters included the relationship between digital learning and blended learning, improving collaboration, pedagogy of digital learning, distributed leadership, teacher development, the impact of ICT on children’s development, universal design and impact on learning outcomes, and digital equity. We feel that it is important that any research undertaken in this area should be publicly available. We heard that in other areas of education a process is undertaken by the ministry called an iterative best-evidence synthesis which results in a comprehensive review of current research in an area, to inform what works best for student learning outcomes.

**Recommendations**

1. We recommend that the Government implement a system that collects, analyses, and disseminates better sector-wide data on digital literacy and 21st century skills to enable more evidence-based policy decisions.

2. We recommend that the Government develop an improved research framework to ensure that educational policies are informed by current research thinking and future-focused thinking in the digital area. In developing the research framework, adequate consideration should be given to ensuring that New Zealand research is shared throughout the country and with international research programmes.

3. We recommend that the Government consider whether it commissions an iterative best-evidence synthesis of digital learning and pedagogies.
3 21st century school buildings and learning hubs

A key issue in providing a 21st century learning environment is ensuring that schools have the right facilities to support teaching and learning. We heard consistently from teachers and students that the single-cell learning spaces of traditional classrooms of the last 100 years do not always meet the needs of learners. We also heard from many submitters that having desks arranged in rows, even if they are now facing an electronic whiteboard, does not maximise the opportunities of learners.

We heard that students are increasingly learning in groups, and in collaborative ways. We heard that some new schools, such as Albany High School in Auckland, and Amesbury School in Wellington, have been designed in an innovative way to accommodate modern learning environments. We understand that many schools are balancing the need to develop more modern environments with current upgrades. We hope that for any new builds consideration is being made to ensure a more modern learning environment results.

We were delighted to hear from teachers who had used a small amount of money and a lot of creativity and determination to transform their old classrooms into learning spaces to better reflect the needs of their students. These new spaces allow students to find the space that best suits their learning needs; if they are working on a collaborative project, they can use one of the larger tables, and if they want to work on an individual project, they can decide whether they would prefer to sit at a desk. We heard that some schools are moving away from “computer labs” to a policy of placing computers in every classroom. Increasing variety and uptake of devices coupled with wireless access could enable students to better determine the space that works best for them.

We heard flexibility of 21st century learning environments was seen as the opportunity for learners to engage in a much wider range of learning activities and situations than possible in a conventional classroom.

We heard that teachers can also benefit from learning in open spaces. We heard from some submitters who work in new school environments that the open spaces can facilitate better cooperation amongst teachers. Albany Senior High School has open space classrooms. We heard that less experienced teachers are often scheduled to teach classes next to classes being led by senior teachers. This allows them to observe the senior teachers, and pick up tips that they can immediately test themselves; so teachers can collaborate more freely, and see the results much sooner. We heard that they believe that this approach is beneficial for all students.

One submitter stated that a flexible physical environment does not support 21st century learning without the right kind of teachers, the right kind of relationships, the right kind of
pedagogy, a broad toolkit of teaching and learning tools, and flexible timetables to allow for personalised learning.

While there are obvious benefits from a better physical environment, there are many existing schools that were built decades ago, and have not been adapted for 21st century learning. We think access to more open, flexible, networked learning environments should be considered, not just in the context of a new rebuild, but also how we convert existing environments. We heard from a number of submitters the benefit of access to wi-fi in more modern learning environments. This is discussed further in chapter 9. When schools cannot offer wi-fi, the students seek out places that do; we heard of students connecting to the wi-fi network offered by a nearby McDonalds.

We heard that some schools act as learning hubs for their whole communities. One way to create an effective hub is to make the school facilities available to the community to use when school has finished for the day. Another option could be to open up the school library to the community. Submitters noted that some schools have set up “parents’ computer rooms”, where parents can use the school’s computers away from students. Other schools have placed computers in the school lobby for use by parents. There are a range of models currently happening around New Zealand, and they need to be considered both in terms of the benefit for children’s learning, and in terms of access to resources.

We heard from some submitters that there can be practical issues when trying to set up a school as a digital hub. One school took two years to complete all the required policy changes so that the community could use the school library when the school day ends. We heard from submitters that legislation and schools’ insurance policies are barriers to allowing non-students to use the facilities except in certain circumstances. We heard that the Manaiakalani cluster formed a trust to allow the community access to their school facilities, which provided an easier mechanism than to change their insurance policy and seek exemptions under the Education Act 1989.

We heard that there is a large variance across the country in the role of school libraries. Some schools have invested significant resource and time in ensuring their libraries are an integral part of 21st century learning. One factor that could be taken into account is the possible difference in role between rural and urban school libraries. We believe there needs to be greater consideration of their role.

**Recommendations**

4. We recommend that the Government investigate the benefits and implications, along with any policy or legislative changes, of extending availability of school facilities and resources, including computer labs and Internet connections, to their communities.

5. We recommend that the Government create best-practice design templates for school buildings so that newly-built schools and upgrades are more open, flexible, and networked.

6. We recommend that the Government consider how school libraries can be 21st century learning environments.
7. We recommend that the Government consider encouraging local government to ensure greater Internet access via public libraries for out-of-school learning as a valuable community resource.
When considering the skills, knowledge, and understanding that will be required of a future teacher, it is important that the approach is open-minded. We understand that technology is rapidly changing, and so the skills required of a teacher cannot be fully anticipated. In assessing the role of the teacher, the changing environment needs to be taken into account. Some submitters have proposed skills that may be more appropriate in the 21st century. The Government has a significant interest and role in ensuring teachers are equipped with the right skills.

We heard from a number of submitters that the current initial teacher training does not equip teachers adequately for a 21st century learning environment. Some submitters suggested that an important first step would be to require all student teachers to demonstrate proficiency in ICT before they can be approved as teachers. We also heard that for 21st century learning, it will be more important for teachers to be lifelong learners, particularly in relation to digital technologies, and be given greater opportunities for professional learning and development. We heard a number of suggested ways that this could be achieved, such as allowing teachers to select a day per month that they could dedicate to professional learning. Other submitters suggested that teachers be encouraged to undertake professional learning and development in collaborative clusters.

We heard calls for change in initial teacher training. There are a range of skills, knowledge, and understanding to consider, both in terms of the future role of a teacher, and in terms of students in the 21st century. They may cover basic ICT skills, e-learning pedagogy, and specialist discipline knowledge in areas such as computer science and programming. We heard from submitters that teachers are not currently required to meet a basic standard of ICT competency, and are not required to take ICT papers or to understand adequately the pedagogy of digital learning in their training. We believe that these skills will become more important in teaching and learning, and all aspects of the economy and society.

We heard that it is important for the professional development of teachers and initial teacher training to reflect the dynamic nature of the changing digital environment. We heard that on-going professional development is essential for principals and heads of departments. Some submitters feel that all principals should be qualified in digital literacy, and should be required to undertake in-service training to build and maintain these skills. These submitters feel that schools need to be led by principals who understand the importance of digital technology, and can provide leadership in the delivery of blended learning in support of 21st century learning. We consider that boards of trustees should also understand the importance of digital technology, so that they can also provide governance leadership in this area.

Some submitters said that the professional development of teachers should use blended learning, with a combination of online and face-to-face learning, making e-learning and multimedia an integral part of their learning experience. We consider that teacher training
could include the development of skills such as accessing high-quality online material, the judgement to integrate international and New Zealand resources to deliver high-quality learning, and the capability to develop students’ information literacy and critical thinking capacities in a digital context.

The digital environment creates many more opportunities for teachers to be innovative. There is an increasing trend in classrooms to move content delivery to collaborative production and problem solving. For example, we heard from a submitter who is creating his own educational podcasts, which he publishes online. This teacher started by making videos for his class, and this has grown almost by accident, so that his videos are now used by students across the country. This has created a large workload, and the teacher has volunteered his time to continue updating the resource. Another example of innovation was given by a science teacher who asked his students to find a way to analyse data in less than the 48 hours taken by a local blood centre. A student in his class developed a method that took only 50 minutes. The blood centre has adopted this method, and dramatically increased its productivity.

We heard that due to the online environment, there are changes occurring in when and how students have access to teachers. We heard this could have implications for teaching time and the sharing of resources.

We heard that librarians have important skills to locate and assess information online. A number of submitters emphasised the increasing importance of this skill for young people in the future.

We heard that for major transformational change to succeed, it is important that there be a focus on both investing in people and technology. Substantial technology investments are being made in the education sector at the moment, such as the rollout of ultra-fast broadband and the Network for Learning. We heard that it is equally important to invest in up-skilling people for 21st century learning. The changes in the way teachers operate will require a sustained investment and commitment by all stakeholders in the education sector. We received advice that the cultural change required could take several decades. We are optimistic that with the right commitment across government, the education sector, and New Zealand society, this could be effected much more quickly. New Zealand needs to ensure we have political consensus on both the vision and commitment to make this change deliver better educational outcomes for our students, now and in the future.

**Recommendations**

8. We recommend that the Government consider requiring all New Zealand teachers to demonstrate a defined standard of digital literacy and to undertake professional learning and development to maintain their digital literacy skills, knowledge, and understanding.

9. We recommend that the Government consider requiring appropriate school leaders to demonstrate a defined standard of digital literacy, and to undertake professional learning and development to maintain their digital literacy skills, knowledge, and understanding.

10. We recommend that the Government consider measuring and evaluating teacher training institutions on the quality of their digital literacy training.
11. We recommend that the Government, in consultation with the education sector, consider whether there need to be any policy changes to take into account potential workload changes as a result of online learning.
5 Improving access to New Zealand content online

We are aware that giving students access to technology and communications infrastructure, such as ultra-fast broadband and enterprise wireless networks, is one part of modernising our learning environments. The educational content made available to students is of equal importance.

We heard from a number of submitters the importance of ensuring there is good access to New Zealand content. Specifically, we heard that the teaching resources the Correspondence School uses could be made more accessible in a digital format, and more widely available online.

We heard that more New Zealand content should be made available for students online. We heard that there have been copyright issues relating to content that has already been produced, such as the School Journal archive. Other potential sources of relevant New Zealand content for schools include the National Library, TVNZ archives, the Film Archive, and the Alexander Turnbull library. We heard arguments that this content, originally funded by the taxpayer, should be available free for all schools to access. We heard that, while a lot of this archival content is already online, students and teachers find it challenging to obtain and use, due to a complex range of copyright restrictions. We heard that the result of these restrictions is that the content is not used, or the copyright is not respected. To allow its easy use by students and teachers, changes are needed to the copyright arrangements.

We heard of three licensing schemes administered by the New Zealand School Trustees Association, which provide content that schools can access online. These are the Schools Music licence, which provides audio content to schools, Copyright Licensing, which provides written content, and Screenrights, which provides visual content. We heard that approximately 70 percent of schools hold a licence for print copyrights, but only 25 percent of New Zealand schools hold a Screenrights licence. We heard that mostly higher-decile schools are able to do this, because of the licence fee, which amounts to $4.19 per student per annum. We heard that in other jurisdictions, such as Australia, these costs are covered by central agencies. However, in New Zealand, this cost falls to individual schools. We heard from one submitter their concern that schools may be unaware of their copyright obligations and may have issues with budgeting for licences. We were given an example of a school which was asked to pay $60 per second for footage of a haka from TVNZ.

We heard a submission from an organisation that is already providing online content to the education system about challenges in terms of copyright and licences. Their online teaching tool provides recorded and live videos streamed and downloaded from over 40 domestic and international television channels. It offers access to content provided by educational organisations, companies, foundations, and government departments. Currently any
resource built by New Zealand teachers using a recorded TV programme or any learning
guides developed around local productions are not universally available for sharing or
purchase by other teachers unless they are in a Screenrights-licensed school. The submitter
advocated that the Ministry of Education should consider granting cross-sector licensing.
They advocated that this model, with associated funding, could confer a bulk purchase
discount, and allow every school equal access to content. We heard that the need for
Screenrights licences will only grow as more content becomes available online. We want
the Government to consider improving access to digital content.

We also heard that licensing fees are preventing libraries from providing e-books. We heard
that e-book technology is still developing. However, we heard that a 21st century learning
environment will increasingly use e-books as a major source of teaching resources, and so it
is important that access to e-books is not constrained by unaffordable licensing fees.

We heard that under the current copyright licensing arrangements that cover New Zealand
schools, certain resources that a teacher develops can become the property of the school’s
board of trustees, whose express, written permission is required before the resources can
be shared. A number of submitters proposed that this could be a large obstacle to
collaboration. One submitter suggested that as few as three schools in New Zealand may
be operating under a Creative Commons licensing agreement. This submitter suggested
that Creative Commons licensing could be adopted as the default setting for schools
regarding resource material they create.

We heard from one submitter that it would be redundant for the Ministry of Education, or
any other content provider, to replicate existing content, such as certain applications, or
educational computer games. For example, mathematics tutorials can be readily used in
New Zealand schools. We heard that some games do not translate so easily to the New
Zealand context. One example is iCivics, a game which provides information on
democracy and social responsibility, and is used in teaching social sciences. This game is
based on the American governance system.

We heard that one way to ensure that resources reflect the New Zealand system is to have
more New Zealanders producing them. We also heard about the benefits of students
themselves generating new resources, as part of their learning. We heard from submitters
that it was important to ensure the development of online Māori and Pasifika content and
resources.

We heard about the importance of ensuring that there are policies in place to prevent
cyber-bullying, and inappropriate online content. We understand the challenges of
developing policies in this area. We note that the Law Commission has recently published a
report, *Harmful Digital Communications*, and we support the work being undertaken to
determine the best response to this issue.

**Recommendations**

12. We recommend that the Government consider ensuring that all appropriate New
Zealand video content produced for public consumption is licensed and funded under a
single national contract, and made available to all schools.
13. We recommend that the Government ensure that policies and guidance are developed to help prevent cyber-bullying and inappropriate online content.

14. We recommend that the Government ensure that more local New Zealand content, including Māori and Pasifika content, is made available to all schools, either through the Network for Learning or by other means.

15. We recommend that the Government ensure that digital educational materials for learning Te Reo Māori are available to all students.

16. We recommend that the Government consider ensuring access to high-quality digital resources to support the New Zealand curriculum for all teachers and learners.

17. We recommend that the Government review the intellectual property framework for our education system to resolve copyright issues that have been raised, including considering Creative Commons policy.

18. We recommend that the Government consider the advantages and disadvantages of whether all documentation produced by the Ministry of Education for teaching and learning purposes should be released under a Creative Commons licence.
Development of 21st century skills

We understand digital literacy is framed in a context of knowledge, skills, and understanding in the 21st century. Our schools fulfil many purposes, and digital technology is only one aspect of a learning environment. We recognise that schools provide an enormous opportunity for the development of a range of skills, including digital literacy, social, and non-cognitive skills. These will remain important in a modern world.

One submitter recommended that the definition of digital literacy should be aligned to the skills that will underpin the New Zealand workforce of the future. We acknowledge that NetSafe, in consultation with New Zealand teachers, has produced the following definition of a New Zealand digital citizen. A digital citizen

- is a confident and capable user of ICT
- uses technologies to participate in educational, cultural, and economic activities
- uses and develops critical thinking skills in cyberspace
- is literate in the language, symbols, and texts of digital technologies
- is aware of ICT challenges and can manage them effectively
- uses ICT to relate to others in positive, meaningful ways
- demonstrates honesty and integrity and ethical behaviour in their use of ICT
- respects the concepts of privacy and freedom of speech in a digital world
- contributes and actively promotes the values of digital citizenship.

We acknowledge that this is one definition of the skills that could underpin the New Zealand workforce of the future. We recommend that the Government consider reviewing these skills.

Some submitters suggested that educational computer games should play a larger role in the future of education. We heard that such games can provide a number of benefits, both for the students and for their teachers. Games can provide immediate feedback to children. One of the advantages of an online environment is that there is potential for more people and tools to provide feedback to students. Educational games can also improve students’ engagement; we heard that students can become so engrossed in the game that they do not realise that they are learning. Teachers and schools can also benefit from the use of educational games. We heard that one possible advantage can be data provided through software. That data may contribute another source of information about how a student is progressing in a particular curriculum area.

We are aware that the ICT industry in New Zealand is experiencing a significant labour shortage, and that many occupations in the ICT sector are included in the Long-Term Skill
Shortage List prepared by the Department of Labour. We heard from submitters that the future growth and success of the ICT sector will require more students who are excited by, and motivated to pursue, a career in the ICT sector. We are also aware that the report to the Prime Minister by his Chief Science Advisor in 2011, *Looking ahead: science education for the twenty-first century*, describes the challenges involved in delivering science education. These two areas—ICT skills development and science education—will require particular attention to ensure that our future workforce is able to meet the needs of the business sectors that will deliver economic growth in the 21st century.

**Recommendations**

19. We recommend that the Government review the definitions of digital literacy to consider a common definition that can be used across the sector.

20. We recommend that the Government review 21st century skills in the context of digital literacy in our education system.

21. We recommend that the Government consider research and the potential for a greater role of educational games as part of digital learning environments for 21st century learning and skill development.

22. We recommend that the Government consider enhancing the role of information science in the education sector.

23. We recommend that the Government better position ICT skills, knowledge, and understanding as educational options that lead to high-value careers.
7 Equity issues

We heard that issues of equity of access to content and services are not confined to income circumstances. We heard that cost was a major issue for some schools and individuals. However, throughout our hearings, we heard examples of inequity between rural and urban communities, between and within schools, in access to devices, and inequity resulting from the digital literacy of individuals. We heard that both the home and school environment impact on students’ ability to be digitally literate.

We heard that public libraries have access to the Internet, but unrestricted access is not provided to users free of charge. We feel that the Government should consider greater public access to the Internet at public libraries, to allow students to continue with study and research after school has officially closed. We recognise that public libraries are funded by local government. Access to the Internet at libraries is also important for adults in the community who are seeking to improve their digital literacy. However, the cost of getting to the library, and time limits on use of the library computer (often only 15 minutes) means that some parents have little chance to improve their own digital literacy.

It is also important to improve adult digital literacy. We were told that the uptake of digital learning increases significantly when parents are involved. We heard from one submitter that they know of 33 early childhood education facilities that are helping children and their parents learn digital literacy skills. We understand that there are many differing views about the provision of digital literacy in early childhood centres. We recommend that the Government undertake research and consider policies in this area.

We also heard that there are benefits from allowing more parents to use the facilities of schools. We heard that schools that offer digital literacy courses on-campus have seen more parents engaging with school. There is anecdotal evidence that parents who complete digital literacy courses are also more likely to engage with the school through other courses.

The 2006 census found that 100,000 families with school-age children did not have computers in their homes. We accept that as a result of the 2013 census we will have more accurate data. We heard from one submitter that they believe a large number of students still do not have access to a computer after school hours. We have advice that while some students do not have access to a computer in their home, they may have access to online learning via another family member or mobile devices. We believe it is important when considering equity of access to online learning, that decisions be based on good data covering a range of indicators including access to computers in homes, access to the Internet, speed of Internet connection, and access to mobile devices among others. Not only may families be limited by lack of access to computers, but we heard an increasing percentage of low-income families no longer have a fixed landline, having switched to prepaid mobile phones to reduce costs. We heard that families that are struggling to pay for a fixed line will not be able to afford broadband access, which will further exacerbate the digital divide.
We heard that this lack of access to online learning could have a detrimental effect on such families’ educational opportunities. We heard that many children are involved with the digital up-skilling of their parents.

We heard that parental engagement is fundamentally important to educational outcomes, and that when parents engage with children and their digital devices at home, students are better able to continue their learning outside the classroom. For this purpose after-hours access to the Internet is important. We note that a few schools are seeking to provide free wi-fi within school clusters extending into the homes of local students. We heard that there is an opportunity to learn from these schools’ early innovations.

Throughout this inquiry, we sought to understand the extent of the digital divide, but found there was a lack of data or research on it in New Zealand. We also heard of a digital divide within schools, where teachers differ in their approach to the use of digital devices, or leaders embrace digital literacy inconsistently.

We heard of a situation whereby there were only 30 computers available to a class of 31 students, and the disabled student was not assigned one. We believe it is important to ensure that digital learning is inclusive and available to disabled students. We heard from the Human Rights Commission that when education software is being developed, a key point that should be considered is ensuring that people with disabilities can use the software. The commission suggested it is too late to adapt the software when it has reached the market, as students with disabilities will fall behind their classmates while the software gets updated to meet their needs. We were told that some governments have regulations that when technology is designed or procured, it must meet the needs of people with disabilities. We heard that in addition to appropriate software, high-quality broadband is also crucial, so that sign language communication will not be hampered. We also heard that online learning may provide huge opportunities to people who have been traditionally disadvantaged by lack of access to learning.

We heard about problems for students who wish to continue learning outside school because most schools use software which is licensed only for use on the school computers. This prevents students from using the software at home, unless they purchase their own copies. Those whose families cannot afford the licence fee go without. One suggestion from several submitters was to encourage schools to use open-source software. They submitted that this would allow students to use the software on the devices that they bring to school, and can also access the same software on their home computer. We heard from some submitters that there is ample open-source software available to meet all the needs of a student, and some schools already operate solely on open-source software. We recommend that the Government review licensing arrangements for software, in terms of access both in schools and in homes, including open-source software.

Some submitters criticised the prioritization of the current rollout of high-speed broadband, saying that they believe it is targeted at commercial and high-decile areas first. We received advice from the Ministry of Business, Innovation and Employment that there was a fair distribution between deciles in the phasing of the rollout, and that all schools will be connected by 2016.
Recommendations

24. We recommend that the Government consider introducing policies and initiatives to ensure that every child at school in New Zealand has access to digital learning at school.

25. We recommend that the Government undertake research and consider policies in relation to digital literacy in early childhood education.

26. We recommend that the Government undertake to consider how digital learning material used in New Zealand schools can be accessible by people with disabilities, including those who cannot see graphics, cannot hear audio, or cannot operate a mouse.

27. We recommend that the Government review licensing arrangements for software, so that students have equity of access in schools and in homes, including the use of open-source software.
8 Improving device access

We heard that tools that allow students to improve their digital literacy form an important component of a 21st century learning environment. We heard from a number of submitters that different schools have various device policies, including funding of devices by parents, school funding, and allowing students to bring their own devices. A consistent theme in submissions was the need to focus less on choosing a specific type of device, and more on ensuring that all students have the opportunity of access to both a device and learning content and services. We heard that it is important to establish device policies addressing issues such as equity, funding options, conditions of use, and ease of use, which also recognise the pace of change in technology.

We heard that one of the benefits of using digital devices in schools is that it helps improve the engagement of students in their learning. We also heard from one submitter that this engagement can reduce truancy. One of the issues raised was that some students cannot access, or have difficulty accessing, digital devices in both the home and the school environment. We also heard that some schools have banned devices. We understand that there may be times when it is inappropriate to use a device in the school environment. In chapter 5, we have outlined some of the issues that have been raised regarding safe online environments in our schools. However, we think it is important for schools to ensure that all students have some access to a device for online learning.

Schools are using various funding schemes to enable greater access to devices for students. For example, the Manaiakalani cluster of schools in south Auckland has facilitated a lease-to-own scheme, where families pay an initial deposit of $40 and then $2.50 per week over four years. Another school has established a lease-to-own partnership with a local provider, under which 100 devices were made available for families to purchase. One school noted that their need for leasing-to-own arrangements was substantially reduced when students were allowed to bring their existing devices. In this school only six students, out of an intake of 300, needed to borrow devices from the school, with the rest able to provide their own devices from home. We are pleased to hear that the schools that were early adopters of devices have been used as case studies by other schools. Over 1,000 teachers have visited one school to observe the teaching environment, and see how it could be adapted for their schools. We understand that, given the variation in different communities’ access to resources, similar arrangements would not be possible in every school.

We heard suggestions that the Ministry of Education be encouraged to develop procurement policies for devices. This could cover device purchases in bulk, or bulk leasing arrangements, to reduce the cost to parents or schools. We heard from some submitters that it would be unfair to pass on the cost of devices to students and their families, as some might not be able to afford them. Some submitters argued that there should be more government funding of devices.
We heard that there are also issues regarding the security of digital devices. We heard that some students are not taking their devices home, because of security fears; and that students feel more confident to use devices at home if the family feels engaged with the device and the student’s learning.

We heard a number of submitters argue that student ownership of devices was more beneficial and delivered better learning outcomes than other arrangements, such as leasing by the school. We also heard that student ownership of devices is correlated with better care of them, and more engagement by families with students’ learning. Most of the evidence is anecdotal, however, as these policies are still new, so there has been little time for research. In considering device policy, we believe that the Government needs to consider adequate research into the potential benefits and drawbacks of ownership of devices.

With the predicted increase in the number of devices on a school site, it will become more and more important that schools have good, responsive technical support. As ICT services become more networked, a lot of technical support can be provided remotely using helpdesk services. We had advice that the ICT support role will need to shift to providing more help for students with device issues. We had advice that given the number of devices that may need support in the future, consideration should be given to consolidated helpdesk arrangements.

**Recommendations**

28. We recommend that the Government consider introducing a policy that every student have access to a digital device for learning, including the appropriate age for such a policy to apply.

29. We recommend that the Government consider research and best practice to develop policies on device ownership and other arrangements to ensure students have access to a device.

30. We recommend that the Government investigate the best bulk supply arrangements to enable possible purchase by families or schools of devices suitable for use by students at school.

31. We recommend that the Government require schools to establish guidelines on the use of devices at school, based on Ministry of Education guidance, which recognises the value of digital devices for learning.

32. We recommend that the Government consider how to ensure access to necessary technical support, to ensure the use of ICT in schools is effective.
9 Ultra-Fast Broadband and the School Network Upgrade Programme

We are aware that the Government is implementing a Network for Learning, and that high-speed Internet connectivity is being rolled out to all schools through the Ultra Fast Broadband (UFB) initiative in urban and provincial centres, and through the Rural Broadband Initiative (RBI). Individual schools are also being rewired under the Schools Network Upgrade Programmes (SNUP) to bring their data and electrical connectivity up to date. We want to ensure that these programmes are implemented in a coordinated fashion and given the necessary priority. We note that the Ministry of Education ran a series of “Learning Without Limits” workshops for schools around the country. Necessary infrastructure, technology, and policy need to continue to be rolled out in a coordinated way to realise the intended benefits.

We heard issues raised by submitters about the rollout of the different components of the ICT infrastructure. Some submitters said that SNUP upgrades are not in sync with broadband rollout, and that the planning of the several programmes—urban and rural broadband connections and rewiring of facilities—was not sequenced, so there is no certainty for resource commitment. We heard from the Ministry of Business, Innovation and Employment that this misalignment is to be expected, as the SNUP upgrades started in 2004, whereas the deployment of UFB and the RBI only started in 2011. Since the deployment, the Ministry of Education has been working to align the two programmes.

We note that information on the availability and price of different components of technical infrastructure comes from various government and private-sector sources (the Ministry of Business, Innovation and Employment, Crown Fibre Holdings Ltd, the Ministry of Education, Chorus Ltd as the wholesale provider, and a range of retail service providers). We heard that it can be difficult for schools to get a clear picture of their technical and commercial options. We heard that the provision of accurate and relevant information to schools on the plans for making infrastructure available is critical. The Ministry of Education provides some information for schools, and links to the websites of other parties for more information.

The Ministry of Business, Innovation and Employment provided us with information on the progress of the UFB and RBI programmes, which indicates that fibre is passing the gates of a large number of schools. As at 30 September, 2012, 1,082 schools were passed by fibre, and 14 remote schools were connected using point-to-point wireless connections capable of peak speeds of at least 10Mbps. However, we also heard that the fibre to the gate is just a small part of getting a school connected, which also involves connection from the fibre at the gate to the school buildings, and contracting with a Retail Service Provider (RSP) for the provision of Internet services. We heard that while a number of RSPs have announced plans for schools to connect, they are still at a very early stage of offering other services over new technology. We understand that the Ministry of Education has advised...
schools that the Network for Learning, a dedicated broadband network for schools, will be implemented from early 2013, providing access to many of the services that schools will need, so schools should not enter into long-term contracts for services with RSPs in the meanwhile. The ministry’s website indicates when some schools can be expected to be connected to UFB/RBI and when they can expect a SNUP upgrade, and provides links to the websites of RSPs. We heard that some submitters feel that there is not a single source of pertinent information for schools.

Schools must negotiate their own contracts with Internet providers. Some submitters commented that their contracts constrained their data use. The Ministry of Education has been helping educate schools in negotiating with Internet service providers, and understanding the contracts, so that they can ensure they are getting what they need. We heard that many schools have not previously needed to negotiate such contracts. We heard from submitters that this was constraining their schools’ operating budgets. We feel that the Government should consider arranging these contracts nationally.

We also heard that the SNUP upgrade does not go far enough, as it does not provide hardware to implement wi-fi access in schools. One submitter suggested that the cost of getting wi-fi added to the SNUP upgrade could be as much as $20,000 per school. We heard repeatedly during the inquiry that students will be accessing more and more content online, and using devices, such as tablets and laptops, that are designed to connect through wi-fi connections.

**Recommendations**

33. We recommend that the Government consider whether SNUP specifications should include high-quality wi-fi coverage in the upgrades provided to schools.

34. We recommend that the Government consider accelerating the SNUP programme.
10 Network for Learning

The Government has established Network for Learning Ltd, a Crown-owned company, to govern the operations of the Network for Learning. We understand that the board is still in the establishment phase, determining its scope, role, and areas of focus, and we hope that our observations can be incorporated in its planning. We also understand that the board of Network for Learning Ltd has appointed a chief executive for this organisation.

A number of submitters raised concerns about the rollout of the Network for Learning. We heard uncertainty from submitters about what exactly the Network for Learning is, and what it is designed to achieve, and we understand this uncertainty extends to a number of principals. We note that from July to September 2012, “Learning Without Limits” seminars were held in 24 locations to disseminate greater understanding.

Some submitters believe the Network for Learning is admirable in principle. We heard that it should build on the experience and diversity of current school networks.

Network for Learning Ltd could be well placed to provide leadership in the use of ICT for learning. This might include promoting a national vision for 21st century learning; provision of the appropriate ICT services; communication with all education-sector stakeholders—boards of trustees, principals, teachers, and education sector agencies; support to sector groups to develop 21st century skills and tools; and reviewing the network’s services and content annually against stakeholders’ needs.

We heard that the Network for Learning should not constrain teachers’ and students’ access to the vast range of resources available on the Internet. We consider that it is essential that all schools have access to high-speed Internet connection.

Submitters suggested the Network for Learning should also enable teachers to share material easily through the Virtual Learning Network, and incentivise sharing by providing tools for developing and sustaining virtual communities of practice.

Submitters suggested that some core technology components should be provided, funded, and managed on a national basis, rather than assigning the funding and decision rights to school boards of trustees. We heard that ensuring these core components are available to all schools would leave boards of trustees, principals, and teachers free to focus on the use of the technology to deliver 21st century learning. The request for proposal for the Network for Learning lists the core services that will be provided as “internet services, managed firewall services, managed content filtering, managed network services enabling school-to-school connections and school-to-content and service-provider connections, management services, helpdesk services, implementation, and transition.” Submitters suggested that these components should all be funded and provided on a national basis, rather than requiring individual schools to make technical and investment decisions that may be outside their expertise.
One submitter was developing a “global log-in identity” so that students could use a single log-in to access content, and move between campuses and teachers without losing access to their e-portfolios. Such a log-in facility is an example of a core ICT service that might be provided nationally on the Network for Learning. We heard that core ICT services to be made available through the Network for Learning could be defined, mandatory for use by all schools, and funded centrally, and that the systems should include, at a minimum, identity and access management, a student management system, a learning management system, e-portfolio, e-asTTle, (an online tool for assessing progress in reading, mathematics and writing) and e-Admin systems such as ENROL, eReturns to the Ministry of Education, and NCEA returns to the New Zealand Qualifications Authority.

We heard that other systems outside the core group could be made available on the Network for Learning for schools to use as they see fit. These systems could also comply with interoperability standards so that schools could use systems and tools seamlessly on the Network for Learning.

We heard that the Network for Learning should be accessible from anywhere, so that students can use virtual programmes from any location—home, marae, church, library, or community centre. We heard that Māori-medium communities in particular should be supported with Māori language menus, content, and resources to allow immersion learners to use the Network for Learning.

We heard from a submitter that the Network for Learning must not only provide raw bandwidth and high-speed Internet connectivity but, equally importantly, the Network for Learning must promote the development of a collaborative community.

**Recommendations**

35. We recommend that the Government consider whether the Crown-owned company Network for Learning Ltd be required to actively seek New Zealand content and services for delivery to schools.

36. We recommend that the Government consider whether the Network for Learning should be accessible not just from schools’ premises.

37. We recommend that the Government consider how Network for Learning Ltd can provide affordable access to high-speed Internet connections with unlimited data to all schools.

38. We recommend that the Government consider the benefits of implementing and operating a single system for core ICT services in schools, including identity and access management, a student management system, a learning management system, e-portfolio, e-asTTle and e-Admin systems such as ENROL.

39. We recommend that the Government consider whether access to high-speed Internet and core ICT services should be funded nationally.
11 Institutional arrangements for ICT and 21st century learning

We heard from many submitters that there needed to be greater leadership from the Ministry of Education regarding digital literacy and 21st century learning environments. The Guardians of the Secondary Futures pointed out that their project, which ran from 2004 to 2009, described a 21st century learning environment very similar to themes that have emerged from the submissions to this inquiry, but no policy or legislation resulted from their work. Others commented on the disbanding of the digital learning group within the ministry, the lack of clear and consistent messages from the ministry on digital learning, and the challenge of ensuring that such learning gets the right priority, and does not become “just another programme that schools have to cope with”.

We heard about barriers to achieving 21st century learning; submitters argued consistently for shifting the whole education system (policy, legislation, leadership, and measurement) from a competitive to a collaborative model. While there may be no “hard” barriers to collaboration (as evidenced by the fact that some people are already collaborating), we heard from many submitters that the system settings do not actively encourage it.

Submitters argued that leadership is a major factor in how effectively schools embrace 21st century learning, and the schools that are already doing so successfully should be recognised nationally. Some submitters argued that we need a system that analyses better learning pathways, and promotes success stories, so that the pockets of excellence that we heard about throughout the inquiry are not considered out of the ordinary. We recognise that Parliament also has a role in promoting 21st century learning that extends beyond this inquiry.

Submitters told us that strong leadership is needed to develop and promote a vision for learning to all education-sector stakeholders. We heard that a change management program is needed to mobilise and align leaders to increase the pace of change across the sector. We heard that this programme needs to engage and communicate with stakeholders, prepare and equip schools, teachers, and communities, and integrate the rollout of technical components and the building of digital capability in schools. We believe that if this sector-wide change happens, we could see transformational change in the way that students learn and teachers teach.

Submitters expressed serious concerns about the ability of the Ministry of Education to provide the necessary leadership. Submitters expected the ministry to already be taking a much more visible and active leadership role in response to global technology changes in education, and to expectations from and action by the sector.

We understand that there will be a range of stakeholders affected by these recommendations, including parents, students, the wider community, and the education sector.
sector. We believe it will be important to actively engage with these stakeholders to ensure that we maximise learning opportunities in the future.

**Recommendations**

40. We recommend that the Government recognise that 21st century learning will require significant change across the education sector, involving a wide range of stakeholders; and that the Government recognise achieving such a change needs government- and sector-wide leadership to develop and promote a vision, and to lead an integrated series of work programmes to implement that vision.

41. We recommend that the Government consider reviewing the best institutional arrangements for providing the leadership to deliver both digital capability and 21st century learning environments. This review should include options such as, but not limited to, strengthening the Ministry of Education, extending the responsibility of Network for Learning Ltd, or establishing a new Crown entity.
12 Changes to legislation, regulation, and government agency operations

This report indicates that in a number of areas changes to legislation, regulation, and government agency operations could allow a swifter, more seamless change from the current teaching and learning environment to one that better facilitates 21st century learning and digital literacy. We recognise that the scale of changes necessary to achieve this vision is likely to be substantial, and could have implications for the allocation of resources across the sector. The full extent of these implications will depend on the Government’s response to our recommendations.

We heard that clusters, networks, and loops of schools are not recognised and cannot be formally assessed by the Ministry of Education or the Education Review Office, and that any moves to establish “federation” or “network” schools face difficulty meeting the ministry’s policy guidelines. Submitters described this as another example of the current education system not making the learner the most important consideration. Many submitters proposed a change to the way the ministry assesses schools, so that schools can federate or operate in a network, if that is what will be best for the students. Submitters advocated that this could allow more collaboration between teachers in different schools, without removing accountability.

We heard that any move to form clusters or networks of schools challenges other aspects of the current system, including school governance. In the current system, each school is governed by its own individual board of trustees, which is responsible for setting the direction of the school and identifying goals. Some submitters said that the Education Review Office should also be able to report on schools at a regional level, so that local networks can be assessed in their entirety.

We heard repeatedly that the rules on the use of school property restrict the uptake of contemporary learning techniques and can hamper digital literacy. We also heard of the importance and benefits of improving the community and parents’ digital literacy. However, access to Internet-capable devices in some communities is limited. Some submitters told us that school hours and facilities policies need to be changed, to allow better access to the resources for students and the community they serve. These submitters argued that schools should be viewed as “learning hubs”, where learning is not restricted to certain hours of the day. If the resources are made available for longer, we feel that the community and students would have a better chance of becoming digitally literate.

We heard of potential opportunities for assessment to be carried out online in the future.

We heard from submitters that addressing these issues might entail changes to the Education Act. Changes that might be considered include changes to hours of school operation; making provision for use of schools for community purposes; conferring power
to direct schools in the use of certain technologies and services; sharing student funding and allocating teachers’ time between multiple schools; and changing the role of the board of trustees. Submitters observed the need for a fundamental shift from a competitive to a more collaborative model to underpin any legislative changes to support the vision for 21st century learning.

Recommendations

42. We recommend that the Government consider that the Education Review Office report on the digital capability of schools in its regular school reviews.

43. We recommend that the Government consider that the Education Review Office reports include information on how well schools collaborate with other schools.

44. We recommend that the Government seek input from the sector on barriers to collaboration, and then modify policy, funding, and operational processes to actively promote collaboration.

45. We recommend that the Government review student assessment to ensure that more online assessment opportunities are realised.

46. We recommend that the Government consider possible regulations regarding the use of school buildings to support the use of digital facilities by the community.

47. We recommend that the Government assess the possible resource implications of our recommendations for ICT expenditure.

48. We recommend that the Government assess possible legislative changes in response to the recommendations in this report.
13 Minority views

New Zealand Labour Party

Closing the digital divide

The New Zealand Labour Party generally supports the thrust of the Inquiry into 21st Century Learning Environments and Digital Literacy. We believe it has been a co-operative and collaborative process and acknowledge the goodwill and intent of all members. We support the bulk of the recommendations.

However, we do not believe the report has gone far enough, and there are a number of matters that we believe need strengthening and highlighting as they are central to addressing the core barriers to achieving equity of access for all New Zealanders to 21st century learning environments and digital literacy.

The New Zealand Labour Party would like to see New Zealand become a leader in the use of digital technology, to help transform New Zealand economically and socially. The future of our nation relies on our children becoming digital Kiwis. In order to realise this future we need to ensure all New Zealand children have equity of access to a 21st century learning environment and that all initiatives must be based on this core principle.

Our economic future will increasingly depend on weightless exports. This requires our children to be digitally literate to be future workers in the digital environment. There are compelling reasons to identify and break down any barriers.

The country must not have a digital divide. The New Zealand Labour Party believes some of our greatest innovation can come out of our most deprived areas. Any initiatives to enhance learning in the 21st century and digital literacy, including the new broadband network, must not result in an entrenching of the divide between the haves and the have-nots.

As the majority report concedes, it is estimated (by the most up to date data) that around 20 percent of New Zealand households currently do not have a computer. Computers in Homes (2020 Communications Trust) has estimated that there are 100,000 families with dependent children who do not have access to a computer at home.

These unconnected homes are predominantly in lower socio-economic areas and are often home to Pasifika and Māori families where children are unable to participate equitably in digital learning and using technology. While programs such as Computers in Homes, Computer Clubhouse, and Aotearoa People’s Network do great work in increasing digital literacy, their success is sporadic because of limited and uncertain funding.

A key way to increase the connectedness and literacy of many New Zealand households is to leverage the education system by ensuring every child has access to a device. The effects of this absence, given the growing importance of Internet access, needs to be understood.
Clear evidence of harm could justify further interventions to ensure all families have a path towards access that is fair.

The New Zealand Labour Party believes that there are significant inequities between schools in access to high-speed broadband and the digital devices required for students to benefit from a 21st century learning environment. We believe that the report acknowledges some of these inequities but has not adequately addressed the solutions that are entrenching a digital divide. The New Zealand Labour Party believes that they need to be addressed urgently and a comprehensive digital divide strategy is needed.

- We recommend prioritising the funding of systematic research, monitoring, and public reporting into the impacts of the digital age on New Zealanders, in particular the barriers for New Zealanders to access technology, the extent of the digital divide, and how investment can make a difference socially and economically.

- We recommend priority investment and implementation in programmes to ensure equity of Internet access and access to digital devices for New Zealand children at school and at home regardless of their circumstances.

It is already existing New Zealand Labour Party policy to roll out a comprehensive e-learning policy to all Year 7–13 students. In the short term, the decile 1-3 schools and Kura Kaupapa Māori would be targeted as the priority in order to reach those students most vulnerable to disengagement, and most unlikely to have access to a computer at home. This will reduce the “digital divide.”

- We recommend that the Government funds access for every student has access to a digital device for learning, including the appropriate age for such a policy.

Other barriers identified in the report include the ability of schools to afford to connect to ultrafast broadband given the existing pressures on their operational budgets.

We heard that services available for schools to achieve the transformation required for 21st century learning environments and digital literacy often depended on the existing abilities of talented individuals in schools, rather than a systematic programme of improvement to school environments, professional development, or to core services and extra resources.

We also heard a consistent level of uncertainty about the proposed Network for Learning and along with the Ministry of Education, the ability for 21st century learning environments and digital literacy to be achieved within the current governance framework. We believe it is critical that:

- The Network for Learning be available to a high degree of public scrutiny and that the ministry’s role, capacity, and funding arrangements be closely monitored.

We do not believe that education services can be, nor should be, delivered through the private sector, but that the capabilities of the entities established to deliver the resources and services for 21st century learning utilise the best advice and draw from up to date evidence-based research.

In addition, the report identifies the important role that school libraries and community facilities are to provide learning environments. They are increasingly important as 21st
I.2A INQUIRY INTO 21ST CENTURY LEARNING ENVIRONMENTS AND DIGITAL LITERACY

21st century learning environments. For many children, and their parents, a community facility may be their only access to the Internet out of school hours. We do not believe the majority report has gone far enough in recognising the important role that school libraries and community facilities play.

- We recommend that the Government consider how school libraries and community facilities can be 21st century learning environments.
- We recommend that the Government enable local government to ensure free Internet access via public libraries for out-of-school learning as a valuable community resource.

We also do not believe the report goes far enough in highlighting the essential role of 21st century learning and digital literacy for preparing our children for careers in the industries of the future on which our economy needs to be based.

We know that ICT skills, knowledge, and understanding are essential for almost all jobs. However, the high-tech industries, and in particular the ICT industries and almost any job upon which contributes to New Zealand’s intellectual property is one which will involve digital knowledge.

- We believe stronger career pathways to these jobs must be prioritised in any strategy for 21st century learning and digital literacy.

Finally, we clearly acknowledge the important role that the community plays in ensuring that transformational change can be successful parents in particular must take on board the impact of the 21st century learning environment has on their children’s out-of-school home life and the barriers that exist for equity of access.

- We believe that close engagement is necessary between government, the education sector, and the wider community on these issues.

We believe that collaboration means just that, that imposing change on our education system cannot be successful without a high level of community buy-in.

We also note that ironically, despite a high level of support for a collaborative and co-operative education model for 21st century learning in the development of this report, many of the National Government’s actual education policies are geared toward competition and erecting barriers to collaboration.

We do not believe that the majority report tackles all of these issues head on. We believe the Government has an important role in showing leadership on this issue. We look forward to the Government’s response.

**Green Party of Aotearoa New Zealand**

The Green Party of Aotearoa New Zealand believes that we have a tremendous opportunity to build on existing innovative work by teachers and schools and move towards greater digital literacy and benefit from 21st century learning environments and education.
This report is a good starting point and contains many recommendations which if enacted would better position New Zealand’s education system for the 21st century and deliver enhanced educational outcomes. It is essential that the changes are consulted widely with stakeholders such as students, parents, boards of trustees, educational unions, and communities if they are to be supported and implemented successfully. In particular, there must be consultation with the sector if there are any structural changes affecting working hours and/or off-site responsibilities of teachers that arise from this report.

Leadership is required at the Government and Ministry of Education level but also an acknowledgment that innovation will not always be “top-down” and there is a need to encourage ideas to come from teachers and schools.

This report lacks strong recommendations to the Government to provide the leadership and implement actions needed at this point in time. In many cases the Green Party of Aotearoa New Zealand believes that the Government needs to go further than just “consider” numerous recommendations in this report, and would prefer actions to be implemented.

At the highest level, the Green Party of Aotearoa New Zealand heard from many submitters that what was needed was a fundamental change away from the current competitive model that sees schools in competition against one another and recommends a move to a more collaborative model. A collaborative school model could better share innovations and best practices amongst teachers and schools to the students’ benefit. The success of 21st century learning relies on an equitable education system and teachers who can facilitate a strategic use of the technology to enhance student learning. It is less about devices than effective relationships and good use of tools.

This report contains many recommendations and it is important that the Government acknowledge the financial implications required and appropriately fund the initiatives if we are to realise the benefits of 21st century learning. For example individual digital devices are desirable in some circumstances and if some New Zealand children are not to miss out, it is essential that financial support is available to ensure that they are affordable for families. Bulk purchase to reduce costs is a common sense step but the Government must enact policies to give a range of ownership or purchasing options.

Schooling and education cannot be taken in isolation from the community and more must be done to “bridge the digital divide” in general if some students are not to be left behind from 21st century learning. The Green Party of Aotearoa New Zealand would recommend that the Government develop a national digital divide strategy with practical initiatives such as ensuring that all public libraries ensure free Internet access. In many libraries this is already the case, supported by Government funds and this is consistent with the U.N. Special Rapporteur’s recent Internet access report. The Green Party of Aotearoa New Zealand also recommends greater funding to the Computer Clubhouses and Computers in Homes programmes currently providing computer and Internet access so that it can reach a greater number of households and communities.

Likewise the Government must ensure access for students with disabilities. Recommendation 26 only requests a consideration of these issues. However the Green
Party of Aotearoa New Zealand member believes including disability-accessible materials and versions of materials is a must to ensure equality of access.

The Green Party of Aotearoa New Zealand supports improving public access to ICT through supporting the establishment of community technology hubs in schools, tertiary institutions, public libraries, and other community centres. This will require appropriate investment in installing hardware and software, as well as providing ICT training.

The Green Party of Aotearoa New Zealand member believes providing all educational materials produced in New Zealand schools under a Creative Commons license would harness and greatly spread innovation and best-practice teaching. We would recommend that the Government investigate this with the goal of achieving it.

The Green Party of Aotearoa New Zealand supports the intent of this report towards greater utilisation of digital tools and a transformational change to 21st century learning in New Zealand.
Appendix A

Committee procedure
The committee called for public submissions on the inquiry. The closing date for submissions was 11 May 2012. The committee received 90 submissions from the organisations and individuals listed in Appendix B and the committee heard 55 of the submissions orally. The committee heard evidence in Wellington and Auckland. The committee met between 9 May 2012 and 12 December 2012 to consider the inquiry.

Committee members
Nikki Kaye (Chairperson)
Clare Curran
Catherine Delahunty
Hon Jo Goodhew
Colin King
Hon Nanaia Mahuta
Tracey Martin
Sue Moroney
Simon O'Connor
Scott Simpson

Gareth Hughes replaced Catherine Delahunty for this item of business
Appendix B

List of submitters

2020 Communications Trust
Aegility eLearning Services
Alan Cooper
Amesbury School
Association of Proprietors of Integrated Schools
Association of Public Library Managers
Auckland Libraries
BEST Pacific Institute of Education
CantaNet
Carolyn Stuart
Catalyst IT
Chris Clay
City of Manukau Education Trust (COMET)
ClickView New Zealand
Committee for Auckland
Computer Clubhouse Trust
CORE Education
Darren Zhang
Digital Media Group, University of Canterbury
Distance Education Association of New Zealand
Dr David Parsons
Dr Hilary Stace
Dr Stanley Frielick
Early Childhood Council
Education Television and Video Communication Trust (eTV)
Edwin McRae
Egressive
Epsom Girls Grammar School
Ernie Newman
Frances Valentine
Google
Greater Christchurch Schools Network
Guardians of Secondary Futures
Human Rights Commission
Ian Mitchell
Institute of Technology and Polytechnic Library Managers
Interim Tamaki Transformation Board
Kate Shevland
Kylie Hickey
Learning Media
Library and Information Association of New Zealand Aotearoa
Louise Starkey
Maharishi Foundation
Manaiakalani Cluster of Schools
Mark Brown
Mark Osborne
Microsoft New Zealand
Nat Torkington
National Council of Women of New Zealand
NetSafe
Network for Learning
New Zealand Council for Educational Research
New Zealand Post Primary Teachers’ Association
New Zealand School Trustees Association
New Zealand Superloop Forum
New Zealand Teachers Council
Orewa College
Paul Seiler
Pinelopi Zaka
Professor Sir Peter Gluckman
Publishers Association of New Zealand and Copyright Licensing
Quality Public Education Coalition
Robin Ohia on behalf of the Virtual Learning Network Council and the Greater Wanganui
Education Network Committee
Room 15 Tawa Intermediate
Rosemary Nisbet
Royal New Zealand Foundation of the Blind
Royal Society of New Zealand
School Libraries Association of New Zealand Aotearoa
Screenrights
Sonny Teio
Stephanie Thompson
Stephen Lethbridge
Stephen Marshall
Sue Davidson
Sue Parkes, Murray Spackman, Roger Hynd, and Wayne Duncan
Tara Taylor-Jorgensen
Te Aho o Te Kura Pounamu
Te Totara Primary School
Telecom New Zealand
Tim Kong
Tuakiri, New Zealand Access Federation
Unitec Library
University of Canterbury e-Learning Lab
University of Waikato
Virtual Learning Network Primary
Vodafone New Zealand
Waikato Institute of Technology
Waikirikiri School Board of Trustees
Wanganui District Council's Digital Leaders Forum
WiFi Guys
Inquiry into Pacific languages in early childhood education

Report of the Education and Science Committee

Fiftieth Parliament
(Dr Cam Calder, Chairperson)
November 2013

Presented to the House of Representatives
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Inquiry into Pacific languages in early childhood education

Summary of recommendations

The Education and Science Committee makes the following recommendations to the Government:

- That it encourage Pasifika communities to increase their participation in school boards of trustees (page 13).
- That it support measures to encourage Pasifika parents to stand for school boards of trustees, and address challenges to Pasifika representation on boards of trustees (page 13).
- That it encourage Pasifika communities to encourage their local schools to establish immersion or bilingual units (page 13).
- That it encourage Pasifika communities to cooperate with Government to make successful use of the initiatives and measures available to them (page 13).
- That it consider how equity funding could be used more effectively to support heritage language learning, for example to target an increase in the number of Pasifika language teachers (page 16).
- That it consider taking steps to determine the number of early childhood teachers who are fluent in Pasifika and heritage languages (page 16).
- That it consider how equity funding could be used more effectively to incentivise growth in numbers of Pasifika early childhood education services teaching in a Pasifika language for over 50 percent of the time (page 16).
- That it consider establishing Pasifika language early childhood education best practice models, to be developed in consultation with the community (page 16).
- That it encourage growth in the number of Pacific Island language immersion early childhood centres (page 16).
- That it continue to work on the provision of online learning resources (page 17).
- That it continue to provide resourcing to improve participation in Pasifika services (page 20).
- That it explore opportunities for cooperation between the New Zealand and Pacific Island governments for sustaining Pasifika heritage languages in early childhood education (page 20).
- That it focus specifically on ensuring that the Strengthening Early Learning Opportunities programme demonstrates more responsiveness to Pasifika communities than the previous programme of professional development (page 20).
• That it require early childhood education partnership activities promoting Pasifika participation in early childhood education to include a specific language focus (page 23).

• That it consider undertaking research to develop a better understanding of bilingual delivery in heritage languages (page 25).

• That it consider undertaking research into Pasifika children’s educational transitions (page 25).

• That it consider undertaking research into the uptake and quality of Pacific languages in early childhood education (page 25).

• That it take into account the broader evidence on bilingual and immersion language learning when considering measures to improve outcomes of Pasifika early childhood education centres (page 25).
1 Introduction

New Zealand is a multi-cultural and multi-lingual society. Auckland is home to the largest Pasifika population in the world; in 2011 there were 177,936, or over 13 percent of the population. The main Pacific languages spoken in New Zealand are Cook Island Māori, Vagahau Niue, Tokelauan, Samoan, Fijian, and Tongan. The Pasifika population of New Zealand is growing, and is projected by Statistics New Zealand to reach 480,000 by 2026. Statistics show that, in the main, Pacific students are below the national average when it comes to achieving educational success. In 2011, 64.8 percent of Pasifika students left school with NCEA level 2, compared with 79.6 percent of Pākehā. In 2009, 67 percent of Pasifika students met the NCEA level 1 requirements for literacy and numeracy, compared with 77 percent of other students.

A number of studies conducted in New Zealand and overseas indicate the importance of early childhood education in establishing the basis for academic success. The Government has recognised this, and one of its Better Public Services goals is that in 2016, 98 percent of students starting school will have participated in early childhood education.

We are aware that a good early childhood education influences a child’s chances of success later in life. However, participation by Pasifika children in early childhood education is below the national average, and if the Better Public Services targets are to be achieved, participation by this group must increase. Not all Pasifika students attend centres that teach in their heritage languages, and there are not enough such centres available to make this possible.

We therefore initiated an inquiry into Pacific languages in early childhood education, as we are aware of evidence from other jurisdictions that the use of heritage languages can improve educational outcomes for students.

The terms of reference for our inquiry were as follows:

- Consider any transitional effects from non-compulsory to compulsory-sector education, and the implications of this on academic achievement and links with the Pasifika Education Plan.
- Consider the overall framework for resourcing Pacific languages in early childhood education, including local and international evidence of best practice.
- Consider the outcomes that are currently achieved based on the present resourcing of Pasifika early childhood services.
- Consider whether there are enough partnerships and opportunities for Government, the private sector, and the community and voluntary sectors to collaborate in the early childhood education sector to improve the prevalence and quality of Pacific languages.
- Consider whether there are sufficient mechanisms to inform the early childhood education system, using research and feedback on the current uptake and quality of Pacific languages in Pasifika early childhood services.
This inquiry explored the importance of receiving early childhood education in one’s heritage language. We investigated the current resources that support Pacific languages in early childhood education, and also considered how the Government, the private sector, and the community and voluntary sector can contribute to improving the prevalence and quality of Pacific languages in New Zealand early childhood education. We also considered whether sufficient research was available to inform decisions on whether to increase the provision of bilingual or immersion units for early childhood education.

We are aware that the Government has a legal duty, as set out in section 20 of the New Zealand Bill of Rights Act 1990, to protect the use of their languages by all linguistic minorities, and their right to promote their own languages. However, the Government has no legal obligations to promote Pasifika languages, although it is obliged not to do anything deliberately to prevent communities from using Pasifika languages. It has no additional obligations regarding the languages of the countries that constitute the New Zealand realm (Tokelau, Niue, and the Cook Islands), and no legal obligation to promote the provision of Pasifika-language education. As there is no legal basis for government policy in this area, policies tend to be determined on a political, economic, or financial basis.

During the course of our inquiry, we heard from many submitters who argued that New Zealand has a responsibility to ensure that the main Pacific languages of New Zealand (Cook Island Māori, Vagahau Niue, Tokelauan, Samoan, Fijian, and Tongan), are preserved. They warned that some Pacific Island cultures, such as Niue’s, cannot sustain their language on their own, without assistance from New Zealand.

In addition, many submitters argued that the Government has a key responsibility to ensure that Pasifika peoples in New Zealand can learn their own languages in early childhood because of New Zealand’s historical relationship with its Pacific neighbours, in addition to its obligations under human rights legislation.

We are aware of suggestions that responsibility for the teaching of Pasifika languages should rely on the nations in question, and that, for example, Samoans who want to learn Samoan should return to Samoa to do so. Some submitters found this suggestion risible; they considered themselves New Zealanders. They wanted to stay in New Zealand, and have their learning needs met by the country they call home.
2 Transition from non-compulsory to compulsory education

Many submitters who gave evidence to our inquiry were motivated by a desire to ensure that Pasifika languages continued to endure and be used in everyday life in New Zealand. If heritage languages are to survive, new generations must be taught them. We heard arguments that learning a heritage language before learning English has cultural and social benefits; and there is evidence from other jurisdictions that bilingual or immersion learning in heritage languages in early childhood leads to better educational outcomes.

We are aware that research in the area of heritage learning suggests that between six and eight years of immersion or bilingual learning is necessary to achieve fluency in a language, so exploring fully the most effective way to ensure heritage languages survive means looking beyond language provision in early childhood education. If children who are educated in bilingual or immersion units in early childhood cannot continue learning in their heritage languages in compulsory schooling, they will not be able to fully master their heritage languages, and the gains made in early childhood education may be lost.

Submitters told us that the community around Pasifika children already supports their use of their heritage languages outside of school, for example when communicating with family and in church. However, they rely on Government assistance for sufficient resources to ensure the survival of the languages; such communities are not in a position to teach the language effectively without Government support. Parents felt very strongly that they need to be able to communicate both with their children and their children’s teachers in the language in which they are most comfortable to support learning effectively.

Early childhood sector

An early childhood education centre is defined by Part 26 of the Education Act 1989 as “premises used (exclusively, mainly, or regularly) for the education or care of 3 or more children (not being the children of the persons providing the education or care) under 6”. When a centre meets this criterion it must be licensed under the Education (Early Childhood Services) Regulations 2008, and if the applicant or service provider meets the “fit and proper person” test, it is eligible for Government funding. Many of the submitters to our inquiry were families or community groups who felt so strongly their children would benefit from early childhood education delivered in their heritage language that they established their own early childhood centres.

We were told that in 2012 there were 93 early childhood centres where Pasifika languages were used more than 50 percent of the time, an increase from 80 in 2002. Those 93 centres serve 3,099 children. Ministry of Education data shows that a further 56 centres report using one or more Pasifika languages as part of their daily routine for at least 12 percent of the time. There are a total of 462 early childhood education services in New Zealand that support Pasifika languages in some way. Between 2007 and 2012, the number of Pasifika two- to four-year-olds enrolled in early childhood education has increased from 8,510 to 11,690.
We heard that the current process for establishing an early childhood education centre is straightforward, but some Pasifika providers reported encountering difficulties. We were advised, however, that 90 percent of the Pasifika centres that opened in 2006 remained open in 2011. We were told that this is due to lack of governance skills, and inadequate financial management skills; funding was also said to be an issue. Many communities have difficulty finding enough volunteers to establish and support a centre, and in some instances the volunteers do not have the skills necessary to provide governance support. Utilising existing skills and expertise in school boards of trustees could help maintain and support autonomous governance structures. It was suggested that a cluster approach might solve these problems; a single management team could oversee the financial management and governance of a number of centres in an area, and could also be involved in bilingual or immersion units at schools.

**Quality of early childhood provision**

In 2007, the Education Review Office (ERO) published a report called *The quality of education and care in Pasifika early childhood services*, based on its reports on 49 licensed services that provided Pasifika education as the central aspect of their philosophy. ERO found wide variation in the type and quality of education provided by Pasifika education services. Approximately 50 percent of the services provided programmes that were culturally enriching. Some were considered to be of high quality, but many were found not to provide an adequate quality of education. ERO noted that much professional development for teachers and management at Pasifika services would be required to ensure they could meet the aspirations of their communities.

We understand that Pasifika services have had high rates of supplementary review by ERO (about 36 percent, compared with a national average of 10 percent). Most commonly, supplementary reviews were required because of concern about the quality of education being provided, in areas such as the responsiveness of learning programmes, the quality of planning and assessment, and interactions between teachers and children. There were also issues with the quality of personnel and financial management, and a lack of self-review. Some centres also had compliance issues related to behaviour management, and inadequate health and safety processes.

ERO raised concerns about certain services, including the level of challenge provided by the teaching, the accessibility and quality of resources, the quality of interactions, legal requirements not being met, and the quality of advice and guidance programmes for provisionally-registered teachers. ERO recommended substantial ongoing professional development of Pasifika early childhood teachers and managers in order to improve quality. The concerns identified by ERO echo those we heard from submitters about the situation in the early childhood sector; while some centres provide education in a heritage language, there is no way to ensure the quality of this teaching.

**Compulsory sector**

We note that few children from Pasifika immersion early childhood centres have the opportunity to progress into a Pasifika immersion or bilingual environment in the compulsory sector. For example, while there are 18 schools with enrolments in Pasifika bilingual or immersion classes, and a further 51 schools offer a Pasifika language as a separate subject, there were no Pasifika immersion or bilingual schools in 2012.
We are aware that under section 156 of the Education Act parents may propose a special character school (a state school that teaches the New Zealand Curriculum but has developed its own set of aims, purposes, and objectives to reflect its particular values) as long as no other local school is already delivering an education reflecting the same special character. In addition, we understand that there are no legislative or regulatory barriers to the establishment of bilingual or immersion Pasifika schools or units within schools. Such units have been gazetted as special programmes under section 11B of the Education Act. Section 11C allows a school board of trustees to determine admission criteria for a unit, which allow it to choose students from outside its home zone who wanted bilingual or immersion education. Those students outside the zone who meet the criteria get first priority for enrolment at the school after the students living in the zone.

Even though the legislation makes clear the circumstances under which a bilingual or immersion unit can be set up, we heard anecdotal evidence which suggested that setting up a unit is harder in practice than in theory. Submitters told us that no additional funding or staffing support is given to a board operating a special programme. The board must also decide how much of a school’s operational grant to allocate to resourcing for special programmes. A consistent theme from submitters was that a lack of governance knowledge presents a barrier to the establishment of bilingual and immersion early childhood centres and units in the compulsory sector. We believe that increasing the Pasifika capability of boards of trustees is essential to ensuring Pasifika communities become more closely involved in Pasifika language education, and the majority of us would expect that the provision of Pasifika language education would increase.

One success in setting up a bilingual unit is the A’oga Fa’a Samoa bilingual unit at Richmond Road School, which is the only licensed Samoan early childhood centre that is connected to a primary school with a Samoan language programme, Mua i Malae. We heard from parents who send their children to the school from outside the school zone because they value the fact their children are being taught in their heritage language.

Some submitters raised issues relating to the funding of Richmond Road School. The Government recently announced roll-growth funding for out-of-zone students in Māori and Pasifika bilingual programmes.

**Impact on academic achievement**

We heard that there is clear overseas evidence that bilingualism can confer cognitive advantages. We heard that bilingual learning is most effective when at least 50 percent of teaching and learning is carried out in the heritage language, the teachers take a positive approach to instruction in more than one language, learners achieve literacy in the heritage language before acquiring a second language, and the heritage language is used in families and communities. Submitters suggested that it is rare for all of these conditions to be present for a child at all times, but said that Pasifika communities are supportive of efforts to keep their languages alive. We note that a thriving community of fluent speakers is vital to ensure the continuation of any language, and if schools fail to ensure that children can continue learning their heritage language, this hampers the formation of a community of fluent speakers.

The lack of schools in the compulsory sector that teach Pasifika languages can make it difficult for students to master their heritage languages, and can also make for a disruptive transition into the compulsory sector, during which learning gains from early childhood education can be lost. Submitters told us that they would like to see stronger ties between
schools in the compulsory sector—that is primary and secondary schools—and early childhood education centres, which would hopefully ensure that students could continue seamless immersion or bilingual learning for up to eight years.

Some submitters told us that they did not know their heritage language, and that this caused them identity issues; they did not feel a part of their own community, while also feeling unwelcome in the mainstream environment. These submitters told us it is important that their children do not feel the same way, and so they are eager to enrol their children in immersion and bilingual units.

In addition to the benefits all cultures derive from bilingual education, submitters pointed to New Zealand’s special relationship with the Pacific Island nations, arguing for a special focus on them. The submitters also noted that the Ministry of Education has itself designated Māori and Pasifika students as priority learners, so there should be early focus on bilingual teaching.

### Pasifika Education Plan

In 2008, Cabinet approved the Pasifika Education Plan 2008–2012, to focus the education sector on actions to improve educational outcomes for Pasifika learners. This plan included two goals specifically related to Pasifika languages and bilingualism:

- **Goal 16** – increase opportunities for building strong Pasifika language foundations through Pasifika language curriculum and resource development
- **Goal 17** – increase effective teaching for Pasifika bilingual students in a range of settings. Increase transitions by ensuring there are clear pathways available from:
  - home to Pasifika bilingual, immersion, and mainstream early childhood education centres
  - early childhood education to schooling
  - within schooling
  - schooling to further study and/or sustainable employment.

The plan was designed to provide language and learning interventions to support a smooth transition to school for learners coming from Pasifika immersion early childhood centres and Pasifika learners who had not participated in early childhood education. In 2009 the Pasifika Education Plan was revised to reduce its size and refocus it to better reflect Government’s priorities. As a result the goals relating to Pasifika languages and bilingualism were no longer visible at a strategic level, but were on an operational level through initiatives such as Pasifika Success, a programme to provide culturally responsive professional learning and development that affirms the identities, languages, and cultures of every learner; and Achieving Through Pasifika Languages, a programme that supports bilingual learners to learn their Pasifika language and be taught in a homework/study centre environment. The key outcome is to raise achievement by fostering learning in Pasifika languages.

A new Pasifika Education Plan for 2013–2017 was launched in November 2012. It emphasised the importance of Pasifika identities, languages, and cultures, and of working closely with Pasifika parents and families. The Pasifika Education Plan’s targets include increasing the number of Pasifika language services teaching more than half the time in a Pasifika language or culture by 2016, increasing the proportion of Pasifika children starting
school who have participated in early childhood education from 86.2 percent in 2012 to 98 percent in 2016, and having 85 percent of Pasifika early childhood centres found by ERO to be effective by 2017. We were advised that in the 12 months to September 2013, the proportion of Pasifika students who had attended early childhood education had reached 89.1 percent. The ministry is developing an implementation plan to ensure the goals of the revised plan are achieved.

**Recommendations**

1. We recommend that the Government encourage Pasifika communities to increase their participation in school boards of trustees.

2. We recommend that the Government support measures to encourage Pasifika parents to stand for school boards of trustees, and address challenges to Pasifika representation on boards of trustees.

3. We recommend that the Government encourage Pasifika communities to encourage their local schools to establish immersion or bilingual units.

4. We recommend that the Government encourage Pasifika communities to cooperate with Government to make successful use of the initiatives and measures available to them.
The principles and strands of Te Whāriki—the New Zealand early childhood curriculum—provide a basis for good practice in any early childhood service, including Pasifika services. In services using good practice adults will be: supporting children to develop and strengthen positive learning behaviours and attitudes; integrating learning and development across a range of dimensions (cognitive, social, cultural, physical, emotional, and spiritual) in contextually and culturally meaningful ways; developing and maintaining strong relationships with families and communities, and providing warmth, encouragement, acceptance, and challenges for children to engage in creative and complex learning and thinking.

We heard from many submitters that a major barrier to the creation of immersion and bilingual Pasifika learning environments is a shortage of qualified teachers, along with a lack of relevant resources. Many submitters told us that there was a great need for high-quality literacy materials in Pasifika languages suitable for use in early childhood education. We heard that many centres previously relied on the Tupu and Fōlauga series of Pacific language literacy materials for use in classrooms. These resources were produced by the Ministry of Education until their production was paused in 2010 as part of an ongoing review of curriculum support resources. We were advised that during the review, both series were audited, and some titles were found to have linguistically and culturally inappropriate content; these titles have since been withdrawn. The ministry also found that the resources did not have a clear, targeted instructional design or purpose. However, we are advised that at least a third of the titles from the series have not been withdrawn and are still available to schools to use as supplementary resources. Some submitters specifically asked for their reinstatement, and continued development and production.

A consistent theme from many submitters was that teaching resources are critical to effective teaching of heritage languages. We heard that some Pasifika units have enough teachers to teach a heritage language, but insufficient resources. Submitters warned that, even if the Government returns to producing resources for Pasifika instruction, unless they are competitively priced many centres will be unable to purchase them without increased funding. Some submitters argued that the Government has an obligation to ensure that there are sufficient resources for bilingual and immersion Pasifika learning, as the market for Pasifika resources is not large enough to produce them profitably.

The ministry is working to produce digital versions of emergent dual-language readers. They are designed specifically for use by Pasifika new entrants from Pasifika early childhood immersion centres and children from a Pacific language background who are moving into English-medium schooling. This work will be carried out over the next 12 months. Resources will be trialled in schools in 2014, and if they are effective will be available in 2015 for use in schools and by parents with their children.

We heard from some submitters that the lack of resources from the Government has meant that many centres are forced to rely on support from the community, with family members and community elders helping to produce heritage language resources. We
understand that using family members and community members as producers of teaching resources may be an interim measure, but this is not a sustainable way to produce the resources that teachers need for instruction.

We also note that the Government is working on projects and resources to support more successful transitions for Pasifika learners transitioning to English-medium schooling.

**Quality teachers**

In addition to a lack of resources, submitters told us that there is a lack of good quality teachers in early childhood education who can teach heritage languages effectively. We heard that a lack of funding for Pasifika centres has contributed to this problem, as some of the Pasifika centres cannot match the remuneration on offer from other centres; some Pasifika teachers choose to find employment at centres that offer a higher wage, with which Pasifika centres are unable to compete. This reduces the pool of potential staff for Pasifika centres. As few young teachers return to Pasifika centres to teach, the centres typically rely on mature teachers or members of the community.

Many bilingual and immersion centres rely on support from community elders to help teach heritage languages, but they are not necessarily trained language teachers; they cannot teach the structure or the phonetics of the language, teaching children informally on the basis of their own knowledge. Submitters argued that these teachers should be supported with professional development workshops to improve their skills in teaching their languages. Submitters expressed concern about the possibility that in the near future when the mature teachers and members of the community who are currently ensuring the survival of these centres can no longer continue to teach, there will not be enough younger teachers to take up their positions, so centres will be forced to close.

In an effort to increase the number of proficient speakers of Pasifika languages available to teach at early childhood centres, the Government funds a range of TeachNZ scholarships to support the training of Pasifika early childhood education teachers. These scholarships cover core study fees and also provide an allowance of $10,000 over the period of study. The Pasifika language scholarships are for people who are proficient in a Pasifika language and have knowledge, understanding, and experience working with Pasifika communities, and want to teach in the early childhood sector. In 2013, 80 Pasifika language scholarships were awarded.

In the last 10 years, the number of registered Pasifika early childhood teachers has increased from 167 to 1,183. However, we were advised that there was no data available as to what percentage of these teachers were heritage language speakers. In 2002, 18 percent of Pasifika early childhood teachers were registered; in 2012, 67 percent were registered. We are glad of this significant improvement, but note that further improvement is required.

**Funding early childhood education**

Early childhood education providers are self-managing, independent operations and organisations. The Government is responsible for regulation, funding, and various aspects of quality assurance in the sector. In the 2011/12 year, total Government expenditure on early childhood education amounted to an average payment of $9,600 for every full-time-equivalent child, of which Ministry of Education funding accounted for $8,400. This level of expenditure is high by international standards; New Zealand was in the top seven countries in the OECD in 2010 for the percentage of public expenditure allocated to early childhood education.
The majority of Government funding for early childhood education is paid to providers through universal subsidies, including one available for up to 30 hours per child place per week, and components of equity funding paid to centres with a high proportion of children from lower socio-economic groups. These subsidies are available to meet demand, provided the centre meets regulatory standards. In 2011/12, the 149 early childhood education services where Pasifika languages were used more than 12 percent of the time received around $54 million in subsidy funding from Vote Education.

In addition to the general funding that the Government provides to all early childhood centres that meet the regulatory requirements, there is an equity funding component for language and culture, which is paid when centres deliver more than 50 percent of the curriculum in a language or culture other than English. To qualify for this funding, centres must attest that they plan and evaluate the curriculum for children using the cultural framework associated with the language of communication, and deliver the curriculum for children using that language for more than half of the programme. Early childhood education facilities receive a lump sum if they deliver more than 50 percent of their curriculum in a language or culture other than English. However, there is little assurance as to the quality of heritage language learning over this threshold.

We heard that the amount of funding that centres qualify for if they meet this target is small compared with other types of funding, so there is little incentive for services to meet or exceed this threshold. Some submitters suggested that this funding could be better targeted, to improve the quality of language education without increasing the overall cost of the initiative. An early childhood funding review is in progress, which is considering how targeted equity funding could be used more effectively to improve learning outcomes for the Government’s priority groups, and we recommend that it evaluate this suggestion.

Submitters told us that they would like to see an increase in funding so that teaching and assessment resources are available in their heritage languages. We heard that some teachers are attempting to develop their own resources for use in the classroom, but cannot keep up with demand despite their best efforts.

**Recommendations**

5. We recommend that the Government, as part of the Early Childhood Education Funding Review, consider how equity funding could be used more effectively to support heritage language learning, for example targeting an increase in the number of Pasifika language teachers.

6. We recommend that the Government consider taking steps to determine the number of early childhood teachers who are fluent in Pasifika and heritage languages.

7. We recommend that the Government consider how equity funding could be used more effectively to incentivise growth in numbers of Pasifika early childhood education services teaching in a Pasifika language for over 50 percent of the time.

8. We recommend that the Government consider establishing Pasifika language early childhood education best practice models, to be developed in consultation with the community.

9. We recommend that the Government encourage growth in the number of Pacific Island language immersion early childhood centres.
10. We recommend that the Government continue to work on the provision of online learning resources.
4 Outcomes of present resourcing of Pasifika early childhood services

We are aware of extensive evidence that participation in quality early childhood education for at least one year before starting school provides children with strong educational foundations and improves outcomes later in life. Studies indicate that participation in early childhood education is particularly beneficial for children from disadvantaged backgrounds. We are also aware that a large body of international and domestic evidence shows that early childhood education helps students achieve higher educational outcomes than others. The Programme for International Student Assessment study of reading literacy in 2009 showed that in practically all OECD countries 15-year-old students who had attended some pre-primary schooling outperformed students who had not, irrespective of socio-economic background. New Zealand data from this study indicates a more pronounced increase in literacy reading scores after at least a year of early childhood participation for Pasifika students than for non-Pasifika students. New Zealand does not collect regular data on student achievement in direct relation to early childhood participation, so it is difficult to evaluate the learning outcomes that are achieved. The data from this study does not have evidence on the specific outcomes achieved by Pasifika services, and we found that there is generally less data available specifically on Pasifika services, something that we address in chapter 6.

The available information indicates that Pasifika children have less exposure to early childhood education than other ethnic groups, a pattern with both socio-economic and ethnic dimensions. The proportion of Pasifika children who had participated in the early childhood sector before starting school in 2012 was 88.6 percent, whereas total participation in early childhood education was 95.7 percent. This lower participation is correlated with poorer educational outcomes by Pasifika students throughout the compulsory education system.

In 2010, the Government invested $91.8 million over four years in initiatives to increase the participation of Māori children, Pasifika children, and children from low socio-economic backgrounds in early childhood education. This package received additional funding of $80.5 million over four years in 2013. It consisted of six main initiatives:

- intensive community participation projects
- supported playgroups
- identity, language, culture, and community engagement
- flexible home-based early childhood education
- engaging priority families
- targeted assistance for participation.

More details of the initiatives supported by this funding are provided in chapter 5.
Professional development

The Ministry of Education’s Early Childhood Education Professional Development Programme 2010–2013 is designed to improve participation by Māori and Pasifika children in early childhood education. An evaluation of this programme in 2012 indicated that Pasifika immersion services did not always feel their specialist professional development needs were being met. The evaluation highlighted the need for more targeted professional development provision for Pasifika immersion services built on appropriate protocols and processes for professional growth. We will await with interest the next evaluation, which is due in 2015.

Submitters explained that Pasifika teachers and support staff need to form professional development networks, so that they can collaborate on teaching and learning opportunities, and we encourage the creation of such networks. Submitters from the A’oga Fa’a Samoa unit at Richmond Road School told us that they try to assist other schools seeking to open bilingual units at their school by encouraging other language groups to come and observe their practice.

We heard suggestions that the number of Pasifika language teachers could be increased by providing scholarships for teachers to return to the islands, to experience the culture and learn the language. In exchange, trained teachers from the islands could be seconded to the centre in New Zealand where the scholarship recipient worked, which would expose the children to a qualified teacher and a native speaker of a Pasifika language.

Many submitters told us they thought the lack of a language policy to support the teaching of Pasifika languages in New Zealand creates problems for them. They said that it is not enough to have teachers who themselves are able to speak a heritage language; they must be able to teach it effectively to their students. We heard that in Finland the Government recognises that language is central to education, and every student has a right to be taught in their own language, even if they are the only student in their school that speaks it. However, the majority of us believe New Zealand is not in a position to adopt this policy; currently there are too few teachers of heritage languages, and insufficient resources to support their teaching.

We are aware that all licensed early childhood services are required to provide professional development opportunities for their staff to meet the required governance, management, and administration standards. In addition to the professional development offered by the services, the Ministry of Education funds professional learning and development with $9.23 million per year, targeted to areas where particular support is needed. The ministry’s programme is called Strengthening Early Learning Opportunities (SELO). It targets areas with low participation rates in early childhood education, services that are likely to enrol children from groups with the greatest potential benefit from participation, and services that the ministry considers at risk of not delivering high-quality programmes. All contracts under the SELO programme require efforts to improve early childhood education services’ recognition of the importance of identity, language, and culture for educational outcomes in the Government’s priority groups.

The SELO programme is designed to take into account the evaluation of the Early Childhood Education Professional Development Programme 2010–2013 in 2012. It is expected that this programme will support the leaders of 92 services through the Pasifika leadership component of the programme in 2013/14.
11. We recommend that the Government continue to provide resourcing to improve participation in Pasifika services.

12. We recommend that the Government explore opportunities for cooperation between the New Zealand and Pacific Island governments for sustaining Pasifika heritage languages in early childhood education.

13. We recommend that the Government focus specifically on ensuring that the Strengthening Early Learning Opportunities programme demonstrates more responsiveness to Pasifika communities than the previous programme of professional development.
5 Opportunities for partnership and collaboration in the early childhood education sector

In the course of our inquiry we learned about various existing partnerships and opportunities for Government, the private sector, and the community and voluntary sector to collaborate in the early childhood sector to improve the participation rate of Pasifika children. However, it was suggested that this focus on increasing participation may have resulted in less emphasis on ensuring good quality provision of Pacific languages. Because early childhood education services are not owned or operated by government, policy in this area has focussed on facilitating and encouraging partnerships between private-sector entities, communities, and the voluntary sector.

Targeted Assistance for Participation

We are aware that the Government has introduced a Targeted Assistance for Participation (TAP) fund, to facilitate partnerships between government and communities for the provision of early childhood education services. TAP funding assists with the start-up costs of new centres and provides incentives to create additional places and establish new services in communities with a high need. TAP funding has three streams: full funding, for the establishment of new child places in high priority areas; partial funding, to provide incentives and partnership opportunities in a wider range of high-priority areas; and a low-cost, high-value funding stream for establishing new places in a wide range of priority areas with low participation. This funding is available to private and community groups, provided they can address the early childhood participation needs of targeted communities. In 2011/12, $23.6 million was invested in TAP funding. A total of 1,941 child places, including 1,019 in Pasifika immersion services, were created to cater to the learning needs and the identity, language, and cultural needs of Pasifika children.

Early Learning Taskforce

The Early Learning Taskforce in the Ministry of Education is a direct Government initiative. Its goal is to pursue the Better Public Services target of 98 percent participation in early childhood education by 2016. The taskforce targets innovative local opportunities with communities. The ministry is pursuing a number of opportunities to enhance collaboration with the private sector and the community and voluntary sector. For example, the taskforce participated in Creekfest, a festival in Porirua which provides music and sports attractions as a platform for health and social service providers to interact with the public. It included a “pop up” playgroup, where local early childhood education teachers and ministry officials gave parents information about options for early childhood education in their area.

The taskforce is supporting a school-based initiative, Achieving Through Pasifika Languages (ATPL), which was developed under the Pasifika Education Plan, and has expanded to include early childhood education. Through this initiative the ministry funds programmes to support bilingual Pasifika learners in Years 1 to 9 in learning their heritage language, including homework or study centres. The taskforce has also supported the
establishment of early childhood education playgroups in ATPL centres. In total 22 ATPL centres have been established, 19 in the Auckland region. Languages supported through this programme are Niuean (three centres), Samoan (six centres), Tongan (nine centres), Tuvaluan (one centre), Cook Island Maori (one centre), Fijian (one centre), and Tokelauan (one centre). We are told attendance at the centres by Pasifika families and learners is high, and the centres have strong community support. The taskforce has also recently developed a strategy to establish partnerships with Pasifika church communities, with the aim of working with Pasifika church leadership groups to drive initiatives through their congregations.

Collaboration between Ministries of Education and Pacific Island Affairs

The Ministry of Education has worked with the Ministry of Pacific Island Affairs to increase participation by Pasifika children in early childhood education. The two ministries have developed a partnership with the Fountain of Knowledge Trust to establish a mobile promotional service for the greater Auckland area, targeting areas where Pasifika participation in early childhood education remains low. We will maintain an interest in the effectiveness of these schemes.

We are aware that the Ministry of Pacific Island Affairs has developed a web-based directory of New Zealand government resources that are written or delivered in Pacific languages, which includes early learning and early childhood centre language resources. A Pacific Languages Framework has been designed to support Pasifika communities to achieve their aspirations for language revitalisation. The framework has been a major focus of the Ministry of Pacific Island Affairs’ work to strengthen Pasifika language use, and includes a focus on encouraging and supporting children and young people to become proficient in their heritage language. The framework involves a suite of Community Action Plans, developed by communities taking ownership of their heritage languages. The seven community language plans include community-led events and initiatives such as language weeks and language programmes, and the provision of Pasifika resources. In 2013 there were seven Pacific Language Weeks including the inaugural language weeks for the Fijian and Tuvaluan communities and language weeks for the Niuean, Samoan, Cook Islands, Tongan, and Tokelauan communities. These initiatives help strengthen language in the community, which in turn creates a supportive environment for early childhood education centres.

Community initiatives

Community action groups are a key vehicle for Government partnership with communities. The groups are established in priority communities, and bring community skills and knowledge to bear on increasing participation in early childhood education, and ultimately meeting the Better Public Services target of 98 percent participation. The Government is responsible for facilitating the establishment of such groups, and providing seed funding. To date 12 community action groups have been established, and some have developed action plans for analysing and overcoming barriers to early childhood participation. The plans include raising awareness of early learning through promotional activities such as play days, hosting events to promote early learning options, and health and social support services initiatives.

There are also Intensive Community Participation Projects, which were established in five high-need communities for a three-year period. Funding from these projects has helped establish Pasifika playgroups in areas with low participation in early childhood education.
While we recognise the importance of increasing participation in early childhood education by Pasifika children, hence the Government’s investment of $12 million in an “Engaging Priority Families” initiative, and support the work that the Ministry of Education and the Ministry of Pacific Island Affairs are doing to this end, we must emphasise that this inquiry is about high-quality teaching of heritage languages, and not just participation. For this reason we believe that the initiatives supported by the Ministry of Education should have a specific language teaching focus.

**Recommendations**

14. We recommend that the Government require early childhood education partnership activities promoting Pasifika participation in early childhood education to include a specific language focus.
6 Research areas to inform the early childhood education system

A consistent theme from submitters to our inquiry was the lack of data on the provision of Pasifika early childhood education. Many submitters spoke from personal experience. They suggested that the Ministry of Education should collect more information about which teachers were teaching in which Pasifika languages, where, and how often.

There is a lack of evidence on the relationship between heritage language learning in the New Zealand context and later educational success. While there is a strong theoretical understanding of the benefits of bilingualism, and good language teaching practice, there is little understanding of how either is working in New Zealand. We feel that developing such an understanding should be a priority for future research.

Pasifika services are subject to the same quality monitoring and improvement mechanisms as other services, ERO being the main source of information on the quality of services. We have noted that ERO data shows Pasifika services have had very high supplementary review rates, which indicates quality problems. ERO has highlighted concerns about the challenge provided to students, the accessibility and quantity of resources, the quality of interactions, and the meeting of legal requirements, among other areas. ERO recommended significant ongoing professional development of Pasifika teachers and managers in order to improve quality.

While there are many accepted indicators of best practice for teaching, learning, and bilingual education in early childhood, there is no strong evidence as to what constitutes best practice in creating a resourcing framework for language education. It was suggested that research should be conducted into whether the best way to teach Pasifika languages is to adapt the model used for teaching other languages, or whether specific Pasifika models are needed, and if so, how they might differ. It was also suggested that Pasifika models would benefit from drawing on successful practices in the teaching of Te Reo Māori to develop a Pasifika language teaching curriculum.

Submitters often cited evidence from European countries, many of which require students to learn up to three languages. This policy is shown to have educational benefits. Research on learning multiple languages demonstrates that knowledge and strategies learned in one language can be applied in many languages; for example, the ability to perform basic calculations can be taught in the heritage language, and then the student can be taught to translate their thinking into another language at a later time. One submitter noted that students who are taught skills in their heritage language of Mandarin or Cantonese do not have a problem in translating their knowledge into English when they reach English-medium education. However, Pasifika teachers were often not taught mathematics in their heritage language, and so must learn how to instruct these skills in their heritage language when they become teachers. Some studies also show that children learn best when they are taught in a comfortable environment, and for many students this means learning in their heritage language.

Submitters recognised the lack of New Zealand-centred research on effective bilingual or immersion early childhood education; most of the research relies on translating
international research to New Zealand, and suggested ways that the body of research could be increased in New Zealand by using pilot programmes. We were told that South Auckland could be a natural base for these research projects. Such programmes would require funding through to completion in order to assess outcomes. Some submitters suggested this has not been available in the past.

**Recommendations**

15. We recommend that the Government consider undertaking research to develop a better understanding of bilingual delivery in heritage languages.

16. We recommend that the Government consider undertaking research into Pasifika children’s educational transitions.

17. We recommend that the Government consider undertaking research into the uptake and quality of Pacific languages in early childhood education.

18. We recommend that the Government take into account the broader evidence on bilingual and immersion language learning when considering measures to improve outcomes of Pasifika early childhood education centres.
7 Conclusion

The majority of us believe that Pasifika languages must primarily remain the responsibility of Pasifika communities; and that if families and communities are not active in learning, using, and promoting their heritage language, there is little the Government can do to change this. If communities are active in preserving their language, as many are, significant support is available to them, and they can be successful. To ensure the active engagement of the community, we recommend that the Government conduct research into the barriers that are preventing Pasifika parents from standing for boards of trustees, with a view to overcoming them. We feel that Pasifika involvement in boards of trustees will be beneficial for the community.

Submitters argued that there is strong community support for the languages to survive, and called on the Government to ensure that there are sufficient resources available to ensure the languages can be taught effectively. This means teachers as well as resources for the classroom. We are aware that more teachers are needed for the Pasifika education centres, and that there is a need for more professional development for the teachers who are already employed in them. We recommend that the Government look to target existing equity funding to address these issues.

There are numerous existing initiatives supporting the pursuit of better educational outcomes for Pasifika learners, on which any future developments can be built. These initiatives range from TeachNZ scholarships which fund the training of Pasifika early childhood education teachers, to ministry-funded professional development programmes targeting areas where particular support is needed. Efforts by Pasifika communities to achieve their aspirations of language revitalisation are supported by initiatives such as the Pasifika Education Plan, Pasifika Success, the Pacific Languages Framework, and Achieving Through Pasifika Languages, and by events such as the seven Pacific language weeks.

We recognise that the Government has invested $91.8 million, with an announced additional $80.5 million over the next four years, to increase the early childhood education participation of Māori and Pasifika children, and children from low socio-economic backgrounds. We note however that participation in early childhood education does not necessarily involve a heritage language focus. We believe it is also important to ensure the quality of early childhood education in bilingual or immersion units.

We also recommend that more research be undertaken into early childhood education in New Zealand, and specifically, the provision of bilingual or immersion education. Most of the evidence that we drew on for the inquiry was from overseas jurisdictions. It is important that government policy is based on strong local evidence.
8 Minority views

New Zealand Labour Party

New Zealand’s unique relationship with Pacific peoples

The New Zealand Labour Party believes that the New Zealand Government does have a legal duty, as set out in section 20 of the New Zealand Bill of Rights Act, to protect the use of Pasifika languages used by the Pasifika communities.

We believe there is a strong argument to be made for the Pacific peoples’ languages and bilingual education to be part of New Zealand’s educational curriculum. Especially in light of the special nature of the relationship between New Zealand and the Pacific inclusive of the Pacific peoples who have made New Zealand their permanent home. This special relationship has been widely and regularly acknowledged by past and present Prime Ministers, Ministers of Foreign Affairs, and Governors-General. Additionally, many Kiwis now embrace New Zealand as a Pacific nation and a member of the Pacific family of island nations.

Though New Zealand does not have a written constitution, these actions have built a clear, if not clearly implied, constitutional position on the strength of New Zealand’s relationship with Pacific peoples.

Pacific languages for Pacific children make economic sense

The Pacific population in New Zealand is expected to climb to 12 percent by 2025 and over 15 percent by 2035. However, it is the school-age population projection at over 20 percent, which is significant in size, that will make up New Zealand’s future citizens. Auckland’s Pacific student population is currently at 22 percent.

For Pacific people to make the degree of economic and social contribution to New Zealand necessary to drive New Zealand’s economic future, a far greater contribution from Pacific people will be needed. At present educational success for Pacific peoples in a holistic sense continues to be an elusive and distant goal in spite of efforts.

Quality bilingual education has a proven international record of raising minority students academic achievement.

In spite of community efforts for maintaining Pasifika languages in the homes, church, and Pacific language weeks, three of the Pacific languages—those of Niue, Cook Islands and Tokelau—are seriously at risk of extinction in the next few years. Research indicates they are able to be maintained and revived if the recommendations of Professor Stephen May’s 2009 report are implemented with urgency.

We believe a greater effort ought to be made to ensure Pasifika language bilingual education is provided for to the next generation of Pasifika New Zealand citizens.

Current policy focus does not help Pasifika children

It is the view of many Pasifika people that under the current policy regime, Pasifika language bilingual education is not being valued, nor is it a key objective of the current Pasifika Education Plan.
It did not help that the specific Pacific bilingual language goals in the Pasifika Education Plan 2008–2012, which were widely supported by Pasifika parents, teachers, and researchers, were removed in the subsequent 2009–2013 Pasifika Education Plan.

Instead of acknowledging that many Pasifika children, especially Samoans and Tongans, were speaking their heritage language at home, in the church and community activities, and that English was a second language for many, this change in focus effectively meant that Pasifika languages were treated as a foreign language in the same way as Russian, Japanese, German, French, and Spanish.

It then followed that the Ministry of Education stopped publishing first language literacy resources for students who already understand or speak a Pasifika language, or who want to become bilingual. Resources currently being published by the ministry are simple literacy materials designed for second-language beginner learners in year 7 upwards only. The materials are no longer available in primary schools for children in years 1–6. Bilingualism is not an objective of these new materials and cannot therefore be achieved.

While the ministry submitted that schools do have a choice of materials, schools themselves must meet the costs of those materials from their own budgets. The experience for most lower decile schools that run a Pacific language full immersion or bilingual class is that they are already under pressure from the current austere conditions their sector faces, so that there is little contingency capital that can be freed up for Pacific language resources. While many schools might rely on parent donations to fill these gaps, it is an extremely tough ask for parents who are themselves already struggling to put food on the table and provide uniforms for several children per household.

The New Zealand Labour Party believes it would have been more appropriate for the Government to pursue the reinstatement of the Pacific language bilingual goals of the Pasifika Education Plans and the continued production of resources for Pacific bilingual language education.

**Evidence to support review of resources**

The New Zealand Labour Party had sought from the Minister and ministry officials what evidence they have to support their view that the resources—Tupu and Fōlauga—were not effective as a school resource for Pasifika language bilingual education, which led to the review of these resources in 2010.

They responded that “this evidence was obtained from research commissioned by the ministry from the University of Auckland in 2010 in relation to curriculum support resources, including how resources can best be designed and used to raise Pasifika student achievement and literacy.”

What the Minister and ministry failed to highlight was that the evidence they submitted to support the review of Tupu and Fōlauga was research they specifically contracted the University of Auckland for “Resources to support Pasifika student achievement in English literacy” and not Pasifika bilingual language education. The terms of reference were to recommend English reading texts for Pasifika children. There was no explicit term of reference to review the effectiveness of Tupu and Fōlauga for Pacific bilingual language education. The basis for these terms of reference was to value English and not Pasifika language. The use of this research by the ministry to back its review of Tupu and Fōlauga Pasifika language texts we believe is inappropriate.
The use of this research, which is clearly for English text and not for Pacific bilingual education, to undermine Tupu and Fōlauga as Pacific language bilingual education resources should cease.

**Evidence based - the 2009 May report**

The New Zealand Labour Party supports a strong public education system and views education of the Pasifika population as an investment in the future of New Zealand. We approach it on the basis that we are accountable to our constituency for providing quality, best practice, achieving best outcomes for our children, even Pasifika bilingual language education where resources allow. To secure the best outcomes for our limited resources, our approach therefore values an evidence base.

While research for the last 40 years has consistently confirmed the cognitive and educational advantages of bilingualism for minority students, the evidence many of us have relied upon has tended to be internationally based. There is now a growing collection of local research focused on our local circumstances that we should be familiarising ourselves with more. Additionally there is also now a real need to build up this local body of quality evidence that is specifically relevant to our peculiar set of challenges.

One particular body of research that is strongly supported by Pasifika is the 2009 report of Professor Stephen May from the University of Auckland.

We recommend the full implementation of the recommendations made in the 2009 report of Professor Stephen May from the University of Auckland.

**Framework for possible future actions**

We believe there is an urgent need to address the possibilities of further development in maintenance of Pasifika bilingual education. In addition to growing Pasifika language learning in early childhood education but to also transition and extend the learning gains into compulsory education. There are already some highly successful documented examples of additive bilingual programmes already operating in mainstream Aotearoa/New Zealand schools (for example, Richmond Road, Clover Park, and Finlayson Park).

These schools have been recognised internationally (Richmond Road is referred to widely in the international research literature as an exemplary multilingual school) and nationally (Clover Park was placed second in 2003 national competition for best school; Mountain View, which won the competition, also has bilingual units).

However, these outstanding examples of good school-based practice in bilingual education remain highly localised and predominantly community and school driven, with little impact upon, or reference to, national education policy. Without a national education policy reference point to Pasifika language bilingual education and a more positive and active approach from a national level, Pasifika peoples fear that eventually, all their efforts will be for naught.

We would have preferred to see the Government working with the Pasifika communities to enable a more positive and active approach that will be anchored to a national policy reference point to protect, promote, foster and maintain Pasifika language bilingual education.
The Green Party of Aotearoa/New Zealand

The Green Party of Aotearoa/New Zealand supported this inquiry as a response to the widespread concern from Pacific communities about the risks to their heritage languages and the specific loss of some language resources in schools. We were disappointed that the terms of reference were limited to early childhood education, but we saw this as a positive opportunity to hear the concerns and to respond to them. This minority view reflects our disappointment that the majority of the committee heard the concerns but are not willing to take a proactive and positive stance towards heritage languages, and believes families and communities need to take full responsibility for protecting them. We do not agree that encouraging initiatives is sufficient to protect the heritage languages of the Pacific region or to sustain the identities of students struggling on the palagi/papa’a education system where English language and paradigms dominate. The results of this dominance are visible in the statistics around student engagement and confidence.

Government neutrality towards the fragile languages, notably Cook Islands Te Reo, Niuean, and Tokelauan languages, is a weak response to the submissions we heard requesting leadership, resources and support from the state. The Green Party of Aotearoa/New Zealand supports the New Zealand Labour Party’s minority views references to our state responsibilities to the Cook Islands as an associated state. The lack of support for heritage language education in the Cook Islands and in this country are interconnected issues.

The Green Party makes a clear distinction between Te Tiriti o Waitangi commitment to Te Reo Māori and the other Pacific island languages, but we also recognise that the heritage languages are a vital part of our country and that active support for them can help lift the achievements and confidence of Pacific Island students and their whānau. We heard that the families were struggling with second- or third-generation students losing their heritage and this identity and how the families were calling for state resources to address this trend. We heard that young children who start their learning journey in their mother tongue have a greater sense of identity and confidence which will then assist their education. We also heard that Pacific communities would like to see more specific references and commitments to Pacific languages in “Te Whāriki”.

We support some aspects of the inquiry’s majority report, namely the recommendation for more research into the importance of heritage languages to student success (in the broadest sense). We deplore the use of the word “consider” and would like to see Government commit to resourcing the research issues that the inquiry has helped identify.

We support government investment in trainee teachers with a strong background in a Pacific language.

We support the training of more Pacific community members on boards of trustees, without assuming this will address the lack of heritage language classes within schools.

We heard the concerns of Toru Fetu early childhood education centre and others that more resources need to be specifically directed at teacher training and centre development. We do not agree with the majority of the committee that the money invested per child across the country is sufficient for the protection of heritage languages nor that Pacific early childhood centres are in the same position as all others.

The refusal to recognise the impact of poverty and palagi cultural dominance throughout the frameworks for early childhood education is a refusal to recognise the barriers faced by
Pacific communities to protect their heritage languages. The Green Party of Aotearoa/New Zealand would support a partnership approach and more robust Pasifika Education Plan that would set budgets and targets for supporting not only early childhood education in heritage languages, but also transitions and school level opportunities for the students. We see the value of a combined approach such as the Toru Fetu model as a practical response to the economic and social challenges of protecting this important educational approach.

The inquiry was in part inspired by the protests against the withdrawal of some Samoan language resources from primary school. We were told that those resources that were withdrawn will be replaced by more educationally suitable resources soon. However, the debate continues as to whether those resources were withdrawn because they were ineffective in heritage language terms or as resources to support English-medium learning. We did not receive a clear commitment to the languages as a key part of the learning strategies of the Ministry of Education.

There is good intent by the ministry but the overall approach of the Government to be “neutral” on these issues is reflected at every level. We do not accept that a language week and volunteer activities can replace a strong Government commitment to support the educational success of Pacific students in the heritage languages. The Community Action Plans referred to in this report are not Government initiatives and cannot be claimed as a success achieved by any Government.

The conclusion of the report lists opportunities and Government investment in early childhood education which, in our view, are laudable as far as they go but do not represent a real commitment to heritage language learning and read as a political justification for a neutral stance rather than a proactive response to what we heard from submitters.

The Green Party of Aotearoa/New Zealand strongly affirms the reality that we are a Pacific nation and therefore these heritage languages have a greater call on state resources than languages of other nations, and that we are failing in our duty to these communities who enhance our national cultural richness. Furthermore, we are failing to support the students who are struggling in a system that encourages them to assimilate while their parents struggle to maintain their unique culture. The social and educational impacts on these families who also experience the effects of increasing economic inequality are very serious. Thus, we view this inquiry as an opportunity lost by the state.
Appendix A

Committee procedure
The committee called for public submissions on the inquiry. The closing date for submissions was 25 June 2012. The committee received 61 submissions from the organisations and individuals listed in Appendix B, and the committee heard 28 of the submissions orally. The committee heard evidence in Auckland and Wellington. The committee met between 9 May 2012 and 20 November 2013 to consider the inquiry.

Committee members
Dr Cam Calder (Chairperson)
Catherine Delahunty
Hon Jo Goodhew
Chris Hipkins
Colin King
Tim Macindoe
Tracey Martin
Simon O’Connor
Grant Robertson
Dr Megan Woods

Su’a William Sio participated in the consideration of this item of business
Appendix B

List of submitters

A’oga Fa’a Samoa
Anna Lolohea
Anonymous
Barbara Hill
BEST Pacific Institute of Education
Bilingual Leo Pacific Coalition
Carlos Tupu
Charlotte Roberts
City of Manukau Education Trust (COMET)
Courtney Talagi
Dr Diane Mara
Early Childhood Council
F T Faalogo
Faavae Gagamoe
FAGASA Incorporated
Feofanaki Pocock
Fetu-Ole-Moana Teuila Tamapeau
Finlayson Park School
Fono Finau
Galumalemana Alfred Hunkin
Heather and Hemi Rewiri
Human Rights Commission
Kainga Pasifika, School of Critical Studies in Education, Faculty of Education, University of Auckland
Limaono Kingi QSM
Lydia Sosene
Ma’anaima Lafoa’i
Matua Atina’e
Michelle Ladwig Williams
Mimisa Siaosi Tofifaasolo
Moemoe Nanai
New Zealand Federation of Graduate Women
New Zealand Kindergartens
Niue Sports Council
Nola Harvey
Nuku21 Pasifika Trust
Nukutukulea Aoga Niue early childhood education service
NZPPTA Komiti Pasifika
Orchid, Stuart, and Luella Bracey
Organisation Mondiale pour l’Education Prescolaire Otago
Pacific Palliative
Pacific Peoples Panel Auckland Council
Papatoetoe Aoga Amata
Pasifika Information Management Network
Poasa Tim Baice
Raise Pasifika
Rosebank ECE Centre
Samoana Early Education Development Services (SEEDS)
Savea Al Hammington Lavea
Sonny Teio
SS La Ta Gagana Trust and Sonealofa ECE Playgroup
Tamasailau Sagaga-Simanu
Tara Queeny Sakalia
Te Tari Puna Ora o Aotearoa NZ Childcare Association
Teachers of English to Speakers of Other Languages Aotearoa New Zealand (TESOLANZ)
Teresa Ma’afu
Uaite-Lose Taunisila
University of Auckland Pacific Island Law Students Association
Vaealikik Mataia
Vagahau Niue Trust
Vaka Tiale
Inquiry into engaging parents in the education of their children

Report of the Education and Science Committee

Fiftieth Parliament
(Dr Cam Calder, Chairperson)
July 2014

Presented to the House of Representatives
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Inquiry into engaging parents in the education of their children

Summary of recommendations

The Education and Science Committee makes the following recommendations to the Government:

- That it amend the fourth National Education Goal to reflect the importance of engaging parents and families throughout the education sector.
- That it review the support available to parent-led early childhood education services in light of some of the concerns raised during this inquiry.
- That it support evidence-based cross-departmental initiatives to encourage parental engagement in education.
- That it review the coverage and take-up of the Early Reading Together and Reading Together programmes, with a view to possible expansion of the Early Reading Together programme.
- That it encourage education providers to consider outreach in their community to be part of their core business.
- That it consider effective models for funding outreach in the community.
- That the Ministry of Education develop best-practice guidelines for education providers to use when developing effective approaches to engaging parents.
- That it ensure that teacher training and professional development includes training on effective methods of parental engagement.
- That it encourage and support trialling methods of parental engagement, so that the most effective can be adopted by other education providers.
- That it broaden the role of the Education Review Office to include a function for reviewing parental and community engagement.
- That it ensure that the Ministry of Education’s web channel redevelopment initiative support the engagement of parents and communities in their children’s education, providing access to learning resources and information about the education system.
- That it ensure that targeted communication strategies are developed for different communities, and that resources are made available to parents in their heritage languages.
- That it encourage teachers to share effective methods of engaging with parents.
- That the Ministry of Education work with education providers to find and share information on good practice in parental engagement.
• That it develop targeted initiatives to support refugee and migrant families who face multiple barriers to parental engagement.

• That it review existing engagement initiatives, and increase investment in the most successful.

• That it continue to support initiatives that help education providers reflect the culture of the community.

• That it ensure that parents have access to information and resources on the importance and means of engagement.
1 Introduction

For most children, their parents are the one constant factor in their journey through the education system. We are of the opinion that children are better equipped to achieve to their full potential when they are supported through their education by a parental figure, who might be an actual parent, a caregiver, or a member of the wider family. To help ensure that such people remain engaged in the education of their children, we must make it as easy as possible for them. We resolved to initiate an inquiry to determine how well parents are engaged in the education of their children, and what can be done to ensure more parents become engaged.

The terms of reference for our inquiry were as follows:

- Investigate the elements of an effective strategy for engaging parents, families, whānau, aiga, and communities in education.
- Identify the best practice examples of approaches, locally and internationally, that support parents and communities to encourage their children’s learning.
- Identify ways to leverage the strength of communities to lift the educational achievement of children and young people in their community.

Many of the submitters to our inquiry referred to an evaluation that the Education Review Office undertook (Partners in Learning: Schools’ Engagement with Parents, Whānau, and Communities) in 2008 of schools’ engagement with parents, whānau, and communities. It defined engagement as “meaningful, respectful partnership between schools and their parents, whānau, and communities that focuses on improving the educational experiences and successes for each child.” This study found that most parents want schools to be open and inclusive places that respect and acknowledge each child’s background and potential to learn. The benefits of such engagement are felt beyond the education sector, and accrue to wider families and their communities.

There is great variation between regions and between education providers in the way parents are engaged in the education of their children. There is also great variation among parents. We feel that every level of education and every provider should strive to improve constantly and to ensure all parents are engaged in their child’s education. This inquiry did not find, or expect to find, a single solution that is guaranteed to improve engagement by parents. Providers must strive to engage their local community. Engagement methods must suit the community supporting the provider. This report highlights some of the best examples that we heard about; it attempts to determine which approaches consistently improve engagement, and suggests how they might be implemented nationwide. We would like to see the examples of good practice described in this report become standard practice throughout New Zealand.

Most of the submissions we received were from the early childhood sector. Of those from the compulsory schooling sector, the vast majority were from primary schools.

In the next chapter we discuss the importance of engagement for all families, and how schools and parents should work together to overcome obstacles to engagement, such as time constraints and socio-economic factors. We also discuss the importance of parents
engaging with their children from birth, and various initiatives that support and promote their doing so.

In chapter three we discuss the importance of engagement with education starting from a young age, to set a child and a family up for life-long engagement. We also recognise the need for particular support for some families at specific times, such as when they are changing schools. This chapter also covers some examples of life-long learning, where parents are choosing to educate themselves, either alongside their children or individually, with a view to supporting their children’s continuing education.

Chapter four covers the roles and responsibilities of key influencers in children’s learning, particularly parents, teachers, and the wider community. We also discuss the possibility of introducing a specific role to help foster the relationship between schools and their communities.

In chapter five we discuss issues that remain to be addressed in the sector, such as research and funding. We also discuss some innovative ways for schools to offer integrated support to their communities. Potential improvements to communication between education providers and families are also considered.

The final chapter looks at the specific needs of some children in the education sector, and suggests ways to further support them and their families.
2 Enabling and encouraging parental engagement

In this chapter we discuss factors outside the education sector that can impact on parental engagement, such as the time commitments of parents. Other factors that contribute to parents’ engagement, such as their own schooling experience, poverty, and transience are discussed later in the report. We also discuss initiatives targeted at children before they enter early childhood education, which are designed to encourage parental engagement in the education of their children. It is important that parents are engaged in the education of their children from an early age, and these initiatives are designed to support families, and ensure there is a strong commitment to parental engagement before children start their schooling. We detail initiatives targeted at families with children in early childhood education in chapter six.

Enabling engagement by time-poor parents

A large number of submitters highlighted limits on the capacity of parents to engage with their children’s learning. Many parents are “time poor” for various reasons, including employment commitments. The 2008 ERO report found that for parents, whānau, and communities, some of the biggest challenges were having the time to sustain engagement, getting to the school, and developing and maintaining effective communication with the school. The best examples of parental engagement that we heard about took parents’ capacity to engage into consideration, and provided opportunities that parents were in a position to take up. ERO made a number of recommendations for improving engagement in schools, focusing on improving learning partnerships with parents; improving approaches and strategies for engaging parents, whānau and communities; and reviewing the nature and quality of engagement with parents, whānau, and communities, particularly in more diverse communities.

There are many ways to ensure that parents can engage, even when their capacity is stretched. Parents need to be engaged at times that suit them, and provided with options for engagement such as phonecalls instead of face-to-face meetings, childcare for young children during engagement activities, and advance notice of events. We feel that all schools should be in a position to support most of these initiatives, without increasing teachers’ workloads.

We understand that some families struggle to find the money, transport, and free time to engage. It can be hard for them to simply get their children to school or an early childhood service, let alone stay and help out. A lack of time to engage affects all families to some degree. Various schools and educational organisations are taking practical steps to allow even time-poor families to engage with their children’s education.

Business

Businesses, as employers and members of local communities, can help parents engage in the education of their children. Where possible, we would like to see work practices and staffing arrangements allow parents and caregivers to be involved in their children’s
education. A parent’s paid work should not prevent educational engagement, and family-friendly, flexible work practices can help address the challenges to engagement.

**Socio-economic influences on learning**

A number of submitters argued that factors outside of the school system had a significant impact on student achievement. We are of the opinion that low socio-economic status is a contributing factor to lower engagement and achievement, but it is not necessarily deterministic. For example, if we examine the achievement of NCEA level 2 or above, on average, students in schools with higher decile ratings perform better than others; but the achievement rates in some decile 1 schools are higher than those in some decile 10 schools. We believe that parental engagement is a key factor in improving educational achievement in all education providers.

Parental engagement in the education of their children is fundamental to ensuring that educational goals are achieved. We heard many excellent examples of schools and parents working together to ensure everyone is engaged in a child’s education. We hope to see all schools continue to improve in this area. We understand that not all families will find it easy to engage in the education of their children. However, we feel that some of the ideas and recommendations raised in this report, along with an intensive focus from parents, schools, businesses, and government to make engaging as easy and rewarding as possible, will result in higher rates of engagement, and better outcomes for their children.

The ministry told us that all countries exhibit an association between socio-economic status and student achievement. One New Zealand-based project, Competent Children, Competent Learners, found that socio-economic status explained 18 percent of the variation in achievement in the Programme for International Student Assessments, an international study that assesses reading, mathematical, and science literacy in 15-year-old students. A synthesis of over 800 meta-analyses relating to achievement, by Professor John Hattie, *(Visible Learning: A synthesis of over 800 meta-analyses relating to achievement, 2011)*, concluded that socio-economic status was the 32nd most influential factor in achievement. An OECD report, *Strong performers and successful reformers in education*, indicates that in the best-performing countries in the world, students’ performance is only weakly linked to socio-economic status. Nevertheless, some of us consider that factors such as poverty and transience remain significant obstacles to some parents engaging in their children’s education.

**Initiatives to encourage parental engagement**

There are many initiatives targeted at parents of babies and young children that aim to establish good practices in parental engagement with the education of their children. One such programme is the Home Interaction Programme for Parents and Youngsters (HIPPY), which is designed to help prepare children for school. Parents and children work on a series of 60 “activity packets” over two years; they involve parents working with their children for 15 to 20 minutes a day for 30 weeks each year. Tutors visit parents in their homes every two weeks; on the alternate week, parents and tutors meet with a co-ordinator. A 2010 review of the service found that Māori and Pasifika families are the main recipients of HIPPY. Reports indicate high parental satisfaction with components of the programme and evaluations show positive outcomes for children and parents in reading, mathematics, and school behaviour.
We acknowledge the important role of parent-led early childhood education services. We received a compelling submission from the New Zealand Playcentre Association, and acknowledge the valuable role playcentres have filled in many New Zealand families. We heard from submitters of the challenges parent-led early childhood education services currently face.

Another initiative targeted at parents in the home is the Supporting Parents Alongside Children’s Education (SPACE) programme, which is designed to support first-time parents in their first year of parenthood. The programme includes 30 to 40 weekly sessions led by experienced facilitators. An independent report (MartinJenkins, *Evaluating Outcomes of SPACE Programmes*) found that parents who participate in the programme extend their knowledge, skills, and understanding of parenting and child development, build confidence and strong support networks, deepen parent-child relationships, and are significantly more likely to have their children participate in early childhood education.

Parents as First Teachers (PAFT) is a home-visiting parent education and support programme to help parents understand how their infants develop and learn. Parent educators work with families, applying the Ahuru Mowai and Born to Learn curricula. PAFT aims to increase parents’ knowledge of early childhood development and to improve parental practices, ensure early detection of development delays and health issues, increase children’s disposition for learning and their participation in quality early childhood education, and ensure positive transitions to school. There are 129 parent educators, 31 percent of them Māori and 17 percent Pasifika. The curriculum involves monthly, fortnightly, or weekly personal visits. The majority of the children in the programme have been identified as at risk of poor outcomes. Parents can self-refer to the programme, or can be referred by other agencies.

The Pasifika Education Centre is unique in delivering bilingual Pacific language and cultural programmes and resources for adult learners in Manukau, Central Auckland, and West Auckland. The centre provides a PAFT programme to parents in the Auckland central area. A PAFT co-ordinator and educator help parents to participate effectively in their child’s early development and learning. Parents are taught the milestones of development in a child’s first three years. The team make home visits and facilitate enjoyable and informative group meetings.

The Manukau Urban Māori Authority is a Whānau Ora provider based in South Auckland. It provides a home-based programme for young single Māori mothers, to help them become key contributors to their children’s development. This programme encourages the parent to watch for signs of readiness in their child and schedule their advancement into more challenging learning at appropriate levels of development. Providers try to understand the circumstances of the parents and caregivers when establishing expectations of their ability to provide a home environment that supports educational achievement.

Whānau Ara Mua is a level 2 certificate in Family Learning and Child Development, developed by City of Manukau Education Trust. The programme is usually delivered through primary schools, and features observation and reflection on the children’s learning and development. An independent report found the economic return from the programme, such as higher expected incomes for children and their parents, improvement in children’s school performance, reduced reliance on government agencies, and lower crime and education costs, amounted to $9.41 for every $1 invested over 30 years. This report noted that these calculations factored in the low socio-economic demographic of participants in
the project, where the marginal returns are higher because the impact on incomes is relatively greater.

The National Education Goals are statements of achievements the Government expects of schools, and statements of government policy objectives for the school system. They detail the Government’s priorities for education. National Education Goal 4 is “a sound foundation in the early years for future learning and achievement through programmes which include support for parents in their vital role as their children’s first teacher”. We would like to see this goal amended to reflect the importance of engaging parents and their families throughout their children’s life-course.

**Recommendation**

1. We recommend that the Government amend the fourth National Education Goal to reflect the importance of engaging parents and families throughout the education sector.

2. We recommend that the Government review the support available to parent-led early childhood education services in light of some of the concerns raised during this inquiry.
3 Early engagement and life-long learning

A number of studies point to the early years of a child’s life as a critical time of development. Early educational experiences can also set the tone for parental engagement throughout a child’s education. Submitters stated, for example, that Playcentre parents tend to be more involved in their child’s schooling later in life. Encouragingly, many submitters felt that the early childhood sector was the most welcoming and inclusive part of the education system for parents and families. These positive early experiences are generally accepted to result in better outcomes for the child, better outcomes for future children in the same family, better family dynamics, and higher likelihood of parental and family engagement in future learning. Early childhood services set out to help babies and toddlers improve neural connections through play. Submitters told us that play is vital to a child’s development, and parental involvement in group play helps to build a bond between parents and their children.

The Government is seeking to increase children’s participation in early childhood education to support improved lifetime outcomes. The Government intends to ensure that 98 percent of all children starting school in 2016 will have participated in quality early childhood education. We hope that early childhood services strive to ensure that these early education experiences are positive for children and their families, so that parental engagement starts early, and continues throughout their education. We support this initiative.

Transition

We are aware that times of transition, particularly to new schools, can often result in families becoming disengaged in the new environment. We would like to see a strong emphasis by schools on welcoming new families to the school community, to ensure that parental engagement does not suffer from the change in circumstances. Times of transition into school, between classes, and between schools are crucial to the establishment of effective, respectful relationships. There is a heightened risk of students’ disengaging at transitions (early childhood to primary, primary to secondary, and so on), so support in whatever form should focus particularly on these transition points to smooth the process for all concerned. It is even more important that schools support students who move between multiple schools in the same year, as it is generally accepted that such upheaval can be detrimental to the child’s education.

A report by ERO found that the relationships of parents with their children’s schools and teachers are often determined by their initial experiences. Positive experiences at an early stage generally lead to the development of strong home-school partnerships. We are aware that the ministry has focused on supporting young people and their parents, caregivers, and whānau as they go through their late primary and secondary school years. The ministry also runs an “Improving early learning foundations” scheme, which aims to ensure a smooth transition to school. We would like to see continued improvement in efforts focused on the early years and crucial transition stages in a child’s education.

We heard that parents can sometimes feel intimidated by the educational jargon used by teachers at secondary schools. Parents already nervous about engaging with their children’s
schools may feel inadequate when teachers converse in education shorthand. This is an aspect of the engagement issue that is hard to address systemically; it needs to be addressed by individual teachers. We would like to see parental engagement become a key component of teacher training and professional development. We are also aware that parental engagement strategies may vary from school to school, and suggest that schools might include a discussion of their particular strategies in their induction of new teachers.

We heard of examples where schools included the whole family in engagement initiatives, for example by holding learning conferences, where whānau, teachers, and students meet. In cases where more than one child in a family attends a school all the children are invited. These hui are viewed as an effective and practical way to engage the family and to support all their children. Research has shown that attendance at parent-teacher meetings rises if the meetings include the student; if one teacher is made responsible for a student’s overall learning; and if the meeting focuses on the student’s learning goals and how each participant can support them.

**Educating parents**

We were told that an important way to improve a child’s development is for the home environment to encourage learning. Many home environments do not do this, and some parents need support in furthering their own education, particularly in developing their literacy and numeracy. Encouraging and valuing parents in their roles as parents and as educators of their own children does not just benefit their children; it has an intergenerational effect on the behaviour of future parents and the outcomes of future students.

Educators may invite whānau into schools and early childhood services to learn alongside children. This encourages intergenerational learning, which is already a common practice in Māori and Pasifika cultures. Intergenerational learning has a number of benefits, with parents modelling life-long learning to their children, becoming better equipped to help their children with their learning, and improving their own employment prospects. We heard from submitters that the Kōhanga Reo system is a successful model of intergenerational learning, in which parents, grandparents, and extended family are involved in the upbringing and the holistic education of the child.

The Reading Together project aims to lift the reading level of underachieving children. The programme involves 594 schools, 77 percent of them in deciles 1 to 3. Schools run a series of four workshops for a group of 15 whānau, linked with a local library. The participants are informed about assisting their children with reading at home. Many workshop participants have unhappy memories of their school days, or struggled with reading themselves, but they are motivated to help their children achieve. Barriers to attendance are reduced by the provision of childcare, food, and transport, and by scheduling workshop times to suit the participants. This programme is proven to increase students’ literacy. Some submitters would like to see its sister programme for children up to age six, Early Reading Together, made available to all children who need it.

Some schools use access to technology to strengthen relationships and engagement with children and their families. Computers in Homes, for example, is an educational intervention programme designed to raise the literacy level of children from low-decile schools. The project provides a recycled computer, internet access, training, and technical support to families who would not otherwise have access to such resources. Parents undergo computer training at their children’s school. Schools that run the programme
report more communication between school and homes, and more positive interaction between parents and teachers. The programme gives parents a reason to come to school with a learning purpose. We were told the programme has helped demystify the school curriculum, and teach parents how they can help with school homework. Many parents who have completed the programme report having more confidence in helping their children and in using computers.

We heard from a number of submitters about the importance of life-long learning and parental education for parents’ engagement in the education of their children. The Rural Education Activities Programme (REAP), a charitable society, runs a Basic Work and Living Skills programme, to improve the numeracy and literacy skills of adults. REAP wants to find places where all families in the locality can access the technology necessary to engage; increasingly, education services are using technology to link parents, students, and institutions, and families that cannot access technology risk becoming disengaged. We heard from participants in Adult and Community Education stressing the importance of access to adult community education opportunities for parents for their own education and the benefit of the example they set their children.

We must avoid the assumption that any type of parental engagement with schools automatically increases student achievement (Hattie, *Visible Learning*). Many school-related activities compete for a parent’s time; some, such as fundraising, are valuable and help build connections with schools but do not contribute to children’s learning. This inquiry is focused on activities that increase parental engagement with the education of their children, rather than engagement with schools.

**Recommendation**

3. We recommend that the Government support evidence-based cross-departmental initiatives to encourage parental engagement in education.

4. We recommend that the Government review the coverage and take-up of the Early Reading Together and Reading Together programmes, with a view to possible expansion of the Early Reading Together programme.


4 Clear roles and responsibilities

To facilitate parental engagement in the education of their children, various influencers, including family members, teachers, boards of trustees, and the wider community, need to collaborate. In this chapter we discuss how the roles and responsibilities of these key influencers may change.

Teachers

The role of teachers in engaging parents is pivotal. As a submitter put it, “people engage with people, not institutions”. Teachers need to have the skills and practical experience to work effectively with parents, to help them develop the skills to be educators, and the confidence to engage with teachers. Teachers should be encouraged to work with parents, providing opportunities for them to learn about and share in their child’s learning and achievement. Parents need to feel their contributions are valued.

We agree with suggestions that training on parental engagement practices should be part of all initial teacher education programmes, and included in professional development and learning opportunities for practising teachers. Schools and early childhood education services should be encouraged to trial various parental engagement opportunities and programmes, and to use those that work best to develop good-practice resources. Schools should also examine the success of their current policies and practice in engaging with parents, whānau, and families in their communities, and explore ways to strengthen their community networks.

Capacity is also a challenge for many educators, especially for teachers balancing their classroom responsibilities with other demands. We heard encouraging examples of key staff being given time to undertake engagement activities that did not compromise their core teaching responsibilities. We would like to see such practices more widely adopted.

We heard that some of the common features of schools that engage their communities successfully include a principal who acts as a community leader, and an approach of starting where parents are, rather than where the school wants them to be; and such schools ask parents what they want to know. Leadership is crucial to sound partnerships. Engagement between schools and their communities works well when school leaders have vision and a commitment to working in partnership with all parents. Schools should be encouraged to work with parents to ensure that high parental expectations are encouraged, as higher expectations are correlated with higher achievement. The school, parents, and students should then work together to ensure these expectations are met.

Boards of trustees

A number of submissions said that boards of trustees have an important role in leading schools as they are the main link between community and school. The Education Act 1989 requires trustees to meet the needs and aspirations of their local communities. Some submitters suggested that some board members may not be able to represent their community effectively because of work commitments, transport issues, and lack of access to board information issued electronically. In some cases these factors can effectively restrict the membership of a board of trustees to a less representative group of people. We
are aware that the ministry has increased funding to improve support for the New Zealand School Trustees Association to increase professional training and support for boards. Support could be provided, for example, in developing a written engagement plan. Submitters told us that few schools have an explicit strategy for parental engagement. Parental involvement with schools is often ad hoc, and dependent on the actions and initiative of senior staff. We would like to see the ministry create guidelines for parental engagement, and help boards to modify it to suit their local communities.

**Education Review Office**

The Education Review Office has an important role in the education sector, as it is responsible for reporting on the quality of education provision across early childhood and schooling. We would like to see its role expanded to include a function of reviewing and promoting parental and community engagement. We recommend many other initiatives mentioned in this report to help schools focus on improving, such as communication with parents. We would expect to see the office include information on these initiatives in its reviews.

**Community coordinator**

Numerous submitters said that coordinating with the wider community should be considered a fundamental part of a school’s work rather than an optional extra. We heard that there should ideally be a dedicated role in each school with responsibility for facilitating parental engagement, as teachers often do not have the time to lead such efforts. They cannot be loaded with new roles and expectations without commensurate lessening of others.

Some schools and community organisations have already taken initiatives of this kind, but no such role is mandated or funded routinely. Such coordinators could be responsible for providing parents with resources and ideas for helping whānau to support their children’s learning, working with schools and early childhood education providers to increase engagement with whānau, and coordinating community events with a learning focus. Such a liaison role could be based in a single school, or might work for a cluster or collective of local schools and early childhood providers. In the latter case, it could be contracted to a particular school, a community organisation, or a charitable trust. It was argued that ideally a coordinator’s role should be government-funded, but some of us feel there may be other appropriate ways to fund such positions. We would like to see the Government consider what might be the most suitable funding model for such positions.

To succeed, a coordinator would need to have wide credibility in the community, be trusted by parents and teachers alike, and work effectively with local support agencies. Strong support from school leadership would be essential. A coordinator position should ideally be filled by someone from the local community. Schools with sizeable numbers of Māori and Pasifika students might consider separate liaison roles, or auxiliary parent volunteers from each of these communities.

Some community coordinator roles have already been introduced successfully, in both early childhood and compulsory education. Raurimu Avenue School in Whāngarei, for example, employs a liaison worker to encourage parents to become more involved in their children’s learning. The liaison worker provides mentoring support for parents. After building a relationship through regular contact at school and at home, the liaison workers provide resources and ideas to help the whānau to engage with their child as a learner; they also
make the school team aware of what they need to know to work appropriately with whānau.

Te Huarahi is a partnership of around 15 schools and kindergartens in Pukekohe, formed in 2010 in response to ERO reports on local schools which highlighted the underachievement of tamariki Māori. Te Huarahi has established an independent charitable trust, and employed a project coordinator to implement its collective plan to get “schools and whanau working together to improve educational outcomes for Māori”. It offers educational opportunities to whānau, including workshops on success factors in areas such as helping gifted Māori children succeed and encouraging strong Māori learners.

Families

Many submitters told us that it can be challenging to engage parents in their children’s education when the parents are not comfortable interacting with schools. Many parents said they do not feel comfortable in their child’s school, particularly when their own experiences at school had been negative. Parents and caregivers who are second-chance learners have often had a negative experience of the education system; they were made to feel “dumb” at school, and lack the confidence to engage with and challenge the education system on behalf of their children. Many also feel that there is little they can do to assist or encourage their children’s educational development when they have not achieved themselves. Some parents fear that they might actually disadvantage their children by becoming involved in their learning. New and varied approaches to meeting with parents are needed to overcome such perceptions, which make parents reluctant to engage with schools and teachers.

We heard anecdotal evidence from submitters that ensuring parents feel comfortable in the school environment can improve their engagement in the education of their children. We were pleased to hear that many schools have taken measures such as introducing “parents’ rooms”, where parents can meet with other parents and with teachers. Other schools have recast themselves as community hubs, and tried to make all members of the community feel comfortable on school grounds.

Sometimes effective measures to help parents feel comfortable in the school environment have little to do with classroom activities. Many schools use breakfast and lunch programmes to engage families. Some schools then build on adult support for and participation in running the food programmes to strengthen their relationships with the school, and with their children’s education. It was suggested schools can create an environment where parents feel included, for example by reaching out proactively to include whānau and parents in the decisions and activities of the school.

One example of a successful programme that helps facilitate parental engagement in the education of their children is the Parent Mentoring Project in Manukau. It monitors children’s achievement, and provides mentor support for parents of children starting school. A study found that on average children of parents engaged in the mentoring project achieved higher scores than others on all literacy measures. We are aware that parental engagement with the education of their children outside of school is also extremely important.

It should always be remembered that getting parents into school buildings and getting them engaged in their children’s education are not the same thing. However, if the former is
achieved, we believe it might go some way towards promoting engagement, or at least give schools the opportunity to try to engage parents.

Young people must also be involved directly in decisions about their education. Children play an important role in ensuring that their parents are engaged, for example by informing their parents of the ways they can be involved. This approach personalises the message parents receive, making it more likely to be well received.

**Recommendation**

5   We recommend that the Government encourage education providers to consider outreach in their community to be part of their core business.

6   We recommend that the Government consider effective models for funding outreach in the community.

7   We recommend to the Government that the Ministry of Education develop best-practice guidelines for education providers to use when developing effective approaches to engaging parents.

8   We recommend that the Government ensure that teacher training and professional development includes training on effective methods of parental engagement.

9   We recommend that the Government encourage and support trialling methods of parental engagement, so that the most effective can be adopted by other education providers.

10  We recommend that the Government broaden the role of the Education Review Office to include a function for reviewing parental and community engagement.
5 Collaboration and integrated support

In this chapter we discuss particular aspects of the education system, including its funding and research, which will need to be changed if parents are to be more consistently and effectively engaged in the education of their children. The changes needed in these areas will need to be led by the ministry. We also discuss the changes we would like to see in the way schools communicate with parents, and how schools can provide more holistic support to parents.

Education providers should be open to receiving support from members of the community in furthering the education of their children. For example, the Clinic at Ngaio Primary School is a group of parents who volunteer to run learning sessions for students at school lunchtimes, operating out of the school’s disused dental clinic. A core project team manages the project, supported by over 80 parents who help facilitate sessions. The Clinic’s sessions are available to students at all levels; about 100 children attend each time. We were told that parents who volunteer become increasingly involved over time.

Community hubs

Some schools are starting to become providers of non-educational support, in the hope of helping build partnerships with parents. We heard from submitters that there are excellent examples of such community hubs, which we discuss below, but that they are not needed in every community. We would like to see further research in this area, to determine whether this model in fact helps lift parental engagement in the education of their children. To date there has been limited exploration of what constitutes an effective hub. There are also policy questions regarding the role of hubs: what they aim to achieve, and what unintended consequences might result from co-location of social services.

We were told that the board of trustees at Manurewa Intermediate School opened a community centre to support the school’s students, whānau, and community, in collaboration with the local Parenting Hub. It offers budgeting and legal advice, parenting and housing support, and many other services. The Parenting Hub provides a place for parents to meet and talk, and it offers parenting and housing support, and fitness and health activities and advice. A number of submitters mentioned Victory Village in Nelson, a partnership between Victory Primary School and Victory Community Health. The school appointed a social worker and began to engage local services in the early 2000s. The hub includes a multipurpose community, health, and recreation centre and hall located on the school grounds. The centre provides health services for residents, and many recreational and social programmes and community events. Community centre services are open to all residents, not just parents of children at the school.

The Families Commission undertook a case study of Victory Village in 2010, which explored the effect of the convergence of health, education, social, and community development goals. The study found a strong pattern of improvement in students’ participation, wellbeing, and achievement as the school shifted to a family-centred model of education and integrated community services. The roll also stabilised, with annual turnover falling from over 60 percent of the roll in 1999 to 9 percent in 2008.
I.2C ENGAGING PARENTS IN THE EDUCATION OF THEIR CHILDREN

Research

We heard anecdotal evidence from many submitters about local initiatives that are working in their community. While many of these initiatives appear successful, we do not feel comfortable recommending their adoption across the country without further research. The ministry is committed to evidence-based approaches to programmes for children and young people in New Zealand, and explained that it will continue to promote evidence-based practices regarding parental engagement. The ministry said that building an evidence base for targeted and universal programmes is a priority. We would like to see the ministry work with education providers to further build on and share the effective engagement techniques discussed in this report, to determine which should be promoted across all schools. Some of us thought that research into the effects of transience on parental engagement would be helpful.

Communication

A crucial part of parental engagement is providing a clear communication channel for parents and schools. Education providers should communicate with parents in ways that are timely, useful, easily understood, and culturally appropriate, and should view communication with parents as an important part of their role; for example, we heard that some schools ensure that phone calls from parents are returned urgently. Submitters emphasised that communication needs to be clear, precise, frequent, and use a range of media and formats. Schools should be innovative in communicating with parents, for example engaging with parents face-to-face outside of school hours, and outside of school grounds. Submitters suggested that parents should be asked at the start of the year about their preferred method of communication.

It is important that parents are kept informed of their children’s learning achievement, so it can be reinforced at home. We heard of good examples in the early childhood sector, where educators engage with parents frequently using learning stories, which have become common practice for documenting children’s learning, and often prove a powerful mechanism for engaging parents. Learning stories can be written for individuals or groups; the teacher details the children’s teaching and learning experiences, and shares them with whānau, so that lessons learned at school can be reinforced at home. Their use is becoming more widespread, with some stories recorded and updated online by parents and teachers in private learning communities, allowing extended family to follow the learning experiences of children. Evidence from early childhood education providers suggests that this narrative approach is effective in helping parents understand and engage in their child’s learning. It also fosters two-way communication between the education provider and the home. The success of learning stories is encouraging, and we would like to see similar results from initiatives in the compulsory sector.

It is important that parents receive balanced communication from schools; if the only information reaching home is bad news there will be little chance of winning support from parents for the efforts being made at school. Schools should proactively and systematically identify families who are not yet involved in their children’s schooling and extend personal invitations for them to become involved, providing clear guidance on what is expected from parents. The ministry is redeveloping its online resources. We would like to see this redevelopment support the engagement of parents and communities in their children’s education.
Funding

We heard that many programmes work best when they operate over some years, but that it can be difficult to secure funding for more than 12 or at best 24 months. Many schools are reluctant to introduce engagement programmes when there is little chance of their being available long enough to be beneficial. On the other hand, some schools are overwhelmed by the large number of initiatives that operate simultaneously. We would like the ministry to determine whether these problems are common.

Recommendation

11. We recommend that the Government ensure that the Ministry of Education’s web channel redevelopment initiative support the engagement of parents and communities in their children’s education, providing access to learning resources and information about the education system.

12. We recommend that the Government ensure that targeted communication strategies are developed for different communities, and that resources are made available to parents in their heritage languages.

13. We recommend that the Government encourage teachers to share effective methods of engaging with parents.
I.2C ENGAGING PARENTS IN THE EDUCATION OF THEIR CHILDREN

6 Respecting diversity

The 2008 ERO study found that schools with diverse communities had developed some of the most successful practices for engaging families in ways that bridged cultural, language, and socio-economic gaps. The strategies they used gave parents the confidence to become involved in their children’s learning. Education providers that are committed to being inclusive allow all parents to be actively involved in decisions affecting their children, and respond to parents’ concerns and questions promptly. This is an important issue in groups where student achievement is lower than average.

Many submitters emphasised the importance of recognising the distinct needs of diverse communities. All population groups have their particular cultures, approaches, and needs, and standard systems and structures are at times not responsive to some groups. Submitters told us they would like to see education providers enable children from diverse backgrounds and family situations to engage and flourish. It is also important that teaching staff reflect and represent the diversity of the community, and that all teachers understand and respect cultural differences. Some providers have already started to reflect local cultural identity through features such as signs in the entranceways and school buildings reflecting local cultures. We would like to see more education providers do so. Anything that makes a learning environment a more familiar and welcoming place can help, from artwork that reflects the local community to removing or minimising physical barriers such as fences. Some submitters suggested that the ministry should also draw up specific guidelines for school receptionists.

Engaging Māori and Pasifika families

Good parental engagement in the education of their children involves ongoing discussion between parents and children about future education plans. We are aware of a number of initiatives that attempt to encourage such discussion, including some designed specifically to help Māori and Pasifika families increase their confidence in career decision-making. One is the Parents, Families and Whānau programme, which operates in targeted communities. It seeks to increase educational achievement through family engagement. From July 2013 to March 2014, this programme provided information to 171 whānau. The recipients reported they are more confident and better equipped to support their children’s learning as a result. The programme also helped 204 whānau in the development of education action plans. Another initiative is the NCEA and the Whānau, a cross-agency collaboration which is intended to increase parents’ and whānau understanding of the NCEA system. After completing the workshop, whānau felt confident making career choices and discussing the subjects their children should enrol in.

Submitters suggested practical steps that schools could take to increase their engagement with Māori: ensuring that leadership teams have a specific vision for Māori education; creating relationships and networks with Māori organisations; recognising the roles of kuia and kaumatua and of grandparents; and setting up Māori teams that take a kaupapa Māori approach and are managed by Māori to work with whānau and students. We were told that Māori immersion and bilingual units often achieve very high rates of parental engagement,
due partly to the very clear expectations that many kōhanga and kura have of their parent community, partly to the coherence of culture and practices between home and school.

We are also aware of a longitudinal study, the Pacific Adolescent Career Pathways project, which is following the early career pathway development of a cohort of Pacific young people from Year 9 through to Year 11. The project explores students’ career aspirations, and what and who influences them. A significant finding from this research is the importance of mothers’ and aunties’ engaging with their children about the education choices that bear on career aspirations. Submitters told us of the value of having grassroots support so that Pasifika families can relate to someone of their own culture. One programme that works this way is the Pasifika Power-Up programme, which helps Pasifika parents, families, and communities to support their children’s educational goals through “Power Stations” in Pasifika communities. The stations provide parents with tailored workshops, run by Pasifika “community champions”. Another is the PAVE Pasifika Families project, which is designed to help develop Pasifika students into competent career managers and decision-makers.

We also heard about the Horowhenua Pasifika Education Initiative in Levin, which seeks to engage hard-to-reach Pasifika families in early childhood and in transition to school. The initiative employs two coordinators, one from the Tongan and one from the Samoan community, to help families choose a school for their children. The coordinators visit families at home, supplying any translation needs, providing information about local education providers, and helping them to develop learning plans to record and celebrate the progress of their child’s learning. These coordinators also support family members when they visit local education providers, and run regular coffee mornings for parents.

Families with disabilities

The ministry has a number of initiatives to support parents of children with disabilities. They include a parent information kit, which lists the support services available to parents of such children, including specific resources for parents of deaf and hearing-impaired and blind or low-vision children, to inform them of the support services available. We are aware of parent reference groups, which help parents of children with special education needs to give feedback on the support they are receiving, and we encourage the establishment of more such groups.

While we acknowledge the work the ministry is doing to support the parents of children with disabilities, we heard from a number of submitters that schools need to improve their engagement with parents who are themselves disabled.

Submitters told us that some schools are very good at ensuring that the physical school is accessible to disabled persons, but that a school may not be accessible in other respects, including digital and written resources. For parents to be engaged in the education of their children they must be aware of what is happening. If schools cannot communicate with parents in a conventional way, it is incumbent on them to find ways to ensure that parents receive information. We are aware that the ministry offers interpreters for deaf parents, to enable them to engage in their children’s education, and that this initiative is available to all parents who request it. We would like to see more work done in relation to families with disabilities.
Rural students
Some submitters said they would like to see flexibility regarding the ability to use closed
schools in rural communities. We are aware that once a school is closed it is the
responsibility of Land Information New Zealand to dispose of it. Some of us would like to
see these classrooms made available for parents or communities to assist students studying
at Te Kura, or for use as after-school support centres.

Migrant families
We are aware that sometimes new migrants can have particular difficulty in engaging with
their new school surroundings. The ministry is taking a number of initiatives to try to
ensure that migrant families feel engaged in their new school communities.

Recommendation
14 We recommend to the Government that the Ministry of Education work with
education providers to find and share information on good practice in parental
engagement.
15 We recommend that the Government develop targeted initiatives to support refugee
and migrant families who face multiple barriers to parental engagement.
16 We recommend that the Government review existing engagement initiatives, and
increase investment in the most successful.
17 We recommend that the Government continue to support initiatives that help
education providers reflect the culture of the community.
18 We recommend that the Government ensure that parents have access to information
and resources on the importance and means of engagement.
Appendix A

Committee procedure
The committee called for public submissions on the inquiry. The closing date for submissions was 19 December 2013. The committee received 79 submissions from the organisations and individuals listed in Appendix B, and heard 33 of the submissions orally. The committee met between 25 September 2013 and 23 July 2014 to consider the inquiry.

Committee members
Dr Cam Calder (Chairperson)
Maggie Barry
Catherine Delahunty
Chris Hipkins
Colin King
Tim Macindoe
Tracey Martin
Hon Maryan Street
Hon Maurice Williamson
Dr Megan Woods
Appendix B

List of submitters

2020 Communications Trust
A Huggard
Adam Buckingham
Adriana Harrison
Adult and Community Education Aotearoa
Angela Dobby
Anna McDonald
Aotearoa New Zealand Association of Social Workers
Auckland Kindergarten Association
Auckland University Faculty of Education and Stand By Me Collective
Blind Foundation
Careers New Zealand
Cherie King
Children’s Commissioner
Clare Bates
COMET Auckland
Council of Social Services Dunedin, Dunedin Community Law Centre, and Law for Change Dunedin
Disabled Persons Assembly NZ
Dr Andrew Burton
Dr Laurie Thew
Dr Natasha Duncan-Sutherland
Dr Penny Pollard
Early Childhood Council
ECE West Auckland Network
Fa’atili Iosua Esera
Families Commission
Family Planning
Footsteps Education
Great Potentials Foundation
Hapai Te Hauora, Te Kahui Mana Ririki, Ruakura Hauora o Tainui, Huakina Development Trust
Heather Garside
Hobby Co
Horowhenua Pasifika Education Initiative
Dame Iritana Tawhiwhirangi
J R McKenzie Trust
Jasmine Williams
Jeanette Clarkin-Phillips
Jeanne Biddulph
Kylie Marshall
Lorraine Cooper
Maharishi Foundation
Margaret Jean Cornish
Margaret Palmer
Melissa Ewart
Michael Gaffney
Moanataiari School
National Council of Women of New Zealand
New Zealand Catholic Education Office
New Zealand Council for Educational Research
New Zealand Kindergartens
New Zealand Playcentre Federation
New Zealand Post Primary Teachers’ Association
New Zealand Principals’ Federation
New Zealand School Trustees Association
NZEI Te Riu Roa
Office of the Children’s Commissioner Young People’s Advisory Group
Otago Youth Wellness Trust
Parenting New Zealand
Parents of Vision Impaired New Zealand
Peter Verstappen
Presbyterian Support New Zealand
Rachel Rix-Trott
Rural Women New Zealand
Safer Aotearoa Family Violence Prevention Network and Transitioning out Aotearoa
Sally Poulgrain
Sophia Te Paea Turner
SPACE NZ Trust
Stephanie Pearce
Storypark
Susan Bailey
To Aho o Te Kura Pounamu – The Correspondence School
Te Tari Puna Ora o Aotearoa NZ Childcare Association
Te Taumata o Ngati Whakaue Iho Ake
The Clinic – Ngaio School
Wairarapa Rural Education Activities Programme
Wanita Astle
Weymouth Primary School
YMCA Auckland
Youthline Auckland Charitable Trust
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**Reserve Bank of New Zealand's Monetary Policy Statement, March 2012**

**Recommendation**

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, March 2012, and recommends that the House take note of its report.

**Introduction**

This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, March 2012, and the central issues we discussed with the bank in our examination. Our approach to considering the statement, our membership, and the transcript of the hearing of evidence are set out in the appendices to this report.

The March 2012 Monetary Policy Statement announced the decision of the Governor of the Reserve Bank to maintain the Official Cash Rate (OCR) at 2.5 percent. This was widely expected by the markets; the OCR was last changed in March 2011, when it was reduced from 3.0 percent to its current record low level. The governor said that inflation has dropped quite significantly, to about 1.8 percent, and is now expected to remain at or below the midpoint of the 1–3 percent target band for the next year or so.

**Reserve Bank’s reasoning**

The concerns about the international situation which dominated recent forecasts by the Reserve Bank have abated somewhat. In Europe, measures taken by central banks have boosted liquidity and restored confidence in banks and governments. The USA, Japan, Australia, and China have also eased their monetary policies. So although growth in our trading partners remains modest and important structural issues still have to be resolved, confidence has improved, and the risk of financial contagion has diminished.

Domestically, the economy is showing signs of recovery, with increased retail spending and some increase in housing market activity. The governor described New Zealand’s economy as being in “a sweet spot” as far as inflation goes. At 1.8 percent for the year to December 2011, the Consumer Price Index was lower than expected, and there is spare capacity in the economy to be absorbed before rebuilding activity in Canterbury begins to increase inflationary pressures.

One consequence of the easing in global monetary policy and a greater market appetite for risk has been a significant strengthening in the New Zealand dollar: it has appreciated by almost 7 percent since December 2011. The statement notes that although a high value of the New Zealand dollar is helpful in containing inflation, it is detrimental to the tradable sector, undermines GDP growth, and inhibits rebalancing in the economy. The Reserve Bank’s forecasts assume that the New Zealand dollar’s trade-weighted value will decline gradually over the next few years.
Given the outlook for inflation, and assuming a gradual depreciation of the New Zealand dollar, the Reserve Bank expects to increase the OCR modestly over the next few years. Should the expected decline in the New Zealand dollar not occur, the bank would see less need to increase the OCR. The Reserve Bank noted that market expectations appear to be for the OCR to remain steady until early 2013.

**Risks in the forecasts**

The statement highlights several risks that may cause the forecasts to change if they eventuate. A key assumption is that the recent improvement in global sentiment is likely to be sustained; the statement notes that financial markets have proved fragile and fickle over recent years, and conditions could change rapidly.

The projections also assume that oil prices will moderate soon, following a marked increase over the past month as tensions in the Middle East raised concerns about supply. Developments in this area will have an important bearing on costs to New Zealand.

**The outlook for growth**

New Zealand’s economy is showing signs of recovery, with GDP growing at about 2 percent per annum at present. While there is spare economic capacity at present, the Reserve Bank envisages this being absorbed over the coming year, and forecasts GDP growth rising above 3 percent by the end of 2012, to 3.7 percent in 2013/14.

Aftershocks in December 2011 slightly delayed the boost to the economy expected to come from reconstruction activity in Canterbury, and caused the Reserve Bank to revise its growth forecast for the current year down slightly from its December projection, from 2.0 percent to 1.8 percent. However, growth thereafter is now expected to be stronger than previously forecast. We asked what is driving this recovery. The Reserve Bank said that retail spending picked up in the latter part of 2011; the housing market is also improving, and agricultural exports increased after a good season. The Reserve Bank also expects a gradual improvement in business confidence and the market for labour.

**Retail spending**

Retail spending increased strongly in the second half of 2011. Some of this was clearly because of the Rugby World Cup—total tourist spending during the tournament is estimated at $925 million—but the pickup appears to have been broader-based, as spending has continued to grow since then. The Reserve Bank believes this reflects gradually improving consumer confidence, as New Zealanders start to feel more comfortable after reducing some debt.

As to why the strong retail spending growth was not fully reflected in GDP growth, the bank noted that retailing has a large imported component which detracts from GDP. We asked whether spending through the informal economy might be a factor; the governor said that New Zealand is one of the few countries that do not incorporate a measure of the informal economy in GDP figures.

**Housing**

Activity in the housing market has picked up gradually over the past year, with an increase in building consents, house sales, and prices. House prices are now almost back to 2007
levels in nominal terms, although in real terms they remain about 13 percent below that peak. An interesting feature is that credit to the household sector remains subdued relative to the increase in housing turnover. The Reserve Bank notes several possible explanations for this: banks tightening credit conditions by requiring larger deposits; new homebuyers being cautious and choosing to save more before borrowing; and existing mortgage-holders paying off more principal as interest rates have fallen. Finally, it is likely that insurance payments from the Canterbury earthquakes—amounting to several billion dollars to date—have been used to reduce mortgages until rebuilding costs are incurred.

An expected rise in construction activity forms an important part of the Reserve Bank’s forecast improvement in growth. As well as repair and reconstruction in Canterbury, which is expected to pick up pace through 2012, residential construction in the rest of the country is also forecast to rise strongly. The Reserve Bank notes that residential growth in recent years has not kept pace with population increases, and growing confidence is expected to bring more activity into the market. The bank does not expect to see a resurgence of the housing bubble, but noted that if necessary it could use macro-prudential tools—such as requiring banks to maintain higher liquidity levels or loan-to-value ratios—as a short-term measure to contain asset prices. It hopes that the scale of construction required in Christchurch will allow lower unit costs, as New Zealand’s have tended to be high by Western standards.

**Savings rates**

There is encouraging evidence that households have been repaying debt and saving more. An important issue will be whether this improved saving pattern is sustained, or whether New Zealand households revert to running persistent deficits.

The Reserve Bank expects to see a shift in the long term to higher household savings, but the governor said this was likely to take a long time. Savings rates have only just turned positive, and it is likely to be a long time before stocks of debt are significantly reduced; such deleveraging is occurring world-wide.

Some of us remain concerned that the predicted return to a rising current account deficit shows that the long-term imbalances in the New Zealand economy remain unsolved.

**International conditions**

It is encouraging that the risks to world financial markets from the European debt crisis have diminished. We asked, however, whether the unprecedented monetary policy stimulus could lead to global inflation and thus impinge on New Zealand’s prospects. The Reserve Bank does not see much inflationary risk yet because Europe still has much unused capacity; the trick will be to remove the stimulus once it has been absorbed. The governor said he has discussed this issue with European central banks, and they are confident they will be able to judge the timing soundly. However, he stressed that nobody underestimates the challenges Europe faces, with tough structural reforms ahead.

Fiscal austerity in many developed economies is likely to keep international activity subdued. However, Asia and Australia remain our most important trading partners, and the outlook there is for soft but gradually improving growth through 2012. Domestic demand in Asia remains resilient, supported by consumption spending.
Exchange rate

The marked appreciation in the New Zealand dollar over recent months is attributed more to international factors—the combination of looser global monetary policy and more appetite for risk in financial markets—than to New Zealand’s economic environment. Prices for our export commodities, while strong, have not improved. We discussed at length the implications of the high exchange rate for New Zealand’s traded sector. We heard that tourism had been hit the hardest; manufacturing exporters have held up remarkably well, especially those exporting to Australia, but import-competing manufacturers are struggling.

Exchange rate intervention

Several governments overseas have been using forms of quantitative easing to lower their currencies. We explored with the Reserve Bank whether this is an option New Zealand should consider, given the difficulty our high dollar presents for exporters.

The governor said that countries undertaking quantitative easing tend to be those which have exhausted orthodox monetary policy tools, with interest rates already reduced to zero. He believed it would be viewed as highly unusual by the markets if New Zealand were to undertake quantitative easing while it still had other monetary policy options available. By way of illustration, he said that if the Reserve Bank felt action was needed, it could lower the OCR in recognition of the lower inflationary pressure resulting from a high dollar.

Asked whether the Reserve Bank has advised the Minister of Finance about quantitative easing, the governor said it had been discussed in general terms only.

The governor described the international scene as characterised by “competitive monetary stimulus” by the big economies. He doubted whether New Zealand could influence our currency’s value in any sustainable way using quantitative easing. He also noted that such expansionary monetary policies can fail in their aims if depreciating the currency also increases inflation so that the real exchange rate does not improve. He acknowledged that efforts by Switzerland’s central bank to peg the Swiss franc appear to have succeeded in the short term, but noted that the cost has been considerable—about €70 billion—and inflationary pressures will need to be managed carefully.

We asked when the Reserve Bank might consider it appropriate to intervene to lower an exchange rate perceived to be overvalued, noting that an effort some years ago had little success. The governor said the bank does not discuss its currency expectations, but observed in general terms that its aim when it is opportune would be to trim the extremes of the New Zealand dollar exchange rate cycle. It has limited expectations of what it can realistically achieve. He commented that the key issue is sustainability: as a general rule, a country hopes to have as strong a currency as it can sustain.

A two-speed economy

We note the phenomenon of a two-speed economy observed in some countries such as Brazil, Norway, and Australia, where strong growth in one sector has not been matched by others. Australia has sought to isolate the mining sector’s foreign exchange earnings by imposing a resource rental, which is then re-invested in foreign currency reserves through a futures fund. We asked the governor whether such an approach might be appropriate in New Zealand. The governor said the issue went beyond the Reserve Bank’s preserve, but
could be worth considering in the future if improving terms of trade continued to adversely affect non-agricultural sectors through the exchange rate.

**Bank funding costs and mortgage rates**

For some time New Zealand banks have encountered high costs and difficulty in borrowing longer-term funds from global wholesale markets. While these pressures have eased recently as European liquidity increased, banks’ funding costs have still risen because of higher currency hedging costs. The Reserve Bank expects upward pressure on banks’ funding costs to persist for some time.

It is therefore of interest that all major banks have lowered their fixed-term mortgage rates since the December 2011 Monetary Policy Statement, despite increased wholesale funding costs. The Reserve Bank attributes this partly to competition among banks for mortgage lending. In addition, as retail deposits have grown strongly while the demand for credit remains fairly weak, it is likely that banks have pre-funded most of their funding needs for this year, so their average cost of funds would be lower than the marginal cost on the wholesale market. Overall, the Reserve Bank considers banks are comfortable with their current balance sheet positions and are unlikely to raise rates at present. We note, however, that this situation could change if international financial concerns resurfaced. This might lead New Zealand banks to increase their rates independently of a change in the OCR.
Appendix A

Committee procedure
We met on 8 and 21 March 2012 to consider the Reserve Bank of New Zealand’s Monetary Policy Statement, March 2012. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O’Donovan.

Committee members
Simon Bridges (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Todd McClay
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Corrected transcript of hearing of evidence 8 March 2012

Members
Paul Goldsmith (Chairperson)
Maggie Barry
David Bennett
David Clark
John Hayes
Melissa Lee
Todd McClay
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Louisa Wall

Witnesses
Dr Alan Bollard, Governor
Dr John McDermott, Assistant Governor
Jason Wong, Manager Financial Markets Research
Dean Ford, Manager Forecasting

Goldsmith Welcome, Governor. [Introductions] We’d be grateful if you could give us your summary of the situation, and we’ll follow up with some questions.

Bollard Thank you, Chairman. Thanks for the invitation. Today we put out our March monetary policy statements forecast and our official cash rate review. It’s been a story that has been really driven very much by our concerns around the international scene. When we last did our forecast in December we were quite concerned at that stage about what was happening in Europe and its implications for bank funding in New Zealand, and its possible implications for contagion around Asian and other trade zones. Since then the interventions from the European Central Bank and some other policy moves have reduced a certain amount of that concern. There’s a lot more liquidity around those markets and quite a lot more confidence about the short-term nature of banks and Governments there now, but there’s still some real difficult structural stuff ahead, and everybody knows that. We’ve also, of course, seen the US Federal Reserve reaffirm that they expect to have very low rates through to 2014. The Japanese Bank of Japan has done more quantitative easing, the Bank of England’s done more quantitative easing, and one might interpret the Chinese People’s Bank’s moves recently as also in the softening area.
The world trading partner growth is still very restrained, but there’s a little bit more confidence around as a result of those monetary policy actions. Of course, one of the implications for us has been that the New Zealand dollar has been strong and strengthening. It’s actually come off this last week, but until this time last week it was really quite a lot higher. This is partly reflecting good commodity prices, but it is also, I think, reflecting partly this competitive monetary stimulus that’s been going on in the big economies around the world, and that is of some concern for us.

The business sector in New Zealand, we see some improving confidence, some growing activity, but off low levels. Bank funding looks like it’s improved, but still very expensive, and demand for credit still remains very low in New Zealand. We’re forecasting gradual improvements in the labour market, gradual improvements in confidence and consumption from the household sector. Actually, the retail sector was quite strong through the latter part of last year.

When we look at housing, we do start now to see some improvement in house turnover, growth in consents, a bit of growth in house prices, but it’s all fairly modest. We’re expecting this year ahead to see further growth in residential investment, particularly in those areas that have had demographic growth, and, of course, particularly in Christchurch as well. But household debt and low credit growth will restrain growth in those areas through the year.

The upshot of all of that is that we are seeing a pick-up in GDP at the minute. We think the economy still has spare capacity, although this will be eliminated through this year. We’re seeing growth something like 2 percent at the minute. We forecast to see that happening, growing to 3 and over 3 percent by the end of the year. We have seen inflation come off quite significantly. The last lot of figures bring the rates down to 1.8 percent—that’s as GST and other indirect taxes come off the system. But there’s also been one side effect of these higher values of the New Zealand dollar. The forecast that we have for inflation now is quite restrained. In our views, we are going to see inflation around or below the mid-point over the next year or so. Given that medium-term outlook for inflation, we now think it’s prudent to keep holding the official cash rate where it is at 2.5 percent. The market sees no particular change in that for some time. But, of course, we’ll keep looking at events as they come through. That’s a very brief picture. We’re very happy to answer any questions.

Goldsmith Thank you very much. My plan is to give all members of the committee an opportunity to ask questions. If I might just kick things off, Governor. Looking at the whole situation in Europe, to what extent do you think we are just storing up problems down the line? And related to that, what do you think the risk of global inflation is, given the amount of quantitative easing going on? In the next few years do you think that’s a realistic danger, and what’s the chances of that flowing through to New Zealand?
Well, on your first question, on Europe, it has been an extraordinary period and there were a lot of concerns at the end of last year and there still are some concerns. I distinguish between banks that now have a large amount of liquidity slopping around from the European Central Bank injections. That does mean they’re highly liquid, but they’ve still got to raise more capital, and they’re hardly lending at all. So they’ve still got tough stuff to do. If you look at Governments in Europe with worries about funding, some of those southern European Governments, again the ECB intervention has helped that significantly. But it’s generally accepted most of those countries are going to have a very, very hard track back to growth with some very tough reforms ahead. So I don’t think anyone’s underestimating how difficult that’s all going to be. We now don’t think that there’s going to be a major amount of contagion into either the financial sectors in other regions or into the growth prospects of Asia. That was always a worry for us. And, I’m sorry, you asked two questions. I’ve forgotten the second one.

The risk of global inflation, given another emergency.

Well, there has been just an unprecedented amount of monetary stimulus in the big economic areas. All those areas have got a very large amount of unused capacity, and at the minute there is not much sign of inflation as a result of that monetary expansion. But if they are unable or unwilling to remove that expansion at the appropriate time, then they will get inflation from it and we will suffer from that as well. I’m hearing a reasonable amount of confidence from central bank governors that they can do that. But really, we’ve never quite been in this situation before. That’s probably a little way off. At the minute, however, there is quite a bit of concern about oil prices.

My first question is—you said earlier that one of the reasons why the New Zealand dollar is at the level that it is, is because of the quantitative easing in other countries pointing to currency risks in those countries that have all ready invested in the New Zealand dollar; I presume that’s what you meant by your statements. And I see that since your announcement this morning the manufacturers and exporters have been calling for New Zealand to perhaps meet our current account deficit through quantitative easing rather than the banks borrowing more money offshore. Have you provided any advice to the Government about whether we should be considering quantitative easing as a tool in this competitive devaluation game that seems to be going around the world?

I might just note that if you’re talking about Mr Walley, he’s been giving me advice for the last 10 years and he was actually advising me not to increase rates right through the housing boom. Of course, you have to wade through history to work out what is good advice in all of this, but that has not always been the case in the past.
Parker That seems very critical of Mr Walley, given that he seems to be advocating protection for exporters that’s been afforded in the United States and Europe—

Goldsmith We’ll let the Governor answer.

Parker Well, no, I thought he took a flick at Mr Walley, and I’m not here to defend Mr Walley’s policies, but there are other countries that seem to be embarking upon quantitative easing in order to protect their exporters by effectively forcing down their currency. Have you given any advice to the New Zealand Government as to whether they should be considering doing likewise?

Bollard I think it’s probably fair to say that in some of our regular discussions with the Minister of Finance we’ve talked around the broad area of this. We haven’t given specific advice about that, but all these countries have exhausted their orthodox monetary policies. They’ve all had to bring rates down to zero and been unable to use orthodox monetary policy, and it would be most unusual to be doing something like that while you still have a monetary policy tool, which we do.

Bennett For the projections in comparison with the December statements, the GDP growth is just a little bit lower for the coming year, and you indicated that you are looking at 2 percent growth now, which seems pretty good. How is that being impacted by the potential rebuild in Christchurch? It might not actually yet come into the system as we had probably anticipated it, say, a while back, and whether that growth has actually been stimulated by us actually trading more, or are we consuming more, or what’s driving that growth, with Christchurch maybe not coming on as quickly as we expected?

Bollard Could I ask Dean Ford, who is head of our forecasting, to answer that question?

Ford I’ll answer in a few parts there. So first of all an update on reconstruction in Christchurch. We, following the December aftershock, decided to push back our projection for reconstruction slightly. But really, relative to the size of the pick-up in construction that’s coming, that wasn’t a huge change. So it’s still the case that over the next 12 months we’re expecting to see a substantial increase in construction activity in Christchurch. As for what’s driven growth to date, we’ve seen signs of a pick-up in domestic spending. So we’ve seen this through the retail spending figures have been quite strong, particularly through the second half of 2011. We’ve seen some of the housing market indicators pick up, but from a very low base. But we’ve seen consents go up; we’ve seen sales go up. And also some of the export volumes from what has been a very favourable production season in agriculture has helped stimulate some of the growth that we’ve seen.
Bennett: So they seem to be quite structurally sound growth and consistent, in the terms that it’s not a big up and down. It’s consistent with what you’ve said over the years—that you’re expecting it to be a gradual process.

Bollard: We’re enjoying, of course, good commodity prices and we’ve had a very good agricultural season.

Bennett: Are you finding that’s coming through in the purchase of plant and material in those industries? There was always that talk about reducing debt within those industries. Are they now buying plant or—

Bollard: Business investment is picking up to a limited extent, but it’s not very strong. But the business sector in New Zealand hasn’t been too exposed on its balance sheets, and hasn’t therefore had to do a lot of deleveraging.

Bennett: But then the agricultural side?

Bollard: Yes, OK, on the agricultural side, of course, there was a lot of credit taken on. That is being worked down now and we’re starting to see farmers probably investing more.

Bennett: So you should see more spending on that—the machinery and things like that, going forward. That helps the local economy as well, that money transferring through. You mentioned the dimensions of the international economy. Do you have any fears with countries like Brazil and that, that haven’t shown the growth rates in the last week or so that they had probably been anticipating? The Chinas and that are still kicking on nicely, but some of those other second-tier ones that are important for us as a country going forward are having a few issues. Is that a problem you perceive or not?

Bollard: I think we’re expecting slightly lower growth out of some of those emerging markets. But we’re not expecting that to impinge on us in a major way. Of course, for us China is increasingly important and for Australia it’s hugely important. Growth there has slowed, but you’d have to say that’s probably a pretty successful soft landing at this stage.

Clark: Governor, the marked pick-up in the residential growth sector, David Bennett covered it before, particularly in terms of Christchurch. I’m interested in to what extent Christchurch is a factor in that and to what extent it’s about a general pick-up in growth. And what if there’s another earthquake event in Christchurch? What if ongoing employment and sluggish wage growth kind of depresses that residential sector growth that you’re anticipating? To what extent does that affect your forecasts and the modelling and the use of tools in the period ahead?

Bollard: I think there are two quite separate things. One is general investment in residential, and some of that is driven by basic demand. There hasn’t been much house building in recent years, and some people are now reasonably confident about the profile of house prices, that there’s a lot more houses
coming on to market and we’re expecting to see some pick-up on that. That’s a significant part of our forecasts.

The Christchurch one is, of course, quite different. It is timed off aftershocks. We have had to put our forecasts back in time as we have had those extra aftershocks. The insurance sector is very sensitive to getting some measures of seismic stability before they’re there for it. But we are starting to see some of those early signs of rebuild now.

Clark Can I just ask—when you say it’s a significant part of the forecast, can you quantify that a bit further?

Ford The Canterbury reconstruction?

Clark The residential—both, actually.

Ford So the total residential construction is the larger part of the pick-up in GDP. So as the Governor has said, the Canterbury reconstruction is quite a large part of it, but the other non-rebuilding type pick-up in residential investment is also a large part of the forecast.

McClay When we consider the current global economic situation, what’s the impact of that likely to be on bank borrowing costs for New Zealand?

Bollard Could I refer to the head of our financial markets, Jason Wong, on that?

Wong So, obviously, banks are finding it quite tough to source long-term wholesale money at the moment. We’ve seen the market open up a bit from late last year. You know, Europe basically came to a grinding halt in terms of funding markets late last year, then you had the ECB step in. We’ve seen tremendous pressure on bank funding costs sourcing overseas money for long-term—5 years - plus. So there’s been easing of some pressures with the European Central Bank throwing a lot of money at the system. That’s helped reduce some pressures from raising money in Europe directly. But when you hedge that money back into New Zealand dollars, the cost has actually gone up recently. So we’ve actually seen some new wholesale money issued in the last month or so. And that’s actually been at a greater cost towards the end of last year, despite this positive move by the ECB. So we’re still seeing a lot of upside cost to bank funding. They’re not going to go away in a hurry, we don’t think, given the ongoing situation in Europe.

McClay And likely impact of that upon borrowers in New Zealand?

Wong Yeah, well, funnily enough, since our December statement banks have actually reduced their fixed-rate mortgages. You’d expect normally at a time when your costs are going up the interest rates would rise. But I think banks are very comfortable with their balance sheets. They’ve pre-funded a lot of their funding needs for this year. You’re also seeing very strong deposit
growth, very weak credit growth, so those strong deposits coming through the
door allows banks to put towards new credit growth and also pay off
any maturing loans through a lot of this year. So they’re not inclined to raise
their mortgage rates just for the fact their costs are going up. Despite
marginal costs being quite high, I guess their average costs of funds is just
gradually increasing over time, and, given the competition in the market,
they’re not inclined to immediately raise interest rates at this point.

Norman Over the years that you’ve been coming in front of this committee we have
talked about quantitative easing on a number of occasions. It’s become
pretty orthodox internationally now; it’s not as unorthodox as it once was.
In terms of the New Zealand dollar, if the Reserve Bank engaged in
quantitative easing what would be the impact, or the likely impact, on the
level of the New Zealand dollar?

Bollard Well, a lot would depend on where the markets thought—what they
thought the central bank was trying to do, how credible they would think
that was going to be, but also what other pressures they would see in the
economy. The sorts of growth rates we’re talking about, while not huge, are
actually reasonably strong by OECD standards now. So if, being completely
hypothetical, we were to try and put in place some form of quantitative
easing at the minute, first of all they’d scratch their heads, because they
wouldn’t understand what we were trying to do. Secondly, they’d say “But
this country is growing and is near full capacity. That’s got to mean
inflationary pressures.” Therefore the OCR is going to at some stage have
to go up faster than it otherwise would. Therefore the New Zealand dollar
might look attractive to buy in. So “I don’t know” is the answer, but I
wouldn’t just assume it would depress the value of the New Zealand dollar.

Norman So in terms of capacity and inflationary pressures, you talked earlier that
actually the New Zealand economy has some spare capacity within it. And,
secondly, you said that the inflation is either around the mid-point or below
mid-point looking forward. So when you talk about those two things, that
seems to be in opposition to what you told us earlier, where you told us
there was capacity—available capacity—and inflation was tracking at mid or
beneath mid-point.

Bollard Well, I mean, once Christchurch starts up we’ll be at full capacity. Then
we’ll, of course, have a real focus on any extra inflation that could be
generated off that. The forecasts we’ve got are assuming that there isn’t
much, but that’s always going to be a risk. But this economy, in some ways,
is actually in a sweet spot in that sense, where inflation is.

Norman But as you said, the tradable sector’s got a problem with the high New
Zealand dollar, which you acknowledge, and fair enough. And you tried to
to kind of put a shot across the bows by saying if this carries on, then we
might lose something. But clearly quantitative easing is part of this putting
downward pressure on the dollar.
Bollard  Again, hypothetically, if we were to feel that something further needed to be done, it would be more likely that we would reduce the official cash rate as an acknowledgment of the fact that the high dollar is resulting in less inflation in the New Zealand system. It would be very unusual to try and do a quantitative easing straight to that. Sorry, can I ask Dr McDermott, chief economist.

McDermott  The other point I think about, if we were to have an expansionary monetary policy—either low interest rates or quantitative easing more than would be the case for our inflation targets—you could imagine a case where the New Zealand dollar would depreciate. That would be fine. Unfortunately, we’d have more inflation and the real exchange rate wouldn’t really change. So New Zealand’s competitive position wouldn’t have actually improved. So our tradable sector wouldn’t have gained any advantage in that particular policy move.

Norman  So taking the Swiss bank example, right, which arguably they’ve threatened a kind of form of quantitative easing—depending on how you want to define it—but essentially they’ve said they’re going to put a cap on the value of the Swiss franc. It’s not so much a peg; it’s more a cap. And they’ve said that if it goes over such and such a point, they will just start buying foreign currency by printing Swiss francs, essentially. Do you think that’s a completely pointless activity? What’s your assessment? Have you looked into it? Do you think it works? Is it a good idea? We talked about it, I think. Last time I asked about it, you were here.

Bollard  The last full year they lost Switzerland €70 billion. That’s a lot. So there’s very big financial risk in doing it. It depends how you’re going to measure success. On the other hand, it does look like it’s had some effect at suppressing the value of the Swiss franc. Now, they’ve been in a much worse, much more difficult position, entirely surrounded by the euro, with almost all their trade or a very large part of their trade in euro. So it really has been hurting them much more. It does look like at the minute they have successfully pegged that rate. There may be problems ahead for them as that economy grows a bit and you start to see more inflationary pressure there. At the minute, they’ve got effectively zero inflation.

Norman  To put it in kind of slogan terms, it’s like can you be a pacifist in a currency war? The Brazilians say: “Look, we’re in a currency war at the moment.” They’ve got Real problems, and because they’re commodity traders, not entirely dissimilar to some of the problems we’ve got as commodity exporters, and because we’re commodity exporters we’re really damaging other parts of our economy with the high value of our currency. Can we just keep being pacifist if there’s this currency war going on and just go “Well, whatever happens, happens.”?

Bollard  In that sort of analogy, you’ve got some big potentially warring economic zones, and it’s very limited what we are able to do about it.
Bennett Is it a war we can fight?

Norman But do we want to be killed in the crossfire or do we want to try to stay out of it?

Bollard Let’s be clear, though. The New Zealand economy is growing at a growth rate that is pretty respectable by OECD standards at the minute. It’s not great by historical standards, but there’s a lot of countries looking at the New Zealand record at the minute and saying they would like to be there. That is one reason why there’s been capital flowing into the country and some effect on the exchange rate.

Peters I suggest that there are more countries looking at, for example, Norway and Singapore, rather than be where we are.

Bollard Well, I’d rather be in Norway with all their gas and oil, and they’ve done extremely well out of that.

Peters And Singapore?

Bollard Singapore, I think, is quite a different story. I know we compare ourselves with Singapore. Singapore has had huge volatility in its growth rates, and that’s because they’re trying to do inflation targeting in a very unusual way—through trying to peg the exchange rate. And they’re able to do that because their exports and imports are something like 220 percent of GDP; ours are 30-something. It’s a very unusual economy, of course, with where it is. It’s also got very big reserves, which we don’t have.

Peters Well, that’s true. We used to support them in the Colombo Plan, do you remember?

Bollard I do.

Peters So maybe they got a few things right, and what you’re really saying is that in your power, you can do little about the level of our currency; it has to be a political decision.

Bollard I’m not sure that the tools are available to New Zealand, whatever the politics of them, to—in a situation where there’s some very large countries doing things for their own benefit, we’ve got a lot of ability to do stuff about them.

Peters There’s a bit of a disconnect between retail and GDP.

Goldsmith Could we just finish? Are there any other supplementaries on that broader question?

McClay I recollect, I think 5 or 6 years ago, the Reserve Bank intervened by selling New Zealand dollars. For the reasons that have been suggested, you may consider it now. I think from memory the market smiled and then the New
Zealand dollar appreciated. If that was the case, is that likely to be any different now, perhaps, if you follow Dr Norman’s policy suggestions?

Bollard

Could I continue our tradition of speaking purely hypothetically about this. Our intervention policy is laid out in public, but we’ve never talked publicly about actual interventions. We had always very limited intentions with that. Our aim would be to knock the top off an exchange rate cycle and push from the bottom on the exchange rate cycle. We think we have done that, but that was limited expectations and we’ve had limited achievements. That’s been the case in the past. We don’t see that’s particularly different at the moment.

Peters

If this inflated dollar carries on, do you envisage there could possibly be a time when you’d actually do something?

Bollard

Part of the reasons for the strong New Zealand dollar has been strong New Zealand commodity prices. So manufacturers may not enjoy that, but farmers sure are. In that sense we have got a lesser version of the problem that Australia’s got where miners are doing hugely well and other parts of the economy much less so. But our country’s pretty limited in how it can bring those two different economies together. Actually, the parts of the New Zealand traded sector that have been hurt from this—we think of tourism, and not so much manufactured exports, which has held up surprisingly well, but import competers in the manufacturing sector, who have clearly been hurt.

Goldsmith

In your experience, how many countries have actually improved their economic outlooks over the long term by weakening the currency? In my understanding, it doesn’t make a country richer just to have a lower currency.

Bollard

I think as a generalisation we want as strong a currency as is sustainable, because that is the measure of how rich New Zealand really is. But, of course, the question is sustainability.

Bennett

Just with what you’re talking about the Australian dollar there—their dollar is very high as well—

Bollard

Far higher.

Bennett

So they must be having pressure on their manufacturing sector. Is there an opportunity for us to pick up some of that—for, say, manufacturers in Australia to move to New Zealand and to take advantage of manufacturing here rather than Australia to avoid their dollar?

Bollard

Well, we’ve certainly become more competitive against Australia, and if you’re in a position, which of course not all manufacturers are, but if you’re able to import componentry and materials in US dollars and export in Australian dollars, then actually you’re doing very well. What we are seeing is not so much what you said about relocation, but we’re certainly hearing
New Zealand manufacturers selling very successfully, and marketing to Australia very successfully.

Bennett And a lot of our manufacturing is to the Australian market rather than the wider market.

Bollard That’s correct.

Bennett Whereas our primary production goes to a wider market than the Australian one. So, in effect, that high dollar hasn’t really hurt the manufacturing capacity as much as it is hurting the Australian manufacturing capacity.

Bollard Well, the Australian dollar has appreciated considerably more, driven by considerably higher terms of trade. I don’t want to resile from the fact some manufacturers have been significantly hurt in New Zealand, but those who have Australia as a market much less so.

Peters Do you believe that there’s a percentage of the GDP that you’re not measuring—that exists, but you’re not getting it?

Bollard Well, yeah—

Peters The black market—I was driving down Dominion Road the other day and there’s restaurant after restaurant, about 100 of them. If you do the mathematics on that, most of those are really flat barely making any money at all.

Bollard Well, we don’t measure the informal economy. We don’t measure the black and the grey parts of the economy, and we’re not sure how those might change in recession. Actually, you might find some of them grow during recession, but New Zealand is one of the few countries that doesn’t incorporate measures of those in their GDP, in contrast to, say, Australia.

Peters Well, just your retail figures and your GDP figures look like there’s a disconnect here. That’s my point.

Ford Sorry, I was just going to make a point. Remember that retailing has a large imported component. So as it grows you tend to draw on more imports, which will undermine your GDP growth.

Barry There’ve been some encouraging signs and you’ve noted that in domestic spending. I mean, retail sales growth’s strong over the second half. OK, putting the Rugby World Cup aside, what’s driving the changes? What’s driving the spending and the growth in the domestic area?

Bollard I think there’s gradually improving consumer confidence. We have seen New Zealanders wanting to improve the state of their balance sheets by saving a lot more and by running down debt, and they’ve broadly been doing that by continuing to pay off higher amounts of their mortgages. But we are seeing a bit more consumption now as a result.
Barry Why do you think that is—a growing optimism from the domestic consumers?

Bollard I think the global financial crisis was a big shock for everybody and it led to a lot of self-examination, a realisation in New Zealand that we have been very poor savers, and that having money purely in houses is not just the way we want go. We’ve seen financial investments picking up, we’ve seen deposits in banks picking up quite a lot. But New Zealanders are also now saying that while not getting back to the high spending of 5 or 10 years ago, there’s still things they want to do and they feel confident enough to do that.

Parker Just on that, the Secretary for the Treasury of Australia was here recently and this committee met with him. I asked him why, in Australian events, when they’ve already got 9 percent compulsory savings, they’re increasing it to 12 percent. His answer to me was that he expected that unless they lock in more savings, they think that residential consumption patterns will return to normal following the change in the cycle. I wonder if that implies—whether you’d have a similar view as to New Zealand conduct returning to type, given that you’ve said that you think that there’s not going to be much inflationary pressure and yet we’re going to have rising consumption, so it’s unlikely to be coming from income growth, and maybe it’s going to come from just saving again.

Bollard Yes, that’s an interesting comment, and the answer is we don’t know in New Zealand, and it is quite an important question. Our forecasts assume they don’t return to old normal, just to a new normal, which does involve ongoing saving. But that’s the sort of thing we’re just going to have to keep monitoring, because we can’t be sure about it.

Hayes Is the bank doing any thinking looking forward as to what sort of policies would be required when we strike oil and gas in the current exploration programme?

Bollard No, I think, is the answer to that. But we’re always alert to economic shocks. I mean, when the earthquake happened we had to work out economically what that meant. A lot depends on what lead-in period there is into things like that, and I’m assuming that, were that to happen, it would take quite some time before we saw a lot of money on the ground. In addition, a lot does depend on how much of investments are domestically funded and how much are effectively foreign-funded. The Australians have found that quite a lot of their mineral investment, of course, is foreign-funded and doesn’t impact that much on the domestic economy in the shorter-term sense.

Hayes But it does for the exchange rate and impact on our agriculture sector.

Bollard Well, if it pushes the exchange rate around.
In terms of the two-speed economy argument, whether it’s Australia, Brazil, or New Zealand, or Norway, one of the ways to deal with the two-speed economy is to try to isolate the foreign-exchange earnings either through a resource rental, which then gets put into a fund, which then gets invested in foreign currency. Australia’s done a little bit with their future fund; Norway, of course, are the experts at it. Is there a role for applying a resource rental to the commodity sector in New Zealand to try to have a similar effect here?

This goes beyond our central bank’s area, but it may be that there will be an issue for New Zealand in the longer-term future if we continue to get improving terms of trade, which impacts the primary sector.

And impacts the exchange rate.

And impacts the exchange rate.

And has a negative impact on the rest of the economy. Are you concerned about a kind of rebound in the housing market? You’ve talked a bit in here about the housing market going back. What if we end up in a similar cycle to what we had last time? Are you concerned about that?

No, we don’t see signs of that happening. We see what looks to be demographically driven rebuild and earthquake-driven rebuild, and those are both desirable things. We’re not expecting big price pressure. We don’t think New Zealanders are expecting that—you know, making those decisions on the basis of capital gains, either. It’s the sort of thing we keep surveying to check, but broadly we’re not. Now, were we to see what looked liked a resurgence of the mid-2000s in housing, we’d also be more inclined to pull out some macro-prudential tools, more in the nature of requiring banks to hold more on their balance sheets—or even, potentially, but I would expect only rather short term, loan-to-value - type ratios. I say that, “only short term”, because that seems to be quite distortionary.

Right, so if you saw something like the housing market boom or the asset bubble appearing again, you would consider some of those.

Yes, I mean, hypothetical, but absolutely. That’s where we think those tools would have a role.

And so in the short term are you concerned about housing supply for creating some of the problem? Because we seem to have pretty low consent. I mean, the consents seem to be coming back but, like you say in your report, they’re still falling behind.

They are coming back. It would be a pity if we ran into a consent blockage. And, of course, in Christchurch you always ask that sort of question. We are hopeful that in Christchurch, where for the first time there is an opportunity to build large scale and try and get unit construction costs
One of the more interesting things, there’s been a traditional worry about the fact that we’re highly reliant on overseas savings for our money for private investment, and there’s been a very significant increase in domestic saving, reducing the need for that. Do you think that’s going to go much further, or are we at the peak there, or do you think there’s been a significant long-term shift to greater saving—

I think it’s going to be a longer-term shift and there’s a long way to go yet. We’re only just at the point where household savings are going positive and, as you know, in New Zealand we’ve had a tradition of Government generally saving, corporates generally in balance, but households persistently in deficit, and I do think a lesson of the last 10 years is that that isn’t a healthy way forward.

Do you think it would take us to get to a more comfortable position, I suppose, taking a broader perspective?

I think you’ve got to think about the long-term deleveraging. The flow measures indicate it can start happening very quickly, but the stock measures say this takes a long term, and that’s what a lot of OECD countries are going through now too.

I just have one, a supplementary, really, to the housing. You talked about first-home buyers and this apparent wedge that’s developed between housing turnover and the household sector. I wondered to what extent our first-home buyers are being influenced by the global economic downturn and the affairs around the economy. Or is it that they’re saving more for their deposits and banks are getting harder about lending?

I’m sure it’s likely to be a mix. We see in the data—well, we suspect in the data—that people are coming with higher deposits for their first home. Some of that will be because the banks are asking for greater deposits. Some of it will be because people are looking round and seeing a relatively high unemployment rate relative to the past 10 years and want to be a little bit conservative.

Thank you very much for coming in. We appreciate that.
Budget Policy Statement 2012

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Todd McClay, Chairperson)
April 2012

Presented to the House of Representatives
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Recommendation

The Finance and Expenditure Committee has considered the Budget Policy Statement 2012, and recommends that the House take note of its report.

Introduction

The Budget Policy Statement 2012 was published on 16 February 2012. The statement is normally published with an economic and fiscal update in December each year, but because of the general election in 2011, the Pre-election Economic and Fiscal Update 2011 was published instead, on 25 October 2011. The 2012 budget policy statement includes a section “refreshing” the Treasury’s economic and fiscal forecasts from the pre-election update. A full update of the forecasts will be provided with Budget 2012.

Appendix A of this report sets out our approach and our membership, and notes the submission we received.

Summary of Budget Policy Statement 2012

The Budget Policy Statement 2012 sets out the Government’s plans for Budget 2012 and future years. The contents of the statement and some of the Minister of Finance’s comments are summarised below.

The Government remains committed to returning the public accounts to surplus by 2014/15. The plans for Budget 2012 and beyond continue to focus on the Government’s four priorities:

- managing the Government’s finances responsibly
- building a more productive and competitive economy
- delivering better public services within tight financial constraints
- rebuilding Christchurch.

The Minister of Finance said that eliminating the fiscal deficit is essential to stem the rise in public debt, which has grown from 5.6 percent of GDP in 2007/08 to 20 percent in 2010/11, and is projected to rise to almost 30 percent of GDP over the next three years. Several years of surpluses will still be needed after the deficit is eliminated in order to repay debt and position New Zealand to withstand recessionary shocks.

The budget policy statement confirms the Government’s intention to control its spending tightly: operating allowances for new initiatives will be kept to $800 million per annum for Budgets 2012 and 2013, and $1.2 billion thereafter, increasing by 2 percent per annum. A net zero capital allowance was also reaffirmed for the next five Budgets, with any new investment to be funded using capital from the Crown’s balance sheet, rather than from
new borrowing. This reflects the Government’s policy of extending the mixed ownership model for public assets.

We heard that the Government’s plans for improving public services are an important part of its strategy. The Minister of Finance explained that it is not simply a matter of containing spending while continuing to meet the public’s expectations about services, although it is necessary to do so. As the public sector constitutes a quarter of New Zealand’s real economy, it is also vital that it should add to productivity, not subtract from it. Future operating allowances will permit continued increases in funding for health and education, and the Government will introduce changes to welfare policies, creating new benefit categories.

Economic outlook
The current economic outlook as reflected in Budget Policy Statement 2012 is weaker than pre-election forecasts, but still reasonably positive. New Zealand’s terms of trade are expected to weaken, but still to remain historically high, and our two main trading partners, Australia and China, are expected to be among the world’s stronger performers. The rebuilding of Christchurch will provide an important boost to domestic activity, forecast to add one and a quarter percentage points to annual GDP growth each year from 2012 through 2016. In the short term, GDP growth is likely to be weaker than previously forecast because further seismic activity has delayed rebuilding in Christchurch, and recent financial turmoil in Europe has weakened the outlook for global growth. GDP growth is now expected to measure 1.9 percent for the year to March 2012 (down from 2.3 percent in the pre-election economic and fiscal update), and 2.8 percent for the year to March 2013 (down from 3.4 percent). However, the forecasts in the budget policy statement expect growth to pick up more strongly thereafter, with growth of 3.8 percent for the year to March 2014 (up from 3.3 percent). This assumes that rebuilding activity and a rebound in trading partners’ growth will support a recovery in the economy. Average growth of 3 percent is expected over the four-year forecast period.

Unemployment is now expected to be slightly higher over the next few years than previously forecast. The actual rate for the three months to September 2011 was 6.6 percent, compared with a forecast of 6.3 percent. The rate is expected to ease back slowly over the forecast period, to 4.6 percent by 2016. The weaker economic outlook is also reflected in lower consumer price inflation than previously forecast. The household savings rate is expected to remain positive.

Risks in the forecasts
The Budget Policy Statement 2012 notes that potential changes to the forecasts are mainly negative. Risks include the possibility of weaker global growth if the European debt crisis is not adequately addressed, and a real possibility of another global recession. There is also the risk of further seismic activity delaying the boost expected to come from Canterbury’s rebuilding.
**Fiscal outlook**

The fiscal forecasts reflect the slightly weaker economic position and outlook, with reduced tax revenue from lower nominal activity, and increased benefit expenses from slightly higher unemployment. The direct costs of the December 2011 earthquake have also added to the operating deficit in the current year by about $300 million, taking it to $18.4 billion at the end of June 2011.

The Minister of Finance told us he expects the operating deficit for the current year to be about $9–10 billion. We note that the Treasury’s forecasts in the *Budget Policy Statement 2012* predict it to be $12.1 billion for June 2012, compared with $10.8 billion in the pre-election forecasts. While a surplus is still expected for 2014/15, it has reduced to $370 million from the $1,450 million forecast in the pre-election update, largely because of the Canterbury earthquakes and changes in the economic outlook. A table on page 5 of the *Budget Policy Statement 2012* illustrates the significant deterioration in the Government’s forecast operating balance since Budget 2011, with the earthquakes and economic changes adding over $2 billion to the deficit in 2012.¹

**The fiscal challenge**

The Minister of Finance acknowledged that returning the books to surplus will be a substantial challenge for the Government, but he believes it is manageable. As the deficit was $18 billion at June 2011, getting it back to zero by 2014/15 represents “a pretty rapid fiscal consolidation by any measure”. While the Government is taking steps to control expenditure, its revenue from taxation is largely related to the economic cycle, and tends to fall, as now, in times of lower inflation.

The Minister pointed out that the challenge is compounded by a third factor: the increased volatility in the Crown’s balance sheet arising out of the Government’s roles as insurer of last resort and owner of commercial enterprises. As well as being committed to meet any shortfall in the Earthquake Commission’s ability to meet claims, the Government has taken on about a $2 billion liability for AMI Insurance. Together, these commitments expose the Government to earthquake claims of some $10–11 billion. Because the final value of claims is highly uncertain, the amount of these liabilities may vary considerably from estimates. The Minister added that similar uncertainty arises from the Government’s role as an owner of commercial enterprises. The profits of State enterprises fluctuate depending on economic conditions, and the Crown faces the same market risks as any shareholder.

We acknowledge the Minister’s point that these large exposures complicate the task of fiscal management. Since even a small percentage movement can amount to a half-billion-dollar change in the fiscal balance, reductions in government expenditure can seem small in comparison.

We asked the Minister how the situation compares with that in 2008. We were told that the position outlined in the 2008 pre-election economic and fiscal update was unsustainable, as the forecasts envisaged 10 years of deficits. When the financial crisis and recession occurred shortly thereafter, followed by the Canterbury earthquakes, it became clear that

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the fiscal track was absolutely unsustainable. The Government is therefore acting to rein in expenditure and reduce debt.

**Tax changes**

We sought clarification of the fiscal impact of the various tax changes introduced since 2008, as the Government has described them as “broadly fiscally-neutral” but this is not self-evident. The Minister provided us with details of the changes. He explained that the total effect of the changes was negative in the first two years—with revenue reduced by $427 million in 2008/09 and $322 million in 2009/10—in order to support the economy during the recession. He said that from 2010/11, however, the effect was positive, because of a combination of cancelling tax cuts planned for 2010 and 2011, tax packages from the 2008 election and 2010 Budget, and tax savings in the 2011 Budget. The Minister said that revenue increased by $270 million in 2010/11, and was projected to increase by $1,483 million in 2011/12, $1,832 million in 2012/13, and $2,087 million in 2013/14. The Minister said the overall effect of the tax changes would be to reduce deficits and Government debt relative to the position in 2008. Some of us do not accept that the tax changes are broadly fiscally-neutral.

**Current account deficit**

The forecasts envisage an increase in the current account deficit to 6.9 percent of GDP by 2015 and 2016. The Minister of Finance said that two main factors lay behind the increase: an expected pick-up in business investment, with strong increases in residential construction, and investment associated with the rebuilding of Christchurch. He attributed 1.5–2 percentage points of the deficit to the earthquake rebuilding.

The Minister acknowledged that New Zealand’s current account deficit has been a persistent problem, which has proved resistant to efforts to reduce it for 30 years. He did not disagree with a point made in recent consensus forecasts published by the New Zealand Institute of Economic Research that the underlying problem is that New Zealand is not saving enough to fund investment, so the imbalance between export earnings and import costs has to be bridged by foreign borrowing. However, he was optimistic that with New Zealanders now starting to save more and the export sector pretty resilient, it should be possible to overcome the challenge posed by the high exchange rate and start to improve the trade balance.

**New Zealand’s debt and savings**

Net debt is forecast to peak at 28.6 percent of GDP in 2015/16, reducing to 20 percent by 2020/21. It is significant that New Zealanders have started to save slightly more than they spend. Household savings rates turned positive in the year to March 2011 for the first time since 2000, and only the second time since 1993. While the savings are still small—only 0.2 percent of household disposable income—they are expected to continue increasing. The Minister of Finance notes that while this will have a slightly depressing effect on economic activity, it is necessary for economic rebalancing.

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2 NZIER Consensus Forecasts, March 2012.
We asked the Minister why he is optimistic that the improved savings pattern will be sustained without any policy change, as we note that Australia is planning to increase its compulsory savings from 9 percent to 12 percent to lock in the behavioural change. The Minister said he believes a change is occurring throughout the developed world, with the debt-funded growth model ceasing to predominate. Even if New Zealanders wished to return to their old habits of spending more than they earn and expecting the balance to be financed by lenders overseas, he does not believe credit will be as readily available. Asked why, if that were so, the Treasury still envisages a current account deficit amounting to 6.9 percent of GDP in 2016—in effect, indicating insufficient domestic savings continuing to be met by foreign borrowing—the Minister said that was “an ongoing point of discussion” between him and his department.

The Minister added that the international credit rating agencies tend nowadays to make less distinction between public and privately-held debt. So as well as seeking to curb the rapid recent growth in New Zealand’s public debt—albeit from a comparatively low level—the Government is keen to see a reduction in private, and particularly household, debt, which remain high. With the effort the Government is making to reduce public debt by adopting the mixed ownership model, New Zealand has the opportunity to maintain or even improve its position as a well-rated sovereign over the next five years. The mixed ownership model would also broaden the range of investments available to New Zealanders.

**Plans for mixed ownership**

The forecasts in the *Budget Policy Statement 2012* now include the full estimated effect of the Government’s plan to extend the application of the mixed ownership model by selling up to 49 percent of its shareholdings in the State enterprises Mighty River Power, Meridian, Genesis Energy, and Solid Energy, and to reduce its current shareholding in Air New Zealand. We discussed at some length the effect of the sales on the Government’s fiscal balance and debt position.

The forecasts assume total sale proceeds of $6 billion, being the mid-point of an estimated range of $5–7 billion, spread over four years to 2016. Foregone dividends are expected to amount to $500 million, offset by a larger amount—$585 million—in the finance costs saved from the $6 billion reduction in net debt. However, when the share of foregone retained earnings is taken into account as well as dividends, this leads to a net decrease in the Government’s operating balance. We asked how the sales would assist the Government’s return to surplus if they have a net negative effect on its fiscal position. It was explained to us that the Crown in effect exchanges an expected future stream of income for a risk-adjusted equivalent amount of cash now, so the net worth of the Crown remains unchanged after the transaction.

**New Zealand ownership**

The Government has stated that it “expects New Zealand ownership of the companies will be around 85 to 90 percent”. We sought clarification of whether this means that 85 to 90 percent of the shares to be sold would go to New Zealanders. We were told that the

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3 See, in particular, pages 6–7 of the *Budget Policy Statement 2012*. 

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intention is that 85 to 90 percent of all the shares following the sales would be owned by New Zealanders in the first instance—whether by individual investors or through institutional investors such as KiwiSaver funds. The Minister confirmed that the Government will not attempt to control the market by placing any restrictions on New Zealanders selling their shares. We note that as this percentage would include the Crown’s shareholding, it could mean that a substantial portion of the shares actually being sold could go to overseas interests.

Majority Crown ownership

We enquired how the Government intends to maintain a majority shareholding if the companies under mixed ownership issue more equity. The Minister said he would expect discussions to cover all the options available to a company for raising capital, including retaining earnings or borrowing. If it was decided that issuing more shares was in the best interests of the company, the Government would have no choice but to invest further capital as the intention is to impose a legislated requirement on the Crown to maintain a majority shareholding.

The Minister added that he was not particularly concerned about the fiscal burden this requirement might place on the Government. First, on current indications, the companies were not likely to face major capital demands in the near future. Secondly, the investment of a few hundred million dollars was not large in the context of the Government’s capital commitments over the next few years, such as the earthquake-related liabilities discussed above. Such an investment also needed to be viewed in the context of the Crown’s overall balance sheet, which involved some $225 billion of assets and was likely to grow by $20–25 billion over the next few years. Any such decision involving risk capital would, however, require careful consideration.

The Minister said he has not received advice on the approach the Government should take if it were faced with the potential dilution of its shares, and has not spent much time speculating about the amount of capital the energy companies might need down the track. He noted that one benefit of the mixed ownership model was that the Crown would only be responsible for half, rather than all, of a company’s capital needs. More importantly, by making companies subject to market scrutiny and disciplines, mixed ownership should result in their improving their performance. This would, in turn, increase the value of the Crown’s remaining shares.

Share allocation

We asked how it is intended to fulfil the Prime Minister’s commitment that first priority in allocating shares will be given to “mums and dads”, iwi, and trusts, and what would be done if shares were fully subscribed by such investors, leaving none available for corporate investors in New Zealand or overseas. The Minister of Finance said the allocation policy has yet to be decided, but the Government would be planning for a series of share floats, and would want to maintain interest across the range of investors.

The Minister emphasised that because a public offering of shares is planned, securities law imposes strict rules about what information can be released in the pre-prospectus period. As a shareholding Minister, subject to strict liability with criminal remedy for any
misstatements, he is therefore constrained in how freely he can comment on issues to do with the float.

Submission

In its evidence to us Federated Farmers indicated that it supported the priorities outlined in the *Budget Policy Statement 2012*, as its members believe reducing Government expenditure and debt is essential to redress imbalances that have developed in the economy since 2004. A small proportion of its membership had offered comment on the mixed ownership model, and was evenly divided for and against it.
Appendix A

Committee procedure
We met on 21 March and 4 April 2012 to consider the Budget Policy Statement 2012. We heard evidence from the Minister of Finance and one submitter.

One submission was received, from Federated Farmers of New Zealand.

Committee members
Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith
Appendix B

Corrected transcript of hearing of evidence 21 March 2012

Members
Simon Bridges (Chairperson)
Maggie Barry
David Bennett
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Hon Shane Jones
Todd McClay
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters

Witnesses
Hon Bill English, Minister of Finance
Gabriel Makhlouf, Secretary of the Treasury
Bruce Wills, National President, Federated Farmers
Nick Clark, Manager General Policy, Federated Farmers

Bridges Good morning. Welcome. We won’t formally introduce everyone, but you see our names. We warmly welcome you to the table.

Wills Thank you Mr Chairman and good morning, committee members. My name is Bruce Wills, I’m national president of Federated Farmers. With me is Nick Clark, our general manager, policy and economist.

Federated Farmers welcomes the opportunity to present its submission on the 2012 Budget Policy Statement. I assume it has been read so I won’t go through in detail. Just a few comments, if I may. The Government’s fiscal policy has significant implications for the economy and the private sector. Decisions on spending and taxes will have immediate impacts on those receiving the funds and paying the taxes and the flow-on impacts on our economy. Fiscal policy’s indirect impact is that these decisions also impact on other aspects of Government policy including, importantly, monetary policy and the exchange rate. From around 2004 New Zealand’s economy was unbalanced. The tradable sector was in recession and at the same time the domestic economy was propped up by rapid rise in Government expenditure.

This is my first time before this select committee, but I’m aware for many years Federated Farmers has submitted to the Budget Policy Statement.
warning of this and urging more restraint in Government expenditure and for Government policies to be working together to promote competitiveness and productivity.

The federation’s position is strongly supported by farmers, with Federated Farmers' latest farm confidence survey once again showing that the highest priority for our members was for Government to reduce expenditure and its debt. It’s going to take some time to unwind these unbalances built up since 2004 and to feel the benefits of the rebalancing to take place. We do support the four key priorities set out in the Budget Policy Statement and the actions taken to advance them. So thank you for the opportunity to present and I welcome any questions.

Bridges I just start by saying it must be a good feeling, Bruce, to be in a position where what you’ve been saying for some time seems to be what the Government is attempting to do. So that’s got to be a good thing. Any questions?

Cosgrove Yeah, I’ve got a couple. Do you support the asset sales policy as it’s outlined in the BPS? Does your organisation support the sale of State assets?

Wills In principle, like many of these things, Clayton, it is a bit of a difficult one. Listen, we do in principle if that money is going to be efficiently and effectively used for core public policies. I guess, to put it another way, our concern is that we think Government debt is high enough. We do acknowledge it’s important that some of these health welfare issues obviously need to be addressed; that’s Government’s prime responsibility.

Cosgrove Have you polled your members on a position?

Wills Ah yes, yes we have.

Cosgrove And what’s the outcome of that?

Wills Nick, did we do that in our survey?

Clark Yeah, we circulated our draft submission on the Budget Policy Statement to our national council and our industry group leaders and the feedback was, of those that answered the question, said…

Cosgrove Sorry, did you formally poll your membership?

Clarke No, we did not formally poll our membership. But, that said, we do a farm confidence survey every 6 months and farmers are free to say pretty much what they want.

Cosgrove Were they asked?
Clark They weren’t specifically asked, but there were a handful that mentioned a concern about state assets being sold.

Cosgrove Did you ask them about whether they would support, or does your organisation support the shares and proceeds flowing overseas, if they end up in overseas ownership?

Clark We don’t ask that particular question.

Cosgrove Do you have a view on that?

Clark Well, my understanding is that the Government’s—

Bennett This isn’t really—

Cosgrove Yes it is, because asset sales are mentioned specifically in the Budget Policy Statement.

Bennett Yeah, but their point of view on—

Cosgrove They’re submitting.

Bridges I think the questions are fine, but I think what you do need to do, Clayton, is you do need to let him finish his answer.

Cosgrove I didn’t interrupt it; your colleague did.

Bridges All right. So if we just let Nick—

Clark Sure.

Bridges —finish where he’s going on what the sort of feedback was.

Clark Thank you. As many people in our response to us our 6-month farm confidence survey, there were maybe about 10 on each side. Some of them said to sell the assets; some of them said not to sell the assets. It’s the same on foreign investment. The two issues are fairly evenly split within our membership. But, as I said, when we circulated the draft submission, the submission was supported.

Cosgrove Sorry. Can I just ask you, you say on foreign ownership your membership is split. So does mean that there’s a 50-50 split on the sale, for instance, of the Crafar farms, with 50 percent of your membership supporting the sale of the Crafar farms to overseas interests? Is that what you’re saying?

Clark Not necessarily. What I’m saying is of those people that chose to make a comment in response to the survey—and they have free comment so basically they can raise whatever issue they want to—there were some people who said that they were concerned about it and others who said to sell it. Of course the vast majority talked about something else.
I.3B BUDGET POLICY STATEMENT 2012

Bridges Last question from Clayton.

Cosgrove You’ve examined, obviously, the Budget Policy Statement. Do you think it has integrity given that the Government has chosen to, in an unprecedented way, bank, if you will, or state the proceeds from the sale of assets, book it, but on the other hand has not booked the decrease in revenue that it will get from the dividends. Do you think that’s an appropriate way? Would a farmer do that in putting their accounts together?

Clark Well I guess all we can really, really take is the material we’ve got in front of us and we would hope that that material had been prepared in a credible and sustainable and logical way.

Bridges Ok. John Hayes.

Hayes Yeah, I just wanted to follow up on the first question about whether your members supported the asset sales, and if I go to point 1.4 in your submission it’s axiomatic that they would support it because you support Crown expenditure to stay below 30 percent GDP—

Clark Correct.

Hayes —so tied into that is bringing in income from asset sales so we don’t have to borrow it.

Clark Correct.

Bridges Look can I just say it’s a fine submission and I think it’s appropriate given your role in our economy that you’re the one and only submitter prior to the Minister of Finance on the Budget Policy Statement.

Cosgrove Sorry I just have one small question.

Bridges Yeah, Clayton.

Cosgrove I missed one thing. When you said you had had responses from some of your membership around the asset sale issue, how many did you say that was?

Clark If I remember rightly, there would’ve been about nine people who mentioned asset sales.

Cosgrove Out of a total membership of?

Clark No, out of about 800 or 900 respondents to our survey.

Cosgrove So how do you claim there’s 50-50 support?

Clark I never claimed there was 50-50 support; what I said was there were about nine people who said that they were concerned about asset sales and there
were nine people who said, on the other side, that they had supported asset sales. The other 800 or 900 respondents made no comment at all on that.

Cosgrove So 50 percent or 0.1 percent. OK.

Bridges You’re going backwards here, my friend. All right thank you very much.

Cosgrove Thanks for that clarification.

Bridges We appreciate your time.

Bridges Welcome Minister, Secretary to the Treasury, to this hearing on the Budget Policy Statement. You know us well and we know you so we just welcome you and invite you to make some opening remarks to us about the Budget Policy Statement and then we’ll of course take questions.

English Thank you, Mr Chairman. The Budget Policy Statement should be seen in the context of the Government’s four main priorities, which the Prime Minister set out earlier in the year: responsibly managing the Government’s finances; a more competitive economy; better public services; and rebuilding Christchurch. We’re committed to returning to Budget surplus by 2014-15 so that we can stem the rapid rise in Government debt, which has already increased from 5.6 percent of GDP in 2007-08, 20 percent in the 2010-11 year, and is expected to rise to close to 30 percent of GDP in the next 3 years. It’s not until we get to surplus that that rise will stop and then of course we’ll need further surpluses in order to repay that debt so the New Zealand Government can get back to a strong position to be able to weather another recession, should that come along.

In the last week the Prime Minister outlined some of the Government’s plans for public services. Now these plans are important for two reasons. One is that clearly reaching our fiscal objectives does require control of Government expenditure. At the same time as controlling that expenditure we need to be able to continue to meet New Zealander’s expectations about public services. The other reason it’s important is that the public sector is about 25 percent of the real economy—that is, buildings, people, IT systems, and it should be adding to productivity, not subtracting from it. So the Budget Policy Statement projections around expenditure are based on a pretty direct control of Government spending.

Just to run over the economic outlook as reflected in the BPS, it reflects an outlook that’s somewhat weaker than the pre-election update, but still remains positive. Our terms of trade are expected to remain high. Terms of trade are around the highest level since 1965, so even if they drop back somewhat, they would still be relatively high. Our largest trading partners are among the stronger performing economies in the world. I think, as we’re aware, the rebuilding of Christchurch will provide some impetus for growth. So under Treasury’s central forecast GDP growth peaks at 3.8 percent in the year to March 2014 and average annual GDP growth of around 3 percent over the next 4 years, with unemployment expected to
ease back to about 4.6 percent. The savings rate is expected to remain positive. This of course will have a somewhat dampening effect on the economy in the near term because people are saving it rather than spending it, but it is a pretty necessary platform for the long term.

Just a few comments around the current account deficit, in these forecasts it’s expected to widen out to 6.9 percent. With current account deficit it’s pretty important to understand what’s driving it. It’s actually a very difficult quantity to change or influence in any direct way, but the drivers do matter. The 6.9 percent really has two drivers, one is strong expected business investment, and that’ll be leant some weight by the housing cycle picking up where the forecasts have very strong increases in residential construction. They’re about 30 percent a year for a couple of years. Also the investment associated with the rebuild of Christchurch, which is somewhere between 1.5 to 2 percentage points of that 6.9 percent. I think that what we need to keep in mind with our economic figures for the next few years is the very unusual nature of what’s going on in Christchurch. Plus the size of it is going to start having an impact on all our economic aggregates in a way that is a one-off and shouldn’t be misread as permanent and long term.

Just in respect of the fiscal outlook, reduced tax revenue in the 7 months to the end of January is broadly consistent with the economic outlook in the BPS. Treasury has identified downside risks to the tax take for the remainder of the year and slightly weaker labour market conditions. When we’re looking at the forecasts for the OBEGAL, that’s the operating balance before gains and losses, we need to keep in mind a number of variables that affect that. Government expenditure, of course is a significant part of it, but there’s a number of less predictable quantities involved. The valuations of EQC liability, with respect to the earthquake are still going on; every 6 months they’re revalued. You can never be quite sure which way those are going to go. Well, at the moment, the pressure seems to be reflecting the same as the private insurers and that is each valuation is tending to show higher liabilities. Since the Government is now effectively the owner of AMI, that is a $2 billion liability and will be affected in the same way as the EQC liabilities. We also have affecting this path to surplus SOE profits. Although they’re discussed as if they’re some kind of permanent flow to the Government, in fact they’re not. They’re profits of commercial businesses and they can fluctuate higher or lower depending on economic circumstances and the management of the companies themselves.

The Budget Policy Statement reflects our intention to return to surplus and Budget 2012; in fact our Budget priorities over the parliamentary term, will be about sticking to that plan. The BPS confirms the future operating allowances. Essentially those allowances permit continued increase in health and education. Although in both cases we need to see improvements in what they can achieve for the higher than ever investment that is currently being made in them. The BPS also confirms the net zero capital allowances for the next five Budgets reflecting that Government policy around the mixed ownership model. In the BPS, as you’ll see, the Government
published a set of figures around the fiscal impacts of the mixed-ownership model. Just in respect of that, we’re now in a period where the Government and particularly shareholding Ministers need to be aware of the need to comply with the securities law. We’ve essentially indicated we’re going to be offering shares and that makes us issuers and that carries a set of obligations subject to the remedy of criminal liability if we get it wrong. So that does necessarily constrain the sometimes looser political discussions that can go on around the Government share offer and the mixed-ownership model.

So just in concluding, Mr Chairman, the BPS confirms the plan for the next 3 years to stick to building a competitive economy, improving public services, rebuilding Christchurch, and getting back to surplus.

Bridges Thank you. I’ll just start you off, Minister. Clearly a key part of sticking to the plan is returning to surplus in 2014-15 and thereby getting into debt reduction. In light of the ever-decreasing forecasts of what the surplus will be, can you just set out for us how challenging it is going to be to return to surplus in 2014-15?

English Well it will be a bit of a challenge because in the year to the middle of 2011, the deficit was $18 billion and that included expensing our commitment to the earthquake. This year we would expect it to be somewhere around $9 billion or $10 billion and heading back to zero by 2014-15. So that’s a pretty rapid fiscal consolidation by any measure. The way to think about it is as there’s three, sort of, significant influences. One is just a tax take and of course that’s pretty much related to the economic cycle. Things can influence it, such as the fact that we’ve now got a lower inflation path as indicated by the Reserve Bank. Because there’s lower inflation, there’s a smaller nominal economy. When there’s a smaller nominal economy, the tax take drops, even if the level of economic activity is roughly the same. Then there’s the expenditure track. That’s the bit over which we have the most control and parts of it that were traditionally regarded as uncontrollable we’ve taken action to bring them under control because you can’t run a sensible fiscal policy by having a whole lot of open-ended, demand-driven expenditures. Then the third influence on the track is those clutch of issues that I talked about before. Because the Government is an insurer of last resort and an owner of businesses, it faces all the commercial risks that anyone does in that position. Those are risks such as increases in the valuation of claims for the Christchurch earthquake where our commitment is already around getting up $10 billion or $11 billion once you count AMI. So, the Government’s got very large exposure to that earthquake and small movements in it amount to half a billion dollars, either way on your fiscal track. Small movements in that liability can dwarf any change in actual expenditure in the traditional sense of health and education and welfare benefits. So that is going to be quite a challenge because of the increased volatility that the Government has to deal with.

Hayes Yeah, thank you for that, Minister. How does the return to surplus in 2014 compare with the situation you inherited in the forecast back in 2008?
The situations change significantly. The forecast in 2008 showed that the existing track of expenditure was unsustainable, because the pre-election update in 2008 indicated about 10 years of deficits. So that action had to be taken at that stage. Just after the pre-election update was issued, or around that time, we had the Lehman Brothers crash and the beginning of the recession. So what was already unsustainable became absolutely unsustainable. The Government at the time decided to maintain spending as a way of cushioning New Zealand from the sharpest edges of recession. At the time we said that that couldn’t continue. We would have to reign in that spending. About the time we were saying that, we had the Christchurch earthquakes. So coming on top of an unsustainable path, followed by a significant recession, followed by a large earthquake—that’s given us quite a challenge. But I think we’re in reasonable shape to deal with that. I think it’s important to understand it was already unsustainable before the other events came along.

Hayes  
Was it 10 years of deficit?

English  
That’s right, yeah. So that’s all. Naturally there’s going to be policy change in that context and that’s what’s happened.

Norman  
Just on the question of when you return to surplus, what will be the impact of the partial privatisation on when you return to surplus, given that the partial privatisation has a negative fiscal impact on the Budget because you lose more in lost dividends than you gain in reduction in interest payments? So won’t it mean that you return to surplus later?

English  
Well that’s not quite correct. As the BPS sets out, actually we’re both speculating here because the profit and dividend tracks of these companies, certainly the profit tracks are quite variable. They’re not actually as automatic as everyone assumes. So we’ll have, you know, profit updates every six months that will tell us. I think there’s two or three measures of the impact, fiscal impact and we’ve said it’s roughly neutral because some are above some are below…

Norman  
BPS says it’s negative.

English  
In the short term, the most significant impact of the sell down is to reduce our need to go and increase net debt. That’s the bit that over the next 4 or 5 years has the biggest impact.

Norman  
The question was will it delay your return to surplus given that it has a net negative impact on the fiscal position of the Government? That’s what the BPS says.

English  
Well no, it has a negligible impact. The BPS necessarily has to have a kind of stylised representation of the flows, but on the statements the Government’s made about the programme you only have a year or two, a couple of years of some companies in a different position after the sell down, with one company, say. Then only about a year or so, a year or two
years, for the other ones. It’s not a significant influence on getting back to that track.

Norman But it is negative.

English Well not necessarily and I guess that’s my point. The BPS numbers reflect the company’s views about their future profitability as they were stated at the time. Those will get updated; in fact the BPS doesn’t even include the 6-monthly profit figures, I don’t think, although it’s probably based on them. I think we should be careful about being more certain than we can about what the profits of these companies are actually going to be, given that you’ve just got to listen now to public commentary about what’s happening with the demand for electricity.

Parker Minister you just said that the asset sales were important so as to stop net debt increasing. Did you mean gross debt or net debt?

English Well, it will affect both quantities. The measure that we focus on is the net debt.

Parker Well will it affect net debt, though, because you lose the asset? Isn’t the net debt gross debt less the assets of the Government including the SOEs so this has no effect on net debt?

English Well strictly speaking it has no effect on our assets either because we just swap shares for cash.

Parker No, my question is you just told us it’s going to stop net debt increasing. I think you’ve made a mistake in that what it does is affect gross debt, but not net debt and I’m just asking you just to concede that point.

English I just got to think that through, but yeah I think you’re probably right. We don’t go to the market to borrow the money, so that certainly does mean less borrowings, less gross debt. We swap shares for—

Parker So you have less debt but less assets.

English No we don’t have less assets because we swap shares for cash. That’s pretty fundamental. We give you a share you give us cash. We’re in a neutral position. The net worth of the Crown is the same after this transaction as before.

Peters Until you spend the cash.

English No, that’s not correct. The schools are an asset absolutely.

Peters But are the schools an equivalent asset?

Parker I think you’ve conceded to me that it has no effect on net debt; it has an effect on gross debt.
It has an effect on net debt to the extent that we don’t have to service a larger stock of debt.

You don’t have income-generating assets to service the debt.

You said that you conceded it was gross not net, but the effect was to produce the need to increase net debt. Aren’t the tax cuts the very reverse but only even more so in terms of your little picture?

No. With the tax cuts the important thing to remember there is you’re comparing the Government policy against the policy that was in place when we became the Government. And if you do that comparison, actually the tax packages that the current Government has done are roughly fiscally neutral, maybe positive, compared with the policy that was in place at the time. Treasury can produce those numbers for you. What people forget is we actually cancelled a couple of tranches of tax cuts.

But the IRD financial review says in black and white the package is revenue negative. That’s what it says. That’s what the IRD says in their financial review that they gave to us.

Well you’d have to ask them what they exactly mean by that.

It means they get less money.

Yeah, they’re getting less money.

I don’t know exactly what they’re measuring, but we’re quite happy to give you the numbers that show the impact of the number of different tax changes, and there were a number of different tax changes over a period of 2 years, which illustrate that we’re roughly revenue neutral on it.

Thank you Mr Chairman. The Budget Policy Statement says, and I quote, the Government expects New Zealand ownership of the companies will be around 85 to 90 percent. It’s not clear from that sentence whether that’s 85 or 90 percent of the shares that are being sold or whether it’s 85 or 90 percent of the companies after the sale. I think Mr Ryall conceded in the House that that was after the sale of the shares. So am I correct to say that the proper reading of that is between 20 and 30 percent of the shares being sold will be sold to overseas interests?

I will answer your question. I just want to come back to your net debt one, because actually I have to correct myself. The table on page six sets out the change in net debt, which is actually 6 billion over the forecast period, cumulative reduction in net debt, so I put you wrong there. So you can go to that. In terms of your question, the Government has made its policy object clear, which is to achieve the 85 to 90 percent, that is of the total companies. With respect to the allocations in a sell-down, those are decisions yet to be made. We’ve made it clear that we will favour New Zealand ownership.
Parker Can I come back to your earlier comments about current account balance. You said that a major part, I think, of the current account deficit going forward relates to the Christchurch earthquake rebuild. Are you able to provide us with a breakdown either now or—if the officials have it, but it is not to hand—later of the percentage of the current account deficit in 2016 when Treasury says it goes to 6.9 percent, the Reserve Bank has the projection a bit lower, that is then attributable to the earthquake? Because I find it surprising that you’re claiming that’s the major cover for the current account deficit out in 2016.

English Yeah I wouldn’t say it’s the major driver of it, just it’s an influence—a significant extra bit at the margin. And yes, they should be able to give you some figures about the breakdown of that.

Parker The reason I ask is that the NZIER forecast, or consensus forecast figures I think they call them, or something like that, that came out late last week said, if I can paraphrase, that the reason is that New Zealand is not saving enough and that the difference between the cost of our imports in interest compared with our exports is effectively bridged by borrowing and asset sales. I just wonder why it is that you disagree that that’s the fundamental problem that we still have in our unbalanced economy?

English I don’t disagree with that. I think that’s pretty standard analysis from the last 30 years or so of the New Zealand economy. I think everyone would agree that, you know, any increase in our external vulnerability, particularly in today’s world, is undesirable. The question then is what do you do about it, because we’ve talked about the current account deficit for 30 years and it appears to have defied most attempts by Governments to lock on new industries or cook up savings incentives or whatever. I’m a bit more optimistic now, I think that New Zealanders have got the message about saving, and the figures illustrate that they are saving more. I think that despite the head wind of a high exchange rate, we’ve got a pretty resilient export sector and could expect to see a trade balance perhaps improving. But with the head wind of the exchange rate, that’s going to be quite a challenge. But happy to hear any other ideas that we think might have a significant influence on improving a 30-year-old problem.

Parker Well you’re more optimistic than both your own department, Treasury, and the Reserve Bank. I think last week you were quoted as saying in the media in a speech that you thought that New Zealanders had put away their former spending habits and that their increased rate of savings during the recession, which always happens, is set to continue. Why are you confident that that will happen without any change to policy settings, when just across the ditch the Australians think that it’s necessary to further increase their rate of compulsory workplace savings?

English Reasonable people can disagree about this. I happen to think that we’re seeing a significant turning point across the developed world. It’s not just New Zealanders shifting their habits a bit, but the debt funded growth
model has come to an end. I don’t think there’s much doubt about that. Whatever New Zealanders might think they’re going to do, the world’s not going to lend them the money that will allow them to either enjoy that sort of unearned increment of growth that’s been there for the last 10 or 15 years funded by credit, or the growth in asset values that’s funded by more borrowings. But I think they understand that. The point I’m making is even if they wanted to go back to their old habits, the question is who’s going to lend them the money to do it? Looking around the world it’s not easy to see.

Parker At the moment it’s 2016. Your own department is saying that the rest of the world is going to lend them that money to the tune of 6.9 percent of GDP in 2016.

English Yeah they are saying that, and that’s an ongoing point of discussion between me and them.

Bridges Just supplementary on that point, on the issue of the credit rating agencies and where your perception is of where they sit and whether we reach surplus in 2014 and how they are positioning themselves in relation to New Zealand public debt.

English Look, the rating agencies used to focus a bit more on separate public and privately held debt—because of the recent experience around the world of bank guarantees they tend to aggregate the debt in their thinking because it’s all essentially on the sovereign balance sheet. That’s very evident in Europe, in the UK, and the US where Government balance sheets have exploded, mainly with dodgy assets and a lot of operational expenditure borrowing. So our issue is partly that we don’t want to see rapid growth in Government debt. The rating agencies, I think, accept that New Zealand started from a low level of Government debt compared with most developed countries, but it has grown at least as fast as most of those countries that are in trouble, so you want to cap that off. You need to put that alongside our still high levels of private debt, particularly household debt. Now the good news is that household debt is shrinking as a percentage of GDP. It’s dropped from a bit over 150 percent of GDP to a bit under. In 2 or 3 years we could have Government debt stopped rising, and the opportunity to resolve our debt issues more easily than most other developed countries who are going to having growing debt for a decade, probably. So in that world New Zealand has an opportunity to maintain or maybe even improve its position over the next 5 years as a well-rated sovereign. A critical part of that is to stop public debt rising in the same way that households have stopped their debt rising.

McClay Minister, how do you see, or do you see, the mixed-ownership programme fitting in with the Government’s policies around lifting national savings?

English There are a number of reasons why we’re interested in this programme. One is the debt issue that we’ve just been dealing with. Second is the
opportunity for a broader range of investment for New Zealanders. We’ve had a lot of discussion, including in this committee over the years, about a strong focus on property. That’s been understandable up to now. There’s some evidence that property values aren’t continuing to increase, bank deposits are increasing pretty rapidly, in fact by about 8 or 9 percent per year. So there’s an opportunity there for New Zealanders through the mixed-ownership model to broaden their range of investment, and probably the fact that the Government is a part-owner might influence that decision.

McClay Are you getting any feedback or do you have any sense of New Zealanders’ interest in these shares and investing in these good solid companies?

English Well we’re certainly getting indications of interest even in the hui that I did a couple of weeks of there a month or so ago. You know, people who were not necessarily supportive of the policy were still interested in how to participate. But there’ll be a programme that outlines that for New Zealanders prior to the first float.

Norman I’m just interested in the question of how you’re going to maintain 51 percent ownership or majority Government ownership if the companies issue more equity right. The Government’s argument has been that this is an opportunity for the company to issue more shares in order to raise capital. How are you going to maintain 51 percent ownership while the companies are issuing more shares?

English In the first place it’s not a choice—we have to, because it’s the Government policy, in the first place. Secondly, because if the legislation goes through it will be legislated, so the Government has no choice but to maintain 51 percent ownership. I would imagine that the process there will be conducted by discussions with the company when it wants to raise capital, about the appropriate way to raise that capital. Whether it’s through retained earnings, whether it’s through more borrowings, if it comes to them raising more capital in the market, then the Government would need to participate.

Norman So in order to maintain your position you’d have to buy 51 percent of the shares issued or provide half of the capital the companies are seeking.

English Yeah well mathematically you would have to. But you’d have to be prepared to do that. If you weren’t prepared to do that, then that would raise a pretty important question about whether they could go ahead with the investment.

Norman If it was in the best interests of the company to raise more capital, your directors on the board would be required, under the Companies Act, to act in the best interests of the company. So they couldn’t block the issuing of more shares on the basis that the Government didn’t want to buy 51 percent of them, could they?

English Well, that’s an interesting question. Depends a bit on the circumstances. I mean the Crown would be free, I would imagine, to not invest, but if there’s
a proposition there, which is in the interests of the company, then the Crown would contribute to maintain its share.

Norman Are you concerned that in a fiscally constrained environment having to come up with large amounts of new capital to invest in, say, Mighty River Power, is going to be quite difficult for the Government? Because actually you’ve got a lot of fiscal pressures on at the moment.

English No, not particularly—for two reasons. One is that the indications of looking through the companies at the moment is that there aren’t really large capital demands, in the foreseeable future. The second issue is that in the context of the Government’s annual commitments in capital investments, even if they came along and said we need several hundred million dollars for this or that, it’s actually not that large. We will commit, I’m not sure if it’s reflected in the Budget Policy Statement, but certainly in the investment statement, you’re looking at, over the next 3 or 4 years, growth in the Crown balance sheet of net value of 20 or 25 billion, so a few hundred million here and there is not actually that big a commitment. Although of course we would look at it pretty carefully because it’s risk capital.

Cosgrove Minister, I’d just like to get something clear. You’ve said in the BPS that one of the two major planks of selling assets was to reduce debt—correct? Secondly, your Prime Minister has repeatedly, including on 8 February, said “We are a capital strapped Government so we’re not going to invest in that way”, and yet you’ve confirmed over the last couple of weeks that if you’re diluted—if there’s a position that could face dilution—you’re prepared to borrow. So how does that add up, and what advice have you received, and can you provide us with advice from Treasury—in respect of that issue?

English We haven’t had particular advice about that issue. What we have had advice about is how the Crown thinks about and controls the demands for new capital and also how current capital is reinvested. You’ve got a balance sheet of 225 billion. In order to maintain that you need significant capital investment each year, particularly in the physical property. If you’re going to grow it, then you need to work out where that capital’s going to come from. In the context of the quite large flows associated with investment on the $225 billion balance sheet, the speculation about what these energy companies might need in, who knows, 2, 5, 7 years time, isn’t a substantial issue and we haven’t spent a lot of time on it.

Peters Look, Mr Key has said that as for the 49 percent, three groups of people have priority: mums and dads, trusts, and iwi. Now if those three groups, for example, totally subscribe for the 49 percent, where will the international corporates or the domestic corporates have an opportunity to buy one share?
English  Well this just raises the issues around allocation, which we’re not in a position to talk about in detail, simply because the decisions haven’t been made about it.

Peters  Hang on, just look. When the Prime Minister says, and you’ve said, that mums and dads will have first preference, if they’re going to have first preference and they fully subscribe or oversubscribe, my question is, how then do international and domestic corporates get even one share?

English  There will be matters of judgment to be made at the time of the price setting process because it is possible that in an initial float there’s very strong public interest, and I suspect that there may be strong public interest. The Government has to keep in mind that it has a series of these floats, that some of the others to come are likely to be as large, or larger, and therefore you need to conduct the share allocation process in a way that maintains interest across a number of bidders.

Peters  Like a cornerstone investor, so you can put the price up.

English  No, we have set a limit on anyone owning more than 10 percent, and we’ve made it pretty explicit that we’re not going to be trying to sell blocks of shares.

Peters  Have you worked out what you’re going to do?

English  Well, the allocation policy isn’t set.

Peters  All these answers we’ve been hearing in Parliament, then, are based on a guess—speculation.

English  They are outlining Government policy, and that will need to be turned into a specific allocation.

Peters  But a Government policy would drive something that’s set by way of decisions. Why are you just picking this out of mid-air? Let me ask you a question: if you’re going to have priority for these three, and you mentioned iwi at the recent hui you were at, and they all totally subscribed or over-subscribed, then why have you got these provisions, because none of these will conform to that? But you’re saying an entity may only get 10 percent. But if the mum and dad, trusts, and iwi are all in there, an over-subscribed or fully subscribed purchase, then, basically, any corporation, whether domestic or international, is now ruled out.

English  We are speculating. It would be a nice problem to have, an excess of demand from New Zealand owners, and we would like to respond to any strong demand from New Zealand.

Peters  Well, just one question: what percentage of these assets do you think is going to end up—have a rough guess—in the hands of mum and dad?
We’ve just said we can’t predetermine that at the moment, but we have said we want 85 to 90 percent New Zealand ownership. And as you’ve pointed out, that is likely to also involve New Zealand-based institutions—private sector fund managers, ACC, New Zealand Super, Kiwisaver fund managers—alongside mums and dads. I hope we have the problem of excess demand. We would deal with that problem in a way that helps to maintain longer-term interest in the other floats to come.

Don’t you think, given the legislation has being introduced—you have had this policy 3 or 4 years, presumably you’ve thought it through—that this late in the day you would be able to tell the people of New Zealand, because they’ve actually got a right to know, how you’re going to guarantee that mum and dad are the first in the queue? How are you going to solve the foreign interest buying through domestic vehicles dressing it up, even if it is 10 percent or a conglomeration, as though that’s a Kiwi buyer? How are you going to guarantee and stop Kiwi mums and dads or any other domestic entity or institution on-selling those shares to foreign interests? How are you going to guarantee that, ultimately, of the 49 percent of whatever is sold it will not end up like Contact Energy, predominantly foreign-owned? Do you think it’s good enough, Minister, to sit here with the legislation before the House and say that we haven’t had any advice, that you presumably haven’t asked for, and you can’t tell the people of New Zealand how you’re going to enforce the commitments you’ve made?

All I can say is we will be taking those positions, dealing with those issues, at the appropriate time. Bear in mind here, as I’ve said at the start, we’ve already said we’re going to make a share offer that makes us issuers which means that any statement we make related to encouraging or connecting people to the share offer is subject to the standard of strict liability with criminal remedy. So we are going to be necessarily cautious about preparing those decisions properly, because they have to be communicated in a lawful way to meet a high standard of truthfulness and accuracy.

Does that mean that, if I can translate that, you’ve made commitments and now you’re trying to truthfully adhere to those commitments—when do you think the people of New Zealand are entitled to know how you’re going to meet your commitments? The day before the float? Because you’ve given no guarantees on any of those key commitments because you can’t give any guarantees.

I think the best guarantee around the higher, broader commitments is the fact that the Government has made them political statements, made all through last year, right through an election campaign. The drive to achieve those will be pretty strong.

Could I just touch on one question, and it’s a pretty simple one, that I don’t see that there’s any legal issue that could prevent you from answering. How are you going to stop, or do you intend to stop, if any entity, or mum and dad Kiwi, purchase shares, and is then made an offer they can’t refuse,
from on-selling those shares to a foreign entity in exactly the same way as happened to Contact Energy, which is predominantly foreign-owned? You say 95 percentage or whatever will be in Kiwi ownership; does that mean you will prevent on-sale, and if you’re not going to prevent on-sale, that makes your promise baseless?

English  

In the first case, one reason Contact Energy is predominantly foreign-owned is that the Government sold the whole thing. In this case—

Cosgrove  

No, I am speaking about the 49 percent, 51 percent; you said 95 percentage of the 49 percentage, so let’s be specific, Minister.

English  

I said, in fact in direct response to the question earlier, I said 85 to 90 percent of the whole company. But with respect to your question, we’ve already answered that and we’ve said we’re not going to try and control the market.

Cosgrove?  

So the commitment’s baseless?

English  

Our commitment is that we will in the process of the float achieve 85 to 90 percent New Zealand ownership, and we’ve been quite explicit. We’ve said beyond that we are not going to try and control the market.

Cosgrove  

So that’s just a snapshot of time going forward a month, a year, 2 years; there’s nothing to stop those shares being on-sold and that will and that commitment being broken?

Goldsmith  

Just wanted to go back to the issue of additional capital that’s required further down the line. Surely that’s one of the primary benefits of the mixed-ownership model, that rather than having to stump up 100 percent of any additional capital that’s required, the Government would now be looking at 51 percent, and so there’s less requirement on investment if these companies want to grow. Is that not how it works?

English  

That is certainly how it works. It’s interesting to observe that Governments of either colour have not put capital into these SOEs hardly at all, except when they’re in distress. So in that sense it hasn’t been an active owner. One of the effects of that is these companies have tended to hoard cash because they don’t want to have to go to the Government to ask for capital. And when they do that, then historically the capital investment decisions aren’t always subject to scrutiny outside of the company, except to the extent that the Crown monitors those decisions at arm’s length. So in the future, one of the benefits we would see as a residual owner, 51 percent owner, or majority owner, is the one you’ve mentioned, that is for whatever capital investment they want to make we don’t have to finance it all because we’ve got all sorts of other risks on our balance sheet now. I think that’s quite important to understand. These businesses are roughly 6 or 7 percent of the balance sheet. The Government balance sheet is much more volatile because it’s got these large investment funds: GSF, the ACC, the super fund, you’re talking about the thick end of 40 billion there of investment
funds, and we’ve seen the EQC effectively wiped out. So that’s the kind of risk that the Government’s involved with. In that context, these kinds of investments are small and they have their own particular commercial risk. So we get two benefits: one is we don’t have to stump up the capital for that when we’ve got other big capital demands; and, secondly, the investments are subject to external market scrutiny. And that, in the long run, is the more important factor.

Bridges Minister, I know we’ve got several questions from members around the room but that’s our time. I want to thank you for coming and presenting on the Budget Policy Statement.

conclusion of evidence
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Reserve Bank of New Zealand's financial stability report, May 2012

Recommendation
The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s financial stability report released on 9 May 2012, and recommends that the House take note of its report.

Introduction
The Reserve Bank of New Zealand is required to report every six months on the soundness and efficiency of New Zealand’s financial system. The following are the main points from its May 2012 financial stability assessment:

- Conditions for New Zealand’s financial stability have improved marginally over the past six months, but remain vulnerable to international developments.
- Europe’s financial situation is fragile. While action by the European Central Bank has eased immediate stresses, little has been done to address underlying imbalances. Further disruption could freeze global debt markets and undermine the delicate global recovery.
- New Zealand’s external indebtedness has been reduced slightly but remains high, as a rise in private savings has been offset by a rapid increase in Government borrowing. This leaves New Zealand vulnerable to changes in global funding market conditions.
- The New Zealand dollar rose strongly over the past six months, before weakening somewhat in the last week or so.
- Credit growth remains low in the household, business, and agricultural sectors.
- The housing market has been gradually adjusting, with overinflated prices falling.
- The banking system continues to perform strongly, and its profitability has increased. Banks have strong capital buffers and are well placed to meet the planned Basel III capital rules.
- The insurance sector has generally coped well with the transition to the new prudential regime, and with the challenge of the Canterbury earthquakes.
- Payment and settlement systems are operating effectively, despite two recent incidents which disrupted some retail payments.
- The Reserve Bank continues to strengthen the regulation of the financial system.

The rest of this report discusses the main issues we considered during our examination of the financial stability report and in our discussion with the Governor of the Reserve Bank.
The international situation and risks for New Zealand

While the New Zealand financial system is coping reasonably well, the international situation remains fragile—particularly in Europe—and presents real risks. The Governor of the Reserve Bank told us that liquidity measures taken by the European Central Bank in December and February have temporarily eased funding difficulties for European banks, but they amount to a holding operation rather than a solution to Europe’s problems. Heavily indebted governments still need to bring their debt into line with their national incomes, and the weak outlook for growth makes the choices all the more difficult.

The governor cited the political controversy over austerity budgets during recent elections in France and Greece, and difficulties faced by Spanish banks in recent weeks. In his view, such “mini-crises” in Europe are likely to continue, leading to continuing pressure on bond yields and funding markets. He does not rule out the possibility of some European banks failing.

We asked about the risks such instability in Europe poses for New Zealand, and our exposure compared with other countries such as Australia or the United States. The governor said that our exposure to Europe’s situation arises less from direct trading than from our banks’ access to long-term secured funding, and the cost they must pay for funds. In broader terms, the financial stability report notes that any further European problems over sovereign debt and banks’ solvency could reignite turbulence in the market, causing global economic conditions to deteriorate. If global growth faltered, weak export demand and resultant swings in export commodity prices would be detrimental to Australia and New Zealand.

The outlook for the US economy has improved somewhat, but growth is likely to be slowed by the need for fiscal restraint. Growth in China and Australia has been slightly weaker recently, but there are no major financial concerns about the economies of these major trading partners.

External debt

New Zealand’s external debt has been reduced slightly, but the domestic economy remains highly indebted, both by historic standards and relative to other developed economies. While household debt has continued to fall, Government borrowing has increased as a result of weaker growth than was projected and the costs of the Canterbury earthquakes. Net external debt is still about 70 percent of GDP. The report notes that this leaves New Zealand particularly vulnerable to changes in global funding market conditions.

The governor emphasised the importance of continued fiscal restraint by the Government. He commented that international funding markets have little tolerance at present for loose fiscal behaviour. The markets do not view New Zealand as sharing the difficulties of some European economies, and he believes it is vital to maintain this distinction. For this reason, the Reserve Bank endorses the Government’s stated intention of remaining on track to return to surplus. Government restraint also sends an important signal to the household sector about the need to reduce its debt. The governor added that even though households have shown more caution over the past few years and an encouraging trend of saving more and borrowing less, it will take a long time before outstanding household debt is whittled down, even in a growing economy.
The governor said that the levels of government and private debt are both important for financial stability. Because of recent problems with European sovereign debt, the markets are currently focusing more on governments’ fiscal positions. He remarked that debt is not a problem in itself, if it is used to fund infrastructure investment, as Australia has done for the past century. New Zealand’s vulnerability arises from the increased household debt over the past decade, as this was largely foreign-funded through the banking system.

We agree with the governor that this underscores the importance of rebalancing economic activity away from debt-fuelled consumption toward investment in productive infrastructure. The governor noted that rebalancing efforts ought to be reflected in movements in the exchange rate, although it is not a simple relationship. A growing external deficit would be a cause for concern if combined with an uncompetitively high exchange rate.

**Interest rates**

We asked whether there is a risk that interest rates could rise substantially because of New Zealand’s prolonged current account deficit. The governor said that a country’s net external debt position is more relevant than the current account in this regard. The markets are increasingly applying a premium for risk, so if New Zealand were seen as a riskier lending proposition, rates would increase. He was not concerned about this at present, but said it underscored the need for reducing New Zealand’s high external debt, both public and private.

We note that New Zealand’s 10-year government bond rates are about 2 percent above those in the US, with the difference averaging between 1 and 4 percent over time. We asked whether the Reserve Bank envisages the difference narrowing in the longer term. The governor said that some difference is to be expected given the relative size of the two economies, and the fact that the US market is seen as safe. The difference could narrow if the US economy were to resume growing and the markets expected the federal funds rate to rise from its current position close to zero, while New Zealand rates remained stable.

**Exchange rate**

The New Zealand dollar has appreciated strongly since the previous financial stability report in November 2011, continuing a marked rise since 2009 both against the US dollar and on a trade-weighted basis. However, recent weeks have seen some easing back in its value. We will be interested to see whether the decline continues. The governor attributed the recent decline to a combination of factors: the volatile global environment, slightly lower commodity prices for New Zealand exports, slightly weaker economic data, and possibly the Reserve Bank’s recent public comments about the dollar being misaligned. He noted that the New Zealand dollar has been moving roughly in line with the Australian dollar, retaining its competitiveness, but of course future movements cannot be predicted.

**Exchange rate intervention**

We followed up on our previous discussions with the governor about possible approaches to reducing New Zealand’s exchange rate in order to ease the challenges facing non-commodity exporters. We note that a recent report by the IMF concluded that a measure
being taken by the Swiss central bank—issuing large quantities of Swiss francs in exchange for euros—was an appropriate response to that country’s situation. The governor reiterated that Switzerland was an unusual enclave within the eurozone, with its own currency, virtually no inflation, and huge capital inflows to its banking system. The eventual cost of the measure taken by the Swiss central bank would depend on how long the bank could comfortably hold its position in euros, but mark-to-market accounting requirements meant the losses could not merely be termed paper ones.

In the Reserve Bank’s assessment, much of the distortion in currency markets at present arises from the policies of quantitative easing in the major economies, and there is little New Zealand can do to counteract it. The governor said that the Reserve Bank has examined possible approaches at length, and if it could find a tool to realign the currency that it believed would work, it would not hesitate to use it. However, its assessment is that there is little New Zealand can do where the benefits would outweigh the distortionary cost of the intervention.

The governor added that there are reverse risks from a debased currency in terms of inflationary pressure, so the desirable position for any country is to have as strong a currency as the economy can sustain, as an indication of its relative wealth.

**Trading in the New Zealand dollar**

It is of interest that despite New Zealand’s small size, our currency is one of the world’s most traded internationally, ranking 11th or 12th. In the governor’s assessment, this is unsurprising. Given the current volatility in global markets, investors see New Zealand as one of relatively few markets that are safe, stable, and have reasonable prospects for growth in the medium term. He noted that the short-term carry trade was also a factor, as New Zealand offers positive interest rates while those in many countries are close to zero. The fact that New Zealand’s public borrowings are hedged also accounts for some trade in the dollar.

The governor noted that the dollar’s liquidity offers a distinct advantage for New Zealand over most small countries, as our companies and banks can borrow in New Zealand dollars and avoid currency risk.

**The banking sector**

Funding conditions for New Zealand banks have improved over recent months. A combination of increased household savings and a freeing-up of international debt markets earlier this year has enabled banks to source relatively more funds from retail deposits and stable long-term sources. However, as a large proportion of banks’ core wholesale funding is due to mature in coming months, there remain risks depending on how developments in Europe affect the markets from which banks source their funds.

Banks’ profitability has continued to recover from the trough in 2009, although it remains below pre-crisis levels. Expenses on non-performing loans have declined. The Reserve Bank considers it unlikely that profitability will increase much further while the demand for credit remains subdued and banks compete for market share.
In the light of the improved funding conditions, the Reserve Bank has now confirmed its intention to increase the minimum core funding ratio for banks from 70 to 75 percent from 1 January 2013.

**The demand for credit**

Aggregate bank lending grew by 3.3 percent in the year to February 2012, compared with close to zero growth in 2010. Despite this improvement, the demand for credit remains subdued in both the household and agricultural sectors, with only modest growth in lending to businesses. With households, the Reserve Bank puts weak credit growth down to a combination of factors: somewhat more cautious borrowing behaviour, a gradual decline in house prices, and the temporary effect of $3 billion in insurance payouts from the Canterbury earthquakes being used to reduce outstanding mortgages before rebuilding. Increased caution is also evident in the agricultural sector, with the income from high commodity prices being used to reduce debt. However, as the sector remains highly leveraged, growth in agricultural credit may remain limited. Businesses appear to have resumed borrowing modestly. The governor noted that some growth in credit is needed for a recovery; the important thing is that it be used for productive purposes, and that the demand for business credit not be crowded out by Government borrowing needs.

**The housing market**

The Reserve Bank notes that a period of stagnation in house prices has helped to redress the imbalances resulting from the property boom. Nominal prices are generally below their 2007 peak, although the Reserve Bank regards them as possibly still overpriced, and significant rises are not expected given the caution being shown by households and banks. Strong activity in Auckland over the past year has not been matched elsewhere. The Reserve Bank continues to expect a large increase in housing market investment, in Auckland to catch up with population growth, and in Canterbury for rebuilding. However, it expects to see this investment more broadly funded, with lower levels of debt than prevailed during the housing boom.

We were interested to note that the estimated number of people per dwelling has risen since 2009, after several years of decline. As well as reflecting past under-building in Auckland, the Reserve Bank attributes this to reduced interest in housing for second homes and investment, and a return to people buying housing to live in, using higher levels of equity.

**The insurance sector and Canterbury rebuilding**

Overall, the insurance sector has coped well with the Canterbury earthquakes and the transition to the new prudential regime. While some insurers have chosen to exit the market rather than register under the new regime, this was not unexpected and represents a very small proportion of the market. The provisional licensing regime came into force on 7 March, with 108 insurers provisionally licensed.

Insurers’ estimates of their claims costs from the Canterbury earthquakes now total more than $30 billion, although the Reserve Bank notes considerable uncertainty in these estimates as few claims have yet been settled and little rebuilding has started. At 31 March 2012, $7.6 billion had been paid out on claims, comprising $4.6 billion from private insurers and $3 billion from the Earthquake Commission.
We asked whether data was available from insurers about projected settlements and therefore what was the likely timing of the rebuilding, as previous estimates have been deferred repeatedly. The governor said he did not have figures, but insurers have strong incentives to get claims off their books; however, insurers, reinsurers, and EQC have had to work through a complex process. He acknowledged the frustrating delays brought about by continued seismic activity, bottlenecks in engineering assessment, and changes to building codes. However, he understands that insurers are working on processing settlements in batches, so that (assuming seismic stability over the rest of this year) rebuilding should be well under way in 2013. We strongly hope that aftershocks experienced during the past few days will not set back the rebuilding further.

**Financial sector regulation**

The Reserve Bank continues to work on measures designed to improve the regulatory environment for the financial sector, based on lessons from the global financial crisis. As well as taking the measures discussed below to reduce the chances of banks failing, it is working with banks to structure their systems for “open bank resolution”, to ensure that any failure is resolved quickly and a bank can remain open, minimising the impact on the wider financial system. We heard that such work is on track, although it is likely to take another year or so before all systems are fully established.

**Basel III**

In November 2011 the Reserve Bank set out initial proposals for implementing the international reforms to banking regulations known as Basel III, relating to capital and leverage ratios. It has now issued a second consultation paper covering three further elements of the Basel III capital adequacy requirements. The first relates to the operation of a conservation buffer, designed to ensure that banks maintain a buffer of capital above the minimum required ratio, for absorbing losses during periods of economic or financial distress. The second element would be a countercyclical capital buffer, which banks would be required to hold when authorities judge that system-wide risks are building from excess private-sector credit growth, and to release during a downturn to avoid a sharp contraction in the availability of credit. Because the focus would be on excess credit growth in the aggregate, it is envisaged that the buffer would be deployed only infrequently. The third measure would entail minimum requirements to ensure that all forms of capital instruments were capable of absorbing losses to support the viability of a distressed bank.

The bank plans soon to release draft standards based on the Basel III proposals, taking into account submissions received, and expects to consult on the draft standards around the middle of the year. We commend the Reserve Bank on this and other work to strengthen New Zealand’s banking system. We are pleased to see it consulting widely to ensure that the measures eventually adopted are appropriate to New Zealand’s conditions.

**Covered bonds**

As another means of improving resilience to financial market volatility, the Reserve Bank has developed proposals for a legislative framework for covered bonds. These are set out in the Reserve Bank of New Zealand (Covered Bonds) Amendment Bill, which was recently introduced to the House. Covered bonds are a form of debt security that provides bond holders with both an unsecured claim over the issuing bank and a secured interest over a specific pool of assets, called the cover pool. We were told that covered bonds are
common internationally, particularly in Europe, and this market proved through the financial crisis to be a relatively stable source of long-term finance. It also taps a large base of long-term investors (through fund managers, banks, and large superannuation funds) that is not available through other forms of funding. The Reserve Bank explained that the proposals would provide clearer rules for the development of this market in New Zealand, to help banks access diverse, stable funding sources.

We acknowledge the benefits of covered bonds as a form of “safe haven” funding source for New Zealand banks. But we are also aware that by providing bond holders with a secured interest over some bank assets, they create risks for depositors and other unsecured creditors. We understand that the bill as introduced proposes a limit on the assets that a bank could encumber in favour of a covered bond programme, amounting to 10 percent of its asset base. We asked the governor how the proposed limit compares with those applied in other countries. We were told that Australia has a limit of 8 percent, but because a different base is used, this roughly equates to the New Zealand proposal. Canada’s limit is 4 percent, and some countries have a 10 or 15 percent limit. Denmark has no limit, and some of its banks fund practically all their mortgage lending from covered bonds.

The Reserve Bank noted that banks’ traditional wholesale funding sources are generally unsecured, but it acknowledged that covered bonds could potentially disadvantage depositors and other unsecured creditors relative to the secured lenders. On the other hand, covered bonds would benefit unsecured creditors to the extent that they reduce pressures on banks by giving them access to a new source of long-term funds. We have no doubt that such issues will be considered further as the bill progresses.

**Payment and settlement systems**

From late February 2012 the payments industry made some important improvements in the way retail payments are exchanged and settled between banks. The Reserve Bank welcomes the new “settlement before interchange” arrangements, as they will reduce the risks involved in settlement, and so promote financial stability.

The financial stability report states that the new arrangements have worked well, and the payment and settlement infrastructure of New Zealand’s financial markets continues to operate effectively. The report does, however, note two recent incidents in which some retail payments were delayed before alternative systems were activated. The Reserve Bank will be investigating the more serious of the incidents, on 24 April, which involved the SWIFT technology which underpins payment exchanges.
Appendix A

Committee procedure
We met on 9 and 23 May 2012 to consider the Reserve Bank of New Zealand's financial stability report, released on 9 May 2012. We heard evidence from the Governor of the Reserve Bank.

Committee members
Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith

Evidence and advice received
McClay Good afternoon, Governor. Welcome, and thank you for coming before the committee this afternoon. We are to hear from you on the financial stability report, which was distributed to members just after 9 o’clock this morning. Can I apologise to you for making you wait for a little bit of time. We’ve had fruitful discussions in our work this morning, I offer you the floor to make some comments, and I’m sure there will be questions.

Bollard Thank you, Chair. Thanks, committee. We’ve got a few brief comments. It’s our financial stability report for May. We do this 6-monthly. It’s now required under the Reserve Bank of New Zealand Act. The broad story is that international stresses do continue, but we feel that the New Zealand financial system’s coping reasonably well with them. From a fragility point of view, it's very much an international story, and it’s a European story. So as you know, the European Central Bank injected significant amounts of liquidity late last year and early this year into their financial systems, and that meant their banks are now quite liquid, and their Governments now look quite funded, but on the other hand it is a holding operation, and their banks haven’t raised more capital and their Governments haven’t, in many cases, done reforms. Consequently, it really should be seen as a holding thing, rather than something that solves the European problems. Of course,
the whole question of austerity budgets in Europe has now taken on quite a political dimension with some recent elections, and led to some quite difficult choices there.

From our point of view, it does mean that we think we are going to continue to see some mini-European crises of the sort that we’ve seen over the last few days with the French and Greek elections, and the sort that we saw a couple of weeks ago with the Spanish banks. That sort of thing is going to continue, and it’s going to lead to ongoing pressure on bank stocks, on bond yields, and, more importantly for us, we do have to be alert to the issue of global funding markets going back to the sort of freeze that we saw a few months ago. On the US side, things are looking a little stronger, but there’s a big deleveraging job ahead of them. We also comment that in China and Australia the economies are both slightly softer than we’ve seen, but we’re not seeing significant financial concerns coming out of those economies.

Turning to New Zealand, you’ll be aware that the exchange rate has come off a little bit over the last couple of days, or in the last week or so. That really, we think, is a mixture of things. It’s partly a risk of environment internationally. It’s partly the market taking account of some softer New Zealand news and some softer commodity price numbers and, I think, probably also taking account of some views that we’ve expressed about the fact that we thought the exchange rate was really getting rather out of line, but we don’t know that for sure. Our national external debt numbers haven’t changed much. They’re falling, but they still remain high, at around 70 percent of GDP.

When we go down sectorally, through the different sectors in the New Zealand economy, the household sector is continuing to save. It does have very low credit growth despite some renewed interest in housing activity in New Zealand. The business sector’s pretty quiet. We’re seeing activities slowly recovering. They’re starting to borrow again, but only at very limited levels. The agricultural sector’s one that’s been through major debt consolidation, but borrowing is very flat, and of course we’re all looking at whether or not a softening in commodity prices could continue and could lead to any softness in that farm sector.

We always focus right in on the banking sector and other parts of financial institutions in New Zealand with this report. Bank profitability has recovered this year, but we do think it’s going to be quite constrained in the future. Non-performing loans look like they’ve plateaued and are declining somewhat which is pleasing. Lending growth is very constrained, very modest, at the minute, but we do note easier credit conditions with the banks. Bank funding looks firmer than it did 6 months ago with our last report, but risks still remain to that in Europe, and we do note that a significant proportion of core wholesale funding is set to mature over coming months, and that’s something the banks will be focused on. We talk and hear about our decisions and requirements around Basel III on
capital—so that’s the new international standards for capital of the banks—and core funding ratio requirements, and our movements towards open bank resolution preparedness in the case of any bank fragility. And we think the banks are generally meeting our regulatory requirements over the time period on that.

Just to conclude, we also note that there’s been quite a bit of action around insurance companies with the Reserve Bank. We’ve now gone through a very big provisional licensing exercise in line with the new Act. There’s 108 insurance companies now provisionally licensed. And the other dominant feature around the insurance world, of course, is the Canterbury earthquake.

One other point of note, and that is in the payment and settlements area. Normally a reassuringly boring bit of plumbing for the financial system, we do note a significant disruption that took place with the new Settlement Before Interchange retail system 2 weeks ago.

Thanks, Chair. We’re happy to answer any questions you might have.

McClay: Thank you very much. I might start this off. On page 15 you say the Reserve Bank remains supportive of the Government’s intention to return to surplus. Can you elaborate on that for me a little more, please?

Bollard: Yes. Well as you know, of course, there is no tolerance for anything but the very best of budgetary planning and forecasting around international funding markets at the minute. In addition, the private sector—the household sector—in New Zealand watches this quite closely as well with their own consolidation, and so we think it is important that the Government is on, and stays on, a track back to planned surplus. We’re merely reasserting that we think that that’s likely to continue to be the case.

McClay: And what effect would our failing to return to surplus in the near future and increasing debt have upon our financial stability in New Zealand?

Bollard: Well, we know we’re facing funding markets that don’t really have tolerance for poor government fiscal behaviours at the minute. Nobody wants to see New Zealand tarred with the same brush as some of the European economies. It’s very important we emphasise the difference there. That’s pretty clear in the market’s mind; we want that to stay that way.

McClay: Thank you.

Parker: I heard on the radio the last day or two that one of the reasons that New Zealand banks are finding it easy to borrow money is that we’re a better bet than other countries, which seems pretty clear that that’s true currently. Do you think there’s much risk that in years to come, the interest costs in New Zealand will become substantially higher because of our prolonged current account deficit and, indeed, trends towards greater net indebtedness? I know at the moment private indebtedness is dropping a little, but the predictions seem for that to be reversed in years to come.
Bollard Well, New Zealand is an indebted country—we do rely on borrowing funds. We do rely on borrowing funds externally so we’re always going to have a dependence on the market. As you know, we’re focused on trying to ensure that that is covered with long-term funding and domestic funding, and the signs there have improved. But the market’s pretty clear. There is a premium for risk now and that risk premium will, I think, be there for the future, and it would increase, were the markets to see New Zealand as a riskier lending proposition. That’s not just the government; it’s the private sector as well. We’re not concerned about that at the minute, but I think it’s going to be with us for a significant time in the future.

Parker Do you think—I see in one of your graphs here the 10-year bond spread between New Zealand and the United States is roughly 2 percent per annum at the moment. Do you see that continuing long term—the spread between New Zealand and the US in terms of interest rates being between 1 and 4 percent was the highest—just over 4 percent going back now to 1990? Do you think there’ll ever be a period when New Zealand’s interest rates sort of get closer to averages?

Bollard Could I ask Grant Spencer, Deputy Governor?

Spencer I think we’d always expect to have some spread. This is a small country, you know, and the US is a big, safe haven country. But interest rates generally around the world and in the US are close to zero at present at the short end. If you get to a point where the markets expect the United States to increase their federal funds rate—in other words, if you get back to more of a growth scenario in the US—then their rates will increase. There would be an expectation of rates increasing, and if ours are stable, then you could have some closing of that gap, because their rate structure is so low at present.

Parker Returning to your reporting on the fiscal stability of our financial sector in this report, as I understand it, which is a slightly different question to the fiscal position of New Zealand as opposed to our banking sector. Is that a fair—

Bollard We’d say the financial stability generally, by which we would mean all the sectors in New Zealand—so, government, fiscal, household balance sheets, business sector, and the banking sector.

Parker And in terms of the—our banking sector seems by world standards to be in good heart and our private sector seems to be heavily indebted by world averages, and our government sector seems to be pretty good—

Bollard We’d say generally; in the private sector, we’d say the household sector as opposed to the business sector.

Parker Yeah. So would you say that the greatest threat to the future financial stability of New Zealand really lies in private sector debt, rather than either government debt or the banking sector stability?
Bollard

Oh, I think we'd point to two areas. I mean, the government fiscal side is important because there is much more focus on this in Europe at the minute. But the big increases over the last 10 years in debt have been in the household sector, and they've been funded through the banking system, and that's been funded foreign. So it's that foreign funding that we've all seen as a vulnerability.

Smith

We saw a very significant rise in household to debt incomes in the last decade, but have seen that come back in the last 2 years. You've identified that level of household debt is probably the greatest risk for New Zealand looking forward and the Government deliberately made the tax switch to try and switch the incentives away from consumptive spending. What level of confidence do you have over the 5-year window of that positive trend in household debt over the last 2 years continuing out over the next, sort of, 5 or 6 years?

Bollard

We think households in New Zealand are deleveraging generally—much more cautionary about their activities. We know that that's happening in a number of OECD countries. Yes, the tax changes have meant less incentives to go back into property in the same way, but that's a really—deleveraging is a very slow process. On the flow measures, it happens reasonably quickly, but the stock measures debt to house value, for example, can happen very slowly, but at least it's happening in a growing economy. If you're looking to do that in an economy that's contracting and house values are falling, it's very difficult indeed.

Smith

The big question internationally at the moment is what's going on in Europe and the election results both in France and Greece, rejecting austerity programmes. What level of exposure does New Zealand have to those European markets and debt as compared with some of our key comparatives, whether it be Australia, United States, Japan, or China? Are we more exposed if there are further difficulties in Europe—those countries—or less exposed?

Bollard

We don't think we're exposed, particularly from a direct trade channel point of view. We think we are potentially exposed from a long-term secured funding for the bank's point of view. Those are the markets that started freezing up again very late last year, and since opened up. That's the main thing—that we focus in on this. The banks are very aware of that. They're not encountering problems at the minute, but we do have to expect to see these mini European crises and be prepared for that.

Norman

In terms of kind of judging how we're doing, which you necessarily get into as part of looking at financial stability, I mean, it seems to me that the current account deficit needs to be at the heart of our assessment. Because if the projections are right and we're going to run the current account deficit back out to 6.9 percent by 2015, I think was the Treasury projection then fundamentally we are not behaving in a sustainable way. I mean, that would
just be my—is that your reading of the situation—that we’re going to run this thing back out again?

Bollard In shorthand, we’d go to the net external debt position, which is obviously related to the current account deficit, and there we see that we’re not in a risky zone, but we’re not that far below some of the high external balances in the world, and we don’t want to be in that zone.

Norman But if we continue to run large current account deficits, then, inevitably, our net external position will get worse, by definition?

Bollard Well, yeah—I mean, it also depends on why we’re running external—why we’re running current account deficits, and a country like Australia has done that persistently for 100 years. Provided you’re basically investing in an infrastructure rather than just consuming, then that’s sustainable. Now, are we doing that? Well, that’s a judgment sort of matter. I think we’d all feel comfortable if we see it coming off, really.

Norman That then, I guess, engages in the rebalancing kind of debate, which is essentially another way of talking about what you’ve just described. And you say, once again, as you’ve said many other times, that the high exchange rate is preventing that rebalancing. So if, on the one hand, what you’re saying is we’re not getting the rebalancing that we need, and we’re also saying we’re going to run another big current account deficit, then actually that is a problem, because we’re going to get a big current account deficit without doing the rebalancing of the economy.

Bollard Well, we’d expect to see any market concerns about the failure to rebalance being reflected through in the exchange rate. We all know that that’s not a nice simple relationship. It’s a volatile one, and sometimes it overshoots—it is overshooting. It’s actually, of course, been coming off over the last little while and it will be interesting to see where that all goes, but if we’re caught with a growing external deficit and an uncompetitively high exchange rate, then, yes, that is a problem.

Norman Then it seems to be the exchange rate is one of the critical issues, and we had this discussion last time. We talked about the Swiss central bank and their rather unconventional methods. I’ve since followed up a little bit on that, because you were saying it’s not such a good idea or whatever, but the IMF are just did a report on the Swiss central bank, and their very unconventional approach is to say: “We will print endless Swiss francs in order to cut the level of exchange rate.”, and the IMF said it was an appropriate response to the situation they found themselves in. Do you think the IMF was wrong?

Bollard Well, I haven’t seen that report. I mean, the IMF has, of course, changed its views on some of these things over the last couple of years. But, as we’ve always said, the Swiss approach is quite an unusual one, because there they are, they’re an enclave with their own currency, and well managed in a Euro
zone which is in a very sad state. There’s been huge capital inflows in, partly because of the economy, but partly because of their banking system. It’s an economy with almost no inflation, and so they haven’t had to worry about sterilisation in their interventions. But having said that, they did take an unconventional approach and it has partly worked for them, but at a high cost.

Norman So just on that question of high cost, because this is the nub of your—where you disagreed last time—you said it cost all this money—it seems to me that what the Swiss have done is print billions of francs and buy slightly less billions of euros with those francs in order to keep their currency at a certain level. If at a certain point in the future their currency gets worse and if they try to buy francs back again, they’ll end up with less francs than they started with. But from their point of view they started off with nothing, printed off a whole bunch of francs, and they now have a whole bunch of euros, which is why they could contribute to the IMF fund. I mean, so when you say they’re going to take big losses, they’re just paper losses; they’re not real losses from the point of view of the Swiss central bank.

Bollard And that all depends on how long they’re prepared to hold on to them, and of course they must follow international accounting standards with their mark-to-market requirements. So you can call them paper losses, but I wouldn’t imagine a central bank would feel too comfortable incurring very large losses on that long basis.

Hayes Thank you very much for your report and your comments. Figure 3.11 sectoral employment growth—yesterday the Australian unemployment figures seemed to be something like 9.3 percent. We’re at about 6.6 percent. Is the difference reflected in the fact that we are driving our economy better than they are—than the Australian Government?

Parker Ask him whether that unemployment figure is right.

Hayes Yes, but it, you’re not aware of – OK, we won’t go there—don’t worry. My second question comes around to your comment around the Basel III requirement, and you said that our banks were generally performing well. Are there some exceptions to the “generally”?

Bollard On the Basel III requirements, what we’ve done is—as you know—we’ve put in place a core funding requirement for liquidity purposes. The banks are meeting that. We actually delayed the last step of that in November last year. We’ve now said that that’s back on track. The banks are all meeting that, and they need to meet it with a bit of a buffer. On the Basel III capital requirements, they’re generally in line, but those are going to take a couple of years. There’s a timetable for those. We’re confident they can achieve those. Currently, the market’s sort of saying to the banks: “You need those levels anyway.” So, in answer, yes. We’re reasonably confident about that.
Cosgrove Just following on from Mr Hayes’ query, could you, Governor, or your staff confirm what the Australian unemployment rate is, to the best of your knowledge, because I think it’ll help—

Bollard Oh, the Australian unemployment rate’s lower than New Zealand’s.

Peters Are you working on the figures of 1 hour’s work—

Bollard Are we going on the official Australian figures?

Peters No, no, no, the New Zealand figures. If a person who gets a job for 1 hour a week, that person is deemed to be employed. Do you think that’s a fair measure?

Bollard Well, we can only use the suite of measures put out by Statistics New Zealand. And, of course, we don’t just look at unemployment numbers; we look at participation numbers, employment numbers, hours of work, and they’re new employment indicators, so some of that stuff does come through. I don’t think we’re getting a distorted figure, probably.

McClay But just on that, isn’t that the same case if somebody’s sitting at home saying they’re interested in a couple of hours’ work—maybe flying an aeroplane—and is judged to be unemployed?

Bollard I can’t remember what our definitional cut offs are, so I don’t know—Bernard Hodgetts can help.

Hodgetts Yeah, but I believe it is a very low hourly requirement before you’re counted as being employed or not—

Peters It is low.

Hodgetts It is very low.

McClay So I’ve got a relation who would love to fly airplanes. He can’t see very well. He said he was looking for a number of hours work—

Cosgrove Is that John Banks? I’ll tell him!

McClay I only say that because it’s his birthday and he’s likely to look in the newspaper. The point that I’m making is, contrary to what Mr Peters has just said, somebody may only have a few hours a week where we count them as being employed. It’s the same if they have unrealistic expectations of what work they may look for.

Peters Look, the IMF said, just 2 weeks ago, that the New Zealand currency is significantly overvalued by a massive 20 percent. If you look at the page 19 figure of agricultural debt to agricultural earnings, and that’s a very, very dramatic rise—

Smith Improved since we’ve been in Government.
Peters Pardon?

Smith Improved since we’ve been Government and _

Peters For goodness sake, we’re not here to try _ propaganda. We’re trying to learn something, and maybe if you keep quiet you will. The real point is here. Where do you think we could actually do something about what is a massively overvalued currency, the most volatile currency in the whole world, and the most inflated for any country excepting, I think, about six countries that are inflated more than ours. These three things are very serious for a country that is export-dependent.

Bollard We don’t think that there’s very much that can be done where the benefits would outweigh the distortionary cost of doing things. We’ve spent a lot of time looking around the world at different measures. We’ve talked many times about the sort of classes of things that are going on. We see very little that would work for New Zealand other than the very limited intervention policies we’ve got currently. We think that a lot of this distortion is coming from quantitative easing from the major economies. There’s not much we can do about that. We think this is gradually going to improve over time. There’s now quite a lot of other economies who do have freely floated exchange rates, although, of course, a lot of them are complaining at the moment, as well. If we could find a tool that improved, we wouldn’t hesitate to use it, but we think everything we’ve heard about has got some downside problems.

Peters Well, you don’t think that Malaysian Prime Minister Mahathir was right, for example, when he sought to react to the Asian crisis?

Bollard Well, he was talking about a totally different financial system; a set of banks that had very major problems, and it may have been right in the Malaysian context, but that was a country that already had significant capital controls, and he put more controls on.

Peters Or there’s Singapore, and South Korea, were very successful with their currency policies.

Bollard Singapore is very unusual. It runs an exchange rate - targeting system to try and achieve price stability. It, of course, is an economy that couldn’t be more different from New Zealand’s. It’s a world hub. We’re a world primary producer. We’re totally different.

Bennett What’s the—just to sum up, the dollar over the last week. How much has it gone down?

Bollard It’s roughly come off 3c against US and then, broadly, on other currencies as well, but we’re moving with the Australian dollar. Of course, there’s been a lot more concern in Australia about their currency, and, indeed, it’s been doing some damage. We seem to be moving roughly together at the moment.
Bennett And the expectation in Australia is that there it continues to go south?

Bollard Well, as you know, we can’t forecast it, and that’s one of the sad this about exchange rates. But in so far as the market seems to think the Reserve Bank of Australia may actually cut rates further, then they seem to think there could be some downside to it.

McClay Australia is our No. 1 trading partner. How has the exchange rate fared against them, as we have appreciated, as to other countries?

Bollard Well, of course Australia was one country we were very competitive against. We’re still quite competitive against them.

Goldsmith I just wanted to get a clearer understanding from you about the dangers of debasing currency—or watering the milk, is another way of explaining it—which seems to be being proposed by the Greens and Winston Peters. I mean, if it was such a solve-all to problems, we would all use it, but it would be great if you could just explain what some of the dangers are.

Bollard Well, I mean, I don’t think anybody wants to see a debased currency, because that would lead to inflation and would reflect poverty in New Zealand compared to the rest of the world. But, being realistic—and I don’t think we’re in any danger of seeing that either. We’re some way away from that. We want to see the highest currency that is consistent with our competitive position on a long-term, sustainable basis, as that is a measure of New Zealand’s richness compared to foreigners. But, I mean as is reflected around the room, we do think we’ve been on a higher level in recent months.

Peters Just to complete, then, this question. Have you got any explanation for why this country with 4 million people out here in the South Pacific, above Antarctica, should be the 7th most traded currency in the whole world; and is that of value to the New Zealand economy or not?

Bollard Well, look, the Bank of International Settlements comes up with various figures. They’ve generally thought we were around the 11th or 12th, not 7th. That is still very highly traded. Overall, the more trading there is, the deeper the market, and the more liquid the currency should be—there should be some advantages out of that. But that’s not to say that there aren’t, clearly, positions being taken that have got no particular relationship to New Zealand’s competitive position or, of course, to our trading needs. We still have this exchange rate, which is a lot higher than most. It has meant that we’ve always been able to get funding, whether it’s from a Japanese housewife or East Asian central banks or European markets. That is a big advantage, but there’s been some definite disadvantages on that level, as well.

Goldsmith Figure 4.2, I found interesting—credit growth by lending sector, which fell away off the cliff in 2008, and has been very low; slowly picking up now. What kind of effect is that, do you think, going to have on growth in the
next few years in terms of, you know, businesses and individuals having access to credit, and how do you see that panning out?

Bollard  Yeah, I mean, we don’t want to see a creditless recovery. We want to see one that’s sensible amounts of credit. We particularly focus on watching business sector borrowing. It’s picked up a little bit, but it is still very low. We’d like to see it funding sensible investment for a longer-term sort of future, and that is a concern. On the housing side, people are behaving differently. They’re certainly quite interested in getting back in the housing market, but not in exposing themselves too much with their debt levels. Again, we think that’s broadly appropriate.

Goldsmith  Just following up on that, what can a Government do to create an environment that encourages a steady growth of that credit?

Bollard  Oh, I mean, we think the Government should just look for stable settings and ensure that you’re not getting private sector crowd out from a Government sector that requires very large amounts of funding itself.

Clark  The Reserve Bank is seeking legislation to empower the issuing of covered bonds and I’ve got a few questions around that—firstly, just wondering if you could offer some comment about overseas experience in comparative countries, and in respect of how long they’ve been doing this, and what kind of levels of bond they have? I think a 10 percent level is proposed for New Zealand.

Spencer  Well, covered bonds are actually quite a common capital market instrument, particularly in Europe, where they’ve been used, you know, for 50, 60 years or longer. In particular, countries like Denmark, Germany, they’ve been used a lot by the housing banks—banks that are raising funds to put into mortgages. Now some of them have restrictions. We’ve put—as you know, we’ve had the 10 percent limit for our banks here. It varies across other countries. Some have a 10 or 15 percent limit; some have no limits. In fact, there are one or two Danish housing banks that are practically all funded totally through covered bonds.

Clark  Examples like—where does Canada sit, Australia, the US?

Spencer  Well, Australia has come in with 8 percent, although their definition of their ratio means that it’s pretty much the same as our 10 percent, just works off a different base. Not sure about the Canada ratio; I’ll have to get back to you on that. I don’t think there’s any restriction in the US, but the covered bonds are not a common form of funding there. It’s more in Europe.

Clark  Could you comment a little bit about the effect on unsecured creditors—you know, those who have already perhaps invested in similar investments that may be affected by a subsequent issue of covered bonds?

Spencer  Well, the basis for the limit is the fact that the more secured funding a bank does, then potentially that dilutes the interests of the unsecured creditors.
And so, you know, if you left the banks to do what they wanted, they would have that in mind, and so they wouldn’t want to have too much secured borrowing. But just to be on the safe side, we put the 10 percent limit in that.

An argument against them would be that they’re essentially lowering the risk for institutional investors at the expense of, often, smaller local investors who already have that unsecured right in the situation where they’re being issued.

Yeah, so I mean most of the borrowing of the banks is unsecured—both the depositors, and also unsecured funding—that’s the traditional means of funding—the wholesale funding. Most of that is unsecured, as well. But you’re right: the secured lender to the bank, they’re going to have first dibs on the assets and so, potentially, in a relative sense, are disadvantaging households.

What risk are you trying to cover off? I mean, I appreciate you’re probably not wanting to introduce this just so that some people are worse off than they are currently. There is, I’m sure, a risk you’re trying to cover off with this proposal. Could you say a bit more about that?

The main advantage is to give the banks diversified funding sources, and also access to a market that is very stable. The covered bond market is very stable, and it kept going right through the financial crisis. So given the nervousness around the world and around the markets, it’s good to have a safe haven to the market that you can go to, and the covered bond market is effectively that.

Who do you expect would be the main investors in that market?

They are banks, fund managers, big superannuation funds in Europe—the sorts of people who basically want pretty safe investments.

With the housing market, you note in your report that in Auckland there’s a shortage of that new housing stock for a growing population, you’ve got the Christchurch rebuild coming in, and you’ve also got credit growth being pretty slow in that area. How do you think all those things will reconcile, and what’s your pick on how the housing market, financially, is going to pan out?

We think that we’ll see a significant increase in housing market investment. We’ll see more new starts in Auckland and related, but we’ll see those broadly funded with a lower level of debt. We’re not expecting to see very much pressure on pricing from that, principally because we think the house prices are pretty fully priced, and possibly overpriced, already, and that New Zealanders sort of understand that. We’re not hearing that New Zealanders are expecting a lot of upside on house prices. The Christchurch story, of course, is quite different, and we still hold to our view that next calendar year is when you really see a significant amount of rebuild. It’s probably
pretty inevitable, but it’s been a very complicated story of insurers and waiting for seismic stability, and having to negotiate arrangements with other insurers, reinsurers, and EQC. That is, as you know, very complex.

Bennett How do you get that housing build to grow if people aren’t borrowing any more without a risk of, as you say, the prices not going to go up? How does that actually eventuate?

Bollard Well, our estimates of, say, non-Canterbury housing recovery are not like the 2000s, which had a lot price pressure and a lot of interest in investor housing. We’re not seeing that so much. We’re seeing people expressing interest in housing for that old-fashioned reason of living in houses, and that’s happening with more equity in them. Banks are being quite out there in terms of trying to attract more customers. Now, you’re seeing lower mortgages. A lot of it is still—most of it’s still floating, or near floating. People do have that equity; I mean, the markets have worked. People haven’t got necessarily poorer over the last little while, and they’re going in on a more cautious basis.

Bennett So that’s like your first-home buyers coming in and purchasing their own home. How does that relate to the stories you hear of Auckland, where the more exclusive areas are going up?

Bollard Well, I think we always hear some media stories there—that’s good headlines. We’re not convinced that that’s a big change in the middle of the market.

Cosgrove I’m just interested in your comment about the price of the rebuild. It’s almost been 2 years, with respect—not your comments, but we have heard all sorts of predictions, a guess of 6 months, next year, whatever. Your prediction that the gun will go off in a big way next year. What specifically is that based on?

Bollard It’s based on continuing seismic stability for the rest of this year.

Cosgrove Other than that?

Bollard It’s based on insurance companies continuing to sort out some of these contractual things and sort of batching through settlements by area in Christchurch, and it’s based on the fact that there’s been a heap of construction and engineering companies that have had a very long time to gear up for this and get through the sort of bottleneck problems that might otherwise be there.

Cosgrove So have you seen specific data—and if you have, I think the numbers from Canterbury would be very interesting—from insurance companies in respect of batched-up work, settlement completions, projections of settlement completion dates—have you seen anything—
Bollard No. At institutional level we’ve heard from them about quite relatively limited numbers of settlements, but an intention to try and batch those up.

Cosgrove Well, with respect, I think they’ve demonstrated a large number of intentions to settle; although the intentions haven’t come to much, so you might want to scratch further.

Bollard Well, if they say they want to settle and insurers want to get these things off their books, and we think that probably is their incentive to do that. So I don’t think they’re holding it up.

Smith I was interested in the analysis around your population per dwelling ratios, and was interested in what was the underlying link with the house prices. I note, for instance, that there was quite a sharp decline in dwelling ratios over the course of the last decade, and there’s been some correction. What’s the link there with financial stability? Are you saying in tighter times, people are moving to have more persons per households, particularly markets like Auckland? Or is it that because there was a speculative element to the housing market over the course of the last decade that we over-built the housing stock and thus saw that ratio come down?

Hodgetts Well, I think, indeed, there’s probably an element of all those things that drove the ratio lower over the last decade when we were building houses—you know, a significant increase in housing stock over that period. We know that a lot of people opted to build second homes and that kind of thing, which, of course, again drives the ratio lower. And there’s also been demographic shifts over, probably, longer than this decade, in terms of fewer people per household, the lower numbers of children, and so on. So this quite fundamental drive is pushing it down over the last 10 years. The recent increase we believe is a reflection of people becoming more cautious about construction, and possibly under a little bit more financial pressure, so the ratio has gone up over the last year or two. We think that is likely to signify that at some point the construction will need to get under way again, and, broadly speaking, we’d probably see the ratio start to fall again when that happens.

Smith Does the Reserve Bank have a view about what, long-term, we want to see those dwelling numbers per house, or is it something at which the bank is effectively agnostic?

Hodgetts I think the latter.

Bollard That’s up to New Zealanders. We want them to have as much choice as possible to do what works.

Peters In your report, very interestingly, you were I think putting this together before the French election and the election in Greece, and you’ve wisely shoved in a little rider that says—page 3, paragraph 2—“However, the European situation remains fragile” and probably thank God for that. But put aside New Zealand’s situation, there’s got to be a day of reckoning
coming in Europe, because you’ve got the French, the Greeks, you’ve got paralysed Belgian and State Government, Holland. Do you think it’s possible that some of these bailed-out banks are going to take a bath here to get them past this political stalemate?

Bollard Sorry, in New Zealand, do you mean?

Peters No, no, forget about New Zealand—in Europe. Because you’ve got, first of all, a Mexican stand-off building in Europe. Do you think some of those banks involved in the bailout and not just about bailing out the economy are going to take a bath of some proportion?

Bollard Yes.

Parker Can I just ask one follow up question for a start on covered bonds. You said that the vast majority of lending to the banks both from wholesale and retail is currently unsecured, which implies that currently some of the lending, albeit a minority, is secured, albeit not through covered bonds. Do you expect that some of that other secured lending will reduce in favour of covered bonds, or do you think the total amount of secured lending ahead of unsecured creditors will increase?

Spencer Well, the other secured borrowing is relatively small, and there’s not a lot of market for mortgage-backed securities, for example. That really hasn’t taken off since the crisis, so covered bonds is the main part of it.

Parker My second question, then, in that part—a quick follow up to that then—is then one of the benefits for unsecured creditors that there’s less likely to be credit pressures upon the bank if they can access the covered bond market and gain long-term credit loans?

Spencer Yes, I would agree with that.

Parker The other query I wanted to follow up on—something Winston Peters asked you—you’ve acknowledged that New Zealand’s the 11th or 12th most traded currency in the world, and given the relative size of our economy, that’s a large amount of trading. Has there been any analysis done as to what that implies of a constant demand for the New Zealand dollar over time—that increases demand for the dollar and therefore underpins a slight margin in our currency being higher than it would otherwise be?

Spencer One of the factors behind us being highly ranked in terms of trade and currency is that most other small countries don’t borrow in their own currency. New Zealand has the advantage that foreigners are willing to lend to us in New Zealand dollars, and it means that we don’t take currency risk on our borrowing, so companies, banks are borrowing in New Zealand dollars. Many other countries will say, no, they’re not interested in lending in local currency, but will lend to you in US dollars, and then you go and manage your currency risk. But in New Zealand, the banks and others don’t have currency risk, so that’s a very positive thing. But one of the
implications is there’s a lot of trading of New Zealand dollars out there, part of which is because we’re hedging our borrowing, and that’s why we’re up the ranking.

Parker The reason I ask is that a senior and experienced economist sort of approached me recently and said that he thought that one of the reasons why our currency stays up is because people trade so much in our currency, in turn because we’re so predictable in our settings. So that if you were someone that had some short-term assets that you needed to put somewhere; it’s a very low-risk thing to put them in New Zealand because nothing ever changes here.

Spencer Well, you know, the world doesn’t park their liquid assets in New Zealand. We have a slight positive interest rate so there may be—you know, there’s the old carry trade. There may be some element of that—that some short-term assets are held here because we’re paying some interest rather than zero interest—but generally, you know, we are a small currency and the money will be invested here because we are viewed as one of the few sort of growth prospects. If people look around and say: “Where’s a country that has a liquid market and also a prospect for growth in the medium term?”, we’re one of the countries that come up, and so we’re a victim of our own reasonably good prospects in that sense. We’re viewed as reasonably safe and with some outlook for growth. A lot of other countries—

Peters You sure you’re not telling us that is the reason why our dollar is described by the IMF as being overinflated by 20 percent—plus—some say it’s 28 percent. You’re not giving that reason you first gave to that last question as the answer to that, are you? Because that’s the first time I’ve heard any other person—anybody commentating on this—say that is the reason. So how did you get that insight?

Bollard Well, this should be standard knowledge.

Peters No that’s not standard knowledge.

Hayes It’s in primer 1.

Peters Sorry, that’s not 101. In fact, it might be part of the cause, but it surely isn’t the cause. It’s more—what Mr Parker said—because of your settings. You encourage it.

Bollard Well, I mean we’ve put in place settings for stability—absolutely; that’s what we do. But let’s remember why we need funds from overseas. It’s because New Zealanders borrowed and haven’t saved. So, I mean, ultimately that’s got to be the root cause.

Peters With respect, look, three out of four of our savings dollars and currency in the Cullen fund and in KiwiSaver are offshore; three out of four Aussie dollars are onshore in Australia. That’s not the only reason surely.
Bollard: Oh, well, that reflects the size of the markets.

McClay: Good. Look, thank you very much, Governor. We'll leave it there. Thank you for your time with us today.

*conclusion of evidence*
Reserve Bank of New Zealand's Monetary Policy Statement, June 2012

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Todd McClay, Chairperson)
July 2012

Presented to the House of Representatives
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Reserve Bank of New Zealand's Monetary Policy Statement, June 2012

Recommendation
The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, June 2012, and recommends that the House take note of its report.

Introduction
This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, June 2012, and the central issues we discussed with the bank in our examination. Our approach to considering the statement, our membership, and the transcript of the hearing of evidence are set out in the appendices to this report.

The June 2012 Monetary Policy Statement announced the decision of the Governor of the Reserve Bank to leave the Official Cash Rate (OCR) unchanged at 2.5 percent. The OCR has been held at its current record low level since March 2011, when it was reduced from 3.0 percent. Inflation is expected to remain near the mid-point of the 1–3 percent target band over the forecast period.

Reserve Bank’s reasoning
The uncertain situation in Europe has caused deterioration in the global economic outlook since the Reserve Bank’s last monetary policy statement in March. Commodity prices for New Zealand’s exports have also declined—the result both of lower global growth, and of increased agricultural supply. While lower export incomes have been partly remedied by a marked depreciation in the exchange rate over the past month or so, New Zealand’s economic activity is likely to be constrained by these weaker external conditions, and by the fiscal tightening signalled in Budget 2012.

Independently of any change in the OCR, monetary conditions in New Zealand have eased significantly due to the lower exchange rate, lower term interest rates, and increased competition among banks as they chase market share in an environment of weak demand for credit. Banks have reduced mortgage rates considerably since March, and many are now well below the current weighted average mortgage rate of 6 percent. Housing market activity continues to increase.

Growth in GDP is expected to pick up, but a little more slowly than previously envisaged because of lower commodity prices. Inflation is expected to be a little higher than in the March projections because of the announced Budget changes to excise taxes, but still comfortably around the middle of the target band.

As a result of the downside risks from the international environment, and because the market has eased monetary conditions itself, the Reserve Bank has seen no need to change...
the OCR from its present level, which it sees as appropriately stimulatory in the current conditions.

**Growth prospects and uncertainties**

Growth in the year to March 2013 is now forecast at 2 percent (down from 3.1 percent in the March projections), rising to 3 percent the following year (down from 3.7 percent). The slower GDP growth mainly reflects lower recent and projected commodity prices. Another factor has been recent revisions to historical GDP data released by Statistics New Zealand on 15 May. This data indicates more muted GDP growth over the recent past than was previously thought, with real GDP growing by 1.1 percent in the year to March 2012, rather than 1.8 percent.

Revisions by Statistics New Zealand are not unusual. The revised figures, based on newly-available information, suggest that real consumption per capita has not grown as much since the global financial crisis as was believed. This appears to accord with other indicators such as weak household credit growth. Such difficulties in assessing the current state of the economy are compounded by the uncertainty over international developments, discussed below, making the outlook particularly uncertain at present.

Like the Minister of Finance in our Estimates hearing the previous day, the governor emphasised the difficulty of forecasting at present because of the complex economic and political stresses and rapid developments in Europe. The governor said that while the domestic environment is able to be forecast, there are many possible outcomes from the euro area debt crisis. Rather than trying to quantify a scenario, the Reserve Bank has included a section in the monetary policy statement (summarised later in this report) setting out the ways in which deterioration in the euro area could affect the New Zealand economy.

The Reserve Bank now sees GDP growth improving a little more slowly than it did in March—to just over 3 percent by the middle of 2013—and inflation rising a little more rapidly than it previously envisaged. We were interested to note that the Reserve Bank’s forecasts are somewhat more cautious than those of the Treasury, on which the Budget outlook was based. As a consequence, the Reserve Bank does not project the Government’s operating balance returning to surplus until 2016/17, two years later than the Treasury does. We note that the Prime Minister has recently commented that the Treasury may revise its forecasts to accord more closely with the Reserve Bank’s in the light of the risks from the European debt crisis, but he said the outlook is particularly unclear at present.

**Return to surplus and external liabilities**

We asked the Reserve Bank about its forecast that the Government will return to surplus two years later than under the Treasury’s scenario, and what this would mean for New Zealand’s net external liabilities. We heard that a more persistent deficit would add approximately $10 billion to the stock of Government debt by 2016/17. This can be compared with an expected increase of about $70 billion in New Zealand’s total net external liabilities over the same period.
The outlook for continued growth in New Zealand’s external liabilities indicates that considerable work is still needed to rebalance the economy and broaden our export base. The governor agreed that the results from efforts to rebalance have been disappointing so far.

**Productivity**

In its growth outlook, the Reserve Bank has assessed that the economy’s potential output, based on measures of productive capacity, will grow by only about 1.8 percent on average over the next three years, down from 2.2 percent in the March forecasts. It estimates that productive capacity has averaged annual growth of 1 percent over the past three years. The bank explained that three factors contribute to this slow growth rate: a recent lack of investment, which has left New Zealand with a lower stock of productive capital, a relatively high level of unemployment despite an increase in jobs advertised, which suggests some rigidity in the labour market, and the generally uncertain environment which makes businesses reluctant to take on risk. While this aspect of the growth outlook is of considerable concern, we note that reduced potential growth is affecting many OECD economies since the global financial crisis.

**Risks from European instability**

Elections in Greece and France were due to be held a few days after our hearing, but the governor did not expect them to provide any immediate indication as to whether or not Greece would remain in the eurozone. The risk of severe deterioration in the European debt crisis has increased since the last monetary policy statement, and the Reserve Bank is monitoring developments closely. While the governor observed that a Greek exit from the eurozone could occur in a “moderately tidy way”, the main concern is the risk of contagion from a Greek exit to other European countries, particularly Spain and Italy, affecting the rest of the world through trade and banking links.

We asked about the relative weighting the Reserve Bank gives to these possibilities. The governor said the bank estimated a roughly 60 percent chance of Europe “muddling through”, with small crises but possibly no exit from the eurozone; a 30 percent chance of a Greek exit; and a 10 percent chance of a wider exit by peripheral countries. We note that this appears similar to the assessment expressed to us by the Minister of Finance the previous day.

While New Zealand has relatively little direct trade exposure to the euro area (it accounts for less than 7 percent of our exports), Europe is an important purchaser of exports from China and South-east Asia. A sharp downturn in European growth would have important flow-on effects for New Zealand if it weakened growth in these trading partners and depressed commodity prices. In addition, there are risks for the banking system if “contagion” spread to peripheral countries like Spain and Italy, which have liabilities with German and French banks. In such a case, New Zealand’s funding markets could come under stress, as well as its trading links.

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1 Monetary Policy Statement, June 2012, p. 27 and Figure 4.11, p. 18.
Possible monetary policy responses

The governor said that if European pressures started to cause difficulties for New Zealand banks in accessing funding, the Reserve Bank would expect to employ the kind of measures it had used successfully during the global financial crisis. In particular, it would plan to make additional liquidity facilities available; if necessary it could also consider reducing the OCR, which there is room to do, but it has no plans to do so at present.

Exchange rate

On a trade-weighted basis, the New Zealand dollar has depreciated by about 6 percent since the March monetary policy statement. The governor described the exchange rate as being in a more comfortable position than it was in March, although its value is still somewhat high relative to New Zealand’s global competitiveness.

We again discussed with the governor possible ways of reducing an exchange rate perceived as overvalued. The governor said the Reserve Bank does not see a close relationship between the OCR and the exchange rate. While a reduction in the OCR might cause the exchange rate to fall, the result was uncertain and there might be other unintended effects. Moreover, he observed that a reduction in the OCR in excess of that needed for monetary policy reasons could increase costs within the economy, thereby actually reducing export competitiveness. As for the possibility of pegging the exchange rate, the governor said the Reserve Bank, along with others around the world, is watching the Swiss experiment closely. While Switzerland has succeeding in pegging the Swiss franc against the euro, it was less successful against the yen and US dollar, and the cost was high when marked to market. He did not believe such an option would work in New Zealand’s situation.

The governor reiterated that the Reserve Bank’s view is that the main factor in the relative appreciation of the New Zealand dollar has been the policies of quantitative easing exercised in the major economies, and there was little New Zealand could do to directly affect them.

The insurance market and Canterbury rebuilding

Since post-earthquake rebuilding will make an important contribution to GDP growth over the next few years, we are concerned about any potential causes of delay. We asked the governor whether the insurance market is working as it should, or whether access to affordable insurance or reinsurance is likely to hold up the rebuilding. The governor told us the reinsurance market has generally worked reasonably well, considering this was the third-largest earthquake in terms of damage that the insurance industry has ever seen. Its inquiries suggest that residential and commercial insurance are available for existing customers, but hard to get for new customers.

In terms of costs, the governor noted that reinsurers are reassessing the risk weighting they had given to Australasia, which had been relatively light in the past. Insurance and reinsurance costs have increased and might well stay elevated for a couple of years, but he believed that over time the industry would narrow its risk assessments, and limit the cost increases to areas with a clear seismic risk.
Housing market

Activity in the housing market continues to increase, supported by recent reductions in mortgage interest rates. We sought the Reserve Bank’s assessment of trends in house prices, as recent media reports suggest that most increases have been in Auckland and Canterbury. The Reserve Bank said it has not specifically studied the geographical spread, but it appears that the recent 5 percent lift in house prices has been quite broadly based across all price brackets, which suggests that it is not confined to Auckland. As to why more housing is not being constructed, the governor said that buyers are probably more reluctant to take on debt than in the past, and property development is being approached more cautiously after the finance company collapses.
Appendix A

Committee procedure

We met on 14 June and 18 July 2012 to consider the Reserve Bank of New Zealand's Monetary Policy Statement, June 2012. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O'Donovan.

Committee members

Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith
Appendix B

Corrected transcript of hearing of evidence 14 June 2012

Members
Paul Goldsmith (Chairperson)
David Bennett
Dr David Clark
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith
Michael Woodhouse

Witnesses
Dr Allan Bollard, Governor of the Reserve Bank
Dr John McDermott, Head of Economics
Dean Ford, Manager, Forecasting

Bollard [recording commenced after commencement of evidence]… for a long time. You can clearly see other possibilities around the Greek elections and outcomes part of all that. We haven’t tried to factor those in, but we are happy to talk about those, if you wish to take that further.

In the meantime the risks tend to be on the international side. Our forecasts incorporate a slightly lower growth rate from China, slightly lower growth rate from Australia, and a bit more strength for the United States as we are getting some better data out of there. Overall, though, the main international impact is that commodity prices have come off since our last forecast back in March. They have come off—particularly in dairying but across a range of other commodities as well—generally, we think, because of supply side features that New Zealand and a number of other support and supplying countries have had better seasons and there is more supply on the market. That, presumably, is a shorter-term thing and doesn’t really change the trend.

We do note, also, that the exchange rate has come down since our last forecast as well, and we can understand why that might have happened. We still think it is still quite highly valued, given New Zealand’s competitiveness but it is certainly a bit more of a comfortable position than it was in March.

The business investment story is that we see increasing investment but only gradually. Business sentiment is alright, but investment has been pretty slow
through this period. Similarly, credit growth is slow, but we think the banks are pretty well funded. Households’ consumption has been weaker than we thought. We do note in these forecasts that Statistics New Zealand has revised some of their starting data, and that is really saying there has been less of a consumption pick-up from the GFC than we had been anticipating and that in fact their figures have been saying. Our view is that this consumption growth continues only gradually.

But we do see a bit more housing activity. We have been forecasting it for some time. We are still saying we see that happening. Some of that is Christchurch; we think that is particularly next year. But there is also more general expectation of increase in housing investment and housing turnover in New Zealand, although we continue to think prices are quite restrained there. I should say some of that is assisted by the fact we are seeing a market-driven loosening of monetary policy in the sense that banks, not only as the exchange rate comes down but banks have been cutting their mortgage rates lately in an attempt to get more business.

We note the Budget in here—pretty much as expected. Our interest, of course, is the net fiscal stimulus out of this, as opposed to the disposition of spending. It reflects now a minor constraint on growth going forward. Our forecasts are a little bit different from the Government’s and Treasury’s Budget forecasts in that we have a little bit less growth and a bit less inflation, and consequently we see the surplus returning 2 years after the Treasury forecast. There is not a lot of difference in that in terms of absolute numbers, but, again, I can talk to that if you are interested.

We see growth picking up a little bit slower than we had it last time—something like around a half percent growth in the next couple of quarters and then a little bit over that for the second half of the year. Broadly speaking, we think there are downside risks from the international environment and perhaps upside from the domestic environment. Our inflation track stays pretty well in zone, as you can see, and as a consequence of this, and also as a consequence of the fact that the market has actually eased monetary conditions itself, we felt that no change in the official cash rate is required at this stage but that we do still need this stimulatory monetary policy, and we have, in the forecast, a 90-day interest rate that is consistent with stability in interest rates through early next year.

Thanks you, Mr Chairman. Very happy to answer any questions you’ve got.

Dr John McDermott, head of economics, and Dean Ford, head of the forecasting team, are here.

Goldsmith Thank you very much. All right. We will take questions. I might just start off. The obvious one, I suppose, is, in this environment, just how easy or difficult is it to come up with forecasts of how things are going to unfold over the next couple of years? Can you give us a bit of an understanding of how you are managing that?
Bollard: Well, we think the domestic environment is, of course, quite forecastable. Around the international environment there is some question about commodity prices in China, growth, but, again, we think that’s forecastable. The hard stuff, of course, is the eurozone. And, because one can see so many different ways that that might unfold, we don’t think it is worthwhile trying to put that into a model format at the minute; instead, it is there as a risk in the room that we keep looking at. We will have the Greek elections this Sunday and we will have more French elections this Sunday. I don’t think that’s going to give a very clear-cut view immediately as to whether Greece exits the euro or not. More importantly for us, I think, is whether or not one can see further growing contagion through into Spain and Italy in Europe. We all know, of course, that in terms of current trade exposure into Europe, we don’t have much. Seven percent of New Zealand’s exports go there. That’s not really the issue though. The issue is whether European growth could really continue to slow to the extent that it slows Asian trade into Europe and, more directly for us, could we see medium-term funding markets for Australasian banks close up again. It is not at the minute. It did happen before Christmas. Banks are currently reasonably well funded, but we’ve got to consider that as a risk.

Parker: Am I to understand from media reports—I haven’t picked this up from the report, which I haven’t had the opportunity to read in full—that you had decreased your assumption as to the productivity growth per annum over the forecast period?

Bollard: Yes.

Parker: And can you just explain why you have done that and what it has been revised to?

McDermott: The key drivers behind productivity, we are looking at three things. One is the lack of investment that has been taking place over recent periods. It leaves us with a lower stock of capital than what otherwise would be the case. We have, basically, less plant and equipment to produce goods and services. The second thing is we’ve been looking at issues in the labour market. We see unemployment staying relatively high, despite the fact that job ads are actually increasing. Again, these rigidities in the labour market make it hard to mobilise resources to produce goods and services. Perhaps the third factor, harder to quantify, is the fact that in this uncertain environment it makes it hard for businesses to take on risk, to innovate, so the efficiency with which we use in our resources is probably less than what otherwise would be the case.

Parker: And in terms of the change to the number, what has that gone to?

McDermott: So we are looking at overall potential growth of about 1½ percent, which is about half what it was in the boom period.
In terms of the effect, if the surplus is achieved in, say 1 year late or 2 years later I want to be able to put that in perspective. What would that mean in terms of the additional Government debt that we would be likely to have from those 2 years late? Would it be less than $10 billion additional Government debt, given that the deficit by then will be, sort of, under $5 billion per annum?

So—

If the Government gets back to deficit later—

Yes.

—which you are suggesting, the additional stock of Government debt as a consequence of being in deficit later would be in the region of $10 billion or a bit less?

Yes, that would be approximately right.

The reason I ask that question is that during that same period, to 2016, according to the Treasury’s estimate, New Zealand’s external net international liabilities increase from, I think last year they were about $130 billion, they are predicting, by 2016, they will be about $200 billion—a $70 billion increase. I just want to get into perspective the fact that that increase in Government liabilities is a small part of New Zealand’s increasing net international liabilities over that period. Would that still be correct?

Yeah.

Which leads to the question, then, about what we do to remedy the larger problem, which is our rising net international liabilities, most of which are not driven by Crown borrowing. The advice we had before you came in was that manufacturing exports are not bouncing back following being hollowed out by some years of high exchange rates, and the export decreases that we are seeing—our export receipts are largely a decrease in prices caused rather than volumes in our primary commodity receipts, because of the dropping prices—and that there doesn’t seem to be much hope that we are going to see much broadening of our export base at the moment towards other sources to make up that gap. Do you have a comment on that?

Yes, on your first part I don’t think we have seen such a hollowing out of manufactured exports after the GFC. We have seen quite a bit of pressure on import substitution. That’s really been the big change since the global financial crisis. So it’s been manufacturers in New Zealand who have had to face more import competition, and they’ve found that more difficult. Manufactured exports don’t look too bad.

I think the time period that was being referred to also included periods prior to the global financial crisis. Can I ask one final question and that is, given that your GDP forecasts going forward are down, it seems that the
growth that is there seems to be even more reliant than it was on the rebuild of Christchurch, as a percentage of the total. I’ve heard that we are still having troubles particularly in the commercial reinsurance market, where affordable reinsurance seems to be a real problem in the Christchurch market still, which could substantially hold up the rebuild of the commercial part, which, of course, is outside the EQC purview. Do you have a view as to whether that is an unsolved problem?

Bollard We think, generally, the reinsurance market has worked reasonably well. I mean, if this is the third-biggest earthquake in terms of damage that the insurance industry has ever seen, this is a major event. Reinsurance has paid up for the first and subsequent round of events. Basically, the reinsurers are saying that they are reassessing Australasian risk, which they had rather light because it has been uncorrelated with other major risk areas they have. We are hearing of some getting out of the market but others coming into the market. We are clearly seeing higher reinsurance costs and clearly seeing higher insurance costs. We’ve got a view that we might have to suffer those for a couple of years, but, gradually, you will see that industry being more specific about just what it is insuring, where, and limiting the increases to those areas that are much more clearly at seismic risk.

Parker Have you heard whether the proposed rebuilders of Christchurch commercial buildings are able to access insurance for their new buildings, are able to get adequate earthquake insurance for their new buildings?

Bollard Generally, the message we are getting on insurance in Christchurch is that you can access, if you are an existing customer, it is—generally, if you are a new customer it is hard to get insurance.

Parker Is that in residential or commercial?

Bollard Well, both.

Parker In both. Thank you.

Bennett One of the comments you made was around the Australian banks and their ability to get capital, and the potential for that to have a weakness in it. How does that relate to the market out that we hear of where banks are very fiercely seeking competition at the moment? Do you just want to explain why there is that fear, and what that would mean?

Bollard Late last year we were observing that the banks were having trouble raising medium-term funding in the European markets, which are important markets for those banks. Then with extra action taken by the European Central Banks, the Australasian banks went out and did raise quite a lot of funds and are generally well funded through this year, now. They, of course, are also observing they are only getting quite gradual increases in credit out the door, both to the business sector and to the household sector. They would like to lend more at the minute, and they are clearly showing that by the fact that they are cutting mortgage rates and have been jostling for
market share and trying to pick up new customers. That is the market working. And we think that is not inappropriate at the minute, and it is good in the sense that it shows they are not funding-constrained right now.

Bennett

What part of the market is not working around property, then, if the money is there and there is the demand, in places like Auckland and that, and yet there probably isn’t the construction going on?

Bollard

We think people are very cautious. They’re not looking to take on debt in the way they used to. And, of course, the property development industry is in a worse state as a result of the demise of the finance companies sector and the fact that any investors are looking for a lot more take-up before they will go for financing in those areas these days.

Norman

Obviously the level of the OCR has some relationship with the exchange rate, and you have said very clearly, and the IMF repeated it recently, that the exchange rate is too high. So, based on that, there is a strong case to lower the OCR. It would be good for our external balances if we had lowered the OCR and put downward pressure on the exchange rate. So, essentially, why aren’t you doing that?

Bollard

Well, we don’t think that—well, a couple of things. First of all, we don’t see the close relationship between the OCR and the exchange rate that you seem to think is there. If we had moved the OCR down, I don’t know what would have happened with the exchange rate. It might have reduced it. But would it have reduced in terms of real exchange rates for the medium term. It is much less clear that that would have happened. In addition, it can have other effects that we don’t necessarily expect. At the minute, we think the main thing is to provide stability and certainty for New Zealanders to get on and build businesses and houses, and so on. We believe, also, that the exchange rate is at this level that we think is above the level that one would sustainably like to see it at to reflect New Zealand’s competitiveness, not because of New Zealand sourced distortions but because of other distortions in the international community.

Norman

So, if we accept there is some kind of relationship, you know, between the OCR and the exchange rate—and you say your objective is to provide stability to businesses—what the export sector are kind of screaming to us and saying over and over is, actually, no, you’re creating a real problem for us because we need a lower exchange rate. So, if your objective is to support the export sector, which I presume you obviously do because you are worried about the external balance, then, surely, that should weigh on your mind to actually lower the OCR further?

Bollard

Well, I’m sorry, I can only repeat what I said, that we don’t believe there is that tight, close relationship. I mean, of course, I get a lot of free advice from the export sector as well, and most of them don’t really see that very close relationship that you are proposing between OCR and the exchange rate.
McDermott  The other thing to keep in mind when we are setting monetary policy is it’s to control inflation. If we set the official cash rate lower than is necessary, we generate an inflation problem. That would increase wages and costs within the economy, and our exporters would lower the competitiveness because their cost structure would actually be higher than their competitors. So, it’s not an easy remedy simply to move the official cash rate to target the exchange rate. We might move the nominal exchange rate, but we really can’t control the real exchange rate.

Norman  So the inflationary pulses in the past that you’ve been most concerned about have come out of the housing sector; other sectors as well, but that is kind of the housing asset bubble has been one of the key sources. So is that at all a part of your thinking at the moment in terms of are you worried that if you lower the OCR, you would get inflationary pressures coming out of the housing sector?

Bollard  Well, I would say that we’ve got that on watch, really. It’s not built into our base forecast. We’ve got a reasonably benign inflation forecast in there. But we do want to make sure we’re not going to now see a mini house price boom. I don’t think we are, but that is a possibility with the cuts in mortgage rates going on at the minute, and, secondly, we have to say we don’t exactly know how the Christchurch rebuild shows through on building costs. There is risk there. Again, we think that gets handled OK, but that is something we will be watching.

Norman  I just want to ask you a quick question. I’m sorry, I’ll be very brief. The current account deficit figures we are looking at. There is a debate about to what extent that is as a result of kind of capital investment that is going to benefit the economy in the long term. So, should we be worried; should we not be worried? Those who say don’t be worried, say that it is fine because it is actually capital investment and it’s going to be good for us in the long term. Where are you on that debate?

Bollard  Well, we’ve seen some rebalancing, and investment is relevant, and some of that especially, actually, investment for Christchurch, but the rebalancing story has been a bit disappointing through this. We haven’t seen what we might like to have.

Smith  The big uncertainty that you’ve identified in today’s report is what’s occurring within the eurozone, of which you’ve said that the indirect linkages with the New Zealand economy are the greater risk and the direct that it is a relatively small proportion of our export markets. So I am assuming your concern is the flow-on impacts of difficulties in Europe for those Asian economies, their indirect impacts on the Australian economy and the degree to which we are particularly linked to Australia and to China. My question for you is to what degree are China and other Asian economies exposed, from the debt point of view—there is a trade exposure for those big Asian economies? To what degree are they exposed to debt issues that are causing so much uncertainty in economies like Greece, like Spain, like
Italy? And is it the trade linkage with China that is the worry or is it also that worry of debt uncertainty in the euro area?

Bollard Yes, I mean, I agree with what you’ve said. I think we are not concerned about China and East Asian contagion directly from debt in the eurozone. Debt in the eurozone, particularly in Greece, is almost all European-owned. And, when one looks beyond that to Spain and Italy, similarly. So that really isn’t the issue; the issue is the trade link.

Peters You were asked a question as to the over-valuedness of the dollar, and your answer was, well, it is still elevated. Given that the levels, even now, would be way out of what was contemplated even, say, 7 or 8 years ago, is it a case of this is so taboo we won’t do a thing about it?

Bollard The way we look at it is that we do regularly examine not just the exchange rate but all the drivers we can see going into it and just what is causing it. In our view, over the last little while it has been very much a risk on, risk off sort of story. You can tell me what’s happened in Greece overnight; I’ll tell you what’s going to happen to the New Zealand dollar the next day—that sort of thing. Particularly over the last couple of years, we think a significant driver has been where some of the world’s big economies are going with quantitative easing and impacts that they are having, deliberately or not, on the exchange rate out of their quantitative easing. Now, when that’s the big driver we don’t think there’s much we can do to directly affect that.

Peters Well, look, other economies have always thought they could do something about that by putting a ceiling and a floor on their currency. What would be so wrong with us doing it, given that we are an export-dependent nation?

Bollard There are a lot of economies looking at that argument about it at the minute. We’re tracking all that. We haven’t found something that would work for New Zealand. I know we’ve talked before about Switzerland. We’re still tracking that.

Norman They’re doing all right?

Bollard Well, a lot of it depends on how you account for it on mark to market they are not doing all right. I mean, it’s costing them heaps.

Norman They’ve printed money.

Bollard They’ve printed money. It does look like they’re pegged against the euro. They haven’t achieved that pegging against the US and the yen.

Norman But their aim was the euro?

Bollard Absolutely, yes. But they’re a bit of an unusual sort of case.

Peters Just remind me. Your trading partner GDP growth percentage, right? How many partners are used for that?
Bollard  How many—

Peters  Partners are used for that operation?

Ford  16.

Peters  16. Well, at best we are doing less than half as well as they are doing. But that’s not the story we are hearing around Parliament. We’ve been told that we are outperforming most of them. Day in and day out in the House, that is what we are hearing. You guys give information to the Prime Minister when he answers these questions?

Bollard  No, but—

Member  That’s not a question.

Peters  It is a question. I just heard the answer: he said no. Thank you very much.

Bollard  But the obvious distinction in that is that the OECD growth rates are always going to be a lot lower than world trading partner growth rates because they include the fast-growing East Asian economies.

Clark  Governor, the growth of the export economy is a lot weaker in the projections than in the previous, March figures particularly in the next couple of years—down 1.3 from 2.0, and down to 0.9 from 2.1, rising back up, presumably, on the expectation of commodity price rises getting back up to near the record levels they were at. Is it perhaps, but perhaps we might hope that’s the case. And, effectively, of course, that means a relatively stronger reliance on growth in the domestic economy. The projections for the current account, then, are also relatively worse over the short term, but even over the longer term they’re not good.

Goldsmith  Your question?

Clark  Well, I guess I am asking for a rabbit out of a hat, aren’t I. There doesn’t seem to be a plan to address it, I guess, is the political comment. I’m not actually sure what my question is. It’s despair, I think; it’s despair. If I could just go on to a real question, then. You’ve predicated most of the figures on a muddle through in Europe. What kinds of chances—you will have done some modelling, some scenarios around how likely that is, and obviously it is your most likely scenario. Could you talk a little bit around the confidence that you have in that scenario and also what kind of planning and perhaps tools you would have, should that scenario not come about? Presumably you’ve done some contingency planning—you know, worst-case scenarios. If that doesn’t come to pass, what kind of measures would you then put in place?

Bollard  Oh yes, sure. If you wish to hear more on Europe, we have Jason Wong, our financial markets expert here, but, broadly speaking, we’ve got scenarios where we have got a 60 percent expectation of—it’s not a technical term,
but, yes, they muddle through the small crises. It’s in place for a while. There’s no definite exit. We’ve got a 30 percent chance of a Greek exit and a 10 percent chance of wider eurozone exit or peripheral countries. And, frankly, a Greek exit could happen in a “moderately tidy way” and not have too much implication. The real concern, both in Europe and around the world, is could a Greek exit spark off contagion through into other peripheral countries that are bigger and more important and where there are liabilities that are held by German and French banks, and I am talking about Spain and Italy. We think there is a small chance of that, but it is absolutely a real chance. And in a situation like that we would be looking very much at both the funding markets and the trading markets. Were we to see funding markets close up to the extent that it was causing any stress in the banking system, we would expect to be able to put in place some of the measures that we’ve already tried out during the global financial crisis, most particularly making liquidity facilities available, on receipt of appropriate securities and at a price. That worked where it was only used to a small extent—it worked well. We know the banks are set up to do that. From a trading point of view, obviously, the official cash rate can be cut. We are in a reasonably comfortable position in that we can do that, but I should say that we are not planning to do that at the minute. Certainly, we’ll watch it as a contingency.

Hayes Governor, thank you for coming today. One of the things that has been quite good has been the increase in household savings. But a consequence, when I rattled through my electorate in the Wairarapa, is that every retailer is finding it difficult trading conditions, because things are quite tight. How do you see household savings heading? Presumably people are influenced by what they see in Europe, but is there some sort of scope for encouraging people to spend it if it is to help local economies?

Bollard Yes, I mean, household savings have picked up. Well, I mean, we have net savings; that’s a new feature. They’ve improved, and we see that as continuing. Of course, the flip side of that is that people aren’t consuming what they’re saving. So, for us, saving is something we would like to see happen, but gradually over a long time period. I think it is generational. That may well have been started off, but yet to see how that all goes. The flip side is less local stimulus through less consumption. We’re hearing the retailing sector is not too badly off. In fact, you might have noticed that yesterday Statistics New Zealand reissued its figures on retail trade for the first quarter of this year, saying they weren’t as soft as they thought. But, you know, that’s a long-term story.

Parker I just want to come back to house price inflation, and let’s ignore Christchurch because there are some pretty unusual problems there. Is my understanding correct that most of the house price inflation that we are seeing is in Auckland and that, indeed, it’s not Auckland wide but it’s area specific? Is that correct?
Ford  No, it’s not actually correct. The Reserve Bank did some work a few years ago just to try to stratify the house price data that we have. We usually look in deciles, so the most expensive 10 percent of houses, right down to the least expensive houses. If you went back to the mid-1990s housing boom, it was very much an expensive house story, which at the time was thought to be Auckland. The top three stratas went up by much more than everything else. The boom through the mid-2000s was the lower-price stratas, whether that was second homes or baches or whatever, we don’t know. The current pick-up—admittedly, it is early days; we are only getting to 5 percent house price inflation, which is nothing like the previous two booms. It is spread throughout the stratas. Certainly, there has been a lot of anecdotal about it being Auckland.

Parker  My question was geographic spread. Is it Auckland or is it throughout the country?

Ford  We haven’t looked at the geographic spread; we will have to rework the strata work. Typically, Auckland has the more expensive houses, even in the cheaper parts of Auckland. We’ve seen all of the stratas pick up in the same manner, which would suggest that it’s outside Auckland.

Parker  Where are those data series? Are they published?

Ford  We don’t publish the stratas, so that the Real Estate Institute has all the base data, and we’ve given them some techniques to do the stratas. They tend to just publish the headline numbers. They do geographic stuff but not by strata. It’s something I’m sure they could look into.

Goldsmith  Thank you very much for coming in. It is much appreciated.

conclusion of evidence
Reserve Bank of New Zealand's Monetary Policy Statement, September 2012

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Todd McClay, Chairperson)
October 2012

Presented to the House of Representatives
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Reserve Bank of New Zealand's Monetary Policy Statement, September 2012

Recommendation

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, September 2012, and recommends that the House take note of its report.

Introduction

This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, September 2012, and the central issues we discussed with the bank in our examination. Our approach to considering the statement, our membership, and the transcript of the hearing of evidence are set out in the appendices to this report.

The September 2012 Monetary Policy Statement announced the decision of the Governor of the Reserve Bank to leave the Official Cash Rate (OCR) unchanged at 2.5 percent. The OCR has been at this record low level since March 2011, and the decision to hold it was widely expected by the markets. The governor indicated that he expects it to remain unchanged for at least a year, and possibly until early 2014. This was Dr Bollard’s last monetary policy statement before standing down as Governor of the Reserve Bank.

Reserve Bank's reasoning

The outlook and risks for New Zealand’s economic activity are broadly unchanged since the June monetary policy statement.

Growth in New Zealand’s trading partners is expected to remain weak. China’s economy has slowed somewhat, and there is a small but worrying risk that conditions in the euro area could deteriorate markedly. Domestically, inflationary pressures are subdued, with headline inflation at about 1 percent and unemployment still elevated. Underlying inflation recently fell below 2 percent, and is expected to remain around the middle of the Reserve Bank’s 1–3 percent target band over the forecast period.

Modest growth in New Zealand’s economic activity is expected over the next few years, at about the current level of 2.5 percent, with repairs and rebuilding in Canterbury as the main drivers of investment. Export commodity prices have stabilised, but the high New Zealand dollar continues to undermine export earnings and to hurt tourism and import-competing industries. A key factor dampening demand will be implementation of the fiscal consolidation plans announced in Budget 2012 to bring the Government’s balance sheet back to surplus by 2014/15. The Reserve Bank notes that this consolidation will lead to a lower OCR than would otherwise be necessary.
International risks and uncertainties

The mood in financial markets has improved significantly in recent months after indications that European leaders are committed to addressing the region’s debt crisis. The governor described the markets as “a little bit euphoric” at present, with the news that Germany’s Constitutional Court has approved the proposed European stability mechanism. Nevertheless, the Reserve Bank still sees a real risk that conditions in the eurozone could get markedly worse. It has assessed the probable impact on New Zealand as less severe than that from the global financial crisis in 2008. In the Reserve Bank’s view, the likely scenario is a continuing series of crises in the euro area, and New Zealand will simply have to live with the resulting short-term ups and downs.

US financial markets were also euphoric in anticipation of the Federal Reserve’s imminent announcement of further quantitative easing, but the Reserve Bank considers their enthusiasm misplaced, as it focuses only on the short-term benefit of such boosts to liquidity. The monetary policy statement notes there is considerable uncertainty and risk in the outlook for the US economy, because of the major fiscal tightening currently required by legislation from the start of 2013.

The pace of growth in China’s economy continues to slow, but the Reserve Bank’s forecasts envisage a “soft landing”, with the Chinese economy continuing to grow at reasonable rates. Since China’s growth has significant implications for New Zealand, both directly through our trade, and indirectly through its impact on Australia’s economy and commodity prices, we asked about the reliability of the data on which assessments of China’s economy are based. The Reserve Bank conceded that there is a high degree of uncertainty, because of China’s size and complexity, leaving scope for various interpretations.

More positively, the Australian economy remains reasonably strong, with commodity prices, though weaker, holding up better than expected.

Rebalancing external debt

We note that some inroads are being made into reducing household debt, but New Zealand remains highly indebted to overseas lenders by world standards. The Reserve Bank’s projections see the current account deficit, now 4.9 percent of GDP, hovering above 5 percent of GDP until 2015. We asked whether this indicates that efforts to reduce New Zealand’s net external indebtedness are failing.

The governor said New Zealand is slowly rebalancing to reduce its net external indebtedness, but the process is difficult at a time when households, Government, and to some extent businesses are all trying to do so, and when other countries are deleveraging aggressively. New Zealand’s net foreign liabilities have been reduced considerably over the past 18 months—to about 70 percent of GDP—which is due in roughly equal measure to households reducing their debt, and to claims on overseas insurers related to the Canterbury earthquakes. However, New Zealand’s net international investment position is
expected gradually to increase again, with the Reserve Bank expecting it to stabilise at about 80 percent of GDP.\(^1\)

We asked about the reasons for this increase. The monetary policy statement attributes it to the imports needed for Canterbury’s reconstruction, whereas the Treasury estimates that reconstruction costs will add a maximum of 1 percent a year to the current account deficit over the next five years. The Reserve Bank said the Treasury’s estimate seems about right. Some of us consider this an important clarification, as the earthquake’s contribution to the current account deficit, while significant, should not be overstated.

The governor emphasised the importance of New Zealand keeping its external debt at “comfortable” levels to keep international financial markets on side. To the extent that New Zealand reduces its net external debt, he said, it will also ease pressure on the exchange rate, since this is essentially a transmission mechanism signalling that New Zealand needs to borrow funds from overseas. The Reserve Bank’s view is that it can do little to affect the current account deficit other than to provide stable financial conditions for New Zealanders’ own efforts.

**Exchange rate**

We remain concerned about the difficulties for our tradable sector caused by the high value of the New Zealand dollar. The exchange rate has appreciated about 2 percent on a trade-weighted basis since the June monetary policy statement (varying from a 3 percent appreciation against the US dollar and euro, to a slight weakening against the Australian dollar). Although export prices appear to have stabilised and export volumes have held up reasonably well—partly because of increased demand caused by drought in the US—the dollar’s strength has been a hard blow for import-competing New Zealand businesses.

We note the governor’s observation in a recent speech that New Zealand’s exchange rate can be distorted by larger countries using quantitative easing or other tools to lower their interest rates.\(^2\) In effect, New Zealand’s high exchange rate and consequent difficulties arise from competitive devaluation by other countries, and are likely to persist as long as international problems lead other countries to respond with such measures.

**Exchange rate intervention**

As we have done in previous discussions with the governor, we asked about the circumstances in which the Reserve Bank might intervene to lower the value of the dollar. We note that manufacturers and others have recently called for a devaluation of as much as 20 percent. The governor said that while the Reserve Bank never discusses currency intervention in specific terms, it has stated publicly its general criteria for intervention which, in essence, entail the pragmatic test: “Can you make a difference?” As the Reserve Bank sees the current exchange rate pressures being driven mainly by international events—quantitative easing in the US, exchange rate policies in other large economies, and risks related to the eurozone—it does not see much that New Zealand can do to influence the situation.

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1. See Figure 5.10, Reserve Bank of New Zealand’s Monetary Policy Statement, September 2012, p. 19.
2. Alan Bollard and Tim Ng in *Learnings from the Global Financial Crisis*, Sir Leslie Melville Lecture, Australian National University, Canberra, 9 August 2012, p. 15.
Some of us are sceptical about this conclusion, noting the Reserve Bank’s acknowledgement that interest rate differences between countries can affect the relativity of their currencies. Since our OCR is relatively high by OECD standards at present and our inflation rate comfortably low, some of us believe the Reserve Bank should take advantage of this situation to help New Zealand’s tradable sector by lowering the OCR and thus bringing downward pressure to bear on the exchange rate. The governor emphasised that the Reserve Bank does not see any automatic connection between a lower OCR and a lower exchange rate, and indeed observed that a perverse outcome is possible. A reduction in the OCR could in fact result in a higher exchange rate if the market did not believe the reduction was justified by underlying factors, and so expected interest rates to rise again. In sum, the Reserve Bank believes that manipulating interest rates in the hope of influencing the currency risks greater distortions, and that New Zealand would not benefit overall.

**Impact of devaluation on prices**

In the light of recent public calls for a devaluation of the New Zealand dollar, we asked the Reserve Bank to clarify the probable effect of devaluation on the cost of living. In broad terms, the Reserve Bank responded that devaluation would not entail a proportionate change in the Consumers Price Index, as only about half the basket on which it is based is made up of tradable products.

**The housing market**

The housing market continues to recover, with more listings coming on to the market, and residential construction picking up slowly. House prices have risen modestly in most regions, with more pronounced rises in Auckland and Canterbury, where supply has been slow to respond to the demand from demographic pressure and the need for reconstruction.

We asked whether the collapse of finance companies was making it hard for developers to access capital, and thus contributing to Auckland’s housing shortage. The governor said there was a clear need for good quality sources of finance to fill the gap left by the collapsed finance companies. At present this did not appear to be a constraint on the market, but there would eventually be a need for good players to finance large projects such as apartment blocks.

The governor has stated publicly that, with the benefit of hindsight, the Reserve Bank should have used macro-financial tools to slow the housing boom in the mid-2000s. He told us that this remains an option for his successor to use to secure financial stability if credit growth became a cause for concern, but at present growth in annual credit remains low, at about 4 percent.

**Canterbury reconstruction**

Reconstruction activity is becoming more evident in the economic data collected by the Reserve Bank, with a significant pick-up in building consents, although actual rebuilding activity remains low relative to what is required. The monetary policy statement notes that the size and timing of reconstruction remain highly uncertain, and it is unclear to what extent increased building will be offset by reduced demolition and repair activity. We questioned the governor about this, and were told that while the timing of the rebuilding has repeatedly proved difficult to forecast, the Bank remains of the view that
reconstruction will accelerate significantly from the start of 2013, and will add between 0.5 and 1 percentage point to GDP growth over the next 18 months.

**Reserve Bank’s legislated functions**

We sought the governor’s view, in the light of his experience and lessons from the global financial crisis, on whether the legislative architecture under which the Reserve Bank operates remains fit for purpose. The Reserve Bank Act 1989 states that the Bank’s primary function is “to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices” (section 8).

Some groups, and a member’s bill currently before the House, have proposed that the primacy currently given to price stability be broadened to include other economic objectives such as maintaining the exchange rate at a level conducive to export growth and job creation.

The governor told us he considers the Reserve Bank Act “completely fit for purpose”. In his view, it does not impose the focus on price stability as a straitjacket, but gives the Reserve Bank scope to take other factors into account. As he put it, “we are flexible inflation targeters”. He considers that this scope allowed the Reserve Bank to address the housing market pressures in the mid-2000s, and to deal quickly and effectively with the impact of the global financial crisis in 2008.

The governor acknowledged that the Reserve Bank’s policy response would be different if its legislation were changed to encompass a range of objectives, rather than giving primacy to controlling inflation. He also acknowledged that in the past few years opinions have diverged, with respected people such as the head of the IMF and economist Joseph Stiglitz suggesting that an alternative framework might be preferable. However, he remains of the view that the Act in its current form is the right framework for New Zealand; he notes that about 23 OECD countries use a similar model, and none has moved away from that framework.

**Complementarity of fiscal policy**

The governor emphasised that the monetary policy framework set by the Reserve Bank Act should not be viewed in isolation, but in tandem with the Public Finance Act 1989. He observed that the fiscal consolidation announced in Budget 2012, with four years of contraction ahead, would make monetary policy measures easier to operate, and lead to a lower OCR than would otherwise be likely. While noting that such contraction limits the Government’s ability to boost growth, he said it was not inappropriate in the current environment, where financial markets and rating agencies have little tolerance for governments that cannot control their spending.

**Change of Reserve Bank Governor**

This was Dr Alan Bollard’s final monetary policy statement. He has been Governor of the Reserve Bank since 2002, and will stand down at the end of September 2012 on completion of his second five-year term. Dr Bollard will be taking up a new appointment as executive director of the Asia-Pacific Economic Cooperation secretariat, based in Singapore. His replacement as governor will be Graeme Wheeler, a former managing director of the World Bank.
We greatly value Dr Bollard’s distinguished service over the past decade at the Reserve Bank, and before that for several years as Secretary to the Treasury. We are particularly grateful for his dedicated response to the challenges faced over recent years as a result of the global financial crisis. We wish him well in his new role.
Appendix A

Committee procedure

We met on 13 and 26 September 2012 to consider the Reserve Bank of New Zealand’s Monetary Policy Statement, September 2012. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O’Donovan.

Committee members

Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith
Corrected transcript of hearing of evidence 13 September 2012

Members
Paul Goldsmith (Chairperson)
David Bennett
Dr David Clark
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith
Michael Woodhouse

Witnesses
Dr Allan Bollard, Governor of the Reserve Bank
Dr John McDermott, Head of Economics
Dean Ford, Manager, Forecasting

McClay  Well, good afternoon everybody. I call our meeting to order. Dr Bollard, Governor, welcome back to the committee. Before I ask you to make some comments on your release today, can I just note that this will be last time, I understand, that you will be before the committee. And I want to particularly congratulate you on your appointment to APEC and your journey to Singapore, and to say, I believe on behalf of all my colleagues, that we’re grateful for the efforts you have put in over the years that you have been in charge of the Reserve Bank on our behalf, and to congratulate you for the work. I think I read in the newspaper today, saying that you can be very proud of your work under extremely difficult times during your period of time in charge. So thank you for that, and I offer you the floor.

Bollard  Thank you very much, Chair, and that’s generous. Our forecast this time is pretty similar to where we’ve been over the last few months. We’re talking about a world that looks a bit weaker to us, but, actually, the numbers haven’t come out that different. As you know, the eurozone continues on a series of euro crises. Actually, at the minute, financial markets are a little bit euphoric about it because they’ve just had some update news. The German Constitutional Court says they can run the European stability mechanism and things like that. But this is just the world that we live in, where there’ll be short-term ups and downs in that sort of market. We have done some work on what could happen if the eurozone got markedly worse. And our view is
that it could. We think it would have more limited spillover than the sort of contagion effects we had out of the global financial crisis back in 2008.

The US—well, again, the markets are a little bit euphoric about this, although not for good reasons. The reason why is that they think that tonight, tomorrow morning, the Federal Reserve will announce that it’s moving to another version of quantitative easing, and they’re taking a very short-term view in thinking that that’s good news. We don’t necessarily see it that way. Of course, there is some uncertainty ahead with the fiscal cliff and how they resolve all that later in the year as well.

We’ve got a slower China story now in our forecasts, but it is still a story where the Chinese economy has troughed out, has a soft landing, and continues to grow at reasonable although softer rates. That has reflected through a little bit in some of the hard commodity prices, and, indeed, Australia already sees that in things like iron ore prices, but the Australian story is still a pretty strong one. We are getting commodity prices that are a little bit—that have come off—but are a little bit stronger than we had thought. They’re reinforcing our views that those have troughed out as well. Of course, some of that is a little bit serendipitous. It’s things like the US drought that is having an effect like that.

We’ve had a good year of export volumes and a reasonably good year on the current account, but that hasn’t particularly structurally changed our concerns there. And, of course, some of these prices—we’re not getting the full effects of them, because we continue to have this very strong New Zealand dollar. The business sector—gradually improving; investment—gradually improving; bank funding—looking pretty sound; bank lending—gradually picking up, but still at low levels; and in the household sector we’ve got residential investment that’s picking up broadly, as we forecast, and we forecast quite a slow pick up. Quite different stories in the sort of the Auckland and related demographically driven demand for housing, on the one hand, and the Christchurch reconstruction and rebuild story, on the other. We’re getting a little bit more confident with Christchurch that we’re seeing some progress on the insurance front resolving some of these outstanding payout issues, and that we’re also getting new insurance—or companies that have had less exposure there, saying they’re ready for business there. And that’s got to be supportive of the sort of numbers we expect to see coming through this coming year with the rebuild.

Household consumption we still think remains pretty constrained. So there’s growth there, but it’s limited growth, and that does reflect back on New Zealanders’ experiences of the global crisis. A consequence of all of that, we’ve got a growth rate in GDP of around 2.5 percent for the year—a bit confusing because actually we’ve got a higher starting point due to revisions in Statistics New Zealand data. The inflation front is very suppressed. Headline inflation—around 1 percent at the moment and likely to stay there for another quarter before it starts to track back up towards the mid-point, but it’s still in that comfort zone. Today, of course, we have held the official
cash rate at 2.5 percent, so no change, and our numbers are consistent with that basically being on hold for roughly a year. That will clearly depend on what happens in that time. There was effectively no market reaction at that, no surprises in it. Thank you, Chair. We’re here to assist with your questions.

McClay Thank you very much. I might start briefly. I note New Zealand is still highly indebted to offshore lenders, or at least by world standards, but it appears we’re making progress in reducing household debt. I don’t know if this is right, and, if so, is it important?

Bollard Sorry, could you say that second bit again?

McClay In New Zealand we’re still highly indebted to offshore lenders, on world standards, but we’re making some inroads into reducing household debt. Is this correct, and, if so, why is it important?

Bollard Yeah, that’s correct. We’re going through a slow rebalancing, and it’s very difficult to have both households, Government, and sometimes business trying to rebalance at the same time, especially if other countries are aggressively deleveraging at the moment. But of course it’s important to New Zealand to help get back our external debt to more comfortable sorts of levels, and, ultimately, that should help in things like exchange rates, where we need to remember the exchange rate is only a transmission mechanism, a price that says that New Zealand requires external funding; this is the price it will be available at. The more we get back in balance on that, the less pressure we think there will be on the exchange rate.

Goldsmith You talk about getting back to comfortable levels. I mean, what are comfortable levels in your view, in terms of output, household debt; and has that changed significantly over the last few years? Presumably it has, has it not?

Bollard Well, we look at things like what we call the net international investment position, which as a percentage of GDP is around—

McDermott We’re looking to settle around 80 percent of GDP.

Bollard A bit confusing, because there’s very big reinsurance flows around Christchurch. Basically, though, of course, we see the international market, it has no tolerance for poorly managed economic or fiscal behaviours around the world. New Zealand—they like New Zealand from that point of view. They need to keep liking New Zealand. We need to stay very comfortably within range. So we know the target, but we know that when you go over 100 percent of GDP, then you get into a group of countries you don’t want to be associated with in financial markets.

Norman I mean, just looking at that, I think it’s table 5.10, which is the net foreign liabilities as a share of GDP. I mean, how do you—page 19. How do you disaggregate the effects of the GFC from the effects of the earthquake? Because you’re saying the earthquake is a significant contributor to the
decline. Because I think it’s important if we’re going to understand the underlying situation, if you take the earthquake out of it.

McDermott Following the Canterbury earthquakes, New Zealand, out of a bunch of fixed assets that were destroyed, initiated some insurance contracts, particularly with reinsurance, so New Zealand ended up with larger financial claims on the rest of the world. That reduced our net foreign liability position. That probably is temporary. As we rebuild Canterbury, some of those financial resources will be used, taking the position back to where we think is about 80 percent. So you can think about maybe half of that move that was down in the figure was solely due to Canterbury, and the rest may be due to some caution on the household sector, watching what was happening in the rest of the world, and then deciding that they don’t want so much debt.

Parker Thank you, Mr Bollard, Dr Bollard, sorry. And can I add my thanks to your years of service as Secretary to the Treasury. You know, it’s a long and distinguished career. Am glad to see that you’re going to try and sort out some of these international aberrations that seem to be so adversely affecting us, and maybe you can help do that through APEC. I hope you can. I’ll just quote you a paragraph from your recent Sir Leslie Melville lecture, when you said: “In a globalised world, big players lowering their domestic interest rates, whether by quantitative easing or any other tool, will, all else equal, tend to promote capital flows to other countries and appreciation of their exchange rates.” And you’ll no doubt be aware that I’ve been saying the same thing in reverse—that we face competitive devaluation abroad and it’s affecting us at home. And I just really wanted to confirm with you that that is still happening and is still problematic.

Bollard Well, we think exchange rates clearly are set by a whole number of things, and some of them they absolutely should be influenced by like commodity prices and anything that really reflects that.

Parker Well, that wasn’t my question. I know all those answers. I had a pretty specific question, which is putting that paragraph to you, and that, in this speech, you were saying that big players lowering their domestic interest rates either by quantitative easing or any other tool tend to promote capital flows to other countries and the appreciation of their exchange rates. So I will finish it off because you then said: “As a small open economy, New Zealand has often seen the effects of carry trades on the exchange rate. This can be distortionary and problematic, because an economy relies on its exchange rates as a signalling price.” So I’m asking you, is this still a problem?

Bollard Well, of course I think that if I said that.

Parker Well, if we take that then and you say that export volumes are holding up, and I think you also said that the problem with the exchange rate is being especially hard on the import substituters at the moment—do you see that problem continuing so long as we have these problems internationally?
Bollard: Yeah, import substitution looks to be the part that was hit by these higher exchange rates, and it happened around the global financial crisis time, and it hasn’t recovered since then.

Parker: And you say that the current account deficit is not as bad as it has been. Is your projection for the current account deficit largely unchanged from earlier forecasts?

McDermott: There are some minor changes, but the big picture would be it’s around or just over 5 percent of GDP.

Parker: And so does that imply that the trend to the end of the forecast period is still to have a large current account deficit and increasing net international liabilities as a consequence?

Bollard: Significant current account deficit. If you go out beyond 2014, I think you’ll find that net foreign liabilities plateaus at roughly these sort of levels.

McDermott: Some of that current account deficit will be, of course, money spent for goods and services we need to rebuild Canterbury.

Parker: The Treasury estimate of that in the lock-up in advance of the Budget was that 1 percent of it—it tops out at 1 percent, and in the out-years goes down from there. Is that about right?

Bollard: Don’t know.

Parker: I just make the point because I don’t think we should defend the current account deficit on the basis of the Christchurch earthquake disproportionately. Would that be fair?

Bollard: Well, when we see a lot of housing activity, we do see it in the current account deficit, so we can’t hold those numbers, but it’s significant.

Parker: OK. Well, if I told you that the Treasury estimate of that contribution was that it topped out at about 1 percent and over time declines, would that be a surprise to you?

Bollard: I’m not sure what you mean.

Parker: 1 percent of GDP.

McDermott: Right, that 1 percent of—

Bollard: Well, 1 percent of GDP is quite significant in the—

Parker: 20 percent of the overall thing.

McDermott: Is that 1 percent per year or 1 percent in total?

Parker: 1 percent per year
McDermott: For about a 5-year period?

Parker: Yes,

McDermott: That would match our figures, which rise from about 70 percent of GDP for net foreign liabilities up to about 80 percent. Not all of that would be counted of course, so those numbers seem about right.

Parker: Thank you. So the long-term trend of New Zealand over 40 years of an increase in our net foreign liabilities as a consequence of a protracted current account deficit seems to be pretty much unfixed?

Bollard: We’ve got an enduring—no, I wouldn’t make as strong a statement as that, but we do have an enduring problem with the exchange rate not assisting our restabilisation of that net foreign liabilities number.

Parker: I’ll just, because I’ve probably taken my allocation of time, I have one further question. We heard someone this week saying that if there was a decrease in the exchange rate, there would be a pro rata increase in the New Zealand cost of living. That was essentially the assertion that’s been made this week. So if, you know, the exchange rate went down by 5 percent, for example, there would be a similar increase in the cost of living in New Zealand. That’s not correct, is it?

McDermott: Well, there’d be redistributional impacts. It would certainly increase the cost of imports immediately.

Parker: But the consumer price index. That’s part of the consumer price index, not the whole thing, so—

Goldsmith: But the quote was standard of living, not cost of living.

Parker: Well, in fact, I think the quote was that other parties were asserted to be favouring a current account devaluation of 20 percent, which isn’t true, in the exchange rate, and that that would cause a similar rise in the cost of living. That’s not correct, is it? Assuming my quote’s correct, that assertion is not correct.

McDermott: We’d have to check what the pass-through would be.

Parker: Well, can you at least agree that either a percentage increase or decrease in the exchange rate does not have a pro rata effect on the cost of living? It’s got to be mathematically true. I thought the statement was a nonsense, so I thought it would be easy for you to agree with.

Ford: Well, to answer, I guess at a high level, about half of the Consumers Price Index is made up of tradable products, and you’d expect that any movement in the currency will have a pretty immediate impact on the price of those tradable products.
But not one for one is the point I’m making.

No. So you’d expect that, say, the exchange rate goes down by a percent, it would affect about half of the basket. And then of the tradable products, there’s still some component of it that’s domestic, so, I don’t know, a tradable product will still have a wage component, but there’ll be imported components to it, obviously.

Thank you.

I have two questions. The first was that I was quite encouraged to see that in this financial year the Reserve Bank has lifted its growth forecast for 2012-13 by 0.4 percent, which is pretty significant. At the same time, you have also said that amongst our key trading partners your growth predictions have reduced by 0.3 percent. What is it that has given, since your last forecast, your improved optimism for New Zealand’s economic performance at a time when you are acknowledging that the growth amongst our trading partners is actually more pessimistic?

Probably the major component is that household spending appears to have picked up, so we have seen the Q2 retail trade number was surprisingly strong. There are some signs that the housing market is starting to recover. So it looks as though, in spite of what is happening in the world, New Zealand householders have decided to spend a bit more over the past 6 months than what they did in the previous 6 months.

The substantive question I am very interested to ask Mr Bollard, of which I think members of the committee would concur with the chair’s comments, is that, in my experience, parliamentarians are sometimes at their most honest and frank in retirement mode. There is quite a substantive debate in the current difficult economic times around the framework that we operate with the Reserve Bank Act and the architecture that was put in place in the 1980s. As one that has been both the Secretary to the Treasury and the Governor of the Reserve Bank, a big question in these tough times is whether the fundamental architecture of our Reserve Bank Act is fit for purpose in the post-GFC environment. And from your experience, even in respect of jobs and those key things that whomever across the spectrum would want to achieve for New Zealand, would you be prepared to share an opinion as to the framework that you have worked with as Governor of the Reserve Bank, and whether we as parliamentarians have got the best legislative framework to achieve the goals that we would want for our country?

Yes, sure. I think the Reserve Bank Act is completely fit for purpose. You can’t obviously think about it just in isolation; it has got to fit within the Public Finance Act, the rules of fiscal policy. That is important. We’ve still got a fiscal policy that can work in New Zealand. Many countries can’t say that. That has made it easier to run monetary policy. The scope the Reserve Bank Act gives—it does give scope. It has allowed us to deal with a very tight, growing housing market back in the 2000s. It has allowed us to deal
very, very quickly with a very nasty financial event back in 2008. We don’t regard ourselves as being pushed into a strict suit of strict inflation targeting. We are flexible inflation targeters. That means we are focused on price stability but we can take other things into account, and we do. That is the model that is being used by, I think, about 23 OECD and other banks that have picked up on that model. And none of them have left that model yet, so I still think it works for New Zealand.

Smith Manufacturers currently in New Zealand, as you have acknowledged, are facing a particularly tough time and have this week been advocating a change in Reserve Bank policy specifically requiring intervention of yourselves in the foreign exchange market to devalue the Kiwi dollar by as much as 20 percent. Is it your view that such an intervention would be contrary to the public interest of our broader economy?

Bollard Well, you will appreciate that we have never, in a public session, talked about intervention in a specific way. But to speak generally, we have laid out publicly our criteria for intervention, and they obviously have a real world, real market sort of test in there, which is “Can you make a difference?” If a lot of the drivers of exchange rate pressure are actually international events reflecting in huge flows as a result of quantitative easing, exchange rate policies of other large countries, and many of the risk-on drivers around the eurozone, if those are the drivers, there is not much that New Zealand can do to influence those.

Norman My questions are not unrelated to Dr Smith’s questions. But working within the existing framework, we can have an argument about whether we need to change. But even within the existing framework, it seems to me that there is a logic that you kind of reiterated in this current Monetary Policy Statement, which is that differential interest rates do have an effect on the currency level. Looking at the trade-weighted index, the differential interest rates between New Zealand and the other currencies in the trade-weighted index have some effect. New Zealand, clearly, is at 2.5 percent. The OCR is relatively high by OECD standards. You have also said that inflation is pretty much under control, whether you are looking at CPI, but even underlying inflation it is in mid-band, and CPI is right at the bottom of the band—the very bottom of the band. You were already quite clear on that. You have also said that the exchange rate is too high and it is damaging the tradable sector. So what I don’t understand is this, putting those bits of information together: why on earth don’t you lower the OCR in order to have downward pressure on the exchange rate in order to help the tradable sector, given that the inflationary pressures aren’t anything serious to worry about?

Bollard The answer is because we fear that that would result in more distortions that overall wouldn’t help New Zealand. About half the criticisms we’re getting at the minute are like that; the other half are saying “You are missing an Auckland housing boom, and if you don’t put rates up, you’re going to have a repeat of the 2000s.” We don’t think that is the case either, but that is the other side to the argument, and we are trying to balance between those.
Norman So does it not follow from that then that if the concern is, for example, one sector like the housing market—I mean, the lesson of the 2000s that I think you yourself spoke of, apparently, in the Q and A earlier today, was that you should have stepped in against the housing market in the mid-2000s and used macro financial tools to slow the housing boom in the mid-2000s. So what that suggests to me is that if we wanted to get the best outcome, we would have a lower OCR to help the exchange rate in the tradable sector, but use tools that directly target the housing sector, if that is your other concern. I agree, it is a legitimate concern, and certainly through the 2000s that is what the Greens called for. You now have those tools or are developing those tools, so why not take that path?

Bollard Well, if we saw credit growth as being the cause of concern, then we would consider that. At the minute we have got sort of 2 percent rise and 4 percent growth in annual credit. That’s really low, and, actually, from an overall point of view we would like to see more credit coming out. New Zealanders aren’t borrowing at the minute. I mean, I can’t speak for my successor, but were the bank to see that really happen in the future then that is an option they have got there. It is not something you would do at the moment. If I did say—of course, my comments were much more guarded than you just said—but back in the mid-2000s, you would think about, if you’re going through that again, that as a possibility, as an additional thing. But it would have to be for financial stability purposes, under the Act.

Bennett The Auckland housing market seems to be doing quite well, and that would be a reflection of supply and demand—it is. I’m just asking. You’ve got a tight supply, you’ve got people wanting to move to Auckland, and you’ve got a growing city, so, naturally, the price is going to go up. The controls that Russel was talking about or intimated that were possible wouldn’t necessarily affect that—if anything, may hurt that supply. What would your response be to that?

Bollard Yes, I mean what we are seeing in Auckland—and not just Auckland, but other areas of demographic growth at the minute—is a little bit puzzling in one sense, because there clearly is demand for more housing, more accommodation, and it is a demand for people to live in, not an investment demand particularly. But we are not seeing much supply response, actually, at the minute, and we need to. I expect we will. We are now starting to see people put housing on to the market much more. They held back as a result of the GFC for quite a while. The estate agents now say that that is changing. But we haven’t yet seen the response that you would want, which is more building. That just isn’t there in the numbers at the minute. The building firms don’t say that they see that demand happening. It has got to happen. We do start asking whether conditions in Auckland are still right for that to happen; if not, it will happen elsewhere in New Zealand.

Bennett The measures that Russel is talking about or indicated were possible and what his party have indicated, they wouldn’t help supply, would they, because they wouldn’t—
| Bollard | Well, no, that’s not supply measures. We’re talking about demand measures there. |
| Bennett | Or supply, even. |
| Norman  | I’m happy to talk about supply issues, but I don’t want to focus on that. When I first asked a question you said that you wouldn’t go down that path because it produced certain distortions—that was your kind of reason for not doing that—then we talked a bit about the housing market. So let’s put that to one side, because you’re saying that that is not your concern right now. So what are the distortions that you’re concerned about if we were to take a strategy of a lower OCR connected to a lower Kiwi dollar, better for the tradable sector? Why aren’t you doing that then? |
| Bollard | Because we don’t see—you just said lower OCR connected to a lower Kiwi dollar. That would be nice, but we just don’t see that connection there. If today we had pushed down, unexpectedly, the OCR, the market would say: “What’s going on there? Why are they doing that?” If that doesn’t look like a credible response, they’re going to have to correct it; that means that the OCR is going to have to increase. That means that potentially you could see an increase in the Kiwi dollar, because they think they’re going to get an upside, not a downside. So all this has got to be credible in the markets for the market to actually respond on that. We don’t see a mechanical link between the two of them. Now, we do run, as you know, a bunch of models trying to say what does impact the Kiwi dollar. At times, that interest rate differential is relevant. At the minute the dominant thing is what happens in the Karlsruhe German Constitutional Court, in Washington FOMC press conference tomorrow morning, in the Dutch elections in The Hague going on at the moment, and in the Euro summit in Brussels on Friday. They are risk-on, risk-off issues. They are not going to be impacted by us moving the interest rate around. |
| Norman  | So just following through the logic of that, you have now—my understanding is—kind of denied that there is this connection between the OCR and the level of the exchange rate. You said that it’s not a mechanical one, to be more generous. And yet in the initial quote from David Parker from your speech and in the statement you’ve given us today where you say: “Other factors consistent with the recent strengthening in the New Zealand dollar have been rising interest rate differentials between New Zealand and the other countries.”, you intimate that there is a connection. I think this is probably one of the nubs of the argument. Do you believe that a lower OCR would put downward pressure on the New Zealand dollar or not? Because on the one hand you seem to say that it would, and on the other hand you seem to say that it wouldn’t. |
| Bollard | If it was lower OCR that was driven off a credible story about reasons for a lower OCR, a softer economy, then I would expect, all other things to be equal, that it could have some effect in an unpredictable sort of way. But if it is just being done to try and move the exchange rate around, I wouldn’t |
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expect it to have that effect. The markets will, of course, look right through
that.

Barry My question, Dr Bollard, is around inflation. Our headline deflation has
dropped to 1 percent. I mean, the underlying inflation is closer to the mid-
point of your target band. You say in your statement that you expect it to stay
that way. But with the growth in the economy—a slightly stronger economic
outlook, anyway—how is that going to impact on inflation, do you think?

Bollard We do see inflation picking up a little bit after the next couple of quarters. A
lot of that is driven by the construction sector, and a lot of that is potentially
Christchurch. Of course, that is one of the things we’ll keep an eye on in
Christchurch earthquake recovery. But in a way, prices are playing the right
role there. They are saying to builders in Wellington: “Come to Christchurch.
Bring your resources.” That is exactly the signal that you would want if there
is that sort of demand there. The Reserve Bank will have to watch that, and
we don’t think there are going to be major bottlenecks that are going to lead
to major price increases there, but if there are, they’ll have to consider that.
We really want to focus on underlying prices. These headline prices move
around a lot. When they were up above 3 percent we said: “Keep focused on
medium-term underlying prices.” Now that they are right down at the bottom
of the band, we are saying exactly the same thing. We think that is the right
focus. We think the news there is appropriate, but we all have to say that
there is some big risk out there with what the big economies have been doing
with their quantitative easing. When the time comes that they actually start to
get bottlenecks in their own economies, there could be more inflation out
there. I don’t want to put it out there as a big bogey—it’s not a big bogey—but
it is not a dead issue for us.

Barry And you are satisfied the band is appropriate still?

Bollard Yes.

Cosgrove Just on the Christchurch stimulus, I note in your report that you say that it is
an open question as to how much any further pick-up in reconstruction will
be offset by reduced demolition and emergency repair activity. Have you
done forecasting around what sort of level of pick-up or offset in the near
term, as you put it?

Ford So the forecast we have for residential investment is for quite a large pick-up.
The exact figure, I think, is adding between about 0.5 and a percentage point
to GDP growth over the next 18 months. The point there really is that it’s
quite difficult, using macro data, to really pick up how some of these unusual
industries are measured. So how do we really measure the—? There are not a
lot of footpaths being repaired in Christchurch at the moment. So that work
that used to happen is being replaced by demolition. Then as we get into a
reconstruction phase, it could be that the indicators we have are a little bit
hard to read.
Cosgrove  What are you factoring in? Are you underestimating, overestimating—what is your sort of feel for it?

Ford  We are putting in that there will be quite a large boost. This will be one of the factors that play quite a big role in growth over the next couple of years. What we’re trying to make in that paragraph there is just to point out, however you might get quite a few confusing reads over the next wee while. We’ve seen, for example, the consents data pick up quite a long way, but it could be that it doesn’t come through in, for example, the quarterly work put in place data.

Clark  Building on what Clayton said, what portion of the forecast that you have got is to do with the housing sector? I’m aware, and the story in Dunedin today—I’m sure probably the lead in the paper, I haven’t looked yet, but online certainly for our local newspaper—is around staff disappearing from Delta. That’s one of the issues there. The immediate issue today is pre-1935 houses not getting insurance in Dunedin, and sales falling over. So there is a housing issue—it’s a smaller one than the Auckland one or the Christchurch one, obviously, but some of the same labour force is involved. And with Delta, they are about to lay off 30 staff. Some of those staff are people who put in drainage in property development areas, and some of them are road infrastructure people who, because the Government’s roading budget is directed north of Christchurch, it means that they are going to have to downsize there. Those kinds of things are happening, and presumably any pick-up will involve a lag, because people are moving offshore who have those skills. I guess I am trying to get a sense of what portion of your growth projections are around that housing market and the level of uncertainty around that.

Bollard  The Christchurch housing rebuild potentially adds up to 1 percent initially of growth, so it is very significant. We have misestimated the speed of that rebuild picking up. We had to say this time would we push it back again, and we decided no. We still think that it happens in a major way next calendar year—from roughly the beginning of the calendar year. Yes, I mean, there are big bottleneck issues there. But one advantage of this after-shock very slow sort of recovery story is that it at least means building firms have had a long time to tee up resources, and the major ones I’ve talked to have been doing that.

Hayes  In your report you talk about the constraints on Government spending or, I suppose, four zero Budgets in a row as impacting on growth as the Government is trying to restore an operating surplus in its accounts. Presumably, the only way of giving growth a bit of a hit would be for the Government to increase its level of borrowing and inject that money into the economy. Would I be right in assuming that if we did you’d probably end up with a downgrade of our financial status by Standard and Poor’s and others because of the increase in debt, which would feed through then to household debt increases, because bank interest rates would go up?
Yes, we can only talk properly about fiscal policy with regard to monetary policy, but, clearly, the Government is constrained in what it can do there by the financial markets and by rating agencies broadly. So it all depends on how much, but there’s no appetite out in the financial markets for Governments that do not look like they can control their spending, and we don’t want to be in that space. The comments about fiscal contraction—yes, we are in that period. It will continue for a couple of years, but it’s not inappropriate, given the overall picture that we’ve got here.

My second question would be how much of concern is there in the international economic situation, and what are our main areas of vulnerability?

Well, our areas of vulnerability, I think the financial markets would say, are our external indebtedness. So that’s not particularly a Government story; it’s principally a household story, but it’s reflected through on this discussion we had earlier on the net international investment position. We know we’re volatile on commodity prices, but so far that’s been working for us pretty well. We think we’ve got less risk exposure to the eurozone, but we know the eurozone prices will continue and we will all have to operate in that very volatile environment for a continuing time. We’re still a small traded country in the world. The US used to be the traditional engine of growth. It hasn’t been this time. But we do look forward to getting some stimulus over there as well.

I just wanted to follow up on the question that was asked by Dr Smith of you about the suitability of the legislation. The answer you gave was—and correct me if I mischaracterise it, because I don’t intend to—that, yes, the primary function is inflation, but we can look at other things like exchange rates. I just wanted to put this to you—I am reading from section 8: “The primary function of the Bank”—primary—“is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.” No surprise to you. It carries forward in the first paragraph under “Policy Targets Agreement”: “Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices.” The reference is later to subsidiary things like, amongst other things, the exchange rate—are subsidiary. I think that’s a fair statement of fact so far.

Isn’t it necessarily—well, I’ll put it this way: it’s axiomatic, isn’t it, that if the range of objectives, rather than having the primacy of inflation in section 8, if the range was there that didn’t put inflation above the exchange rate, the response of the Reserve Bank might be different?

Yes.

Thank you.
Smith: A quick sup on that: would that be better for New Zealand? In other words, having had your experience in both Treasury and, more recently, in the Reserve Bank, is it your view that changing the primacy of that architectural legislation from the primary objective being price stability, and the secondary objectives—as David rightly quotes from the Act—is it still your view that that is the right framework?

Bollard: Yes.

Smith: The question I wanted to conclude with was around—

Parker: Could I just follow up on that, then, because that’s a new question right there. Is it also true that that is a moot point internationally, and that there are some very credible thinkers, including the head of the IMF, Stiglitz, and others, who would have a contrary view? I’m not saying they’re right, but it’s just it is a moot point these days, more than it was 3 or 4 years ago.

Bollard: I think I’ve expressed the established view, but, absolutely, there’s a range of different opinions on it.

Goldsmith: I just wanted to go back to the question of house prices. Where I’m based, in Auckland, it’s highly topical, because they’re going up very substantially, driven by supply and demand primarily. Isn’t a big aspect of it—and you’ve mentioned the puzzle as to why more new supply isn’t coming on—a lack of ready capital for developers in that area that used to be catered for by finance companies and has now broken down? I’m just interested to know how you thought that will resolve itself over the next few years, and whether there’s anything that the bank and Government could be doing to facilitate that.

Bollard: Yes, I mean there’s a gap in mezzanine finance as a result of the decline of a number of finance companies. Some other players are starting to fill that gap at the edges. But we still, in my view, need more good finance companies able to operate in that area. At the minute we’re not hearing particularly that constraint on finance is constraining new builds. That would be more applying to large apartment blocks and things like that. So we’re just not hearing that. It will at some stage, but, equally, I would expect the markets to start attracting in players, who should be better-quality players this time to provide that.

Clark: My question relates to table D on page 23—the current account balance projections. Again—and this is a consistent picture, obviously, this kind of wide gap: minus 5-point whatever out into the future. Is it fair to say that with the current tools you have at your disposal, there is very little you can do about that?

Bollard: I think that what we can do is provide stability so New Zealanders can get on and do the best for themselves. We’re limited, but I don’t know what tools would actually necessarily improve that. I don’t think it’s simply a matter of being able to move an exchange rate around. These numbers are slightly better than we’ve had in the past, but there’s still a continuing deficit.
Clark Yes, but there’s a persistent issue there that is very difficult to address in the current settings.

Bollard Yes. Countries like Australia have successfully had current account deficits for 100 years.

Clark It used to be the orthodoxy that that didn’t matter at all. I mean, there’s an emerging view that that is a really important issue that needs to be addressed.

Bollard We’re constrained on where we can go on that, yes.

Smith I was interested that in the broader report you make reference to the greater connection with China, and the fact that both directly from China and given the significance of our trade and indirectly through Australia, what goes on there is going to have a greater impact on our own economic performance. You say that your expectation in China is one of—you’ve described it as a soft landing. My question to you is what level of risk is there of uncertainties? We’ve long-established and there’s pretty open, good-quality reporting systems that we’re pretty used to out of, for instance, the United States. What level of confidence do you have about the quality of the economic data coming out of China, and, more significantly, what sort of level of uncertainty is there around your soft landing commentary around the Chinese economy?

Bollard There’s a fairly high level of uncertainty. As you know, there are some questions around some of the data. But in addition, you can just see the very wide range of expert views on China. There always have been. There’s a number of different pictures you can have of that same economy. It is a very big, very complicated economy. So, absolutely, there’s a wide range of uncertainty around our numbers.

McClay Dr Bollard, thank you very much. I thank you for your time today. I reiterate on behalf of all my colleagues our thanks for your many, many years of service to New Zealand, and, particularly, over the last few years your dedication to the challenges we’ve faced because of the global financial crisis. We wish you the very best for the new duties you are taking on and, I’m sure, looking forward to.

Bollard Thank you, Chair. Can I just say, I would like to thank the select committee. I’ve been in front of the select committee in various guises quite a lot. I don’t think the public realises how much work you put in to going through these sorts of examinations, and what you manage to get out and expose from that. You certainly keep our noses to the grindstone in doing that. You might think we’re not taking any notice of you. That would be completely untrue. We work a lot on some of these issues that are raised. I’m sure that will continue with my successor in the future. So thanks for the work you’ve done there.

**conclusion of evidence**
Reserve Bank of New Zealand's financial stability report, November 2012

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Todd McClay, Chairperson)
December 2012

Presented to the House of Representatives
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Reserve Bank of New Zealand's financial stability report, November 2012

Recommendation

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s financial stability report, November 2012, and recommends that the House take note of its report.

Introduction

The Reserve Bank of New Zealand is required to report twice a year on the soundness and efficiency of New Zealand’s financial system. The following are the main points from its November 2012 financial stability assessment:

- New Zealand’s financial system has strengthened since May, despite a challenging international environment.
- Measures around the world to ease monetary policies have kept interest rates at unprecedented lows. Combined with various steps to manage the euro area crisis, this has lifted the mood in global financial markets, improving major New Zealand banks’ access to global funds.
- Global economic activity is weak, however, and growth in China and other emerging markets is slowing. The fragile euro area and the possibility of major fiscal tightening in the US could undermine prospects for global growth. These factors present significant risks for New Zealand’s financial system.
- New Zealand banks have continued to build their liquidity and capital buffers, improving their ability to withstand stresses. They are well placed to meet the increase in the core funding ratio from 70 to 75 percent on 1 January 2013.
- Banks’ profitability has improved, their return on assets returning to near pre-crisis levels.
- Households and businesses continue to reduce debt, but outstanding household debt is still relatively high.
- Debt in the agricultural sector also remains high, with some dairy farms particularly vulnerable to a fall in export commodity prices.
- House prices are rising in response to supply constraints, especially in Auckland, and banks appear to be easing their conditions for residential mortgage lending.
- International conditions have contributed to upward pressure on the exchange rate.

The rest of this report discusses the main issues we considered during our examination of the financial stability report and in our discussion with the Governor of the Reserve Bank. This was our first meeting with the new governor, Graeme Wheeler, who took up his appointment in September.
The Reserve Bank’s toolbox

A new policy targets agreement was signed with the incoming governor in September 2012. While the new agreement remains focused on price stability, it places more emphasis on maintaining financial stability. Along with many other central banks in the wake of the global financial crisis, the Reserve Bank has been developing macro-prudential instruments that it might use when necessary to help maintain a sound and efficient financial system. The four instruments it is considering are the core funding ratio, a counter-cyclical capital buffer, adjustments to sectoral risk weightings, and loan-to-value ratio limits for housing mortgages.

The Reserve Bank expects such instruments to be used infrequently, but sees them as buffers it could use to cushion credit cycles—for example, to counter the type of bubble in house prices that developed in the mid-2000s—and to reinforce monetary policy. It is discussing with the Treasury a memorandum of understanding between the governor and the Minister of Finance about the parameters for operating these macro-prudential tools.

Some of us would like to see the Reserve Bank make more use of macro-prudential tools in addition to the official cash rate, and to use them in a more targeted way, rather than just seeking broad financial stability.

Loan-to-value ratios

We sought more information about loan-to-value ratios. The Reserve Bank said such limits serve to prevent credit growing at excessive rates and inflating asset prices. They are used in many countries, including Canada and the Nordic countries, and extensively in Asia. Just that week Israel had increased loan-to-value ratios at the same time as reducing interest rates. We heard that as loan-to-value ratios relate to secured lending, they tend mainly to affect mortgage financing. Generally, first-time homeowners are exempted, the measure being targeted at people trading up or buying investment properties.

Quantitative easing

Asked to comment on recent suggestions that New Zealand should undertake quantitative easing, the governor told us the bank did not think it was “something that deserves serious thought at this point”. He believes the Reserve Bank still has plenty of scope to lower interest rates using the OCR if necessary, and he described quantitative easing as “a sign of desperation” on the part of central banks in the US, Japan, and the euro area, reflecting their inability to lower interest rates any further to offset the effects of deleveraging and get some growth back into their economies. He questioned the extent to which the massive quantitative easing programmes in those economies were proving effective in increasing output. He also noted that the difficulty of returning to normal monetary policy settings after such measures had long been recognised by the Federal Reserve, which was now signalling that US interest rates are likely to remain low for a long time.

The international situation

The external environment continues to present significant risks for New Zealand. Recent months have seen expectations of global growth lowered, with signs that economic activity is slowing in China and other emerging markets, while the euro area remains in recession,
with its prospects fragile. In the United States, quantitative easing may continue to support modest growth, but its benefit could be undermined if no compromise is reached on the major fiscal tightening legislated for 2013. This “fiscal cliff” would entail a reduction in spending and an increase in taxation equivalent to a net 4.5 percent of GDP in 2013, which would deal a sharp blow to economic recovery. Uncertainty over the prospect is already causing business investment in the US to slow.

While emerging market economies have continued to perform well since the global financial crisis, growth in their exports has slowed, particularly from Asia, in response to weakening demand from developed countries.

Australia is particularly exposed to developments in the Chinese economy, as its strong performance in recent years has been supported by growth in its resource sector to supply China’s construction boom. Expectations of slower construction activity in China have led to a sharp decline in iron ore prices over the past year; exports of ore minerals constitute about 38 percent of Australia’s exports.

Prices for soft commodities, including dairy products, have also declined over the past year, but with some recovery recently. Drought in the US has helped to maintain prices for agricultural commodities.

**Banks’ funding costs**

An improvement in the mood of international markets in recent months has enabled New Zealand banks to issue debt at spreads considerably lower than six months ago. While this is good news, we also learned that the cost of swapping foreign currency funding for New Zealand dollars remains high, accounting for more than half the eventual cost of funds landed in New Zealand. We discussed this with the Reserve Bank, as we are concerned that such costs will ultimately be built into the rates charged to retail borrowers. The bank said that swap costs are unlikely to fall, but believes the main influence on prevailing interest rates is the strength of our economy relative to others.

**Debt reduction**

New Zealand households and businesses are continuing to make progress in reducing debt, but the stock of household debt is still high by international standards, as is the national net external debt, at 70 to 80 percent of GDP. This exposure to overseas lenders leaves the economy vulnerable to any global developments affecting the price or availability of credit. The Reserve Bank therefore continues to stress the importance of keeping the government deficit under control and reducing private sector, and particularly household, debt ratios.

We asked the Reserve Bank what a comfortable ratio of debt to disposable income might be for households. We recall that it expressed strong concern when, in 2011, the household debt-to-disposable income ratio exceeded 140 percent—having increased two and a half times in 20 years. The ratio is still high, at about 130 percent. The Reserve Bank said it does not have a target, and accepts that the norm in future may well exceed the historical average. The problem is that such high debt can leave households exposed to any decline in house prices. The governor pointed out that throughout the 1990s house prices averaged about three times a household’s annual disposable income, but the multiplier is now about
4.5 (down slightly from 5 in 2007). If the market were to revert to earlier norms, households could be left with very large debts relative to the value of their properties.

**Exchange rate**

Like his predecessor, the governor acknowledged that the high value of the New Zealand dollar is of concern, but sees nothing likely to lead to a major depreciation in the short term. He observed that in the current environment many other countries are experiencing similar upward pressure on their exchange rates. Quantitative easing has resulted in a flood of capital, much of it coming into the Asia-Pacific region, particularly into countries like New Zealand with faster growth and higher interest rates than the US and Europe, sound macro-policy positions, and favourable terms of trade. New Zealand also has the problem of having long relied on an inflow of foreign savings to finance its consumption and investment. Together, these factors indicate that the pressure on the currency is unlikely to ease soon.

We asked why the Reserve Bank did not lower the OCR to encourage a fall in the dollar, while using macro-prudential tools such as loan-to-value ratios to prevent a new bubble in housing prices. Some of us consider this the logical response, given the Reserve Bank’s acknowledgement that New Zealand’s relatively high interest rates are contributing to upward pressure on the dollar, and its acceptance that the high dollar presents an obstacle to economic rebalancing and debt reduction and thus, potentially, to financial stability.

The Reserve Bank said that relative interest rates are only one of several factors influencing the exchange rate. Investors do not just look at the interest rate differential, but consider the various factors determining a country’s growth prospects. In the longer term, New Zealand’s exchange rate has tended to track close to its terms of trade, which are almost at a 40-year high. The governor also observed that previous OCR adjustments have had very little effect on the exchange rate—consistent with the recent trend in Australia, where the currency remains strong despite the OCR being reduced by 150 basis points over the past year. He concluded that the relationship is not straightforward, and that not even the direction of the currency’s movement following an OCR adjustment can be predicted.

**Current account deficit**

We asked whether the Reserve Bank’s projections for the current account deficit accord with those of the IMF, which expects New Zealand to have the second-highest current account deficit in the developed world this year, after Greece, and the highest next year. The governor was unsure of the exact comparison, but agreed that New Zealand’s current account deficit is too high, at about 4.5 percent of GDP, and has been a persistent problem for more than three decades. He said that the Reserve Bank is just beginning an intensive round of forecasting in preparation for the next monetary policy statement on 6 December, and he would be in a better position to comment at our next meeting. However, he did not expect the forecasts to show any significant improvement in the current account.

We asked what policies could help break the cycle that has seen New Zealand’s external indebtedness worsen for decades. The governor said the economy will benefit in the long term from policies that keep inflation and hence interest rates low, and which reduce inflationary expectations. In his view, the current account problem comes down to New
Zealand’s longstanding savings-investment imbalance: the reliance on foreigners’ savings to finance our own consumption and investment. This was starting to change, with an improvement in household savings, and the adoption of the objective of returning the Government’s books to surplus, but improvement would take time.

**The agricultural sector**

Assessing areas of vulnerability in the economy, the financial stability report notes that the agriculture sector remains highly leveraged, with some dairy farms particularly exposed to a potential fall in export prices.

The report notes that dairy debt increased from $11 billion to $24 billion between 2003 and 2008, and accounted for 63 percent of total lending to the agriculture sector, with almost half that debt held by just 10 percent of farmers. Such farmers were left highly exposed when milk prices dipped during the 2008/09 season in the wake of the global financial crisis. While farmers have shown more caution in recent years, debt remains higher than before the crisis. Notably, loan-to-value ratios have increased markedly over the past four years, reflecting a 20 percent decline in dairy farm prices. The Reserve Bank cautions that this places dairy farms in a vulnerable position given forecasts that the dairy payout will again fall below $6 for the 2012/13 season.

We acknowledge the Reserve Bank’s point that borrowers and banks need to exercise caution, but believe the picture needs to be viewed in perspective. We note that heavily-indebted dairy farms are relatively few in number, and we believe further analysis would probably show that such farms tend to be the most efficient operations in terms of production and earnings per hectare. Limits on lending might thus disadvantage precisely the type of farmer most likely to contribute to New Zealand’s export earnings. The Reserve Bank said it was not suggesting loan-to-value restrictions should be imposed on the farming sector; it was merely highlighting dairy farms as an area of vulnerability in the economy.

**The housing market**

House prices have been rising over the past year, mainly in Auckland and Christchurch, in response to supply constraints. The Reserve Bank considers houses overpriced, and expects the rate of increase to moderate as supply catches up. However, we note that banks appear to be loosening their conditions for residential mortgage lending, with higher loan-to-value ratio lending becoming more prevalent. We will continue to watch this aspect of the economy closely, as excessive credit growth could worsen housing market imbalances. Homeowners could be left burdened by disproportionate debts if house values returned to historical norms. Such an adjustment could be triggered by adverse developments overseas.

**The insurance sector**

Insurers continue to focus on settling claims from the Canterbury earthquakes. The total cost of claims is estimated to be well over $30 billion, of which about a third have been settled; payments so far total $10.8 billion, comprising $3.8 billion from the Earthquake Commission and $7 billion from other insurers. The final cost is hard to predict as many significant issues affecting insurance claims have yet to be resolved. New property insurance is becoming more available in Christchurch, as the underwriting constraints imposed in the aftermath of the earthquakes are now being eased.
On the regulatory side, the transition to a new prudential regime for the sector is well under way. Insurers are working to complete the full licensing process by September 2013.

**Bank profitability**

New Zealand’s banking system has continued to perform strongly, with one measure of profitability—return on assets—returning to near pre-crisis levels. Banks’ returns on equity, however, remain below those of 2007, as they continue to build their capital bases to meet the international standards agreed under Basel III.

We asked how New Zealand banks’ profit levels compare internationally, as they have grown very substantially in the five years since the global financial crisis. The Reserve Bank told us the return on assets is at or below the average of banks in other OECD countries. As to whether the profits remain in New Zealand since our major banks are Australian-owned, the governor said the distribution policy is largely up to the boards of the New Zealand subsidiaries. In his view, the important issue for New Zealand is that the banking system should be strong, competitive, and efficient, without barriers to entry. He is satisfied that New Zealand banks exhibit strong competition and efficiency.

We sought the governor’s view as to whether record bank profits are the price one must pay for financial stability, as some commentators have suggested, as this seems at odds with the collapses of highly profitable banks like Lehman Brothers. The governor noted that Lehman’s was a highly leveraged investment bank, and he emphasised that banks’ returns should be evaluated in terms of their degree of leveraging and the quality of their asset portfolios. The Reserve Bank assesses New Zealand banks to be sound, and considers they are making acceptable rates of return that are not out of line internationally.
Appendix A

Committee procedure
We met on 7 and 28 November 2012 to consider the Reserve Bank of New Zealand’s financial stability report, released on 7 November 2012. We heard evidence from the Governor of the Reserve Bank, and received advice from our independent specialist adviser, Brendan O’Donovan.

Committee members
Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith

Evidence and advice received
Appendix B

Corrected transcript of hearing of evidence 7 November 2012

Members
Todd McClay (Chairperson)
Shane Ardern
Maggie Barry
David Bennett
Dr Jackie Blue
Dr David Clark
Hon Clayton Cosgrove
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith

Witnesses
Graeme Wheeler, Governor
Grant Spencer, Deputy Governor, Head of Financial Stability
Bernard Hodgetts, Head of Macro-Financial Stability
Andy Wood, Acting Head of Prudential Supervision
Mark Perry, Head of Financial Markets
Mike Hannah, Head of Communications, Board Secretary

McClay We are now in public session. Can I welcome Graeme Wheeler, Governor of the Reserve Bank of New Zealand to the committee, and in particular congratulate you on your appointment. This is the first occasion that we've had the honour to have you with us in committee. So we're very much looking forward to your presentation. Can I say we're likely to see a bit of each other over the next little while, so I hope you feel extremely welcome.

Colleagues, we have until 1 o'clock with the governor. Governor, I'm going to ask you to maybe make some opening comments and then it will be time for questions. Can I ask my colleagues to direct questions towards the governor and not at each other, and via the chair.

Governor, I offer you the floor, please.

Wheeler Thank you very much indeed, Mr Chair. My colleague with me is Grant Spencer, who is the deputy governor, and, I'm sure, very well known to the committee.
Just a few comments on the Financial Stability Report. New Zealand’s financial system has strengthened, despite a challenging international environment. There’s been a synchronous slowdown in global growth in recent months. We’ve seen that the euro area remains in recession. There’s been a marked slowdown in China, and weaker investment in the United States. Uncertainty around global growth remains high due to the scale of deleveraging, the slowdown in global trade, and the outlook for fiscal policy in the US, although there are some encouraging signs in the US in respect of the housing market and the oil and gas sector.

Nevertheless, in the US, the eurozone, and Japan, real GDP per capita is below 2007 levels. Despite this, financial market sentiment has improved since our last report. The access to global funding markets has improved, interests rates remain at low levels, global equity markets have recovered since June, and credit spreads have declined in the euro area. Our economy continues to grow at an annual rate of around 2 to 2.5 percent. New Zealand banks have better access to global funding markets. New Zealand households and firms continue to reduce their reliance on debt, but household debt levels remain high, and borrowers remain vulnerable to any decline in house prices.

Leverage in the agricultural sector, especially parts of the dairy sector, remain high and leave the sector exposed to any fall in export prices. Banks continue to build their liquidity and their capital buffers. They are well placed to meet our minimum core funding ratio requirements when we move that ratio from 70 to 75 percent on 1 January.

We continue our steps to increase or strengthen the financial system. These include measures such as implementing the main elements of Basel III capital adequacy requirements, continuing to develop the macro-prudential framework. We’re working with banks to pre-position systems in respect of open bank resolution and to have that completed by 1 June next year. We’re putting in place new prudential and licensing arrangements for insurers, and we’re reviewing our statutory powers for overseeing the payments and the settlements system.

Thank you very much, Mr Chair.

McClay Thank you very much.

Barry The households and businesses are making progress in reducing the debt. You’ve identified that. But can you talk about why we are making progress in this area, because you’re still seeing it as a vulnerability.

Wheeler Yes. If you look at overall household debt as a percentage of household income, then the ratios are still very high. I mean, they’ve come back since 2008 or thereabouts. You’ve seen a reduction in household loans as a percentage of household disposable income. You’ve seen the same on the consumer side. In essence, it’s partly a result of households increasing their
savings ratios, and certainly we needed to do that in New Zealand. The household savings ratio has been negative for many, many years. That’s partly a result of households deleveraging—just, in a very tough situation, trying to reduce their debt, increasing their savings ratios. So that’s what’s helped pull back those ratios on the consumer and the housing side. But they still remain at a high level.

Smith

Just a quick supplementary. Do you have a view about what level of household debt-to-income ratios the Reserve Bank would be comfortable for? You know, historically, you’ve expressed concern that it got very high, up to 140 percent. It is currently sitting at 120. Do you have a view as to what level you would be comfortable, long term, in terms of financial stability, for New Zealand’s debt-to-income ratios for households?

Spencer

I don’t think we have a particular target, because the norm may not be the historical average. The historical average, as you say, was a lot lower than where we are now. But we still feel it’s symptomatic of the broader national external debt. The national external debt is still in the 70 to 80 percent range, which is high by international standards. As long as it stays there, New Zealand will be vulnerable. And we’re more vulnerable in this post-crisis world than we were previously. So the key to getting the national debt down is, one, making sure that the public debt stays under control, and, two, private debt ratios are reduced to lower levels, and the household debt is the main part of that.

Wheeler

And if you look at house prices, for example, the vulnerability is to some extent—and perhaps even a considerable extent in respect of house prices—if you look at house prices as a percentage of disposable income, or look at that multiple, I should say, then that ratio is around 4½ times household income. It was around five in 2007, just before the global financial crisis, but it’s up substantially from three in the 1990s. For a decade in the 1990s that ratio was a multiple of around three. So it’s currently 4½. So one of the issues is if there was a substantial correction, for any reason, in house prices in New Zealand, you don’t want households sitting there with a lot of debt behind that asset.

Norman

Can I ask just a supplementary on that? Welcome, new governor. Isn’t that then an argument for the Reserve Bank advancing its work on loan-to-value ratios and so forth, so that you can try to bring those ratios between incomes and debt much more into aligned to how they were before? But I understand that you’re not proposing to use loan-to-value ratios at the moment, is that right?

Wheeler

Well it’s one of the macro-prudential instruments that we’re working on. We’re currently discussing with the Minister of Finance and Treasury a memorandum of understanding for how those instruments could be deployed. But, in essence, macro-prudential instruments are designed much more for obtaining financial sector stability. It’s when asset bubbles build
up; it’s where credit grows at excessive rates that feeds through to asset prices and the like—that’s when you want to be deploying those sorts of instruments.

Peters Just one supplementary. You regard LVRs as being rather orthodox thinking, you wouldn’t regard it as being extremist, would you?

Wheeler They are used in many countries. I mean, just recently—in fact, earlier in the week; I think it was Monday—I think it was Monday—Israel increased loan-to-value ratios at the same time as reducing interest rates. They’ve been used in Canada. They’re quite extensively used in parts of Asia, and they’ve been used up in the Nordic countries.

When countries deploy them, or when central banks deploy them, what’s tended to happen is first-time homeowners are exempted in some way, and it’s mainly catching people who are trading up or moving into second homes.

Parker In paragraph 8 of your report—welcome, by the way—you say that the cost of swapping foreign currency into New Zealand dollars, mainly presumably by the banks, is increased and “remains elevated and accounts for more than half of the landed cost of funding in some instances”. Do you have a view as to whether that’s likely to continue?

Spencer Well, that’s what’s termed the cost of the basis swap. So the bank is borrowing US dollars—

Parker I understand what it is.

Spencer So that cost has been high since the crisis, but has come off just in the past 6 months to a year. So I guess I would have to say that it’s hard to see it coming back any time soon.

Parker So are you now saying that that’s lower than it was? Because your report says the opposite.

Spencer No, the overall cost of bank funds has come down—

Parker But the cost of the—

Spencer —but the cost of the basis swap—

Parker Which is what I—

Spencer —is still a significant part of it.

Parker Well, in fact, what it says here: “the cost of [the foreign currency swap] … remains elevated and accounts for more than half of the landed cost of funding in some instances.” My question is: do you think that that’s likely to continue into the future? That’s my first question.
Spencer Yes, I think it is likely to continue. The main way that it would reduce is if there was an increase in demand from offshore for Kiwi dollars, and there’s no sign of that at present.

Parker If that component of New Zealand interest costs remains high, is that foreshadowing the likelihood that you think that New Zealand interest rates, going forward, are going to remain higher than the international norm?

Spencer I wouldn’t conclude that, no.

Parker Well, how can they be lower if we’ve got higher costs of foreign currency swaps than all our competitors seem to be facing?

Spencer Well, that adds to the cost of funds, which does contribute to the cost of what you actually pay on a mortgage. So the gap between the mortgage cost and what our official cash rate is is affected by that cost of funds.

Parker Yeah, so the effective cost to a New Zealand borrower is higher.

Spencer Yeah, but all I’m saying is that the overall level of interest rates in New Zealand will depend on supply and demand. If we have a stronger economy than the rest of the world, then our interest rates will tend to be higher.

Parker But, all other things being equal, the high proportion of New Zealand retail cost that goes to foreign currency costs or swapping out into New Zealand dollars seems set to continue?

Spencer It would be a brave person to say it’s going to shrink, yes.

Parker The next area, if I could, Mr Chair—I’ve got one other question, really. You note that New Zealand’s current account balance is—well, sorry, you’ve already spoken that New Zealand’s net international liabilities are high by international standards. We’ve heard from the IMF that this year New Zealand is expected to have the second-highest current account deficit in the developed world after Greece, and next year it’s projected to be worst in the developed world. Do you agree with the IMF’s projections or have a different one?

Wheeler I don’t know the exact comparison—whether it’s second—but if you ask me, is the current account deficit too high, at around 4.5 percent of GDP, the answer is yes.

Parker Did the Reserve Bank projections going forward show that current account deficit going even more negative from where it is now?

Wheeler That’s something that I’d be very happy to talk about when we do the Monetary Policy Statement. I’m not trying to be evasive—that’s not the intention—it’s just that we’re going into an intensive forecasting round,
where we’ll be exploring a lot of those issues. But I don’t believe that our forecasts are likely to show any significant improvement at this point.

Parker So under current settings in New Zealand we’ve got amongst the highest net international liabilities in the world, the highest current account deficit in the world, going forward. That’s true?

Wheeler Well, as I say, I don’t know the international comparisons, but I do say that the current account deficit is high.

Peters Look, when Naomi Mitchell put out the press statement of the summation, 7 November here, there is two references to New Zealand banks accessing global funding markets, New Zealand banks building up their liquidity and capital buffers. They’re not really New Zealand banks, are they?

Wheeler Well, they’re New Zealand subsidiaries of Australian-owned banks.

Peters Well, if you look at what Westpac declared as profit just the other day, alongside the rest—Westpac was 22%; the rest were about the same or not too far off it. Look at the 5 years of the global financial crisis. They have doubled their profits in the space of those 5 years, and more. Those profits have not been spent back in New Zealand, have they?

Wheeler The individual cases, I don’t know, because by and large it’s up to the boards of the New Zealand subsidiary to make judgments about dividend policy and all of that. But what I can say in terms of bank profitability is that if you look at the return on assets in New Zealand, it’s recovered to where it was prior to the global financial crisis. If you compare it to the return on assets across most OECD economies, we’re in fact about average or below. If you look at the return on equity, we haven’t got back to where we were prior to the global financial crisis, and that’s partly because these banks are building up capital as part of the Basel III requirements and the Reserve Bank’s requirements. So ROA—return on assets—probably at the OECD average or slightly below. ROE not back to where it was back in 2007. And in essence we want a strong, competitive banking system. We want it to be competitive and efficient and basically to be a contestable market, not to have barriers to entry, and to force these institutions to compete amongst one another, and we see a lot of competition there.

Peters All right. Do you think our dollar will go to 85c shortly?

Wheeler I’m sorry, I didn’t hear that. I’m sorry.

Peters Do you think our dollar will go to 85c shortly?

Wheeler You know, the exchange rate is clearly an issue of concern. It’s an issue of concern to the export and import substitution industries. It’s a feature that many countries around the world are experiencing, particularly countries that have higher growth rates than, for example, the States or Europe; countries that have positive interest rate differentials with those countries;
countries that have commodity prices that have been increasing so that terms of trade have been picking up. So you can look at many countries around the world right now where there would be central banks, treasuries, and parliamentarians and ministers of finance who would be concerned about the upward pressure on the exchange rate. So it’s hard at this point to see any factor that would lead to a major depreciation in the exchange rate in the short term—at this point.

Peters Just—could I refine that? So does that mean that you admit that there’s a distinct possibility it could rise to 85c or better—or worse, depending on how you look at it?

Wheeler I wouldn’t claim to have any expertise to try and forecast the exchange rate, but there are pressures on many countries, as I say, around the world, that have the sorts of characteristics that I mentioned: good macro policy frameworks, terms of trade rising, commodity exporters’ stronger growth than other countries. And in New Zealand we have the additional problem of we’re heavily reliant upon foreign savings to finance our consumption and investment. So we consistently draw on foreign savings, and that’s part of the reason that, in essence, we have higher exchange rate pressures.

Bennett Yeah, well, with the LVRs, how do they work with businesses? You’ve talked a little bit with Russel about households. Do you want to give us a bit of an idea of what those other countries have done with businesses? So do they use them or not?

Spencer Well, the LVR policies relate generally to mortgage finance or secured funding, and most corporate business funding is unsecured. So that policy doesn’t really apply, but it probably may apply more, say, for small-business lending, which is more often based on, effectively, a form of mortgage lending.

Bennett So if you look at New Zealand, for example, you’ve got the dairy people you’re talking about there, that’s secured against the land, for example.

Spencer Right.

Bennett So how would it apply?

Spencer So it could be applied, that’s right, for something like agricultural lending that’s secured on the value of the land.

Ardern Just a supplementary to that. The concern I have with that comment—it’s a welcome position—is that it says in the advice that we were given that about 60-odd percent or better of the agricultural sector debt, particularly the dairy industry debt, is held by about 10 percent of the farmers. So, in rough figures, there are about ten thousand dairy farmers—a bit less than that, actually, but ten thousand dairy farmers—and a thousand of them are heavily indebted. What I don’t see in any of the information here is what
their economic farm surplus, or their EBIT, is. My experience of the
industry is that the guys who are the heaviest in debt are the most efficient
operators. Given the New Zealand economy profile, 26 percent of the
country’s income coming from the dairy sector, to have some kind of
restriction to entry into the industry on those who have a equity-debt ratio
structure—which is what happens inevitably, because those who come from
a more affluent background have a higher equity and can borrow the money
to enter the industry often aren’t the best farmers. It is the young, hungry,
aggressive—and I can speak a little bit from personal experience here—that
will drive efficiencies in the business that potentially might be the best in
the long run of New Zealand’s economy.

So where do you draw a line, and what further analysis is done as to those
that are the most efficient in the industry, because an overlying figure that
would be interesting to look at here would be: that 10 percent debt in the
sector that is concerning—and clearly it is—how efficient are they as
operators? And all of that information is available on the computer now
from DairyNZ. There is no real research programme has been done yet, we
know that. I would suggest to you that potentially those guys are the top 10
percent of operators as well in terms of production per hectare, production
per cow, EBIT.

Spencer I’ll just say we’re not suggesting we’re about to put LVR restrictions on
farmers.

Ardern No, no, you’re—

McClay Just let him answer, Shane, please. Go ahead.

Spencer Really, at the end of the day, the banker has to assess the risk and consider
the whole range of factors, as you’re saying, before they make a loan, and
deciding how big a loan to make. But we’re just really pointing out in that
piece in the report that there is a concentration of risk in that sector. It is
very vulnerable to a drop in the dairy payout, and so, given that lending is
picking up in that sector, you know, the banks need to be careful—the
borrowers and the banks need to be careful not to get over-extended.

Ardern But there are a thousand farmers involved. You need to bring it into
context. It’s not hundreds of thousands.

Norman Given your comments earlier that this is about financial stability—this is the
report you’re doing today, and so that should be the focus—and also in the
context of record profits that the banks have announced over the last profit
season, do you subscribe to a view which says that record bank profits is the
price we pay for financial stability?

Wheeler No, I think what I’d say is let’s look very carefully at what the returns from
banking are—and we can look at international comparisons, as I responded
to the honourable Winston Peters. And that is one factor that you might
want to look at. But, in the end, do you want a healthy system that’s with
strong banks that compete aggressively with one another, that are efficient, and you have a contestable framework that removes the protective status of banks in some way, so that in the end they’re competing for the intermediation of savings and making judgments about business risk and lending portfolios—so quality and volume of loans? And when that gets out of line—or when we worry about that getting out of line—that’s when we look very carefully at our prudential supervision.

Norman You may have read some comments from Alan Bollard that were interpreted along that line, and there’s certainly been some discussion that record bank profit is the price you pay for stability. But when you go through and you look at the banks that failed during the GFC—for example, Lehman Brothers, which was doing a return on shareholders’ equity of 25 percent before it failed; Merrill Lynch, which was doing 20 percent return on equity before it failed; Bear Stearns, which was doing 19 percent return on equity before it failed; Royal Bank of Scotland, 18.7; HBOS, 19.7—we have a whole series of banks that had to be bailed out, that failed, that were having excellent returns in profitability. Isn’t that an argument that says just because a bank is getting record profits that doesn’t mean it’s going to be a stable institution? So that shouldn’t be the price we necessarily pay to have a stable banking system.

Wheeler Well, if you take Lehmans, for example, Lehmans was a highly leveraged investment bank—highly leveraged—so that every time there was a bull market the ROEs were spectacular; every time there was a bear market the market around Wall Street and London was always full of rumours about Lehmans’ pending failure and collapse. So you have to look at ROEs in respect of gearing ratios and leverage, and the quality of their portfolios—their asset portfolios. But the banking system here, as we see it at this point, is healthy, it’s sound, and it makes what we believe to be acceptable rates of return that aren’t out of line—that aren’t out of line—with international comparisons. And we see, as I say, a lot of competitiveness and a lot of efficiency.

Norman Just on a kind of different question, what I liked in your report, amongst many other things, was the acknowledgment that interest rates have an effect on the value of the dollar, so that New Zealand’s relatively high interest rates put upward pressure on the dollar. You’ve also acknowledged in the report that the high level of the dollar is an obstacle to the rebalancing of the economy, and the very high level of external indebtedness is a problem for the New Zealand economy and, potentially, for macro-financial stability. So it follows from that, it seems to me, that, even from a financial stability aspect, reducing the level of the OCR and interest rates, hence putting downward pressure on the New Zealand dollar, hence enabling the New Zealand economy to rebalance, should be something that’s of concern to the Reserve Bank. Yet in your last MPS you took no action on lowering the OCR, which may have assisted the rebalancing of the New Zealand economy.
We’ve already had the discussion earlier about how we can use loan-to-value ratios, so even if we have a lower OCR that doesn’t necessarily result in a housing asset bubble, which is, obviously, of concern to everybody. So why not put those things together—a lower OCR, using those macro-prudential fields alongside it—so that we can control that housing asset bubble at the same time as assist the rebalancing of the economy, which we have all acknowledged is a major problem?

Wheeler There are many factors behind the appreciation in the exchange rate, and, as I said before, many countries are experiencing this. The sorts of factors that are important are, essentially, if you look at a mapping of New Zealand’s exchange rate, it maps pretty closely—pretty closely, but not so much just recently, but pretty closely over the longer term—with terms-of-trade movements. And our terms-of-trade movements in New Zealand are very close to a 40-year high—a 40-year high. What’s happened more recently is, with quantitative easing in the US, Japan, and the euro area, where there is a flooding, if you like, of global liquidity, investors have been looking for higher expected returns, and in doing so they look at countries, by and large, that have sound macro policy positions—they have good prospects in terms of, if they’re commodity producers, terms of trade. They will look also at interest rate differentials—that is one factor that they will look at. And so a lot of capital is moving into those economies.

Norman Like ours.

Wheeler Like ours, that’s correct.

Norman So we’re borrowing their printed money and then paying interest for the privilege to use it?

Wheeler Well, I just said that there are several factors that are driving the exchange rate. You know, if you look at past OCR adjustments in New Zealand, and you look at what’s happened intra-day to the exchange rate, or you’ve looked on a weekly basis to what’s happened in the exchange rate as a result of that interest rate adjustment, you’ve seen very, very little impact—next to no impact. Indeed, in some cases, for some reason, the exchange rate has moved the other way, and that may be just a lot of exogenous factors coming into the system. So there’s no easy solution out there that simply says “Cut interest rates 25 BPS and the exchange rate will come off 10 percent.” That just doesn’t work.

Norman But isn’t that an argument for not saying the OCR—for saying the OCR is a useless tool. I mean, you’ve kind of made an argument that says it doesn’t do anything.

Spencer Could I just add that, you know, this important factor of the liquidity effect coming from the rest of the world into the Asia-Pacific region. Over the past 12 months, the Australians have dropped their official cash rate by 150 points, 1.5 percent, and their currency is still strong. You know, it hasn’t—
because of this flow that’s coming into Asia-Pacific, which is a higher growth area. It is actually not the interest rate that has been the dominant factor.

McClay  Russel, we have to move on.

Norman  We are borrowing their printed money into our economy.

McClay  Russel, thank you. We are going to have to move on here. We have a few other people. Colleagues, I have a question. Governor, we have heard widespread calls from different groups and political parties for quantitative easing in New Zealand, and, indeed, I think a week or so ago you made a statement in your first speech as governor that you did not see that it was necessary in New Zealand. Indeed, I think you spoke of some peril to our economy. For my colleagues around the table, could you run us through some of those perils, please?

Wheeler  I was in G20 meetings for a number of years, and I remember in 2008 the Federal Reserve representative who was one of the governors on the board came in and talked about re-entry problems—how do we get out of the system and back to more normal rates of monetary management. That was in 2009 when we were having that discussion. We are now looking at forward guidance from the Fed that looks at low interest rates for a long, long time.

When you’ve seen quantitative easing, it’s essentially been a reflection of nowhere further to go on interest rates, interest rate declines. Indeed, if the Fed did have scope to lower interest rates rather than inject huge amounts of liquidity, then I think that is probably the normal monetary response that they would probably want to adopt. In essence, where they are is largely a sign of desperation. It is a sign of desperation in the US, in Japan, and also, to some extent, the euro area, given the financial crisis in Europe, especially. So these are things that really, as I say, signs of desperation by central bankers to try and offset the deleveraging process, to try and get some growth in the economy. But if you look at what has happened to output growth as a result of this massive amount of quantitative easing, it is very hard to find any relationship between quantitative easing and output growth in those economies.

Peters  One supplementary question.

McClay  Winston, I said through the chair, and I have had somebody ask me for a supplementary question, so you can have one afterwards, please. Calm down, guys.

Parker  I accept what you are saying about how it’s difficult to get out of current settings and back to more normal settings, if you’re into quantitative easing. I accept that point. But I would say it also applies to New Zealand getting out of our current higher interest rates than the rest of the world that we
have now had for two decades, and an exchange rate that has been inflated so that we have had a current account deficit of four decades. It seems to me that the Reserve Bank, given its requirements at the moment at law, always gives us that answer. And here we are with the highest net international liabilities of any Western country outside of Europe, second only to Greece, a current account deficit which is second-worst in the world this year, and projected to get worse next year. How do we get out of these current settings, which for decades have our balance sheet in New Zealand getting worse?

Wheeler Well, we think there are benefits over the longer term to the economy that are significant in terms of maintaining low inflation and getting the interest rates down that accompany low rates of inflation, that are locked in, and have inflation expectations at low levels. The current account problem in New Zealand is a real concern. I mean, it’s been something that’s been there for at least the past three decades. It’s substantial. It contributes to high levels of external debt. If you look at it, a lot of it comes back to what I describe as a savings-investment imbalance in this country. You know, we rely extensively on foreigners’ savings to finance our own consumption and our own investment. Now, more recently, the household savings ratio, having been negative for a long time, has started to pick up, but it hasn’t picked up that much. It is still not positive by very much, but what you have seen is the Government has moved from a surplus position to a position of deficit, and that’s been significant, and that’s why the Government has an objective to move back to financial stability—to financial surpluses.

McClay Before you go on, we’ve got a few moments left. Everyone will get a chance. I have one more because I started this, and then we will go to sups. Then, I am afraid, we will be out of time. So you’ve said to us that you don’t believe quantitative easing is necessary in New Zealand, and, indeed, could be damaging for the New Zealand economy. Should a future Government change the policy settings to instruct you to use quantitative easing, and, I guess, therefore join other countries of the world that you’ve suggested are doing so through desperation. As Governor of the Reserve Bank, setting aside what you said to us, you’d be obliged to do so, use that tool, would you?

Wheeler If the issue is should we move to quantitative easing in New Zealand, we don’t think that that is something that deserves serious thought at this point. We’ve got plenty of scope, still, in respect of the OCR to lower interest rates if we need to.
Peters One of your predecessors, the first one, in fact, the first Governor of the Reserve Bank, when a compulsory savings option was put to the country, which would have had a dramatic effect on turning around our dependence on foreign savings, even to say hypothetically to the idea that he’d make no comment at all at the time, and this is the price we pay for that sort of leadership, but my question to you is by way of analogy. You’ve got a spluttering, non-performing machine. Do you think the mechanic with one blunt tool, a wrench, anti-inflationary, is going to fix this or fine-tune this machine, or the mechanic that has some quality tools, all of them capable at his disposal to use? Which one would you rather pick?

Wheeler Well, I think any practitioner wants a full toolkit of instruments to be able to address problems.

Peters Thank you.

Clark In respect of—just a question around the modelling. We have this current account deficit problem, which is projected to get worse and worse and worse over time. I’m assuming that your modelling, firstly, has the asset sales built into it, in terms of the widening current account deficit and an expectation that some of those will go offshore—some of the shares as they come to market will head offshore?

Wheeler I’m not sure. I can talk about that at our next meeting once, as I say, we have gone through all the forecasts.

Clark In respect of, just a follow-on from that, the Trading Among Farmers proposal—you have outlined here the challenges facing the dairy sector with high leverage and so on, and the prospects scenarios with prospects around a dairy payout falling. Will the Trading Among Farmers proposal, which has now been legislated, presumably contribute to that widening current account deficit? Over time, one would assume that would be a fair assumption, wouldn’t it?

Wheeler Certainly, terms-of-trade movements will always affect the trade balance, and therefore the current account balance.

McClay All right, Governor, thank you very much.

**conclusion of evidence**
Reserve Bank of New Zealand's Monetary Policy Statement, December 2012

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Todd McClay, Chairperson)
December 2012

Presented to the House of Representatives
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Reserve Bank of New Zealand’s Monetary Policy Statement, December 2012

Recommendation
The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, December 2012, and recommends that the House take note of its report.

Introduction
This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, December 2012, and the central issues we discussed with the bank in our examination. It was the first monetary policy statement from the Reserve Bank’s new governor, Graeme Wheeler. Our approach to considering the statement, our membership, and the transcript of the hearing of evidence are set out in the appendices to this report.

The December 2012 Monetary Policy Statement announced the decision of the Governor of the Reserve Bank to leave the Official Cash Rate (OCR) unchanged at 2.5 percent. The OCR has been at this unprecedented low level since March 2011, when it was lowered to help limit the adverse consequences of the Canterbury earthquakes. The governor indicated that he expects the OCR to remain unchanged in 2013.

Reserve Bank’s reasoning
New Zealand’s economy continues to recover at a modest pace. GDP grew by 1.6 percent in the first half of the year, but the rate of growth has slowed more recently. Inflation remains low, at an annual rate of 0.8 percent in the September quarter. There are differing measures of unemployment, but it seems clear that the labour market has weakened somewhat in the second half of the year. Housing market activity has increased, particularly in Auckland. Mortgage interest rates have been reduced to their lowest level in 50 years, helped by competition between banks and a drop in their funding costs of 30 basis points since the beginning of the year.

The global economic outlook remains soft, but the Reserve Bank now considers this less threatening than it did previously. There remain underlying problems in the euro area, but the risk of a severe deterioration has abated. Information about China’s economic performance has been more positive of late. The outlook for growth in the USA, however, is constrained by uncertainty over the extent of fiscal tightening likely to be required in 2013.

Repairs and reconstruction in Canterbury are gathering pace, and will provide major stimulus to the economy for the next several years. Against this, several factors will dampen economic activity and inflationary pressure: the Government’s fiscal consolidation as it seeks to bring its books back to surplus, continued caution by households and businesses as debt remains high, and the elevated exchange rate, which the Reserve Bank acknowledges represents a strong headwind for the economy.
Balancing these factors, the Reserve Bank envisages stronger growth over the next two years, at 2.5 to 3 percent per annum, with unemployment falling to below 5 percent, and inflation rising gradually to the 2 percent midpoint of the target range. The bank will be monitoring conditions carefully for any signs of weaker economic conditions or stronger inflationary pressures than expected. On balance, however, the governor expects to hold the OCR at its current level to the end of 2013.

**Outlook for economic growth**

The economy grew at an annualised rate of 3 percent in the first half of 2012, but slowed to 1–1.5 percent in the second half as the boost provided earlier in the year by strong agricultural production and expansion in the services sector subsided. The Reserve Bank expects GDP growth to accelerate again, to between 2.5 and 3 percent over the next two to three years, aided by the stimulus from rebuilding activity in Canterbury, which is now estimated to total $30 billion.

We note that the expected growth rate of 2.5 to 3 percent places New Zealand among the better-performing countries in the OECD, and compares favourably with our historic average GDP growth of about 2.25 percent over the past 30 years. Some of this, of course, is the expected impact of the post-earthquake rebuilding. The Reserve Bank told us that earthquake-related investment and reconstruction is estimated to account for 0.5 percent of the projected annual growth rate over the next few years, and to represent between 1.5 and 2 percent of potential GDP from 2015 to 2017.

The Reserve Bank concurred with us that its projections show New Zealand’s economic outlook to be generally positive, with growth, employment, and the fiscal balance all forecast to improve. However, it pointed out that there remain issues to contend with, particularly the large current account deficit, which is expected to rise to 5.5 percent of GDP by 2015; forecasts by the OECD suggest it might go even higher. We also remain concerned about the effects of the high exchange rate.

**The housing market**

House prices have increased by 5 percent over the past year on a nationwide average, but much more rapidly in Auckland, where latest figures show a 12 percent increase in 2012. We are concerned about this rapid rise in Auckland, and see a growing risk of a new housing-market bubble, with consequences for the affordability of housing—prices in New Zealand are already high relative to incomes—and for renewed inflationary pressure dampening the economy’s recovery. We questioned the Reserve Bank closely about the reasons for house-price inflation, and what it intends to do about it.

The Reserve Bank agrees that the increase in Auckland is substantial, but is not greatly concerned about it at present, as it believes supply will increase, stabilising prices. The bank attributes the rise to a current shortage relative to Auckland’s growing population, after several years of under-investment in housing, especially since 2007. Borrowers can take advantage of the lowest mortgage rates in 50 years, which is contributing to demand, and competition has led some banks to lend at higher loan-to-value ratios. The Reserve Bank is talking to banks about this lending behaviour, as it would view any rapid credit growth with concern.

Some of us are firmly of the view that the situation warrants the Reserve Bank using the macro-prudential tools it has been developing, for example requiring lower loan-to-value ratios or higher capital adequacy ratios. Such measures might not only dampen the
Auckland housing market, but might also serve to reduce other pressures in the economy and potentially alleviate the high exchange rate. Since such macro-prudential instruments were developed in response to the housing market bubble of the 1990s, it appears to some of us that they should be used in precisely these circumstances as an adjunct to monetary policy, as they can be tailored to a regional level more readily than interest rate adjustments. The Reserve Bank has publicly stated, however, that it will use such tools only for broad financial stability purposes.

The Reserve Bank said it would consider using macro-prudential instruments if it saw an asset-price bubble developing, but does not see a case for doing so at present. Credit is growing moderately nationwide, at 2 to 3 percent, although the bank acknowledged that in recent months a more rapid rise has occurred, equating to about 5 percent on an annualised basis. Even that rate of growth, it said, was not of concern in itself; however it could see grounds for taking action if the acceleration continued and was accompanied by a general shift to higher loan-to-value ratios. The bank agreed with us that houses are already expensive in New Zealand, at about 4.5 times annual average household disposable income, compared with a historic average of about 3 times, so there are issues of affordability. It forecasts that the rate of house price increases will taper off to about 2 percent on average as supply responds.

The Reserve Bank confirmed that its draft memorandum of understanding with the Treasury envisages macro-prudential tools being used to address the financial system’s stability and efficiency, and to reduce its vulnerability to shocks, be they asset-price bubbles or disturbances related to credit or liquidity.

**Growth in credit**

We explored with the bank whether it might be underestimating the rate of growth in bank lending because of distortions caused by earthquake-related insurance payments. We asked what allowance it has made in its calculations for the mortgage repayments made to banks when insurers pay out on earthquake claims. The Reserve Bank told us it takes such repayments into account in estimating credit growth; their effect is balanced out by the expected acceleration of credit growth once rebuilding gathers pace, so it does not think the overall distortion significant.

Given that $12 billion in insurance claims has been paid out to date, we asked the Reserve Bank to keep a close eye on the effect this may have on the rate of credit growth.

**Mortgage interest rates**

Easy global monetary policy and better international financial conditions have reduced funding costs for New Zealand banks. Along with strong competition between banks, these factors have reduced mortgage rates to historically low levels. We asked how New Zealand rates compare internationally, as they seem historically high relative to those in the USA, Europe, and the UK.

The Reserve Bank told us it is difficult to make direct interest rate comparisons between countries, especially at present. The exceptional measures taken by countries such as the USA since the global financial crisis have reduced their interest rates to near zero. Generally, however, countries like New Zealand with a savings/investment imbalance tend to have higher interest rates as a natural consequence of their need to borrow overseas.
Exchange rate

The Reserve Bank told us it doubts whether the use of a macro-prudential tool like lower loan-to-value ratios would affect the exchange rate in the current circumstances, even though it might make a marginal difference in the longer run. It considers the appreciation of the New Zealand dollar to be driven by the massive amount of liquidity injected by quantitative easing in major economies, combined with overseas investors’ perception of New Zealand as having a relatively high growth rate, sound macroeconomic policies, and a reasonable outlook for its terms of trade. However, it agrees that the high exchange rate is a problem. Quantitative easing, it seems, has distorted the normal relationship between New Zealand’s terms of trade and the exchange rate, with the dollar remaining high despite the fact that our terms of trade have declined over the past five quarters.

Canterbury reconstruction

The estimated total cost of rebuilding after the Canterbury earthquakes has been increased substantially to $30 billion (in 2011 dollars), from $20 billion previously. The revised estimate reflects an assessment that more damage was caused to commercial assets than previously thought, and revised earthquake-strengthening requirements will require some assets to be rebuilt to a higher standard than previously expected. While the total clearly represents a very major stimulus to the economy over coming years, the Reserve Bank does not expect the change in the estimate to have major implications for monetary policy over the next few years, as the extra building activity now envisaged is likely to occur in the second half of the decade.

We asked how the bank arrived at its new estimate, and how reliable it is. We were told that it is a “new, improved estimate”, but still highly uncertain; it has been rounded to the nearest $5 billion. The estimate was derived from many discussions with Canterbury agencies, insurers, and the Earthquake Commission. While previously the bank had given weight to an assessment of economic factors, the estimate is now based more on expected insurance claims, after deducting $3–4 billion unrelated to actual rebuilding, such as claims for loss of business.

The Reserve Bank told us it is not aware of any insurers inflating their costs. In fact, it believes insurers have the incentive to contain costs and get the work completed quickly, as their payouts are generally based on replacement cost.

Unemployment

According to the most recent household labour force survey, unemployment increased sharply in the September quarter, to 7.3 percent. The Reserve Bank considers the survey result out of step with several other indicators of employment. For example, the quarterly employment survey, the quarterly survey of business opinion, and the number recorded as receiving unemployment benefits by the Ministry of Social Development all paint a more positive picture. The bank notes that individual measures can be volatile from quarter to quarter, so it considers a broad range of data when assessing labour market conditions.

Overall, the Reserve Bank concludes that momentum in the labour market has slowed in later 2012, but less severely than the household labour force survey alone would suggest. It forecasts unemployment to fall markedly over the next two years, from 7.1 percent for the year to March 2013 to 4.9 percent in 2015.
Fiscal policy

The Reserve Bank’s forecasts envisage the Government making substantial progress in reducing its operating deficit over the next three years, but falling short of the stated goal of returning to surplus by 2014/15. The operating deficit is projected to decline from 4.1 percent of GDP in the years to June 2012 and 2013, to 1.7 percent in 2014, and to 0.8 percent in 2015. Explaining the variance from the Treasury’s forecasts, which project a fiscal surplus by 2014/15, the Reserve Bank says it uses similar real GDP forecasts but a lower price deflator, so expects lower tax revenue.

The Reserve Bank noted that the projection represents substantial fiscal consolidation over the next few years. Its task of managing monetary policy is made easier to the extent that the Government approaches fiscal balance, as this should reduce the need to raise interest rates to counter inflationary pressure.

Banks’ profitability

Recent data released by the Reserve Bank updated information it had provided to us in November about New Zealand banks’ profitability compared with those in other OECD countries. The new figures indicate that the profitability of Australasian banks is in the upper range for banks in advanced countries, rather than the mid-to-lower bracket as the governor had indicated at our earlier meeting. The governor explained that the bank’s earlier reply was based on the best information available at the time.

Some of us find it a matter for deep concern that the Reserve Bank’s data places Australasian banks as the fourth most profitable in the OECD on the basis of their returns on assets, and that data from the Bank for International Settlements suggests Australasian banks were actually the most profitable in the world in 2011. As the four major New Zealand banks are subsidiaries of Australian companies, some of us note that the repatriation of their profits must represent a drain on the economy, and a significant contribution to New Zealand’s current account deficit.

The Reserve Bank urged caution in drawing conclusions from the data. It said that accurate cross-country comparisons are difficult to make because of extraordinary items and tax issues, and also the data must be viewed in context. It pointed out that the profitability of banks in many OECD countries has been hard-hit since the global financial crisis, and that most banks in Asian countries would be more profitable than New Zealand’s, but are not included in the data. The Reserve Bank agreed that it is not desirable for a country to have the world’s most profitable banks, but pointed out that all countries want their banks to be healthy, which many in the OECD are not at present. It is satisfied with New Zealand’s prudential arrangements and does not consider an inquiry into bank profitability warranted. It noted that such an inquiry in Australia had concluded that there were no major problems, and recommendations had been on issues like the ease of switching between banks.
Appendix A

**Committee procedure**

We met on 5 and 12 December 2012 to consider the Reserve Bank of New Zealand’s Monetary Policy Statement, December 2012. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O’Donovan.

**Committee members**

Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith
Appendix B

Corrected transcript of hearing of evidence 6 December 2012

Members
Todd McClay (Chairperson)
Maggie Barry
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Alfred Ngaro
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Dr Nick Smith

Witnesses
Graeme Wheeler, Governor
Grant Spencer, Deputy Governor
John McDermott, Assistant Governor and Chief Economist

McClay Well, Governor, good afternoon and welcome back to the Finance and Expenditure Committee. You have today published the Reserve Bank Monetary Policy Statement and I thank you for giving us time before the committee today. I invite you to make some comments and then my colleagues will have questions.

Wheeler Well, thank you very much indeed, Chairman, and thank you for the invitation to be here. I’ve got two colleagues with me. On my right is John McDermott who is the Assistant Governor and Chief Economist of the bank, and on my left is Grant Spencer who is the Deputy Governor.

In terms of brief opening comments, the economy grew at a 3 percent annual rate in the first half of the year. We think the economy slowed to around an annual rate of 1 to 1½ percent in the second half of the year. Inflation in the labour market was weaker than most economists, including the Reserve Bank expected. Our forecast suggests annual growth is likely to accelerate to around 2½ to 3 percent over the next 2 years and there are several positive factors that will act as a stimulus for the economy, and let me go through those and talk about some factors that will dampen growth.

In terms of the supportive factors, the global economy remains soft but we see it as less threatening than we did earlier. Repairs and construction in Canterbury are gathering pace, the funding costs for banks have declined by
around 30 basis points since the beginning of the year, and mortgage rates are at their lowest level in 50 years. But some factors will also dampen growth, and these include the Government’s fiscal consolidation, the continued caution by households and businesses in their spending decisions, and the high New Zealand dollar is a significant head-wind for the economy, so the outlook is one in which we see, on balancing those factors out, stronger growth in domestic demand, and inflation rising gradually towards the 2 percent target midpoint.

Our focus in setting monetary policy will be to keep future average inflation near the 2 percent target mid-point, we’ll closely monitor the economic indicators over the next several months to see if there’s any further moderation in inflation that we need to take account of, and we’ll also look at those indicators with the reconstruction driven pick up in investment to see whether there is a greater degree of inflation pressure than our forecasts assume. But our central projection for the official cash rate is to remain at 2½ percent for the period and through to the end of 2014.

So thanks very much, Chairman, I’m happy to answer questions.

Parker You’ve commented that there’s been 12 percent house price inflation in Auckland plus some house price inflation pressures in Christchurch. For me the Christchurch pressures are unsurprising given what’s happening there, but the Auckland prices are of real concern. You have also, in answers to questions at the press conference you held earlier, said that you are developing macro-prudential tools under a memorandum of understanding with the Government, but you don’t propose to use them in the current circumstance, and you don’t believe that they should be used for monetary policy reasons as opposed to financial stability reasons. I just want to ask you how you justify that stance, given that we’ve got 12 percent house price inflation in Auckland and a current account deficit which is getting worse?

Wheeler The house price inflation in Auckland is significant. I mean house prices have increased 12 percent. We think that there are several factors that underpin that: there’s housing shortages, there’s a supply issue, there’s growing population, we’ve seen under-investment in housing in Auckland in recent years, particularly since 2007, and we’ve also got mortgage rates at the lowest in 50 years and some higher loan-to-value ratio lending by some banks. So they’re things that are a concern there that we’re looking at and talking to banks about.

We’re not seeing house price inflation accelerate significantly for the country as a whole. I mean, house price inflation for the country is around about 4 to 5 percent. In Auckland it’s running at 12 percent.

Parker On top of already very, very high prices relative to incomes.

Wheeler Yes, house prices here are expensive and the house price ratios as a multiple, if you like, of household income are still high. They’re around 4½ times for the country. They were around five in 2007, but they’re well above the three that were there in the 1990s. So house prices, in my view, are expensive. So there’s affordability issues there.
But my main point is that if you look at the credit numbers, credit is growing at around about 2 to 3 percent on an annual basis, that’s not dramatic or significant or something that would cause us major concern at this point in time. We’re seeing the credit numbers increase on a monthly basis more recently, but in terms of an annual basis they’re still at around 2 to 3 percent. House prices for the country as a whole are growing at around 5 percent. We think there’s some affordability issues and the supply side response that will stop house prices from increasing dramatically in the next period of time. Our forecasts, in fact, show house prices growing at around 5 percent and then coming down to 2.

But in terms of the macro-prudential instruments, yes we are in conversation with the Treasury. We’ve produced a draft memorandum of understanding that would be signed once it is agreed between the Governor of the central bank and the Minister of Finance. We had an initial discussion with the Minister yesterday. It will be used essentially to help address issues around financial stability, and issues that, basically, to try and reduce the vulnerability of the financial system to potential shocks that could be in the form of asset price bubbles, or it could be credit-related shocks, or it could be a liquidity-related shock, and that’s why we see these instruments.

Parker You haven’t mentioned exchange rates—as to why you would use them. I just find it incredible that we’ve had 180,000-odd people leave to Australia, we’ve got 175,000 people unemployed, but still you’re not willing to contemplate the use of instruments other than the interest rate to control some of the imbalances that we have in the New Zealand economy and that currently are getting worse.

Wheeler Well, the exchange rate appreciation is a problem, we’ve said that before. It’s something of a concern. If you look back historically it’s tied in with terms of trade movements to a considerable extent, but what’s happened in New Zealand is that for the past five quarters the terms of trade have declined and you’ve seen significant quantitative easing by major economies and major central banks in the world, and there is a strong relationship between essentially quantitative easing, bullish share markets, and exchange rate appreciation in those countries that have higher growth rates, sound macro policy, and tend to have commodity prices that have a reasonable outlook.

Parker The non-bank finance sector has been cleaned out, so according to one of our advisers, there’s very little risk of intermediation by other financial lenders if you were to introduce loan-to-valuation ratios or some other macro prudential tools like capital adequacy ratios to dampen down the Auckland housing market. Can you envisage ever a better time to use macro-prudential tools than you currently have?

Wheeler Well, you know I think we would very much have wanted these tools in the period 2001 to 2007, because then you had the highest house price appreciation in the OECD occurring in New Zealand. That’s when the tools would have been tremendously helpful. But as I say, at this point in time, if we had the tools available to us—if we did, in respect of say, for
example, a loan-to-value ratio—then as we see the housing market at present on a national basis, and given the credit growth figures that I talked about, we wouldn’t see the need to use LV ratios at this point in time. But if we felt that there was a danger of a credit bubble emerging, or an asset price bubble emerging, then we would want to use those tools.

Parker So you think the Canadians and the French and the Israelis are wrong to be using them?

Wheeler They’re valuable instruments, as I said. If you take the Canadian case, Canada hasn’t had any house price decline that I’m aware of since the global financial crisis.

Parker But their prices weren’t as high as ours.

Wheeler House prices have continued to—they didn’t have the same appreciation during 2001-07, that’s correct, but they’ve had quite rapid appreciation since. Israel over the last 3 years—when I last looked at the numbers I believe they were up of the order of something like 50 percent.

Parker I find it hard to accept that with the high levels of unemployment, the house price inflation in Auckland, and the heightened exchange rate, that now of all times you wouldn’t be using other levers other than the interest rate in order to try and take pressure out of both house prices and perhaps alleviate pressure on the currency.

McDermott If we want to pick up on the exchange rate, there’s many factors that are going to drive the exchange rate and we know it is a very important price—relative price—between New Zealand and the rest of the world, and the key drivers that we think about, one is the growth performance in the relative economies. Now it may be that New Zealand’s recovery is very slow but when we look to the rest of the world there recovery is even worse, so that matters. In addition, the market’s bounced around between taking risk on and risk off and that’s moved around a little bit since the global financial crisis, and it is an important factor to take consideration of.

The third factor you have to keep in mind, and it also mirrors the relative growth performance, is interest rate differentials. So we have an interest rate setting that’s appropriate for New Zealand to keep inflation stable.

Parker In part because you’re not using LVRs.

McDermott No, no.

Peters The point, sir—look don’t come along and give us an economics lesson. We know how you explain that we do nothing, we’re asking why don’t you do something?

McClay Colleagues, before we go on, I’ve got a list of others that have first questions, so we’ll let you continue and then we’ll move on. Winston, you’ll a chance in a moment—I have you on the list.

Peters We all know why they’re not doing anything.

McClay Well, you’ll have a chance to question in a moment. Please go ahead.
Spencer  There has to be a financial stability issue to address. I think it’s very questionable, if we applied LVRs tomorrow, whether it would have any impact on the exchange rate. It may have some marginal impact over time, but the basic rationale, our powers are for the purpose of stability and efficiency of the financial system. I mean, credit is still growing at 3 percent, sure LVRs are creeping up, we’re watching it, but there’s not a case yet to say there’s a financial stability issue. So that’s why we are not proposing to use them at this point in time.

Goldsmith  Now you are forecasting New Zealand’s economic growth to be 2 or 3 percent a year over the next 3 years, and I’m interested in how that compares with other developed countries, and particularly interested—you were saying that the risk of a severe near term deterioration in the Euro area has decreased and that the bond yield seemed to indicate that the risks have dropped. But when you think about the basic issues in Europe they don’t seem to have gone away. I’d quite like to hear a bit more about why you think that’s not so dangerous and how New Zealand’s growth compares with the rest of the developed world in that area?

Spencer  The Greek situation has at least been deferred. There’s still a lot underlying imbalances, a lot of economic issues in Europe, but the funding of the southern European countries has been substantial from the European Central Bank, and just recently there has been a further tranche of funding, some $40 billion euros from the so-called troika. So at least for the time being they have the funds to be going on with but that’s not to say there won’t be problems down the track.

But what we’re saying in the document is that those risks of financial disruption over, say, the next year have diminished as a result of this new funding agreement.

Wheeler  In terms of growth rates for the next 2 years, it’s one of the better performers in the OECD. If you look historically at New Zealand’s growth over the last 30 years the economy has grown on average at around 2.25 to 2.3 percent, so these projections suggest the economy will be more closer to 2½ to 3 percent.

Parker  Your table on page 19 shows that in 2015, even ignoring the second round effects from reconstruction, the first round spend is over 1½ — between 1½ and 2 percent of GDP. So in respect of the growth figures that you are quoting to us, is it true that if you take the 2015 year, for example, around 1.7 percent of the growth, ignoring second round effects of that, arises from the reconstruction spend in Canterbury?

McDermott  Can I pick up on some detail? Obviously in a purely accounting sense Canterbury’s very important to future economic activity, that’s inevitable. But in a counter-factual case, had the earthquake not taken place there would have been a whole bunch of other industries that would have continued to be successful, particularly tourism. So a pure mechanical calculation, while correct, also misses the fact that New Zealand would have been in a far better place had the earthquake not taken place.
That may well be so, but my question is to you, according to page 19 it says that the earthquake-related investment and reconstruction share of potential GDP is between 1.5 and 2 percent. It looks as if it’s about 1.7 percent, sort of 1.75 percent, maybe, the next year.

That’s figure 5.2?

Yes.

Correct.

So is it correct that in those years, of the increase in GDP, about 1½ to 2 percent of it is actually spending the insurance money, or the Government contributions to it?

It’s investment in things like infrastructure, buildings, residential buildings, commercial buildings and so on.

Could I just clarify that? That’s not a contribution to growth, that’s a level. So the contribution to growth over the next few years is more around half a percent of GDP in terms of the contribution to that overall 3 percent growth.

Well, just following on from that, trying to cheapen the results I suppose, but presumably if the Government wasn’t having to deal with the massive amount of spending—and capital spending—that’s been required in Christchurch, so there wouldn’t be quite the need for some of the fiscal constraints that we’ve got over the next few years, and so I expect growth would be held back?

Yes, the Christchurch reconstruction assists economic growth in that sense and it should also help the manufacturing sector, given the close tie between the construction sector and manufacturing through durable goods and house construction and all of that.

Out forecasts build in investment flows of $8 billion over the forecast period. That’s $8 billion out of $30 billion in real terms.

I assume that the Reserve Bank is very neutral in its presentation of this information. When you say the mortgage rates are at 50-year lows, that’s New Zealand mortgage rate. If you compare that with Europe, Japan, USA and the UK, the differential is the highest in 100 years, is it not?

We’re always neutral in our information, whether it’s the highest in 100 years I’m not sure.

But by comparison, if I was to compare 100 years ago to every decade and into now, those countries mortgage rates with ours, ours is the highest in 100 years—is that not true?

I would have to check that, I really would.

Well, take a stab in the dark, you’re pretty familiar with those figures.

What I can say is mortgage interest rates in many of the economies such as the US and Europe are low. We’re at the lowest for 50 years and you can
get mortgages now for under 5 percent, for example. Whether that
differential is the largest in 100 years—

Peters  But it’s 40 times higher than Europe.

Wheeler  I beg your pardon, sorry, I missed that I’m sorry.

Peters  40 times more than Europe in cost.

McDermott  Well, we prefer not to have a European economy.

Spencer  The mortgage rate, comparing between different economies, different
currencies, you know, you have to compare like with like.

Peters  Well, I’m comparing a mortgage on a house with a mortgage on a house.
That’s what Joe Bloggs in Timaru is paying. That’s what he wants to know.
He doesn’t want to have an economics lesson as to why he’s putting up
with this while nobody does a thing about it, he wants to know is the
political system capable of doing fairer business in terms of a mortgage for
him as against his international competitor. What’s your answer to that?

McDermott  For a long time New Zealand hasn’t had enough savings for its own
investment purposes whether that be business investment or building
houses. As a net consequence New Zealand has built up a rather large debt
position. Countries that do that tend to pay higher interest rates, so it is a
consequence of New Zealand’s savings behaviour, both private sector and
public sector, over a very long period.

Peters  I can take that as a given. Of course, the Reserve Bank was very neutral
about the idea of a compulsory savings regime 13 years ago. Do you recall
that?

McDermott  Not exactly.

Peters  Well, I do.

McClay  About 4 years ago in interest rates, people in Timaru were probably paying
about 9 percent for their mortgage against their house in New Zealand. Do
you know what the interest rate probably was in Europe at that time? So
when we had exceptionally high rates rather than 50-year lows, what was the
interest rate in Europe at that time?

Wheeler  Could we get back to you? I wouldn’t want to mislead you.

McClay  Certainly.

Peters  Can I ask you this question. Look, are you not alarmed at the speed with
which the estimated Canterbury reconstruction’s gone from $20 billion to
$30 billion? These are colossal figures, all being presented by the same
people in such a short time. Are you alarmed by that?

Wheeler  Well, there’s been a lot of uncertainty around those numbers. It is a
substantial increase, that’s correct. Those numbers are in real terms as well,
real prices. We get the numbers from talking to CERA and talking to the
insurance agencies, the underwriters, the EQC, but it is a substantial
increase compared to the initial projections.

Peters  Has any insurance company artificially inflated this cost?
Wheeler Not that I'm aware of.

Peters But there have been warnings about it from overseas. Precisely about 3 months ago these warnings were coming to us saying “watch out for this very almost inevitable effect of insurance industrial behaviour.” Nobody's asked any questions in the Reserve Bank?

Wheeler It's not an issue that's been brought to my attention. One issue that I think is a potential concern is that the insurance payouts could be of the order of $35 billion, and the amount paid out to date, I’m told, is around about $10 or $11 billion. That's a huge amount of liquidity going into a small economy and one would want to make sure that, to the extent possible, that that's invested and invested wisely.

Cosgrove Just on the verification issue of the cost estimates, when you’re talking with CERA do you attempt to validate their forecast or how do you assure yourself that their forecasts aren’t wildly inconsistent?

Spencer One of the important sources of the information for CERA is actually the estimate of the total insurance claims, which actually comes from our prudential department. So we've been trying to sort of triangulate this from an economic side and from the insurance side, and there had been a bit of a gap, and now that the number—

Cosgrove How big was the gap?

Spencer Well, the total insurance estimate was like $33, $34 billion. But a lot of that insurance—that’s a nominal number—also, a lot of the insurance claims are things other than rebuilding, like loss of business, etc. So we've been trying to do that reconciliation, but we’re doing another hard look at it, and have also discussed it with CERA, and so our estimates have moved up more towards the insurance-based estimate than the sort of bottom-up economics-based estimate.

Cosgrove And you’re pretty confident with the information you’ve received.

Spencer Well, no it’s highly uncertain that’s for sure. But the numbers have been moving around. But because of that uncertainty we had tended to stay in previous forecasts with the number that we had. Do we have a good case? We thrashed it out with CERA and came up with this new improved estimate, we think, of $30 billion.

Cosgrove Much fat built into it?

Spencer Well, I would say about the insurance companies, a lot of the insurance policies—most of the residential policies are replacement, and so it's really in their strong interest to try and contain the cost, because they have to front up to replace the buildings, so if the cost goes up and it's taking longer to complete a replacement of a house, then generally they have this inflation effect which they have to wear basically. So there is an incentive for them to try and contain it and get it done quickly.

Smith The line of questioning I want to pursue is around your forecasts for 2013. If I look at page 24 of your December statement I see that you are projecting growth of 0.7 percent in the March quarter next year through to
0.8 for each of the three other quarters. It effectively totals growth for 2013 of 3.1 percent, which would be the strongest economic growth that New Zealand's had for a decade?

Peters What's your question, forget the speech.

McClay Winston, thank you. Nick, carry on, please

Smith And then I turn to the broader macroeconomic predictions of unemployment coming back from 7.1 to 5.9, inflation for the year at 1.6, and a halving of the Government deficit. Would it be fair to describe this, when I reflect on the last few years, as you projecting 2013 actually being the best year for the New Zealand economy for a very long period?

Cosgrove Break out the champagne!

Smith Well, that's what he says. I know you guys deal in bad news. Is it fair to describe these projections as 2013 being the best economic year for New Zealand for many years?

Wheeler In terms of output, on page 26 you'll see expenditure on GDP 2008 was 3.6. But my main point is, look, this is strong growth relative to history, I suppose. As I said, going back 30 years the average growth rate was around 2½ percent in New Zealand. These forecasts do have fiscal consolidation in them. We don't have fiscal balance by 2014, 2015 in our projections. By 2014-15 we still have a deficit of around 0.8 percent of GDP. We do have inflation under control heading towards the mid-point of the band. The economy’s got unemployment down to around 5 percent towards the end of the projection period, but it still has a large current account deficit. I mean it’s still sitting here with a current account deficit of 5½ percent of GDP, and we do have other projectors, other forecasters like the OECD in fact saying that that current account deficit may be a bit higher. So generally it’s a good picture but there’s still some issues out there that are very important.

Norman My question, Mr Wheeler, is about bank profitability and just revisiting some of the issues around that, which I think are relevant today, but previously you told us that if you compare return on assets across most OECD economies we are, in fact, about average or below in terms of bank profitability on a return on assets basis. Do you stand by that statement?

Wheeler Well, I issued a statement the other day in response to this and I think the position was very clear in that statement. Now that we’ve completed the work I think it shows that profitability is in the mid to upper level of advanced countries rather than the mid to lower level. But comparisons are difficult because of extraordinary items and tax issues, but that’s how we see the situation at present.

Norman That was the graph that you sent me when I did an OIA request following that meeting, and in that table New Zealand, if you take Singapore out, which isn’t an OECD country, if you look at return on assets, which is the generally accepted comparator—right data set—then New Zealand is the fourth most profitable banking system in the OECD?
Wheeler: In terms of that particular measure, based on the comparison countries there, that would be the case.

Norman: And do you agree that another data set which makes sense to look at in this context is the Bank for International Settlements, who do produce a data set on comparative profitability within banks looking at return on assets, and they find the Australasian banks, so the Australian banks including their New Zealand subsidiaries, the most profitable in the world in 2011, and if you do break out the New Zealand subsidiaries they’re actually doing better. So we have probably the most profitable banking sector of the big four within the OECD. Do you think the Bank for International Settlements is wrong with that data or right?

Wheeler: The Bank of International Settlements collects very good data. I mean they’re a high-quality institution. I’m not sure of the New Zealand data in the table you’re referring to—I see a reference to Australia, but I don’t see a reference to New Zealand, which is not to say that it isn’t there, but I’m not aware of it. And if you look at the comparator countries that they use in that table, a lot of them have been very significantly hit by the global financial crisis, and several of the comparator countries have been significantly hit by the global financial crisis.

Norman: The reason why I think it’s important and kind of impacts on the whole issue is that it seems to me that we want banks that don’t go bankrupt. I think we all agree on that, but banks that are the most profitable in the world, it seems to me that profit’s got to come from somewhere, and given that they’re not exporters, they’re just domestic service providers, that profit must come from the domestic economy, and surely having the most profitable banks in the world that are taking all of that money out of our domestic economy and sending it back to their owners overseas, how can that be good for our economy?

Spencer: I don’t think you can say that the banks are the most profitable in the world. I mean from the OECD-type comparisons they’re in the upper range, but we’re observing that a lot of the countries in the OECD have been affected by the financial crisis and so their profits are down below normal. In the BIS comparison there’s essentially an OECD-type comparison. Most of the countries in that list, the European countries, or the US, or Switzerland, if you actually made a comparison, say, including Asian countries, most of the profitability of those banks would be above us, so you can’t say we’re the most profitable in the world.

Norman: OK, so if we use the OECD data—that’s where we started with this conversation because that was the governor’s comments, the return on assets within the OECD—we are at the top or very near the top with that dataset. Do you agree with that?

Spencer: Yes, for the time being. But you would hope so because a lot of those other countries have been badly affected by the global financial crisis, which is ongoing in terms of the impact on bank profits.
Norman So in terms of the broader point that I was trying to make in the second part of what I was saying, in terms of the relationship between very high profitability for our banks and our whole economic health, if you like, which is a major concern of your Monetary Policy Statement, do you want, or is it your aim, or is it your hope that the banks will sit up there right at the very top with the highest profitability within the OECD? Do you think that’s healthy for our system?

Spencer It’s healthy for the banks to be profitable—to earn reasonable profits. We’re certainly not looking for our banks to be the most profitable in the world. But you have to take the data in the context of what’s happening in the rest of the world, and if half of the banks in the OECD are being hit by significant serious problems, you have to take that into account. They’re not in a healthy state. Our banks are in a healthy state, which is good.

Norman And yet one of the issues that you raise, I think quite rightly, is the chronic and high current account deficit, and we know that probably the single largest contributor to that current account deficit is the transfer of the banks of their profits, essentially, back to their Australian owners is a huge chunk of that current account deficit. Aren’t you concerned that this very high level of profitability is making a big impact on our current account deficit, which is one of our major structural weaknesses?

McDermott Can I pick up on the economic point here? Apologies for giving another economic lesson, but there are no free lunches here. Suppose the New Zealand businesses or households got that credit from another source that wasn’t through the current banking system. You’d be able to go offshore, and, because we don’t domestically supply sufficient savings, we’d be paying offshore interest rates. So either way, because we want to access global financial markets, there’s a price to pay. And you can pay it through dividends or you can pay it through higher interest rates. Either way the economy has to pay that price unless it changes its balance between investments and savings.

Peters Can I just ask one thing. Look, you’re aware in Canberra there have been a number of inquiries into banking charges and practices—in Australia, of their own banks. Now, one would assume that they have got some suspicions as to whether they’re getting a fair go in Australia. Does it not concern you that with these sorts of questions today, and a number of New Zealanders’ concerns about what they have to pay, that there’s been no inquiry in this country at all into foreign banks?

Spencer We have a very close relationship with APRA. We’re talking to them all the time. APRA are the institution in Australia that keeps close to the banks, they watch their behaviour, they watch their prudential state. We’re doing a similar thing in this country, and we have that dialogue. We’re happy that we are working on a similar basis from a prudential point of view.

Peters No, no, no. Look. Excuse me, I’m talking about, there have been, when I say Canberra, I’m talking about the Senate and the representatives there. They’ve had a number of serious investigations into their suspicions as to—and there was a joint agreement between the two political parties going into
the last election as to banking costs in Australia. These Aussie banks—now, does that Ned Kelly behaviour stop when they come to New Zealand?

Spencer Well, they came to the conclusion after extensive inquiries that really there wasn’t anything particularly wrong, except to try and improve the mobility between bank accounts, and certain actions were taken to try and have portability of account numbers and this sort of things. But really, nothing else came out of it in terms of findings of mispractices or whatever. So there was an inquiry, yes, but, you know, the findings were pretty benign.

Barry My question is around unemployment, and the household labour force survey deteriorated significantly in September. That’s excited a lot of comment. But that’s at odds with other measurements, and I look at your projections, you know, we’re looking at 4.9 percent unemployment 2014-15, 5.9 percent next year. Why do you think it is that the HLFS is out of step with some of the other indicators?

Wheeler Well, it is out of step with other indicators. It’s a reasonably volatile series. There are revisions, I’m told, occasionally, but not like GDP revisions, which can be quite substantive. If you look at what we call the QES—the quarterly employment survey—you get a different picture. If you look at the Quarterly Survey of Business Opinion, you get another picture about the labour market here. And you get a lot of firms talking about the difficulty of finding skilled and unskilled labour. And if you look at the Ministry of Social Development in terms of their unemployment benefits, you get another picture completely. So what we’ve tried to do in our forecast is essentially take a middling position between what a number of these indicators are showing. So we didn’t accept the HLFS data as it is. We took somewhere in between as our view of the labour market.

Barry And ultimately the other projections that you make over the next 2 years reflect more optimistic or better outlook.

Wheeler Yeah, we see unemployment coming down quite markedly.

Hayes With inflation and interest rates expected to remain low for the next few years, what part will the Government’s fiscal policy play in that?

Wheeler I mean, the Government has an intention of reaching fiscal balance by 2014-15. As I mentioned earlier, our projections suggest that the Government won’t get there. We have similar GDP forecasts as the Treasury does in terms of real GDP, but we have a lower price deflator, so therefore you get less taxation revenue coming in under our forecast. So that’s what the difference is. To the extent that the Government is moving towards balance of surplus, then in essence that takes some of the pressure off monetary policy and makes our job in the central bank easier.

Norman I was intrigued by your comments about credit growth. I didn’t quite catch the numbers. You said 2, 3 percent annualised? But you said in the last few months it had increased significantly. If you took the last couple of months—

Wheeler It had increased. Not significant, but—
Norman: If you took the last couple of months and annualised the number, what kind of annualised number are you talking about in the last couple of months?

Spencer: About 5 percent.

Norman: And so if you got a 5 percent annualised credit growth number, would that raise your concerns? Because you’ve said you’re not concerned about the current annualised number, but clearly, there has been an increase in recent months, which may well be connected to the big increase in what’s going on in Auckland, I don’t know, but would you be concerned by a 5 percent number?

Spencer: I’d say that we’d be concerned if it the acceleration continued. I wouldn’t be concerned particularly by a 5 percent number per se, but if it was acceleration, particularly combined with increasing shift to high LVR lending, etc., then that would be an issue.

Parker: I’ve just got a supplementary—

Norman: Can you give us a metric—sorry, I’ll just be very—just a metric. What is the number where you would take action, say, for example, on LVRs?

Spencer: It’s too complicated, the formula, sorry. There’s no one number threshold, and, you know, we look at a range of indicators, and if it was that simple, it’d be a lot easier.

Parker: The insurance payments that have been made to settle claims in Christchurch will often involve repayment of a mortgage, and the mortgagor will require repayment of that when the insurance money comes out. Is there any risk that you are underestimating credit growth in a material way because of the credit repayments that are being made as a consequence of the insurance repayments in Christchurch?

Spencer: We don’t think that’s a significant factor. There is potential for additional credit demand around Christchurch, you know, where people—

Parker: I know. I understand that demand bit. I’m asking you, on the repayment part of the cycle, when the insurance pays out, the insurance has to repay the mortgagee, the mortgagee’s interest is noted on the insurance policy, and the bank is repaid in full at the time when there’s a settlement of a property that’s been demolished, for example. Do you take that into account in your estimation of what’s happening to credit flows at the moment? Because that’s a temporary—

Spencer: We certainly try to, yeah. We certainly try to take that into account.

McDermott: Of course, you run the risk on the other side, because once you start rebuilding—

Parker: That’ll be part of credit growth. I agree it will be, but you should—

McDermott: We have to try and look at it as best we can.
Parker  So your 2 percent credit growth is already net of those credit repayments, which are temporary. Have you got an estimate as to how much that is of credit growth?

Spencer  We look at the flows at the margin, not just the overall stock movement, and because—

Parker  Could you provide us with an estimate as to what is the calculation you are making in respect of those repayments that are coming from insurance reflows, please.

Spencer  Well, we don’t have a specific—we’ll check to see if we have a number on that.

Parker  If you haven’t got a specific figure, then doesn’t that point to my fact that you might be underestimating the impact of that on credit growth at the moment? We’re talking billions of dollars of insurance repayments that are coming through.

Spencer  Well, we’ll try and give you an estimate.

McClay  Thank you. If you could check that and come back to us. Governor, thank you for your time today.

*conclusion of evidence*
Budget Policy Statement 2013 and Treasury’s Half-year economic and fiscal update, December 2012

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Todd McClay, Chairperson)
March 2013

Presented to the House of Representatives
Budget Policy Statement 2013 and Treasury’s Half-year Economic and Fiscal Update, December 2012

Recommendation

The Finance and Expenditure Committee has considered the Budget Policy Statement 2013 and the Treasury’s Half-year Economic and Fiscal Update, December 2012, and recommends that the House take note of its report.

Introduction

The Minister of Finance’s Budget Policy Statement 2013 was published on 18 December 2012 with the Treasury’s Half-year Economic and Fiscal Update 2012, and stood referred to the Finance and Expenditure Committee.

From our examination of the statement we wish to draw the attention of the House to the following matters.

Summary of Budget Policy Statement 2013

The Budget policy statement for 2013 outlines the Government’s plans for Budget 2013 and subsequent years. The key issues from the statement and our hearing with the Minister of Finance are summarised below.

The Government intends that Budget 2013 will focus on the following priorities:

- managing public finances responsibly
- building a more productive and competitive economy
- delivering better public services within tight financial constraints
- rebuilding Christchurch.

The statement reiterates the Government’s commitment to controlling spending tightly and returning the public accounts to surplus by 2014/15. A modest surplus of $66 million is forecast for that year, increasing thereafter, provided there is no further deterioration in world economic conditions. The expected surplus is lower than the $197 million projected in Budget 2012. The Minister emphasised that continuing surpluses will be needed well after 2015 to enable the Government to reduce debt to prudent levels, rebuild buffers against natural disasters and economic shocks, and resume contributions to the New Zealand Superannuation Fund.

Core Crown expenses are forecast to fall to 30.3 percent of GDP by 2015/16, having peaked at 35.1 percent of GDP in 2010/11 as the Government sought to cushion the impact of the recession, the global financial crisis, and the Canterbury earthquakes. The statement notes that reducing spending will require particularly firm control over costs in areas such as welfare, health, education, and law and order. As in recent Budgets, the priority for new spending will be given to health and education.
The Budget policy statement reiterates the Government’s intention to constrain operating allowances for new initiatives to $800 million in Budget 2013 and $1.2 billion in Budget 2014, increasing them by 2 percent a year thereafter. Most areas other than health and education will be expected to stay within current spending baselines. New capital spending will be funded from existing capital, particularly the $5–7 billion expected to be raised from the planned sales of shares in state assets. The proceeds from sales under the mixed ownership model will be put into the Future Investment Fund for investment in new public assets; Budget 2013 will provide details of planned allocations from the fund.

Budget 2013 will continue the programme of microeconomic reforms set out in the Government’s business growth agenda, which is designed to help businesses become more competitive internationally. The Minister of Finance told us the programme comprises 300 specific reforms. Budget 2013 will also show what action is being taken by the public service to achieve specified results in areas such as reducing crime and long-term welfare dependency, and boosting skills and employment.

The Minister informed us that the Budget will be delivered on 16 May 2013.

**Economic context**

The New Zealand economy continued to improve modestly in 2012, despite an uncertain international outlook in the lingering aftermath of the global financial crisis. The half-year economic and fiscal update predicts annual growth averaging 2.5 percent over the next five years. This assessment by the Treasury is slightly lower than the average of 3 percent growth projected in the 2012 Budget update, reflecting a revised judgement that the economy’s underlying rate of growth is likely to stay slower for longer. The Treasury says its projections are broadly consistent with those of other forecasters.

The unemployment rate is forecast to improve over the next few years, falling below 6 percent in 2015 and to 5.1 percent by March 2017. The demand for labour is expected to rise as business confidence improves and rebuilding progresses; employment is forecast to increase by 1.9 percent in 2014/15, its fastest growth since 2007.

Core Crown debt is expected to peak at 29.5 percent of GDP in 2014/15 and 2015/16, and to lessen subsequently as the Government continues to achieve modest operating surpluses.

The half-year economic and fiscal update notes that the exchange rate is likely to be a drag on growth over much of the forecast period, constraining the earnings of exporters and import-competing businesses. The current account deficit is forecast to increase from 4.6 percent of GDP in the year to March 2014 to 6.5 percent in the year ending March 2017, about 1.5 percentage points of the increase arising from the imports needed to rebuild Canterbury.

The Minister said there are two main explanations for the slow pace of New Zealand’s recovery from the global financial crisis. Historically, financially-driven crises take longer to recover from; and so many countries were affected by the downturn it is difficult for them all to make similar adjustments, such as increasing exports or devaluing their currencies, at the same time. In these circumstances, the Government’s focus is on improving the competitiveness of the domestic economy, since this is an outcome over which it has some control.
The Minister indicated that New Zealand’s economy is in good shape compared with those of many other countries. It is expected to grow more strongly over the next four years than the euro area, the UK, Japan, and Canada, and at a similar rate to Australia and the US. Although greater saving by households has weighed against economic activity in the short term, he emphasised that it is necessary to lay a stronger base for sustainable growth in the future.

Risks in the forecasts

The risks to the economic outlook have moderated, but it remains more likely that conditions will deteriorate relative to the forecasts than improve. The global outlook is uncertain, with Europe and, to a lesser extent, the US still facing long-term structural problems. For New Zealand, the main domestic risks concern the timing and scale of Canterbury’s rebuilding, the extent to which households save and reduce their debt, and changes in the exchange rate.

The following table sets out the Treasury’s principal forecasts.

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<th>Summary of the Treasury’s economic forecasts</th>
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<td>March years, %</td>
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<td>Economic growth</td>
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<td>Consumer Price Inflation</td>
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<td>Unemployment rate</td>
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<td>Current account (% of GDP)</td>
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<td>Current account excluding Canterbury rebuild investment (% of GDP)</td>
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Rebalancing the economy

We asked whether the Minister believes progress is being made on the Government’s stated objective of rebalancing the economy away from debt-financed consumption and on to a more sustainable, internationally competitive footing. With the current account deficit forecast to increase and export volumes down in the quarter to December 2012, it would appear that New Zealand’s economic activity is still underpinned by borrowing from overseas. The Minister agreed that efforts to rebalance are being hampered by headwinds such as the exchange rate, but he said the fact that the current account deficit has been reduced from over 8 percent since 2008 shows that progress is being made. He believes the numerous reforms in train under the Government’s business growth agenda represent a sound policy approach to improving New Zealand’s long-term international competitiveness.

Some of us doubt this assessment, and consider that efforts to rebalance are failing; rather, New Zealand appears to be ever more reliant on the primary sector for its growth, as evidenced by the plight of some manufacturers, which we discuss below. A recent assessment by Westpac suggests that both the current account deficit and household indebtedness are worsening, increasing the likelihood of a hard landing for the economy—when interest rates eventually rise again.

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1 Budget Policy Statement 2013, p.7.
Regional distribution of economic growth

We note that the growth rates Treasury is forecasting are underpinned by the expectation of increased construction investment over the next few years for earthquake rebuilding. At our request, the Minister undertook to have the Treasury calculate what proportion of growth is likely to be accounted for by the rebuilding. The secretary said he believed it is about 0.7 percent, but would attempt to provide more information.

Some of us consider this breakdown particularly important (and are disappointed the Treasury could not provide it earlier in response to requests under the Official Information Act 1982) as it indicates the extent to which New Zealand’s prospects are dependent on rebuilding activity in Canterbury, or represent broader, more sustainable growth. In this connection, the declining employment base outside New Zealand’s principal cities is of serious concern for some of us, as many regions suffer an exodus to Australia and an ageing population. In the Minister’s view, such trends are not new, as the competitiveness of businesses and industries changes over time. He noted that over the past decade some primary industries have been shrinking, affecting regional areas, while others have grown. For example Taranaki, on the strength of the oil and gas industry, has a relatively stable population and growing per capita incomes. He added that the Government considers the regulatory framework for the water resource to be vital, as water is central to production and jobs in regional areas.

Current account deficit

The current account deficit has been reduced over recent years as activity slowed during the recession, but it is forecast to increase from 4.6 percent of GDP in 2013/14 to 6.5 percent in the year ending March 2017. The Minister acknowledged that it would be preferable if the current account were in line with the rate of nominal GDP growth so it did not increase New Zealand’s external liabilities as a percentage of GDP. He said that some increase is unavoidable over the next few years as imports are needed for Canterbury’s rebuilding, but says he does not agree with the size of the increase the Treasury is forecasting. In his view, the steps the Government is taking to encourage investment and help businesses become more internationally competitive should improve the current account position.

The Secretary to the Treasury commented that, although the forecast current account deficit is high, he does not believe New Zealand’s position is unsustainable given its policy strategies for the medium to long term. The policy objective, he noted, is not to fix the current account deficit per se, but to improve living standards in New Zealand. Some aspects like the current account deficit, which has been a long-standing problem, will take some time to improve.

Manufacturing and the exchange rate

Some of us are concerned that New Zealand’s growth prospects appear ever more reliant on the primary sector, which is unlikely to be able to sustain the country’s economic health on its own. Evidence received by the current parliamentary inquiry into the future of manufacturing indicates that some manufacturers are struggling to remain profitable at current exchange rates. As manufacturing employs about 11 percent of the workforce, some of us find this situation alarming, and believe the Government should take steps to ease the pressure on manufacturers from the high exchange rate.
The Minister of Finance said that not all manufacturers are struggling to make a profit. He acknowledged that they are under pressure—the result, he said, of the high exchange rate and the accumulated effect of past policy settings—but said that surveys show the pressures to be uneven, with some industries doing well nevertheless. Looking at the broader context, he said the adjustment New Zealand needs to make because of the effects of the global financial crisis, while difficult, is manageable and more moderate than that which most countries are undergoing. However, significant areas like the exchange rate are beyond the Government’s control. He said it is therefore focusing on what can be influenced to help businesses invest and grow, and is open to the views of manufacturers about what the Government could feasibly do beyond the 300 measures already planned under the business growth agenda. Some of us are concerned that the Government has been selective in its consultation with manufacturers; the Manufacturers and Exporters Association, for example, has been unable to have its views heard by the Minister for Economic Development.

It was pointed out to the Minister that the top three measures proposed by some manufacturers to the parliamentary inquiry are broadening the Reserve Bank’s legislated objectives so that inflation is not given higher priority than the exchange rate; introducing a capital gains tax; and making KiwiSaver universal; the Government appears to reject all three options. The Minister responded that he does not reject the thinking behind such views, but believes resolving the issues comes down to improving the fundamental competitiveness of the economy. He suggested that calls to lower the value of the exchange rate amount to a desire to lower the real wages of workers, as the flip-side to devaluation of the currency is a lowering of purchasing power and household living standards.

**Exchange rate**

Some of us continue to doubt the value of New Zealand being one of the few countries not prepared to intervene to lower the value of the currency to help the tradable sector. The Minister remains of the view that the exchange rate is outside the Government’s control; he told us steps would be taken to lower the dollar if it were likely to be effective, but said he has heard no feasible proposal that would allow the Government to influence the exchange rate in a sustainable way. The Minister commented that while people call for action to lower the dollar, they cannot specify what action the Reserve Bank should take: should it raise or lower interest rates? The way the market might react to either move was unclear, and any action might rebound and worsen the situation.

The Minister added that New Zealand’s interest rates, although historically low, are high compared with those of the UK, Europe, Japan and the US. Such countries have been prepared to experiment with unorthodox monetary policy measures as they had run out of other policy options. The Minister described their economies as “patients in the emergency room”; by comparison, New Zealand is out training for a triathlon. He added that, having taken such untested measures out of desperation, policymakers in these countries will face the challenge in the next decade of how to return to normal policy settings.

The Treasury concurred. It considers that much of the current pressure on our exchange rate arises from the extraordinary measures being taken by other, larger economies, and that it cannot be eased by any steps New Zealand takes alone. It noted that there is international debate over whether coordinated action is possible or desirable. Fundamentally, however, it sees the main determinant of the exchange rate to be New
Zealand’s savings and investment history, and considers this the area to be addressed for the longer term.

The secretary was reluctant to comment on possible monetary policy measures, but considers that the Reserve Bank has adequate tools available in addition to interest rates to address issues like price pressures from the housing market and to maintain financial stability.

**Foreign direct investment**

The Minister said the Government recognises the critical importance of investment for the economy, and is striving to create conditions that make New Zealand attractive for both domestic and foreign investment. Some of us recalled that the Minister for Economic Development recently went so far as to suggest that foreign direct investment will be crucial for job growth, and therefore infer that it is of concern that foreign interests have been reducing their investment in several industries around New Zealand such as wool spinning, log processing, and aluminium smelting. The Minister of Finance commented that recent instances of foreign disinvestment have included business failure, which was not abnormal, and New Zealand investors buying assets back. He noted that New Zealand’s main sources of foreign investment have traditionally been the UK, Australia, and the US, and the caution being shown by their investors is understandable given the pressures their economies are under. This made it all the more important for New Zealand to have an environment conducive to investment.

The Secretary to the Treasury commented that New Zealand ranks among the best places in the world to do business, with a top rating for transparency and accountability. We agree that it is important to maintain such perceptions, and are therefore concerned that some business people overseas have told us that it can take too long to get things done in New Zealand. The secretary acknowledged that some of the processes required by the Resource Management Act 1991 can take a remarkably long time. We were told that the Treasury is examining the effectiveness of the Act, and the rules for inward investment, to ensure they are not restricting investment that might benefit the country overall.

**Public expenditure**

The half-year economic and fiscal update indicates that core Crown expenditure will be reduced over the next three or four years, to just over 30 percent of GDP in 2015/16. The Government is also working to improve the quality of its spending, by developing more effective public services focused on specific outcomes such as better NCEA results and less reoffending by prisoners. The Minister of Finance said he believes it possible to eventually achieve a virtuous circle, where the best result for the community is also best for the Government’s books.

We note that the submission we received from Federated Farmers, while supporting the priorities outlined in *Budget policy statement 2013*, strongly advocated holding core Crown expenses below a firm target of 30 percent of GDP. The organisation said its main concern is the effect that Government spending can have on the exchange rate, by putting upward pressure on inflation and interest rates. It considers control over public spending to be preferable to unorthodox monetary policy efforts to achieve a more export-friendly exchange rate. Some of us believe that despite two decades of responsible fiscal management, the New Zealand exchange rate has remained at high levels relative to the
fundamentals of our economy, as evidenced by New Zealand’s prolonged current account deficit.

**Tax revenue**

Core Crown tax revenue is forecast to increase over the next four years at a faster rate than the economy, but by less than envisaged in the 2012 Budget update, owing to a slower outlook for growth and inflation. Policy changes to fuel excise and road user charges will, however, provide $1.1 billion of additional revenue over the period to June 2017. In addition, lower inflation and interest rate forecasts mean that expenditure on benefits and finance charges will also be reduced, partly offsetting the lower expected revenue.

Some of us are concerned that policy decisions in recent years have eroded the tax base, a trend made worse by the behaviour of some multinational corporations in avoiding paying their fair share of tax on earnings in this country. We asked what advice the Treasury is giving on tax rules to ensure that overseas businesses operating in New Zealand compete fairly and are good corporate citizens. The Secretary to the Treasury did not have details but agreed this is an important issue, though not one New Zealand can resolve on its own. He said it is being addressed in an international context through the OECD, and he believes there is consensus among the international community that such issues must be tackled; unfortunately, reaching international agreement will take some time.

**IRD’s computer systems**

We asked what input the Treasury has into the plans for overhauling the Inland Revenue Department’s computer systems, as it would appear that New Zealand firms are being excluded from contractual arrangements in favour of Capgemini, a large international firm. We suggested there might be scope for breaking the project down into smaller components to allow competitive tendering. The Treasury told us it is working closely with the IRD on this issue among others, and that no decisions have yet been taken.

**Rebuilding Canterbury**

Rebuilding activity in Canterbury is gaining pace, consistent with earlier projections, and the investment activity is expected to feed growth in jobs and incomes. The Minister noted that the main issues will be the pace of the rebuilding, and how well the region copes with the inevitable labour constraints and price pressures.

Estimated damage from the earthquakes has been revised upward in the half-year economic and fiscal update, with fixed capital investment for rebuilding now expected to amount to about $30 billion, of which $13.1 billion would be financed by the Crown. Just over half the total spending on rebuilding is expected to be incurred in the period covered by the forecasts, to June 2017. This includes all the infrastructure investment needed, most residential rebuilding, and about $3 billion of commercial and social investment.

We asked what the Government is doing to remove obstacles to rebuilding. The Minister said that, apart from some insurance issues that are inherently difficult, the pace is already picking up considerably on insurance settlements and new building. The Government’s focus is on continuing to work with local councils on the regulatory side to improve the pace and results of decision-making. In particular, it would like to see the Christchurch city council relax some of its rules to allow infill housing; for example, if it would approve more than one kitchen on a section, the amount of available accommodation could be increased quite rapidly. He said the Minister of Housing is also trying to speed up Housing New
Zealand’s processes, which have been somewhat slow. Regarding reports of people forced to sleep in cars in Christchurch, the Minister agreed there is an understandable shortage of housing after the earthquakes, but said he accepts the assessment of the Minister for Canterbury Earthquake Recovery, who is most closely in touch with the issues, and would not term it a housing crisis.

**Policy focus for future growth**

In addition to the specific issues covered above and the acknowledged importance of New Zealanders sustaining better savings habits, we asked the Treasury to indicate other broad policy areas that it sees as important for growth in the long term. The Secretary to the Treasury was reluctant to rank specific policies, but said issues that would rank highly include the effectiveness of the Resource Management Act and how water resources are used, the quality of teaching and skills development in New Zealand’s education system, and whether New Zealand’s tax system is fit for purpose and promoting appropriate incentives. He added that Auckland is very important to New Zealand’s economy, where major work is needed to ensure the supply of land and the consenting regime support an effective housing market.
Appendix A

Committee procedure

We met on 13 and 27 February 2013 to consider the Budget Policy Statement 2013 and the Half-year Economic and Fiscal Update, December 2012. We heard evidence from the Minister of Finance and the Treasury.

We received one submission, from Federated Farmers of New Zealand.

Committee members

Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark (until 27 February 2013)
Hon Clayton Cosgrove
Hon David Cunliffe (from 27 February 2013)
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Kate Wilkinson
Appendix B

Corrected transcript of hearing of evidence 13 February 2013

Members
Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Kate Wilkinson

Witnesses
Hon Bill English, Minister of Finance
Gabriel Makhlouf, Secretary to the Treasury and Chief Executive
Vicky Robertson, Deputy Chief Executive
Dr Girol Karacaoglu, Chief Economist

McClay Good morning. Welcome to the Finance and Expenditure Committee so early in the new year. We have before us a hearing of evidence on the Budget Policy Statement of 2013 and the Half Year Economic and Fiscal Update for 2013. Minister, we have 45 minutes available to us, and then I understand that the Secretary to the Treasury will stay for an additional period of 45 minutes. Welcome again. I offer you the floor.

English Thank you, Mr Chairman. The Budget Policy Statement confirms that we are on track to continue with moderate growth, more jobs, and return to surplus, despite the uncertainty around the world. The statement sets out the Government’s plan to return to surplus and reduce debts, a wide-ranging programme of microeconomic reform, and getting better results and better value from public services, and rebuilding Christchurch. Budget 2013 will continue to implement the plan.

The half year update forecasts a moderate operating surplus in 2014-15 of around $66 million, and that’s on a deficit track that 2 years ago was $18 billion, last year $9 billion, and this year about $7 billion deficit. For next year these forecasts show a deficit of around $2 to $4 billion, and then a
surplus around 2014-15, and with core Crown debt peaking just below 30 percent of GDP, and thereafter surpluses are forecast, although the surpluses forecast in this half year update are lower than those in the last Budget.

Continued control over spending has allowed the Government to continue to forecast getting to surplus, while revenue remains somewhat uncertain due to difficult global economic conditions. The half year update shows growth averaging 2.5 percent per year over the next 5 years, increasing numbers of New Zealanders in employment, and falling unemployment. Budget 2013 will confirm the Government’s commitment to responsible fiscal management. This will require restraint well beyond the surplus target of 2014-15. We will be looking to reduce pay-down debt, and build a buffer against whatever the next global shock is going to be and whenever it comes.

We are also continuing to address New Zealand’s significant economic challenges, including a rebalancing towards the internationally competitive sectors of the economy. A broad range of targeted microeconomic reforms is under way, and that is set out in some detail in the Government’s Business Growth Agenda, focused on the dozens, if not hundreds, of things we need to do to help lift New Zealand’s productivity and competitiveness.

In respect of growth, since the lowest point of the recession in the June quarter of 2009, the economy has grown at an average of 2 percent per year in real terms. Increased household savings has been good for our long-term rebalancing of the economy but has weighed against domestic activity in the short term.

It does appear that the European sovereign debt crisis is slightly less urgent than it was, but, never the less, we believe there are still long-term structural problems in Europe that need to be resolved, and we are a bit too cautious to expect that is going to be a smooth process. It is somewhat the same in the US—there are some signs of optimism that the US economy may grow a bit faster than expected this year, but, again, while it has made more progress than Europe in resolving its structural issues, I think we’re all familiar with the fiscal policy problems that they’ve got ahead of them over the next few months. So that’s just one example of the kind of uncertainty that could have an impact on decisions in New Zealand.

Never the less, at an average of 2.5 percent a year of growth, we are expected to grow more strongly over the next 4 years than the euro area, the United Kingdom, Japan, and Canada; pretty similar to Australia; and about the same as the US.

Our current account deficits are forecast to be slightly smaller now than they were forecast in Budget 2012. These forecasts show quite a significant effect of the Christchurch earthquake. In fact, it is somewhere around 1.5 percentage points. So when we are talking about current account deficits of 5 or 6 percent, the Canterbury effect is something like 1.5 of those 5 or 6
percent forecasts, and, of course, that is an impact on the economy that will work its way through over the next 4 or 5 years.

We have a number of positive opportunities over the next decade related to our growing trade and investment links with Asia. The Government has signalled from the start of the year a particular focus on encouraging investment in New Zealand. If we look at investment over the last 4 or 5 years, investment levels have been relatively low. It is particularly notable in the construction industry, and, I think, fairly obvious there, but even in our industries that have proven to be more resilient, say in primary production, investment levels have been relatively low. So there is somewhat of a backlog of investment catch-up to be achieved.

These forecasts show that we are expecting pretty strong growth in construction investment over the next couple of years. The Government believes we need to do more to encourage investment across the rest of the economy, because in the long run our employment levels and income levels are related to current levels of investment. That includes a positive view about the role of foreign investment in New Zealand. So our businesses are becoming more competitive through this process, and so we will continue to see growth from the export sector not as fast as we would like, and, of course, they have to deal with the headwind of the exchange rate. In my view, our export sector has proven itself to be remarkably resilient in the face of the headwinds that it has had to deal with.

The Christchurch rebuild is a significant factor in the growth forecasts, and it looks as if the actual activity on the ground now is consistent with the forecasts that were made in the half year update. There is no doubt that level of activity is picking up; it's just a matter of how fast and how Christchurch is going to deal with the inevitable constraints, such as labour supply, that will arise, and also pricing effects from the strong upsurge in construction activity. But it does look like it’s on top.

So we’re in a good position to translate the opportunities we have with our growing export markets and the Canterbury rebuild into higher incomes and more jobs, and that’s what our programme is aimed at. Budget 2013 will be the next step in that plan, and I’m announcing today the Budget will be delivered on Thursday, 16 May. Thank you, Mr Chairman.

Parker

Thank you, Minister. The Half Year Economic and Fiscal Update introduced the new petrol tax and increases in ACC levies in out years. Were it not for those new taxes, would you have been in deficit beyond 2014-15?

English

Well, there’s no increase in ACC levies. There was a recommended decrease, which the Government didn’t proceed with, and there was an increase in petrol excise and road-user charges. Yes, they bring in more revenue—it’s about $150 million in 2014-15 for the petrol taxes. But, look, we would regard it as—well, there are two points I’d make about it. The first is that with the dedicated road-user fund, which finances both maintenance and capital investment, the Government’s got a programme, it’s quite a large programme, and the increases were driven primarily by the
need to align the funding with the projects that we’d already committed to. Secondly, yes, of course it makes a difference to the surplus, but only in the same way as any number of other decisions make a difference to it. For instance, if we hadn’t budgeted on $200 million or $300 million of savings in the core public sector, we wouldn’t be showing a very slim surplus either.

Parker You’ve gone to some trouble to separate out what your estimate is of the contribution of the Canterbury rebuild to the current account deficit. I’m intrigued why you haven’t gone to the same effort to work out how much of our projected growth is coming from the same quarter.

English Well, I’m sure we could show the composition to the extent possible of the GDP number. I think in the case of the current account deficit, it’s simply because of the significance of it. So we’ve heard both the Government and plenty of other commentators talking about rebalancing the economy. When you look at the aggregate figures, progress on that is slow, and for the next number of years it’s likely to continue to be slow, because we have this very significant boost in domestic activity related to the earthquake, which we are committed to achieving; we’re not trying to redirect resources away from that into the export sector. So the reason I’ve commented on it is because it’s very significant in the context of the current account.

Parker It seems very significant in respect of GDP growth.

English It is.

Parker So you say you could do it. Are you willing to do it?

English Well, yes, I’m sure, to the extent that they can. My understanding is that of the 2.5 percentage points it would be somewhere between 0.5 and 1 percentage point of it.

Parker It would be useful if you could do that, because we did an Official Information Act request to see whether there was such an estimate, and we were told that it had only been done in respect of the current account deficit, and it seemed to be almost political that you were defending the poor current account deficit projections but not conceding the point that the same thing works for you very substantially in respect of the growth figures.

English Well, we’re quite happy to provide the figures on the composition. I think it’s not a matter of politically trying to explain things; it’s a matter of the facts. The Christchurch rebuild is big for growth, and that has some impact on the current account deficit. I think that’s fairly obvious.

Parker The Official Information Act request that we had said that there had been no such work done by Treasury, so I’m pleased that you will now allow it to be done.

English It’s not a matter of allowing it to be done. I mean, they give the GDP number, it’s got a statistical basis, and I’m sure they can separate something out. There are various indicators: there’s strong growth in construction investment, which is significantly driven by Christchurch but not only; there are measures of flows across the border.
Cosgrove Can I ask: will you provide that to the committee now, will you?

Makhlouf Of the Treasury, I’m very happy to have a crack at providing that to the committee.

Parker Great, thank you. I am interested because, you know, in your Budget Policy Statement 2012 you said: “We are moving towards growth that’s driven by savings, export, and productive investment in the parts of the economy that trade with the rest of the world.” That’s quoting your words. You’ve said again that you’re trying to rebalance the economy, yet the half yearly fiscal update shows that again we’ve got a current account deficit that is increasing—$10 billion in the last year—and we’ve got export volumes predicted to go down in the next year. I would suggest that we’re by no means rebalancing the economy, and that we still have construction- and consumption-led growth, rather than export-led growth.

English As I indicated in my comments, there’ve been headwinds to the rebalancing. Is there progress? Well, if you stand back a bit, yes, there is. I mean, if you take the current account deficit as a measure, then 4 years ago it was 8 percent of GDP, and it is currently less than 4 percent. And even the forecasts—as we’ve said before, I’m a bit more optimistic than the forecasters about it—show it’s going to grow. Of course it would be best if the current account deficit was somewhere around nominal GDP levels, and was sustainable and not growing our external liabilities. And we’re aiming for that. I think the question really is what further actions can policy makers take to achieve something New Zealand has not achieved in the last 30 or 40 years. We have laid out a whole suite very transparently—all the things that we’re doing through the Business Growth Agenda, which we think will encourage investment and rebalance the economy. I’m happy to hear and argue over other better suggestions.

Parker Doesn’t it worry you that your colleague Steven Joyce just in the last week effectively said—and I don’t think I exaggerate—that the fundamental key to job growth in New Zealand is foreign direct investment? He placed great emphasis on that. Yet our foreign direct investments outside of the primary sector are disinvesting—whether it's the wool spinners in Ōāmaru or the log processors up north or the aluminium smelter in Invercargill. You show me an area of substantial foreign direct investment other than in the primary sector.

English Look, I don’t have the breakdown of figures here, but to the extent that investment is important—and we believe it’s very important—then we do need to work quite hard at creating conditions that make us attractive for all investment, which will include foreign investment. Some of that disinvestment that you’re referring to is about businesses that have failed. Well, that’s not abnormal. Some of it is about New Zealand investors buying back what used to be New Zealand assets. But you’re right, our world of foreign investors—which has largely been the UK, the US, and Australia—are all economies under pressure, including Australia now, and they are very considered about where they push their investments. So we need to have an environment that’s very conducive to that.
Parker You’ll be aware that there’s an inquiry—it’s not through this committee, because it was blocked by your members on the committee having a select committee inquiry into manufacturing. But the manufacturers are telling us that they can’t make a buck, whether they’re from New Zealand or from overseas, under current settings.

Cosgrove Don’t think you were at the inquiry, were you?

Parker Many manufacturers, even manufacturers that are dominant in the world, high-tech manufacturers, are saying they cannot make a buck under the current settings. Therefore they say that we are not investing, they are not investing. And it’s the same pattern whether you’re foreign direct investors or New Zealand investors. Outside of the primary sector there is virtually no investment in the economy. I put it to you that our economy is becoming more and more reliant on our primary sector base and that we cannot get wealthy as a country on the back of that primary sector alone.

English Well, there’s a number of different issues there. In the first case, of course there’s pressure on most businesses. New Zealand is going through an adjustment related to the global financial crisis and the state of our markets, which is a difficult adjustment but a more moderate adjustment than most. So, yes, it’s difficult, but it’s manageable. As you know, there are significant aspects of it that we don’t control. Secondly, it’s not correct that no manufacturer can make any money.

What we find through the surveys that are done, the activities of Treasury and the Reserve Bank, and politicians around the place, is that it’s very patchy. Some industries are doing very well and some poorly. Even within industries some companies are doing well and some poorly. That is the competitive pressures of a relatively high exchange rate and the accumulated effect of New Zealand not managing its domestic policy setting as well as it should have. We’re doing our best to sort out the bits that we can control. So I’m not saying it’s easy, but I think in the circumstances we’re keen to hear from the manufacturers about the next set of things they believe the Government should do to help them invest more, because we’re willing to do whatever is feasible.

Parker I have one last question on that, and then my colleague has got just a supplementary question on it. Are you worried that the census this year is going to show some pretty scary population trends in our regional areas—showing the effects of the mass exodus of people to Australia, the ageing of our population, and the decline of our employment base in so many of our secondary cities and towns?

English I don’t know if there would be anything particularly new about those trends. It’s been evident in a number of our regional areas for some time, but not in others. For instance, in Taranaki, which has one of the highest per capita incomes in the country, the population has been relatively stable and incomes have grown on the back of the oil and gas industry, which we want to continue to encourage, and others want to stop. You can’t have it both ways. With respect to a lot of our regional areas, we need a reasonable
framework around the economic and environmental pressures on water, because it is a key to production and jobs in those areas.

Parker  
So primary production again seems to be the only answer that you have.

English  
It’s not a matter of my answer; it’s a matter of what’s working. We don’t agree with this view that primary production is somehow some kind of dim-witted production process. That’s the wrong sort of growth.

Parker  
Well, I’m not saying—no one’s said that other than—

Cosgrove  
That’s your characterisation.

Parker  
That seems to be your view of manufacturing, actually, rather than our view of primary production.

McClay  
We’ll come to a supplementary question from Clayton, then we’ll move on.

English  
I’ll simply disagree with that. Our view is that businesses and industries that can be competitive should be—we can support every business that’s here and some of them will turn out to be competitive and some of them less competitive, and over time that changes. There are parts of the primary production industry that aren’t competitive at all and have been shrinking consistently for the last 10 years, and there’s not a lot that we can or, in my view, should do about that.

Parker  
You still maintain the view that there’s nothing that you can do about the exchange rate?

English  
Very little. That’s right, yes, still of that view. And, actually, I haven’t heard any other feasible proposition that allows us to choose our exchange rate in a sustainable manner.

McClay  
Clayton has a supplementary, and then Paul Goldsmith.

Peters  
Hang on a second.

McClay  
Winston, hang on. We’ve got a list here. I’ve got you on the list. You’ll have an opportunity to go into those areas.

Peters  
But my supplementary relates to that last statement. He just said he’s never heard of any sustainable manner with respect to the currency. That’s an extraordinary statement to make against worldwide examples where you’re palpably wrong.

English  
Zimbabwe?

McClay  
When we come to your time for questioning, you’ll have an opportunity to raise that.

Peters  
No, no, Switzerland; not Zimbabwe.

McClay  
We have a supplementary, and then we’re moving on.

Cosgrove  
I’m interested in your information—

Peters  
That’s an extraordinary statement to make.

Cosgrove  
I’m interested in your information sources, because you obviously seek information from a variety of entities, but you say you are keen to hear from
manufacturers. Would it surprise you that the Manufacturers and Exporters Association, the MEA, I think the former president on Monday in public session told the manufacturing inquiry that that organisation has tried to engage with Minister Joyce since he became Minister for Economic Development and has never been able to achieve a meeting or a conversation or a telephone call or any sort of engagement? Is that the sort of priority—or are you just happy to listen to advice that suits you, rather than a widespread, wide-ranging set of advice?

English

Yes, we had very wide-ranging advice. I’ve had a number of discussions with representatives of I think pretty much any manufacturing organisation, and we have regular engagement on a detailed level with the business community. That’s part of the purpose of the Business Growth Agenda and the publication—

Cosgrove

Your Minister for Economic Development won’t engage with one of the most representative organisations of manufacturers in the country.

English

Well, you’d have to ask him about that.

Cosgrove

Won’t return a call.

English

The Minister for Economic Development is very well informed about the situation.

Cosgrove

From people he wants to listen to.

English

From a whole range—

Cosgrove

From people he wants to listen to.

English

Well, no. The discussion with business groups is a bit like the discussion with the social—

Cosgrove

What’s wrong with the MEA, and engaging with them?

McClay

Let the Minister answer.

English

Just hear me out. What the Government has done is bring to those discussions transparency and grittiness.

Cosgrove

Grittiness?

English

So we have set out 300 separate initiatives in the Business Growth Agenda and we most weeks—

Peters

Three hundred?

English

Yes, 300—most weeks—so they can open it up and have a look at each policy initiative the Government has taken. Most weeks Minister Joyce, other Ministers and I are engaged in one way or another with the business community, with this simple challenge: “Tell us the next thing we can do to help your business.”

Cosgrove

Let me put this to you—

Peters

They’ve been telling you for ages.

English

Have they ever seen the list of everything we’ve done?
Cosgrove  That would be great if your Minister for Economic Development would actually engage with the MEA and those groups. How can they have input if the Minister just won’t engage with them?

McClay  Clayton, let the Minister answer the question, and then we’re going to move on to Paul.

English  They have every opportunity—they have every opportunity—to say: “Yes, we agree with those 15 things. Those three there you’ve done but they didn’t make any difference. And here’s the next five things we want to help us to be more competitive.”

Parker  As a supplementary to my question, can I say that they have given a list.

McClay  David, we need to move on to Paul now. We can come back, if there’s time, later.

Goldsmith  We’re on target for a surplus in 2014-15 of $66 million. If you look around the world, a lot of other countries are struggling to get to a surplus, or it’s out in the never-never land. So why have you decided that it is so important to get to that surplus in 2014-15?

English  It’s just important so we can stop debt increasing. In a world that’s hostile to debt, that matters. It’s also important for the stability of public services, because there’s a lot of countries on their way to surplus, but I have say their pathway is much more dramatic than ours. In our close neighbour Australia you will find a couple of states in the last 12 months have fired 10,000 public servants, or more. We haven’t done that sort of thing. So it’s not just about getting to surplus; it’s about that we’re on a moderate track of adjustment to surplus. I think for our households the other important aspect of it is—for New Zealand households it’s an important indicator of Government focus and leadership, because they know that they’ve got too much debt. It would be hopeless for us to be saying to the households: “Well, you’ve got to reduce your debt but, by the way, we’re running loose on ours.” As it happens, at the moment they are reducing their debt and ours is still increasing fairly significantly. That’s why it’s so important that we get back in sync with where New Zealand households are, but not overdo it. I think we’ve got that track about right.

Goldsmith  You talked in the Budget Policy Statement of reduced growth, a fraction in the out years, and you’ve described it as moderate growth, and compared with other bouncing back from recession periods it is relatively modest. Why do you think that is such a relatively slow uptake or growth out of recession? You’ve talked about the headwinds of the currency. Is that the main thing, or are there a number of other factors?

English  Look, there’ll be people writing PhDs on this for another 50 years, but there are a couple of things that matter. One, I think, is the coordinated nature of the downturn around developed economies and quite a lot of developing economies—not all of them—so that’s clearly had an impact. It’s hard for everyone to make the same adjustments at the same time. Most developed countries are trying to make the same adjustments at the same time. So we’re trying to boost exports, and so is everybody else. In fact,
much as some advocate it, they can’t all devalue their currencies at the same
time. It just won’t work. It doesn’t matter how hard you try, weaker
economies are going to end up with lower valued currencies relative to
stronger-performing economies. When you’re one of the stronger-
performing ones it’s virtually impossible to make that adjustment, all at the
same time. Then there is the other theory, that because it’s essentially a
balance sheet driven crisis—a financially driven crisis—historically those
have taken a long time to recover from. Either way, we know what we need
to do, which is focus on the competitiveness of our domestic economy,
because we have control over that.

Peters In a recent statement before this committee you said: that our terms of
trade remain high and our businesses are becoming more competitive.
You’ve seen the figures for the fall in exports for the end of December last
year, and also the trade deficit for that period. So how can you make those
two statements, against those facts?

English Well, I think we just need to be a bit careful about which facts we’re using
here.

Peters The facts that you’ve given from your department—a 5 percent drop in
exports, for a start, as at the end of December last year.

English I don’t know which figures you’re actually referring to, so I’m best not to
comment on them.

Peters Exports fell 5 percent in the December quarter last year, according to the
Government.

English Yes, well, that could be a seasonal—

Peters In that quarter.

English It could be the seasonal or quarterly effect. The general point here, I think,
is in any quarter you can find figures that are going to be jumping up and
down, so those figures may or may not be useful. If your general point is
that export sectors are under pressure, then we certainly agree with you.
The question then is what do you do about that, and the Government’s
view is that we should focus strongly on our domestic competitiveness. We
haven’t seen—there’s some discussion about whether you can get some
exchange rate effect that will relieve pressures on those exporters, but we
haven’t seen a sort of viable, sustainable proposition to do that, because if
you could just make that choice, well of course you would.

Peters When?

English If it was costless, but it’s not costless.

Peters When? Hang on. When? Your Governor of the Reserve Bank says—this is
what he says—that the high dollar is “undermining profitability in export
and import competing” businesses. So when it gets to about 90, will you act
then or what?

English Well, the question is what is the action? So I’ve been asking a few people a
simple question: should the Reserve Bank Governor put interest rates up or
down, if you want to lower the exchange rate? And, you know, even people who’ve thought about it for 30 years can’t tell me the answer to that.

Peters Well, you keep on saying that about interest rates—

English Because, of course, if he puts interests down right now, the market might look at that—it may; this is just hypothesising—and it might look at that and say: “Oh, that means he’s going to have to put them up further later, and that’s a better bet on the New Zealand exchange rate, so let’s go and buy Kiwi dollars.” And the exchange rate goes up.

Peters Yeah, but you are on record as constantly saying that we have the lowest interest rates in the last 50 years, yet in comparison with the UK, Europe, USA, and Japan, it is the highest in 50 years by miles—in real terms against those competing economies. Why don’t you admit that?

English Well, not quite, but you make a fair point that there is a margin over those other rates, which is pretty similar to how it’s been in the past, although it does fluctuate. But it’s a bit like saying: “Well, the patient who’s lying in the emergency room and is half dead has got a slower pulse rate than the person walking along the street.” The fact is those are economies that are in extreme situations, and that is why they have 0 and 0.5 percent interest rates. It’s not because they’re healthy; it’s because they’re really sick. And we happen to have positive interest rates because we’re in a bit better condition than they are.

Peters Oh really?

English That’s one of the reasons, yes.

Peters Well, OK then. Manufacturing employs about 11 percent of the workforce, right, which is twice as many as tourism, so why is there virtually nothing about manufacturing in your latest statements?

English There is. If you go to—

Peters Apart from the odd sop: “I can’t do anything. Sorry about the currency, chaps.” But I can’t think of a way internationally where it describes what China’s doing, Singapore’s done, South Korea’s done, what Japan has done, Switzerland is doing. You say there’s nothing that you can do?

English No, we’re not saying that. If you look at the latest statements, there are five of the six business growth documents that are out there. They’re pretty solid reading. You know, you’d have to persist to get right through all the initiatives and all the analysis that’s there.

Peters Three hundred of them.

English Yeah, that’s right.

Peters Why not 301, by any chance? Why just 300? And how many times are you going to regurgitate the same stuff as some sort of new initiative?

English Well, how often are you going to regurgitate magical thinking about the exchange rate?
Peters  Oh, OK. So Lee Kuan Yew doesn’t know anything about how to run the economy—is that what you’re saying? Or the Finance Minister in Taiwan doesn’t understand economics? Or the Chinese Finance Minister or Finance Ministers don’t understand basic economics? That’s what you’re saying, isn’t it? That they are doing things that you would not agree with.

English  Well, I’ve had a chat to the Chinese Minister of Finance about their exchange rate regime, and they are moving towards liberalising their capital account, because in the long run they know that they can’t run for ever on a fixed—first, they can’t run for ever on a notionally fixed exchange rate, but, actually, what they do is try and track the market, and, actually, they have a lot of internal politics over what’s happening now about their much higher wages on the southern coast of China. There’s going to be quite significant dislocation there because their relative competitiveness is changing significantly and fast. So they’re not immune. They might have some different theories, but they’re not immune at all from the economic adjustments that are similar in nature, although much more intensive in scale, to those that affect our manufacturers.

Barry  Minister, the Federated Farmers, in a submission to this committee about the BPS, have largely commended what’s been done. They’re very supportive of the Government’s spending being reduced and Government debt being reduced as well. But they’re very concerned about the 30 percent of GDP that we need to reduce Crown expenditure down to. What other measures are you going to be doing—perhaps announcing in the Budget—to achieve that sort of target?

Cosgrove  I think you know the CEO of Fed Farmers, Mr English.

English  Yeah, I do, yes, and I don’t always agree with him.

Cosgrove  Do you return his calls?

English  Ah, well, it depends what he’s on about. Look, Government expenditure is going to drop from the peak of about 35 percent of GDP down to 30 percent of GDP over the next 3 or 4 years, which takes us, actually, back to the levels it was in about 2005-06. So it’s not radical but it is necessary, and that is going to occur despite relatively slow economic growth. So when the economy was growing at 4 percent it’s not that difficult to hold your Government expenditure, because you could spend a lot of new money each year and still maintain it as a proportion of the economy. When it’s slower growth, it’s a bit more difficult, but I have to say that while Government expenditure as a proportion is dropping, we are developing more effective public services, and I think it gives lie to the notion that spending more money solves every problem, or that you prove you care by spending more money. Actually, you prove you care by getting one more child protected from abuse, by getting one more kid who didn’t have prospects through NCEA 2. That’s how you prove you care, not by spending more money. And the public sector I think has become much more aware of the power of its collective impact. And we’re going to be measuring that through the results. So this is about getting results, not spending more money. So I think we can continue to shrink Government as
a proportion of the economy for the next 3 or 4 years and get better results from our public services. And what's become clear from all that work is that the best result for the community is the best result for the books. So a prisoner who doesn't reoffend we save a lot of money. When a young person gets correctly diagnosed and supported and off the sickness benefit, we save a lot of money. And over the next 4 or 5 years I think we might—it's possible we could see a virtuous circle developing, particularly around welfare spend. So despite the fact that expenditure’s dropping, I’m not concerned about it bouncing back up, because if we focus on—

Peters
That's what Bill Birch used to talk about—a virtuous circle. Remember that?

English
No, I don’t.

Peters
It never happened, did it?

English
I didn’t listen to him as much as you did, Winston.

Peters
No, no. In the halcyon days of Bill Birch, he talked about the virtuous circle, and it never ever happened, did it?

English
It did happen.

Peters
Nor will yours happen.

English
No, it did happen. In fact, it was still operating even when you were Treasurer.

Peters
But we had serious surplus back then, not the flimsy one you’ve got.

English
Exactly. There you go.

Barry
Just a final question on Christchurch—1.5 percent, as you say, that Canterbury affects accounts for our current account deficit. But what are you doing to remove the roadblocks to the rebuild, to make sure that we achieve the targets?

English
Well, some are just inherently complicated, particularly insurance cases. The easier ones are getting dealt with in increasing volume, and the housing new builds are getting started, and that number is starting to pick up reasonably significantly. We'll be focusing on continuing to work with the council around the regulatory environment that might slow things down, so make sure that they and we are contributing to quick decision-making, low-cost decision-making, and results.

The other area where we’ve had quite a lot of focus is around skills development, and the Government has committed very large amounts of money to extra skills development for Christchurch. And it is a unique opportunity because employers know they’re going to have steady work for a long time, so it's a great chance for a young person to develop their skills, knowing that they’ve got steady employment.

Cosgrove
Just on the Canterbury rebuild, do you agree with your Cabinet colleague Mr Brownlee that there is no housing crisis in Christchurch, when we have mounting evidence that, one, people in jobs, if have a look at TV3, are
living in cars; families who have kids are worried they may—and, again, on
the public record—have difficulty with the welfare of their children,
because they can’t find rentals; when rentals are sky high; and when very
little is being done, for instance, even though you guys were warned of the
influx of the tradespeople, mostly from overseas, that are coming in, in
terms of housing to accommodate those people and take the pressure off,
so that ordinary Cantabrians can, even in a temporary sense, get into a
home while their home’s being rebuilt? Do you agree with Mr Brownlee
that there’s not a problem, there’s not a crisis?

English I certainly agree with his view of it. I mean, no one knows as much or pays
closer attention to the overall picture in Christchurch as Mr Brownlee. So
given a contest of his judgment versus someone else’s, I’d go with his. I
think the difference here—

Cosgrove That’s a big call.

English I think the difference here is over whether is there a housing—are there
housing problems in Christchurch? Yes. Is it a crisis, which is a word
thrown around a bit easily? The answer is no. I mean, there’ve been housing
problems since the day of the earthquake. There are some things that can be
done about it, and I know Mr Brownlee’s focusing on these. One is the city
council could relax some of the rules it has about allowing infill and other
dwellings on the section, and they just don’t, which seems a bit odd. If you
could have two kitchens, you could have a lot more bedrooms and a lot
more housing pretty quickly in Christchurch. Housing New Zealand
Corporation, in so far as it’s got influence, has been a bit too slow. The
previous and current Minister of Housing have been working on that, and
they are picking up their level of activity pretty strongly, too.

Cosgrove It’s 2½ years.

English Yeah, they have taken a bit too long. I agree.

Cosgrove It’s 2½ years. So is it acceptable that somebody in paid employment,
earning money, not wasting money, not dilly-dallying around, is forced to
sleep in a car for 6 months, simply because they can’t find a rental
property—not that suits them but that they can simply afford? And you’ve
had 2½ years. I’d say that’s more than a bit slow.

English No. Of course it’s not a good thing.

Cosgrove I’d say it’s an appalling thing, isn’t it?

English But on the other hand, in a city that’s been severely disrupted by
earthquakes, it’s not actually that easy to manufacture houses rapidly,
particularly in circumstances where the council itself hasn’t been, until
recently, seized of the urgency of allowing that kind of activity to happen.

Cosgrove Mr Brownlee does have extraordinary powers. He could use them.

Norman When you took over in the new Government, Mr English, you said that
rebalancing was one of your key priorities for the New Zealand economy,
and that’s something we applauded. It seems to me that the key kind of way
to measure the balancing or imbalancing of the economy is the current
account deficit. It’s projected to go to 6.5 percent of GDP in 2017. Isn’t that a fundamental failure on rebalancing?

English No. In the first case it’s a projection, and we’ve got to see whether that’s what actually happens, and I simply don’t agree with the projections. It’s just a difference of opinion. You know, Treasury do their job.

The second thing is that there is a fairly large one-off factor in there, related to the Christchurch earthquake. And that’s a matter of fact, not, you know, assertion or convenience—it just is.

Norman 1.5 percent, probably—something like that.

English Yeah, that’s right. So you take that into account. You’re talking about a gradual improvement, in my view, from what were the peaks through 2006-08 of 8 percent of GDP, which I think everyone agreed was unsustainable, and there was a set of factors that contributed to that, some of which were controllable, some of which weren’t. So, you know, given the long-running challenge here for New Zealand, I was describe it as moderate improvement, and I think we know that the fundamental driver of it will be improved savings behaviour by New Zealanders. Now, there have been signs of that. We’ll find out how sustainable that it.

Norman OK. So you’re saying “gradual improvement”. The numbers from your own department show gradual worsening of the current account deficit. That’s produced by your department, showing that the current account deficit is getting worse. Right? So you’re just completely at odds with the advice coming out of your own department of the current account deficit.

On top of that, just to quote Westpac, right—I don’t always quote the banks, but let’s quote Westpac—this is their latest economic overview: “The high exchange rate is hurting New Zealand’s international competitiveness … The current account and household indebtedness are going the wrong way.” We’re going back to exactly the problem you inherited. In spite of everything you’ve done on microeconomic reform—and I appreciate that you and Mr Joyce, whatever way one might think about it, are trying to do stuff on microeconomic reform. But you’re not succeeding in those critical measures around the housing sector, household indebtedness, household inflation, but particularly around the current account deficit and the tradable sector. You have failed in that critical respect and that key job you set yourself, which was right. You set yourself the right job, and you have clearly failed at it.

English Well, I just disagree.

Norman On your own numbers from your own department.

English OK. We can get into an argument about the numbers.

Norman They’re your numbers, not mine.

English Yeah. I mean, these things work in long cycles, right? So regardless of what decisions are made by businesses and households, New Zealand has a 30-year accumulation of external liabilities, right? I can’t just wish that away. It’s there. Right now you’re going to have a combination of effects around...
the current account in so far as—and bearing in mind here we don’t influence it directly—it’s sort of a result of what the economy does. But there are two things going on. One is a cyclical change that’s related to the recession we’ve just had. So the current account shrunk during the recession, and as you recover you expect it to grow as investment picks up. They’ve got to get the stuff from somewhere, and they get a lot of it from offshore and they’ve got to pay for it. We want a strong investment cycle, and that is going to help push the current account up. And then it’ll settle back a bit. So you’re going to go through a phase where the current account goes up. But in a structural sense, the economists will tell us, if we are improving our competitiveness relative to the world, and our savings behaviour’s improving, then in the long run it’s going to tend to be better, and I think it will be better than 8 percent, which it was.

Norman

So Westpac say that “The eventual circuit-breaker will be higher interest rates … And when that happens there could be a nasty downturn in house prices.” If there’s a nasty downturn in house prices, there’s going to be a nasty hard landing for the New Zealand economy. That’s where you’re taking us. That’s where your projection is going to take us—with your ballooning current account deficit. You wanted to rebalance the economy. You were right. You haven’t achieved it.

English

Look, there’ll be adjustments. That’s what happens. Are interest rates going to up? Probably—yeah, they will go up at some stage—and that may well be a good thing. I mean, there are people arguing right now that the fact that savings rates are flattening out and house prices are rising tells you that interest rates are too low, and why doesn’t the Reserve Bank Governor get on and lift them? But the manufacturers probably disagree with that. In my view we have the possibility of long-run structural improvement and a 30-year problem. OK? In the short term those numbers are still going to follow the kinds of cycles you would expect.

Norman

Just to take you up on that. So the currency, right? The currency debate, right? So you’ve obviously tried to make it very difficult to have a rational debate around it, by kind of scaremongering about printing money and all the rest of it, right? But if you look overseas, Lord Turner, the chair of the Financial Services Authority in the United Kingdom, has just given a big speech all about how printing money has got a role to play for financing Government deficit and all sorts of things. Right? There is a big international debate about unorthodox monetary policy, right, which New Zealand isn’t participating in. What is the value in us being the one of the few countries that is not using interventions on our currency to lower the rate? Most of our trading partners are lowering the value of their currency using unorthodox mechanisms like quantitative easing or whatever. And the result is that because currency’s a relative price, our currency is overvalued against other currencies, which is having a dramatic effect on the tradable sector, and yet you say we can’t possibly do that because that’s unorthodox, it’s outside the neo-liberal model. But the effect is that our tradable sector, which we depend on, is getting devastated—that’s what the manufacturers
are telling us—because we can’t have this debate about unorthodox monetary policy.

My view is not whether it fits some orthodoxy; it’s whether you could find something that worked. And so I’d make two points about that. In the first place the UK is an economy with some real difficulty. Real incomes have dropped in the last 4 or 5 years by 6 or 8 percent or something. In New Zealand real incomes have gone up. They’re looking at possibly at triple dip. They’re in an extreme circumstance in the same way as Japan regards itself as in an extreme circumstance. So these are patients in the emergency room, and New Zealand, by comparison, is out training for a triathlon.

Norman Not with a current account deficit at 6.5 percent, it’s not.

They’re not doing it because they just think it’s a nice idea; they’re desperate. The second thing is even if they decide to do all this stuff, as other central bankers have said, they’re getting well down a road that no one has ever been down, and they have no idea how to get back. And that’s going to be a challenge in the next 10 years in those developed economies.

And the third thing is, as I said in my earlier remarks, in our own discussion here in New Zealand no one has yet put forward a proposition that looks like a sustainable way of choosing a lower exchange rate. OK? There’s been various talk about it. I’m not saying proposition—I just think no one has actually put one forward, so there hasn’t been an opportunity to debate whether it’s sustainable or not.

Parker You have told us of your 300-long list of microeconomic interventions, and you’ve said that you’re after other things on the list that manufacturers want. Well, they’re actually saying that the top three things on their list are broadening the objectives of the Reserve Bank so that inflation doesn’t trump the exchange rate, removing the capital income tax exemption—i.e., capital gains tax—and deeper savings through universal KiwiSaver.

All of those—on that they have, yes. Those are their top three. They’ve explicitly said they’re their top three on their list. You reject every one of them. Is that correct?

We don’t reject the thinking behind it, but in terms of the propositions

Give us a straight answer.

Well, in terms of the propositions, the question is you can set any objectives you like for the policy targets agreement. In the end, the tool is interest rates, and my question to the manufacturers is: “Should the Reserve Bank Governor drop the interest rate or increase it?”, and no one’s answered that question.

Isn’t it axiomatic that the Reserve Bank would behave differently and would pay more attention to the exchange rate relative to inflation if its objectives were broader?

No, because if you look around the Reserve Bank policy target agreements, and they all express things in slightly different ways, but when you look at their behaviour, they all behave in remarkably similar ways. So changing the
words in a policy targets agreement doesn’t change the economic fundamentals.

Parker I didn’t say the policy targets agreement; I said the Act. The Act, not the targets agreement.

Peters The Act is what might be changed.

English Well, look, it’s just magical thinking. In the long run, even in New Zealand, actually, when it had a fixed exchange rate regime, you still have to respond to the fundamental competitiveness of the economy—that’s the first point. And the second point is—

Parker Well, that’s exactly what the manufacturers are saying.

English The second point is what they’re actually telling you is they want to cut the real wages of their workers, because that is the other side of this equation.

Parker Rubbish—what rubbish.

Norman But you’ve said it’s overvalued, as well.

English Ironically enough, the workers need a voice in this debate, because no one is sticking up for the fact that the exchange rate underpins household living standards.

Hayes Minister, you said that the Budget this year was going to be on 16 May. Could you please say what its focus will be this year?

English It’s set out to a large extent—it’s set out in the Budget Policy Statement. The focus will be to continue the plan the Government has in place because in our view straightforward objectives like getting back to surplus, improving the competitiveness of the economy, and better public services are setting the foundation for reasonable economic growth in the circumstances and the kinds of jobs and incomes that go with it. While there are a number of issues, like the exchange rate, that can be debated and we’re open-minded about those debates, we haven’t seen a case for changing course. I think if we stick to it, they’re pretty straightforward things that people can all understand, and there will be real gains for the New Zealand economy. In fact there’s a bit of a risk, I think. If there’s any risk, it’s a risk of hiving off, chasing magical thinking that somehow there’s a way around basic household economics, and there isn’t.

McClay All right, Minister thank you very much. Thanks for your time. The Secretary to the Treasury is able to remain with us, I understand. Thank you for your patience today.

Gabriel, welcome to you also. Thank you for giving us the time today. We do have 45 minutes available. We offer you the opportunity to make comments, should you wish, and then I’m sure there will be questions.

Makhlouf Good morning, Mr Chairman. Thank you very much. Perhaps I’ll just kick off by introducing my Deputy Chief Executive, Vicky Robertson, to my left and to my right Dr Girol Karacaoglu, who is my Deputy Secretary responsible for macroeconomics and also my Chief Economist.
I will make a statement this time, Mr Chair. I am pleased to present the Treasury’s Half Year Economic and Fiscal Update, or HYEFU, to the committee. I would like to briefly recap on key aspects of the Half Year Economic and Fiscal Update and note some developments since it was finalised in December. The New Zealand economy has experienced a slow and uneven recovery from the 2009 recession. This is in keeping with many other advanced economies and reflects a range of factors, including slower growth in the global economy since the financial crisis, with associated impacts on funding costs and the exchange rate, changes in household and firm behaviour following the build-up of debt over the mid-2000s, and the Canterbury earthquakes and their impact on sentiment and activity.

Nevertheless, economic growth rose to 2.5 percent in the year to September 2012 and is forecast to remain at around this level, on average, over the next 5 years. This is down from around 3 percent in the 2012 Budget forecast.

We expect the Canterbury rebuild to be a key driver in New Zealand’s economic growth over the next 2 years. Information compiled by the Canterbury Earthquake Recovery Authority led us to revise up our estimates of damage caused by the Canterbury earthquakes in the half-year update. The amount of fixed capital investment stemming from the Canterbury rebuild may be around $30 billion. A significant contribution to financing the rebuild comes from the Crown, with the latest estimates of the cost being $13.1 billion.

While there are still uncertainties about the scale and timing of the rebuild, overall just over half of the total expected rebuild cost is factored into the Half Year Economic and Fiscal Update forecasts, which cover the period out to June 2017. This includes all of the required investment in infrastructure, most residential rebuild activity, and around $3 billion of commercial or social investment.

Other key features of the economic outlook include low consumer price inflation. Annual inflation was only 0.9 percent in the December 2012 quarter. The outlook for inflation has also moderated since the Budget update, due to factors such as the exchange rate and falling imported commodity prices, although we do expect inflation to rise as these influences fade and the economic recovery continues.

External factors, particularly the weak economic outlook for advanced economies, mean the exchange rate is assumed to remain close to its current level over the current year and into 2014, impacting on growth in the tradable sector.

Employment is expected to rise as the Canterbury rebuild and improving business confidence increase demand for labour. We see employment rising by 1.9 percent in the March 2015 year—its fastest annual growth rate since the March 2007 year. Unemployment is expected to drop to just below 5 percent in the June 2017 quarter.

The Canterbury rebuild is set to boost investment in housing. Once it’s in full swing, the residential rebuild comprises over 15 percent of total real residential investment. Residential investment activity in the rest of the
country is expected to increase over time, as pent-up demand in some regions comes through. The current account deficit is expected to rise from 4.7 percent now to 6.5 percent in the year to March 2017. Part of this rise reflects the investment activity related to the rebuilding of Canterbury.

In forming a view of the likely growth of the economy, we have considered the underlying supply capacity and note its potential outlook. While we are expecting economic growth to continue, our downward revision to the average rate of growth in the Half Year Economic and Fiscal Update largely reflects that the judgment of the underlying growth rate of the economy will be slower for longer.

In the fiscal forecast for the Half Year Economic and Fiscal Update a surplus of $66 million is expected in 2014-15. The weaker economic inflation outlook has resulted in $2.1 billion lower tax revenue expected in 2014-15, relative to what was in the Budget update, but also $0.8 billion lower expenses on benefits, financing costs, and GSF expenses in that year.

Other changes, including policy changes, timing differences, and tax forecasting also provide an offset totalling around $1.2 billion to the OBEGAL in the 2014-15 year, relative to what was in the Budget update. Net core Crown debt is expected to continue rising from 24.3 percent of GDP in 2011-12 to a peak of 29.5 percent in 2014-15 in 2015-16 before falling slightly in the final year of forecasts.

By way of a brief update since the Half Year Economic and Fiscal Update, revised GDP data from mid-2012 indicates that growth was weaker than we expected, but the run of recent data is pointing to a pick-up in December. Reports on data relating to Canterbury indicate that the rebuild is gaining momentum and businesses seem more upbeat. The latest tax revenue outcomes for the 5 months ending November were largely as we expected.

Global market sentiment has improved significantly in the new year, driven by the US avoiding its fiscal cliff and a pick-up in macroeconomic data, particularly in Asia. Global equity markets are at 5-year highs. However, while sentiment has improved, global growth in 2013 is still expected to be slightly below trend.

The New Zealand dollar continued to appreciate in the new year. Again, this is largely the product of external factors. In the difficult global environment, international investors have taken an increasing interest in countries with favourable growth outlook, sound and stable institutions, including fiscal and monetary policy, and higher interest rates.

For New Zealand, the high dollar is a drag on export growth but also helps to keep inflation low. It has also helped to keep down the costs of some capital imports, including those employed in the Canterbury rebuild, and has helped keep other imported costs low, such as fertilisers and fuel, and it has lowered the price of consumer goods, including cars and electronic goods.

The latest employment figures for the December quarter have employment, unemployment, and labour force participation all dropping. It’s been
acknowledged that the household labour force survey can sometimes produce surprising results, and last week’s report is at odds with other indicators of the labour market, such as the various employment confidence measures that are flat or improved in the quarter, as well as PAYE, which has held up well of late. Wages continue to grow moderately, filled jobs are higher, and labour input is up. We think the medium-term outlook for employment is more positive than the survey suggests. Factors supporting employment growth include increased activity in Canterbury, low interest rates, and solid ongoing demand and higher prices for our commodity exports.

Of course there are uncertainties in any forecasts, and the Half Year Economic and Fiscal Update reflects our best assessment of the situation, based on the data available at the time. The risks are still skewed to the downside, but they have become less extreme. For now, it is fair to say that developments over the last few months are generally consistent with what we expected.

In summary, our Half Year Economic and Fiscal Update forecasts for economic growth were lower than our forecasts made at the time of the Budget in May. This period also saw other forecasting institutions, such as the IMF, the OECD, and the Reserve Bank, revise down their forecasts, in light of factors such as the weaker global recovery. Overall, the Treasury’s forecasts are consistent with the consensus on average growth rates. New Zealand’s gradual economic recovery is forecast to continue, but it’s a bit slower than we previously thought. While the global environment continues to present challenges, we need to continue to seize the opportunities to give ourselves the best chance of success. By pursuing policies that strike the right balance between limiting debt and supporting economic growth, by ensuring efficient markets, and remaining among the best place in the world to do business, and by maintaining the strength of our institutions and our standards of transparency, we, the Treasury, are proud to see New Zealand’s No. 1 rating for Budget transparency and accountability. Keeping the door of opportunity open and inspiring high levels of trust and confidence are important for encouraging growth, at a time when every country’s economic and fiscal performance is being closely scrutinised.

Thank you, Mr Chair.

McClay Thank you very much.

Bennett What impact do you think the weather is going to have—you know, the drought up in the North Island—for agricultural production this year? Can you factor that in?

Makhlouf Sorry, what impact I think the weather—

Bennett Yes. They’re having a drought up north and they’re going to have lower production.

Makhlouf I don’t—

Cosgrove Rain will help, I think is the answer.
Makhlouf: I don’t have a specific answer. Obviously the weather does play an important factor in the economy. If we’ve got that sort of information, then I’m very happy to provide it to the committee.

Bennett: So you haven’t perceived there being an issue from that?

Makhlouf: Well, I mean a lot of this depends on how long the drought continues, and the extent to which it actually impacts on the overall production. But whether or not we’ve done that in our forecast—

Karacaoglu: Not specifically related to weather.

Makhlouf: Yeah, not specifically related to the weather. We haven’t—

Bennett: Earlier we’ve had questions around countries and printing money and things like that. What does the Australian economy do about that? Have they engaged in that process, and have they looked at that option?

Makhlouf: The printing of money?

Bennett: Yes, to solve their economic issues.

Makhlouf: I’m not aware that the Australians have done anything like that.

Bennett: And they’re our major trading country, aren’t they?

Makhlouf: Yes.

Bennett: What would the impact be if you created a different system here, from Australia? Would that be a major challenge for the New Zealand economy?

Makhlouf: Well, I think it would ultimately depend on what you get. It would certainly be a challenge if we adopted a system that was not in cycle with the Australian economy, if we decided to do something completely different. But ultimately it would depend on what it was that we did. As a general proposition what matters more is that we’re extremely cautious and deliberate about any changes we make to our current framework, our current institutional frameworks, and our current macroeconomic policy frameworks, which have got a lot of respect internationally. So if we’re going to change them, we should do so cautiously and deliberately.

Bennett: Because what’s proposed is sort of that British model of countries that are in deeper economic trouble and then seeing some saviour for the rest of the New Zealand—

Cosgrove: Like Switzerland.

Bennett: Yeah. It would actually create, as you say, some dilemmas when you’re trying to be conservative and take it step by step. Wouldn’t that be true?

Makhlouf: I’m not sure I would associate myself with every single word you’ve just said.

Cosgrove: Wise move.

Makhlouf: What I think is important is that when we look abroad for international comparisons that we actually think quite hard that we’re comparing similar economies in similar situations. So when I think of what’s happening in the United States and the United Kingdom, in the euro area, for example, I
mean these are all pretty interesting things to pay attention to and learn from, but I would be very cautious about assuming that because the United Kingdom is doing something or the United States is doing something, that it’s of application to New Zealand. I think that probably a direct jump would probably be one too far.

The fact is that the United States and the United Kingdom are in deep trouble as economies. The United States actually, I would suggest, is a very, very special case and it’s pretty hard to compare any other country to it because it’s so different. But, I mean, the sort of situation for the rest of the world, they’ve got to really just thinking about monetary policy itself. The reality is they’ve run out of room in monetary policy space, which is why they’re now looking at sort of radical and unorthodox tools. We’ve still got room.

Bennett Australia has still got room, as well, hasn’t it?
Makhlouf And Australia has still got room.
Cosgrove Just while we’re sort of making comparisons with Australia, just for the record, it’s also true that Australia has a compulsory capital gains tax, compulsory superannuation, and allows, through its legislation, the governor of its Reserve Bank a wider number of factors to consider when setting monetary policy—all the things that we don’t have here and all the things that, say, for instance, the manufacturing sector and other exporters have called for. Correct?
Makhlouf Broadly, what you’ve said—I’m not sure about the last bit—but broadly—
Cosgrove Well, they do have a CGT, right?
Makhlouf Oh, yes.
Cosgrove They do have compulsory superannuation.
Makhlouf He means he’s not sure it’s been—
Cosgrove And the Reserve Bank governor does have a wider basket of factors that he consider in setting monetary policy, correct?
Makhlouf Yes.
Cosgrove And they’ve had that for quite some time?
Makhlouf I’m not a complete expert on Australia’s monetary policy framework, but it is slightly different to ours. On the other hand, I think it’s quite important that we don’t—and you need to ask Graeme Wheeler about this—conclude that the governor does not take a whole series of factors into account when he arrives at his decision. He’s got a particular focus. The economy is a complicated thing, and I’m pretty sure that the governor does think quite broadly about what he needs to do before he decides.
Cosgrove But unlike the Australians, there’s no formal requirement, as I understand there is with the Australian MPS. There’s a formal requirement to consider other factors that are not included in the formal requirement for our Reserve Bank.
Makhlouf I’m not the complete expert on what the Australian system is. I mean, I know it’s slightly broader than ours.

Norman So the monetary policy debate, your argument—the Reserve Bank governor and you guys are all on one page on this kind of neo-liberal framework—is that we’ve still got room on the OCR so we don’t need to consider these unorthodox things. But then when we questioned you about the OCR you say: “Oh, we can’t lower it any further.”, and so we end up in this problem where we say: “OK, what about unorthodox things?”. You say: “Well, we’ve got room on the OCR.” OK, so let’s lower the OCR. Then you will say: “No, we can’t lower the OCR.” Now, it seems to me the reason why you can’t lower the OCR is because house price inflation is the concern. Right? So then we say: “Well, let’s use loan-to-valuation ratios to try to target the inflation coming out of the housing market and as a trade-off we can have a lower OCR, which can give us some relief on the exchange rate, which is destroying the tradable sector.” Do you agree with the line of argument that says we can use an LVR to try to deal with some of the price pressure coming out of the housing markets so that as a trade-off we can have a lower OCR and a lower exchange rate?

Makhlouf If I can I will try and answer bits of your question, but if I can just sort of make it clear at the beginning that most of these questions are questions you should be asking of the governor, all right? So I don’t have a particular—

Norman I ask him as well—don’t worry.

Makhlouf No, no, but you’ve asserted that I said that we can’t lower the OCR. I don’t have a view as to whether or not we can lower the OCR. I leave that to the governor to decide what he can do. I think that’s quite important to the extent that what Treasury and the Reserve Bank have are on the same page, to use your words. It is basically about the framework that we’re operating—that it is one that we basically think is sound. But I think it’s really important to make sure that we all understand that the OCR decision is the governor’s decision. Should we use loan-to-value ratios to control house prices? That’s your basic question.

Norman And whether they’re reading the flows from that.

Makhlouf I think—I’m not sure, is my answer. I’ll ask Girol to come in, in a minute. The reason I’m not sure is I think what’s important, certainly at the moment, is that we think quite hard about how to pick house prices and loan-to-value ratios, what their impact is on the financial stability or stability of the financial system. Should we actually interfere directly, whether by the Reserve Bank or through some other mechanism, in controlling house prices? I’m not sure about that because I’m not sure it will actually fix the problem. We’ve been involved in this housing affordability debate, we’ve seen lots of papers, and we had a Productivity Commission do a whole report on it. It’s a very complex issue, and fundamentally I think Treasury’s position would be trying to fix the fundamentals of this for the medium term. Now should we actually start using tools like LVR? Girol, I don’t know whether you have a perspective on this?
One or two points. First of all, on the exchange rate debate and issue, there is a growing realisation that a small open economy like New Zealand cannot fix that on its own. There’s a lot of agonising going on as to whether international coordination is the right answer, because otherwise the situation where some large economies are going for broke and printing money leaves smaller economies like us in an almost impossible position, given that chasing that could increase the vulnerability of a small open economy like New Zealand’s.

In terms of the Reserve Bank of New Zealand Act and the policy targets agreement, I note that in fact these documents, while they make inflation control—that is, monetary stability—which is low, and sustainably low inflation, the primary targets also give a lot of space to our central bank to consider the implications of that for the real economy, as a constraint on those decisions, and also increasingly in the latest revision, emphasis on financial stability issues. The Reserve Bank is constantly developing a series of tools, including LVR and other ratios, and some of the other tools they have recently introduced, like the core funding ratio is a good example, which is expanding the set of tools, taking into account both inflation and stability. So that is an evolving framework.

So in terms of vulnerability, the Westpac analysis, what they’re saying is the high exchange rate, the large and growing current account deficit, and household indebtedness all go the wrong way. The result will be a jump in interest rates at some point, to try to control that. You will get a nasty downturn in house prices. So that doesn’t seem to me a very sustainable outcome, or a very resilient outcome. So we can do nothing, as Treasury and the Reserve Bank advocate, about any of this, but the result is not going to be stability, if stability is your objective.

I think it’s wrong to say that we’re advocating doing nothing. What we’re advocating to be doing is a whole series of things. First and foremost, making sure that the Government keeps to a prudent fiscal policy and keeps prudent debt levels, that the Government uses the resources that it’s got as efficiently and as effectively as possible, and that financially, we implement a whole series of reforms to promote growth. So there are a number of things that Treasury has advocated that we should be doing. Doing nothing I think is—well, it’s just not right.

OK, but do you accept that based on your own projections—

Can I just say something about—

But is it working? That’s my question. Based on your own projections—

Last one, then we’re—

So my last question, then. Based on your own projections, right, looking at the current account deficit of the numbers that you provided, that Bill English says are all wrong, right, but you’ve said 6.5 percent. That’s a big, big number for a current account deficit, in a world like ours right now, which is very volatile. Is that sustainable? Is it working? Are your strategies working?
Makhlouf I think we’re pretty confident that our strategies over the medium to long term will deliver lower—no, no; I agree. I think at the moment the conditions that we’re in, the circumstances that we’re in, it’s not unsustainable. If we were building—

Norman Did you say it’s not unsustainable, or it’s not sustainable?

Makhlouf I said it’s not unsustainable. But if we thought this was going to be a long-term forecast, and it was heading upwards, then I’d be very worried about it. But at the moment I feel that—I mean, the objective of a lot of this is not to fix the current account deficit. The objective is to improve living standards in New Zealand, and fixing the current account deficit which, as the Minister said earlier, as we all know, is a longstanding problem will take time and it will require a range of things to happen. I absolutely agree with that. Do I think that we’re on course for making everything worse? I don’t.

Clark I have got a few questions around the tax base. I wonder first if you could just tell me in real terms what percentage the tax base has dropped since the Government took office in 2008—percentage of GDP.

Makhlouf I don’t have that figure.

Clark I think I roughly know, but I did want to have your view. So we were told, with the briefing to the incoming Minister, that it had dropped 4 percent from the IRD’s briefing, 1.5 percent of which was attributable to the global financial crisis and 2.5 percent due to Government policy decisions. And now you’re saying in the Half Year Economic and Fiscal Update that there’s a further 1 percent drop expected, so if we add those together we’re roughly in the 5 percent category, maybe slightly more, because of what’s happened in between, which amounts to over a $10 billion hole in our tax revenue. That tax revenue, of course, is important for health and education, and so on, and there are some very real threats to our tax base. This seems to be a trend that isn’t slowing. We keep hearing unexpectedly that the tax base is dropping further and further, and one of the problems of course is the behaviour of multinationals and their ways of avoiding tax and shifting their revenues to lower-tax zones. What is the Treasury’s advice on how to address that problem? What advice has the Treasury supplied?

Makhlouf Can I just say just a general thing about the tax base because it’s important to be clear on the definitions. Some of the reductions in tax revenue are a direct result of changes in growth rate. And then you’ve got the issue of policy.

Clark Yep.

Makhlouf So it’s important to keep those two things—

Clark Yep. I mean, I agree with you absolutely, and the tax cuts in 2010 were supposed to stimulate the economy, but that that doesn’t seem to have happened.

Makhlouf They were broadly neutral. But I mean, on the international side, I think our prime advice is that we should work with the OECD because taking action unilaterally—
Clark: Well, what does that mean in practical terms at this stage? I mean, this is a rapidly, I think, accelerating problem because it’s also—I’m getting more and more IT businesses coming to me and saying: “We cannot compete with the likes of Google and Facebook when we’re paying corporate tax rates in New Zealand and being fair and just citizens.” And larger multinationals are shifting their money around so they’re effectively not paying tax, or they’re paying roughly 1 percent on the revenues that you can calculate coming out of New Zealand. They’re paying roughly 1 percent of what other companies are obliged to pay. Surely it’s a problem that needs swift action, not, you know, statements that say we should broadly move in tune with the OECD. The Minister’s said that, made several press releases that say the same thing—we should keep moving with the OECD—and refusing to supply further detail. That’s where my frustration arises. I’m sure Treasury has given some advice as to what that means. What does it see that the OECD is doing that’s useful, and what kind of time frames to implement that, because the tax base is drying up rapidly, and it’s also making the economy uncompetitive, or our New Zealand companies uncompetitive in the international economy.

Makhlouf: Yeah, well, I’m not sure about the last bit of that. In terms of the very latest advice that we may have given on this, I’m not sure what the latest advice on this is, but, I mean, I’ll give you a broad picture. Firstly, the OECD point is important. The OECD acts as the world’s tax authority.

Clark: I agree with that.

Makhlouf: And, unfortunately, these international institutions just take time to arrive at a consensus and an agreement. So what I would say is that the system, the international tax system, already has a range of rules, and tax authorities have a range of tools that can take them quite far down the road of trying to make sure companies, whether they’re multinationals or anything else, are actually paying the right amount of tax.

Clark: With respect, they’re not working at the moment, though, in the case of those multinationals.

Makhlouf: Some of them could be improved, and we’ve been looking, and we have in the recent years in New Zealand made changes to our thin capitalisation rules, for example. And I think the OECD is looking again at those sorts of things. It’s looking again at its transfer pricing rules. And all I’d say is, I mean, I agree completely with you that this is important, and I think there’s consensus across the international community that there are issues here that need to be addressed.

Clark: OK. I guess I kind of wanted concrete Treasury advice because to me it feels like an urgent issue, because we’ve got this deficit and you’re projecting net debt to go from 24 percent to nearly 30 percent in a few years’ time. We’ve got an issue here—

Makhlouf: No, no, we—
Clark —that is becoming more and more urgent in my view because every projection we get says that we're losing more than we thought at the moment, and that's consistent over the last several years.

Makhlouf Sure. I mean, I—

Clark Is the Treasury not—

Makhlouf The important thing here in terms of our deficit is to get the economy growing in a sustainable way. Certainly making sure people pay the right amount of tax is an important part of this too, but I would—we're not at the moment planning to—

Clark So there's no hurry?

Makhlouf No, no, no. There is a hurry, but these things take time. So there is—

Clark Can I perhaps—

Makhlouf The international community, and for this year it's going to be led specifically by the G8, is looking to make real inroads into this, and we will participate in that. All I'm saying is you can't fix it on your own.

Clark Well, what's New Zealand's view, then? Presumably Treasury's speaking into that advice and saying what should happen to—I mean, tinkering with the current model clearly is not working. Should we be looking at ways of taxing revenue at source, you know, rather than in country of origin of the company or base of the company? Are those kinds of solutions being looked at?

Makhlouf I don't know the full range, the detail that we've—

Clark OK. Could I move, then, on to a different set of questions—just one, actually, Mr Chair; I'm aware that time is tight. What advice has Treasury provided around the contracting, letting out, of the business transformation programme in the IRD? The computer system there, obviously, it's 20 years old. There are problems that have been acknowledged, and the Government has given estimates. Bill English said that $700 million was going to go towards it, in one public statement. John Key is on record as saying it will cost about a billion. The department estimated about $1.5 billion. We've got a wide range of estimates of how much it's going to cost to fix it. But what advice has Treasury provided around that tendering process, because there's a view that seems to be—certainly amongst the IT community, again in New Zealand—that New Zealand firms are effectively excluded by the contracting arrangements, and also that there is a huge risk around tendering to one company an enormous contract like this. I mean, it's way bigger than INCIS, this contract, it's a lot bigger than Novopay, and it looks from the outside like Capgemini has this whole thing in the palm of its hand. Has the Treasury provided advice that would suggest the risk associated with a major project could be circumvented through letting contracts to smaller—to breaking the project down to smaller parts and letting that out to separate companies?
Makhlouf  We’re working very closely with IRD as they develop their business case and their planning, so I don’t think—to my knowledge, nothing’s been settled as to how this is going to be taken forward, so—

Clark  Sorry, it’s not going to be what? I didn’t catch that.

Makhlouf  Nothing has been fixed or settled or decided. We are currently actively working with IRD on precisely the set of issues that you’ve been talking—

Clark  It’s been going for a couple of years now. When is a timetable or something like that expected to be announced?

Makhlouf  Certainly this year we’re expecting some decisions to be taken, but what, precisely, depends on deciding the sorts of things that you’ve just talked about.

Clark  Yep. Is the Ministry of Education—I mean, are you actively working with the Ministry of Education over the Novopay—

Makhlouf  No.

Clark  No.

Cosgrove  No?

Barry  Mr Secretary, you were talking about the rate of growth not being as fast as it could be, and you talked about the importance of pursuing policies that would really, you know, keep us on track. What are the most important policies? I’ve been looking through household growth and some of the things that you’ve talked about there around encouraging people to save more and so forth. Just as far as Treasury advice is concerned, could you just prioritise the policies that will work the best, do you think?

Makhlouf  Well, there’s a number of policies. I’m not sure I want to actually rank some over others, but reforming or looking really hard at how the RMA’s working and the effectiveness of the RMA, looking really hard at how we’re using our water resources, looking extremely hard at—and some of these are long-term issues, but, you know, looking really hard at our education system and, in particular, the quality of our teaching. That’s a really important issue for us, but there’s a whole range of things with the education space. You mentioned savings but, I mean, making sure our tax system is fit for purpose and actually promoting the right set of incentives. The development of skills is—I mean, it’s linked to education, but specifically skills. Those are just some of the ones that I would put extremely high on the list.

Barry  So with the apprenticeship schemes and so forth, that’s very much along the lines of what you would consider? OK.

Makhlouf  Yep.

Barry  OK. Just a supplementary question on that in terms of the Auckland housing market and what that’s doing to drive the ability of consumers to invest more in houses or to save more—where do you think that the impact lies there? Is it—
Makhlouf: The impact of?
Barry: Of Auckland as a particular part of the market and the way it drives housing prices.
Makhlouf: I’m not sure I’ve got enough time to answer that question—
Barry: Right.
Cosgrove: Big impact.
Makhlouf: Look, what’s happening in Auckland—Auckland is an incredibly important part of the New Zealand economy, and what happens there matters a lot. What is happening in the housing market obviously matters, and it’s why the Government has got a whole, pretty major project of work, which the Minister’s announced. And at the end of the day, making sure that there are affordable homes in Auckland, that the supply of land, that the consenting regime, that the system’s working as efficiently, as effectively as possible, is really important for the economy.
Barry: OK. Thanks.
Hayes: Thank you. I’d just like you to come back to your written statement and the bit where you said we’re one of the easiest countries in the world to do business with.
Makhlouf: Yep.
Hayes: I was in Hong Kong at the beginning of the year with a group of New Zealand businessmen, expatriate businessmen, and I said, “What do we have to do to get this talent pool back into New Zealand?” They said, “You’re running around with this”—exactly as you’re saying—“but the reality is that our systems take too much time to deliver outcomes.” That’s the first thing they said: it takes too long to do things in New Zealand. Second thing was the tax rate and, third, they didn’t like living as tall poppies back here. But coming back to the first point, what do you think about this, that you seem to be able to, on the one hand, tick all the boxes, and we seem to have a fast system, but actual users seem to be saying it’s taking too long.
Makhlouf: It also depends what it is that may take too long. I certainly think and have said before that the some of the RMA processes I do think take a remarkably long time. It obviously depends on what business the people you were talking to are working in. In other aspects I think international surveys do show that there’s quite a lot of stuff that we do that we do pretty well and do pretty quickly. So I think it’s a mixed picture. Certainly one of the issues for us in terms of overseas investors is that we’ve got one of the tightest regimes for inward investment, and we need to make sure that the settings around that are actually at the right place and that they’re not, at the end of the day, restricting investment that would benefit the country overall. So, I mean, that is one of the issues that we’re a bit concerned about.
Hayes: Just a quick supplementary question on top of that. One of the issues was, they said, we are one of few jurisdictions that charge tax on income earned in other tax jurisdictions. This was their argument; sitting in Hong Kong
paying 12 percent, they’re a bit conscious of this stuff. So I did some work on this, and it seems like we collect about $250 million from individuals, about $1.3 billion from companies, and about $120 million from trusts, so you’re talking about $1.3 billion, which was I think the total figure. Is that a huge amount, and, if further work was done to establish that that actually was one of the reasons why we couldn’t get our business people back here, or investors back here, is that a huge amount of money to consider in the overall scheme of things? I mean, if you were going to bring people back, could you afford to get rid of that particular tax obligation to attract them back, or is the amount we’re collecting so much that, no, you wouldn’t want to do it?

Makhlouf: I mean, I don’t know the numbers myself that you just quoted, but the first statement, that we’re the only country that taxes overseas income, I would just sort of—

Hayes: He said we’re one of the very few.

Makhlouf: Well, I think there are international rules that basically operate on the basis that, in broad terms, countries tax entities that are resident within their borders irrespective of where the income is earned. And then there’s a system that, through double taxation agreements, tries to, essentially, make sure that people pay tax only once. So I don’t know the precise circumstances of the people that you spoke about. You know, is $1.6 billion, or whatever the number was, a big number? It sounds a big number to me, and with a $66 million surplus in 2014-15 it sounds a very, very big number.

Parker: Two things. Firstly, thank you for the offer to provide us for some information as to the estimates on GDP and employment growth as to the knock-on effects of the Canterbury rebuild, because I for one am very interested in—because it’s a wonderful thing that in this period of international uncertainty we have all this money to spend, which is actually one other thing that’s holding up the economy, which is a good thing. But I fear that it shields an underperformance in the general economy because the impact of the Canterbury rebuild on the—you know, without it, there ain’t much else positive happening in the New Zealand economy.

Makhlouf: I think you’re being unfair. We will come back to you with all the—I will check this. But I think the Christchurch, or Canterbury, rebuild is contributing about 0.7 percent of growth, so there is—

Parker: Is that the first-round effect only? Because I would have—

Makhlouf: I’d pause—

Parker: I don’t know, so—

Makhlouf: Yep. I think we’ll certainly look at that, and we’ll let you have whatever information that we’ve got.

Parker: Well, I’ve been told that you’ve got very little information, and so I was sort of pleased that you might be doing some to actually just—

Makhlouf: We’ll give you everything that we’ve got. I suspect we haven’t got—
Parker Well, I thought the offer of the Minister went further than that to actually analyse what is the impact on GDP.

Makhlouf Yeah, sure. No, no, we’ve—

Parker Because I’ve already got a letter here from you guys saying there is nothing.

Makhlouf No, no. Look, I’ll give you—we’ll have a crack at it. That’s what I said earlier.

Parker OK. The second point—I just want to go back to Girol’s comment about how we’re suffering the consequences of overseas jurisdictions changing what they’re doing in respect of monetary policy, and I absolutely concede that that’s what’s happening. The nervousness I have is that if we sit here and we wait for the international community to fix that up for the benefit of New Zealand, it’s a big risk. That’s a big risk because in the meantime our non-primary sector is being decimated.

Makhlouf I don’t want to underplay at all the importance of this issue and the difficulty also of what it is that we can actually do, and the consequences—the unintended consequences—of the various things that we could do. I mean, certainly, I’ve said before I think our monetary policy framework is basically sound. That doesn’t mean at all that we mustn’t continuously look and test our assumptions, but at the moment we are in pretty extraordinary times internationally, and what’s happening in the United States, the United Kingdom, in the eurozone, now in Japan, are pretty extraordinary things. And what’s the best way for New Zealand to manage its way through this currency issue is something we’ve got to look at pretty hard. The Minister earlier said that he hadn’t seen anybody, you know, suggest a realistic—I can’t remember what words he used, but—

Parker A viable alternative to—

Makhlouf Yes. There are two things in particular, because you mentioned them or they were mentioned earlier. Looking at the mandate of the Reserve Bank and changing that—firstly, one needs to just be clear, be sure, that, as Girol and as I said earlier, you’re actually asking the governor to do something new that he isn’t already doing. Secondly, I think it’s really important that we bear in mind what the institutional framework—the implications for the macro-economic institutional framework that we’ve got in place in New Zealand, of a change like that—

Parker On the first issue, though, I can’t accept that. Look, I mean, that’s like saying the Reserve Bank Act is meaningless to the Reserve Bank, and whatever it said, they’d do the same thing. That’s got to be wrong.

Makhlouf I didn’t say that. I didn’t say that. All I said is that I’m not personally—and, as I said, you’ve got to ask Graeme Wheeler this question. All I’m saying—

Parker Well, actually, can I deal with that because the Treasury’s meant to provide advice to the Government as to whether our settings are right.

Makhlouf Yep.

Parker It’s for the Reserve Bank to implement them.
Makhlouf: That’s right.

Parker: But it’s not right for the Treasury to wash their hands of an issue—

Makhlouf: We’re not.

Parker: —just because someone else has devolved responsibility to implement it.

Makhlouf: I agree. And I’m not washing my hands about it. What I’m saying is that when he is doing his duty of implementing, what factors he takes into account in executing his implementation is really something that you need to check with him.

Parker: Yeah, that’s fair enough. Can I—

Makhlouf: If I could just finish, because I think this is an important point. On the level of the exchange rate, the Treasury’s view is that this is fundamentally about our savings and investment history. It’s also about commodity prices, but it’s critically about our savings, and I think for us that is, if we’re going to address some of these issues over the long term, that’s the space that we need to be in.

Parker: The last thing on this issue: a businessman recently sent me the biography on Volcker, and I think with the benefit of hindsight Volcker would seem to be standout performer in the last century, more than Greenspan and some others. What strikes me, as reading that book, is that Volcker the whole way is motivated by maintaining the wealth of America through maintaining settings that maintain a current account surplus over time. Now, they might pretend that they’re inflation targeting ahead of everything else, but they’re worried that they maintain the competitiveness of their export economy, because otherwise the balance sheet of the United States got worse, and that was the motivating factor in a lot of the changes that Volcker oversaw, whilst also, you know, maintaining control of inflation, which no one denies important. I have this fear that in New Zealand we have been so fixated in such a radical way compared with the rest of the world on our view of inflation targeting that we as a nation for 40 years have had an eroding balance sheet, and we’re continuing down that same path.

Makhlouf: I haven’t read Mr Volcker’s biography, but—

Parker: It’s worth a read because he’s seen as an inflation hawk.

Makhlouf: Yeah.

Parker: And yet—

Makhlouf: I think there’s sort of—

Bennett: Is that your Bible, is it?

Parker: Actually, I read quite widely. It might help if you did occasionally.

Makhlouf: What I will say is that in many ways I hope this is a shared view around the place, which is that these issues are incredibly complicated. It’s one thing for the United States to decide to do something. It’s quite another for New Zealand, just because of the sheer scale of the economy. Doing things
sometimes have unintended consequences, so we should be cautious and
deliberate—

Parker   Everyone agrees with that, but in New Zealand that seems to be, say,
preserve the status quo despite a 40-year current account deficit, which is
going forward uncured.

Norman   The current Reserve Bank Act had unintended consequences—

Makhlouf If I just speak to you on Treasury’s view on this, which is that we need to
continuously test our assumptions, look at evidence, and then come to
conclusions.

McClay   OK, well, thank you very much to you and your colleagues for your time
today.

**conclusion of evidence**
Reserve Bank of New Zealand's
Monetary Policy Statement,
March 2013

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Todd McClay, Chairperson)
April 2013

Presented to the House of Representatives
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Reserve Bank of New Zealand’s Monetary Policy Statement, March 2013

Recommendation

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, March 2013, and recommends that the House take note of its report.

Introduction

This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, March 2013, and the central issues we discussed with the bank in our examination. Our approach to considering the statement, our membership, and the transcript of the hearing of evidence are set out in the appendices to this report.

The March 2013 Monetary Policy Statement announced the decision of the Governor of the Reserve Bank to maintain the Official Cash Rate (OCR) at 2.5 percent. The OCR has been held at this historically low level for the past two years, since it was lowered in March 2011 to help limit the adverse effects of the Canterbury earthquakes. The governor stated that he expects the OCR to remain unchanged through 2013—an unusually explicit indication of the Reserve Bank’s expectations.

Reserve Bank’s reasoning

The decision to hold the OCR at its current level represents a finely-balanced judgement. The economy has shown signs of stronger growth since the December monetary policy statement, but the recovery is uneven. Surveys indicate that consumers and businesses are becoming more confident, but the high exchange rate continues to make conditions difficult for exporters and import-substituting businesses. Conditions in the labour market continue to be weak, with unemployment near its recessionary peak.

Inflation remains low. At 0.9 percent for the year to December 2012 it is below the Reserve Bank’s target band of 1–3 percent. The main contributor to the low inflation rate has been the unexpected strength of the New Zealand dollar.

The Reserve Bank projects that GDP will grow at 2 to 3 percent annually over the next three years, boosted by increasing reconstruction activity in Canterbury and residential investment elsewhere, and by interest rates remaining low, supporting domestic demand. While inflationary pressures will increase as a result, they will be offset to some extent by the Government’s fiscal tightening, estimated to represent 3.25 percent of GDP over the next four years. The Reserve Bank expects inflation to increase gradually to the 2 percent midpoint of its target range by 2016.

Risks from the lingering effects of the global financial crisis have receded, especially in Europe. Growth rates for New Zealand’s trading partners, which slowed during 2012, now appear to have stabilised, and prospects for growth in the US and China are improving. Australia and emerging Asian economies have continued to grow at a faster pace than other regions, supporting New Zealand exports. Overall, however, demand in many major
economies remains subdued, with structural obstacles to growth over the next few years. The monetary policy statement notes that, despite some improvement, global conditions continue to exert a drag on the New Zealand economy.

**Risks in the outlook**

There are several risks that concern the Reserve Bank. While it has stated that it expects the OCR to remain unchanged throughout 2013, there are indications in the monetary policy statement that the OCR could be moved up or down depending on how these pressures develop. We note that the bank’s projections for 90-day interest rates imply about 125 basis points of tightening from 2014 to 2016.

Factors that could dampen GDP growth and warrant lower interest rates include further appreciation of the already overvalued New Zealand dollar, or a prolonged worsening of the current drought. On the other hand, the Reserve Bank is concerned about house price inflation, particularly in Auckland and Christchurch. It has indicated that if housing demand were to get too far ahead of supply, it could see grounds for a tightening of monetary policy to maintain financial stability and to dampen inflationary pressures. Other inflationary risks include the possibility of pricing pressures from the Canterbury reconstruction spilling into other regions and sectors, and households reverting to their previous patterns of spending rather than saving.

**Potential impact of drought**

The Reserve Bank’s forecasts, finalised in the first week of March, have factored in a reduction in GDP growth of about 0.2–0.3 percent in the first half of this year as a result of the current drought. This is coming through in the form of reduced milk production, which has not been offset by increased meat production or transport activity as stock numbers are culled, because the extra supply has reduced meat prices in supermarkets. A resulting shortage of supply could, however, eventually push meat prices up.

Were the drought to continue for the next two months, the consequences for output growth and GDP would be longer-lasting, with poorer grass growth affecting the quantity and quality of breeding stock for the coming season. As an indication of the potential impact, the Reserve Bank notes that the drought of 2007–08 reduced agricultural output by 20 percent, which translated into about a 1 percent reduction in aggregate GDP growth.

**The housing market**

The Reserve Bank is clearly concerned about escalating house price inflation, particularly in Auckland and Christchurch, where house prices increased by 12 percent in the twelve months to February 2013, compared with just over 4 percent in the rest of the country. The average rate of house price inflation nationwide is roughly 8 percent at present. The Reserve Bank forecasts that it will peak at 8.5 percent in 2014, before an increase in the supply of housing and elevated household debt start to gradually restrain the rate of increase. The bank has made clear that it does not wish to see housing prices continue to increase at the current rate. Apart from the inflationary effect, such a boom increases the potential risks for financial stability from a subsequent bust in the form of a sharp downward adjustment in house prices.

We asked whether such concerns make it more likely that the Reserve Bank will use the macro-prudential instruments it has been investigating to prevent a housing bubble like the one that lasted from 2002 to 2007. Its recent release of a consultation paper about a
possible framework for the use of such tools appeared to signal that the bank was leaning more toward using them. Some of us would welcome this, having urged the use of such tools for the past two years.

The Reserve Bank told us it sees macro-prudential instruments as potentially a very valuable part of the central bank’s toolkit, but it has not increased its emphasis on them. It is waiting to see what feedback it receives through the consultation process; replies are due by 10 April. The bank added that it does not see the current situation as comparable to the housing bubble of 2002–07, when New Zealand had the most rapid house price appreciation in the OECD; if it had had macro-prudential tools available then, it would have used them.

As to the factors driving Auckland’s house prices, the Reserve Bank indicated that most are relatively clear, such as the lowest mortgage rates in 50 years. It believes it has a good understanding of banks’ lending behaviour, regulatory issues on the supply side, and domestic demand; but the extent of foreign demand is less clear. One recent limited survey by the BNZ indicated that about 24 percent of sales nation-wide were to first-home buyers, 19 percent to investors, and 9 percent to overseas buyers. In Auckland, the proportion of overseas buyers was higher, at about 11 percent.

Reserve Bank’s tools

We asked about the likely efficacy of macro-prudential tools in dampening inflation in the housing market, compared with traditional use of the official cash rate. The bank told us that three of the tools under consideration—a countercyclical capital buffer, the core funding ratio, and sectoral capital requirements—would act on prices by affecting banks’ cost of funds at the margin. Their impact was likely to be less than an OCR increase, potentially increasing the cost of funds by 10 to 20 basis points. The fourth tool—restrictions on high loan-to-value residential mortgage lending—would affect the quantity of credit available, and so could potentially have a more significant impact, but one that could be viewed as more draconian.

The Reserve Bank noted that it is also examining various micro-prudential measures, such as the risk weightings on housing lending. However, it emphasised that none of the measures being considered would be able to stop a housing bubble from forming; they could simply hope to slow down an escalation in prices until market forces eventually worked to turn the cycle around by increasing the supply of houses. For this reason, the bank is particularly concerned about factors that are constraining supply. The governor commented that housing supply has proved remarkably rigid, despite quite a prolonged period of low interest rates under accommodating monetary policy, which suggests that specific measures are needed to encourage an increase in supply.

Exchange rate

The Reserve Bank’s main projections assume that the New Zealand dollar will remain elevated throughout 2013, but depreciate gradually thereafter. The monetary policy statement notes, however, that exchange rates often go through cycles of sharp, rapid swings, and that the New Zealand dollar has occasionally risen to levels inconsistent with prevailing economic conditions. The Reserve Bank devotes a section of the statement to examining what persistent strength in the exchange rate would imply for monetary policy. It notes that if the dollar’s movement differed significantly from the path the bank has assumed, there would be important implications for inflation, GDP, and monetary policy.
It is of interest that the statement sends some unusually strong signals about the Reserve Bank’s views on the exchange rate. As well as explicitly calling the New Zealand dollar overvalued, it comments that “if the exchange rate rose for reasons not justified by New Zealand’s economic fundamentals, all other things equal, this would lead to a lower-than-expected OCR”.\footnote{1} We note that the New Zealand dollar fell by 70 basis points against the US dollar following the monetary policy announcement. Conversely, the Reserve Bank also notes that if the exchange rate were to decline rapidly, this would add to inflationary pressures, and monetary policy would need to respond.\footnote{2}

We explored with the governor the extent to which the Reserve Bank considers the dollar to be overvalued. He said that the IMF’s research, with which the OECD would concur, puts the overvaluation at about 15 percent; whereas he would personally gauge it at between 10 and 15 percent. Some overvaluation has persisted for several decades, he noted, as inadequate savings by New Zealanders have been manifested in a persistent current account deficit of about 5 percent of GDP. The impact of the overvaluation has been seen in reduced profitability for exporters and import-competing manufacturers, and in constrained output and employment growth. The Reserve Bank expects the dollar to drop at some point, and on the basis of experience with such corrections, it could do so quite sharply. This would necessitate corresponding adjustments by businesses.

As to when a correction might occur, the governor said nobody can predict it; it will depend partly on when the US can start to return to more normal monetary policy. The US remains a powerful economy, and its currency is undervalued partly because of the quantitative easing it has undertaken.

**Employment**

It is clear that conditions in the labour market remain soft, although indicators differ as to the extent. The monetary policy statement discusses the variations, with the Reserve Bank concluding that the household labour force survey—which suggests that employment conditions have deteriorated significantly over the past six months—probably overstates the degree of weakness at present. However, the bank does note that the unemployment rate, at about 6.9 percent, remains near its recessionary high. It is projecting that unemployment will decline over the forecast period, to 4.8 percent in 2105/16, partly because of the jobs created in Canterbury’s recovery.

**Fiscal policy**

The Reserve Bank’s projections envisage the Government’s operating deficit falling from 3.9 percent of GDP in the current year to near balance by 2014/15, and a surplus of 0.5 percent of GDP in 2015/16. It notes that this represents a substantial fiscal consolidation, amounting to 3.25 percent of GDP cumulatively over the four-year forecast period, which will reduce the need for the Reserve Bank to raise interest rates to counter inflationary pressures.

We sought the Reserve Bank’s assessment of the likely unemployment rate in the absence of such fiscal contraction by the Government. The Reserve Bank estimates that the impact of fiscal consolidation on the labour market would be roughly equivalent to its effect on GDP, so unemployment would be about 1 percent less a year without it. The bank notes

\footnote{1}{Monetary Policy Statement, March 2013, p. 5.}
\footnote{2}{Ibid, p. 9.}
that this assumes hypothetically that other factors were held equal—for example, that there would be no monetary policy response to the inflationary impact of Canterbury’s reconstruction.

Quantitative easing

We discussed with the Reserve Bank the various risks to and pressures on New Zealand of the vast increase in global liquidity caused by quantitative easing in major economies.

Regarding financial markets, the Reserve Bank said it sees a real risk of bubbles forming in some asset classes as international investors, including central banks, seek secure avenues for the roughly $5 trillion in funds newly created by quantitative easing. The effects would spill over to New Zealand financial markets. It notes there is already some evidence globally of such imbalances in fixed-income assets and junk bonds.

The Reserve Bank acknowledges that the financial imbalances caused by this huge injection of global liquidity are a significant part of the reason for New Zealand’s elevated exchange rate. Countries like New Zealand, Australia, Canada, and some of the Nordic and Latin American countries have attracted liquidity flows because they are seen as good credit risks compared with many other countries, which are facing serious imbalances, and because they have higher interest rates than the present 0 to 1 percent offered in major economies. Like New Zealand’s, such countries’ exchange rates are appreciating.

As to why New Zealand does not engage in quantitative easing of its own to counter the pressures on its exchange rate, the governor emphasised that our situation is very different. New Zealand is not suffering the deep-seated balance sheet problems of countries such as the US, where median real household net worth fell 38 percent between 2008 and 2010, the Eurozone, where excluding Germany the unemployment rate is over 14 percent, or Japan, where prices have fallen to 1995 levels. The situation in Switzerland, which is using quantitative easing to stabilise its exchange rate, also differs from ours, as it has negative inflation and zero interest rates, so cannot use standard means to stimulate its economy.

Inflation and the Canterbury reconstruction

The monetary policy statement points out that inflation has been lower over the past 18 months than expected by the Reserve Bank and private forecasters. In large part this is because the New Zealand dollar has remained stronger than expected, reducing the cost of imported goods. Favourable growing conditions have also contributed to food prices declining more than expected. Among non-tradables, the communications component of the Consumers Price Index declined sharply since mid-2011, as competition among providers of mobile and broadband services pushed prices down. Most other components of non-tradable inflation have moved in line with expectations, including construction costs, which are expected to rise and contribute to inflation as Canterbury’s rebuilding progresses.

The Reserve Bank’s forecasts assume that repairs and reconstruction in Canterbury will total $30 billion (in 2011 dollars) over the next several years, providing a boost to construction-sector activity equivalent to about 15 percent of annual GDP. The bank sees some inflationary impact from this spending as inevitable—and, to some extent desirable, to draw resources into the region. It would not see any monetary policy response as necessary unless price increases were to spill over beyond the Canterbury region and the construction sector into more generalised inflationary pressures.
Appendix A

Committee procedure
We met on 14 and 27 March 2013 to consider the Reserve Bank of New Zealand's Monetary Policy Statement, March 2013. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O’Donovan.

Committee members
Todd McClay (Chairperson)
Maggie Barry
David Bennett
Hon Clayton Cosgrove
Hon David Cunliffe
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Kate Wilkinson
Appendix B

Corrected transcript of hearing of evidence 14 March 2013

Members
Todd McClay (Chairperson)
Maggie Barry
David Bennett
Hon David Cunliffe
Paul Goldsmith
John Hayes
Hon Trevor Mallard
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Kate Wilkinson

Witnesses
Graeme Wheeler, Governor
Grant Spencer, Deputy Governor, Head of Financial Stability
John McDermott, Assistant Governor, Head of Economics

McClay  Governor, good morning. Welcome to FEC. We have received a copy of your Monetary Policy Statement for March 2013, and we thank you for that. Can I offer you the opportunity to make comments, and then my colleagues, I’m sure, will have questions.

Wheeler  Thanks very much indeed, Chair. On my right is Grant Spencer, who is the Deputy Governor and the Head of Financial Stability in the bank, and on my left is John McDermott, who is the Assistant Governor and the Chief Economist.

Let me make a few opening comments. The outlook for economic growth and inflation is being shaped by many forces. Internationally, the tail risks around global growth appear to have receded in recent months, especially in Europe, and there are better prospects for growth in China and the US, and the Australian economy is still growing at around trend.

On the domestic front, monetary policy continues to remain accommodating, the Canterbury rebuild is gaining momentum, residential investment is increasing, recent indicators of retail spending have improved, and surveys suggest that consumer and business confidence is strengthening. But we’re also seeing house price inflation continuing to increase, and there are several factors that could dampen growth. First is the overvalued New Zealand dollar, which is undermining profitability in export- and import-substituting industries. If the drought continues to
deteriorate, that will certainly slow aggregate output growth and reduce farm incomes. And there is ongoing fiscal consolidation.

So there are several upside and downside risks around these forecasts, and several upside and downside risks that the bank is currently managing, but at this stage we expect the OCR to remain unchanged through the end of the year. Thanks very much.

Mallard Thank you. I want to just dive into two or three areas. The first is the drought. Can you outline for us both the short-term—say, this half year—effect of the drought and the long-term effect of the drought? I’ll phrase it another way: is it correct that actually the drought is stimulating the economy now, and it will worsen later?

Wheeler I’m not sure that it’s stimulating the economy now. I mean, when we did our forecasts—and the cut-off point was about 8 to 10 days ago—we had built in a reduction in GDP from the drought of the order of 0.2 or 0.3 percent of GDP.

Mallard Over which period?

Wheeler The first half of the year. That was coming through lower milk production. It was coming through—yes, lower milk production mainly, but with some offsets in terms of higher slaughter of beasts, meat manufacturing would be slightly higher, and higher dairy prices perhaps, given New Zealand’s importance in the international dairy market. Longer term—

Mallard Before you go on to longer term, could I ask you about feed prices and transport?

Wheeler Feed prices we would expect to go up as a result of the drought.

Mallard Yes, and the massive transport that’s occurring, is that stimulatory or not?

McDermott It’s an offset for lost production that would otherwise have taken place.

Mallard So that what you’re saying is that all the upside is in milk—all the downside is in milk, and all the rest of the activity doesn’t make up for that, notwithstanding the increase in milk prices?

McDermott Yes. That’s what we’re saying.

Mallard Are you sure?

Hayes I have a supplementary. Could you please explain to me why the milk gets scarce so the price goes up, and the lamb production comes down and the price also comes down? That’s what’s going on.

Mallard Because you’ve got to kill them quickly, that’s why.

Hayes No, no. Lamb is going to be a scarce commodity, like dairy. Production is dropping because of the drought. That’s what’s happening on my patch. But the lamb price is being forced down and the dairy price is being forced up. I don’t understand why.

McClay To the degree you can answer that question, do so, but, John, that’s probably not really before us today.
McDermott: But just very quickly, right now you have to kill the surplus stock because there’s no feed, and that puts supply of meat into the supermarkets, so the price is going down right now. In the future it will increase, because there’ll be a shortage of supply.

Bennett: And dairy cows are going down in price as well.

McDermott: Yes, supply and demand.

Bennett: So you’ve got a negative from that too.

Mallard: I’m just expressing some surprise that you are so negative there. Prices have gone down but slaughter has gone up, and that, I would have thought, was more stimulatory.

The next question is: in the next year or two, assuming the drought goes on for a bit, what is your feeling is going to be the effect then?

Wheeler: Well, if there are no significant rains over the next 2 months, for example, then certainly grass production and livestock numbers get affected in terms of carrying capacity for next year, and the quality of the livestock and the breeding stock all get affected. If that were to happen, and one looked at, for example, the 2007-08 drought, which was a serious drought, where agricultural production fell 20 percent, the impact of that in aggregate was around about 1 percent of GDP.

Mallard: I want to switch away from there to what I understand was a change in emphasis this morning around your macro-prudential tools and the possibility of their use. Do you want to tell us if that has been correctly interpreted, and what has led to that?

Wheeler: I don’t think there’s any change in emphasis on the macro-prudential tools. I mean, what we’ve done is produce a document, a consultative document, that’s out with financial intermediaries at the moment. We’ve asked them to get back to us by 10 April. So we’re really in the consultative phase, where giving a lot of background is—a lot of talking with intermediaries themselves, explaining, answering questions. So nothing’s changed; we’re just—

Mallard: So it’s not more likely now than it was a few months ago that they might in fact be used?

Wheeler: Well, we’ll wait and see what comes out of the consultative process. Certainly we’re concerned about the rise in house prices. You know, you’ve seen Auckland house prices up 12 percent, you’ve seen Christchurch house prices up 12 percent. New Zealand nationally is up around 8, and if you take Auckland and Christchurch out of the New Zealand numbers, then it’s about 4.25. There are many reasons behind that, including, of course, the lowest mortgage rates for 50 years. There are a number of supply side and regulatory factors in the Auckland market, etc. You know, we don’t wish to see house prices continue to increase at this sort of rate. That’s one of the reasons why we’ve got the macro-prudential document out there, because it’s potentially a very valuable tool kit for the central bank.
Mallard OK, just going back to where I started on that question, so the people who have analysed your statement this morning and thought that it signalled a more likely use of the tools than your previous statement are wrong?

Wheeler I think, you know, the statement that we put in on house prices was the one that we put in, by and large, fairly well word for word with the OCR statement 6 weeks ago. What’s happened this morning is the exchange rate has come off by about 70c or so against the US dollar, which we regard as a good thing, and that was partly because the market was basically looking for a more hawkish statement, and they’ve had to adjust their positions.

Mallard My final question is on other tools—are you continuing your work looking at alternative tools to the OCR and the group that you’re currently consulting on; if so, what are they?

Wheeler We are currently spending a lot of time, of course, as you say, on the macro-prudential instruments, and there’s four of those, but there are also micro-prudential instruments that we look at—for example, the risk weights on housing lending is an important consideration. That’s something we’re looking at at the moment.

Mallard OK, so there’s no big tools being looked at.

Wheeler These are all big tools.

Mallard Well, I see two noes and one yes between the shakes of the heads.

Wheeler Oh, in terms of others? No, I am saying these are big tools. In terms of other things, no.

Mallard Thank you.

McClay Thank you very much.

Goldsmith Thank you. You’ve talked today explicitly about what you say is the overvalued dollar. I sense you’ve been getting a bit more—you’ve been making stronger statements over that over the last few months, and I just want to tease out how you can be definite about that, and how you judge what is overvalued and what you think is appropriate value, and how you can determine that over time.

Wheeler Overvalued—I mean, in essence, you see a persistent current account deficit in this country. It’s been around, for three decades, of the order of 5 percent of GDP. It’s continuing to deteriorate at this point, or, at least, our forecasts build in a deterioration. You see a high level of external indebtedness in respect of claims that foreigners have on New Zealanders, and you see the impact on the traded goods sector. You see it, for example, on export profitability, the profitability of import substitution industries and manufacturing. So you see it in terms of output growth, employment growth, and profitability in those sectors.

In terms of the degree of overvaluation, the IMF basically says it is around about 15 percent or thereabouts, in terms of their research, and the OECD would not differ from that assessment.
Goldsmith: But, I mean, the current account deficits and the external indebtedness have all been consistent—well, not consistent, but long standing, when the dollar’s been low compared with what it is now. What’s changed on that score?

Wheeler: Well, I think New Zealand in many respects has had an overvalued exchange rate for quite long periods in the past. I mean, we’ve had repeated cycles of—if you look at a real exchange rate series, you see some very sharp cycles and some quite major corrections. One of the issues now is you’ve got, we believe, an overvalued exchange rate that’s doing some damage to the economy. We think it will come off at some point, and if you look at past experience, it can come off quite sharply, and that creates a lot of output in employment costs, that sort of adjustment.

Goldsmith: The next question is: we’re seeing a very strong performance in asset classes internationally, and I just wanted to know, you’re suggesting that the risk of external financial headwinds have reduced somewhat over time, but do you think there is a risk of bubbles forming internationally in the asset classes and that leading to trouble down the line that we should be concerned about?

Wheeler: Yes, I think there’s a real risk of that, and I think it’s already happening in international fixed income, and it’s happening in respect of junk bonds; it’s happening in respect of emerging market spreads.

I mean, the problem that we have, in essence, is as follows in many respects. You’ve got countries that represent two-thirds of world output, with interest rates between 0 and 1 percent. So that’s all the G7 countries. It is the eurozone, which, of course, includes France, Italy, and Germany. It’s Switzerland and Sweden—add it all up, it’s roughly two-thirds of world output. You’ve got the major central banks, who have been adopting quantitative easing, primarily because the problems that they face are much more severe than the problems that we face in this economy, but they have been injecting roughly US$5 trillion of quantitative easing. So you then, with all this massive global liquidity, have investors scouring the world for countries and investment prospects that look more favourable, and New Zealand has a higher growth rate, a reasonably sound macroeconomic policy, so it looks a good credit risk and it’s attracting a lot of foreign capital.

What’s also exacerbating the problem, to some degree, is the portfolio strategies of central banks themselves. I mean, you’ve seen a massive build-up in foreign reserves globally since the Asia crisis in the late 1990s. And you’re now seeing central banks themselves looking around the world in terms of their portfolio management for attractive countries. So some of the flows—just some of the flows—coming into New Zealand are coming in from other central banks and Asia and Europe, plus sovereign wealth funds tied in with them.

That’s what’s behind a lot of the exchange rate pressure, because, you know, what we’ve seen is the terms of trade decline here now for 18 months. Labour productivity is not particularly strong in New Zealand—it
hasn’t been for quite some time—yet we still attract large capital inflows, and a lot of it is because of the policy settings and the problems in other countries.

Mallard So, just in simple terms for the non-expert—a summary of what you just said is that overseas central banks printing money and investing it in New Zealand is resulting it in our dollar being overvalued?

Wheeler I’m saying as a result of the excess global liquidity, you’ve got investors that include private sector and investors from the official sector that are basically scouring the world looking at good investment prospects. So you’ve got countries like Australia, New Zealand, Canada, some of the Nordic countries, some of the Latin American countries all facing the same sort of exchange rate tension that we’re facing.

Mallard Was that a yes or a no?

Wheeler Well, I thought I was fairly clear. I’m sorry.

Mallard Is the increased liquidity through overseas central banks effectively printing money, which is then invested in New Zealand resulting in our—does that result in our dollar being higher? Sorry, not all of us are quite the experienced economists that you are.

Spencer I think that’s effectively right, but we just want to make sure—it’s not the central banks like the Fed who are printing money and investing it straight into New Zealand. The Fed is printing money, pumping it into the economy, pushes the rate structure down, so all investors are looking for alternatives with higher yields.

Mallard But if they weren’t, they wouldn’t?

Peters Didn’t the Fed intend that they print the money so that it be spent in their economy?

Spencer Yes, that’s the intention.

Peters Well, what’s it doing over here?

McClay Wouldn’t it be the case also where you’ve had countries that have had a very, very low interest rate—0 to 1 percent—that some of their investors are looking at other countries of the world for better returns, and in the case that there’s not liquidity being pumped in, money is flowing looking for the best return?

Wheeler That’s correct.

McClay Yeah, so it’s not strictly because money’s being printed, although that can have an effect upon the currency value of the country concerned.

Norman So just to finish off that previous conversation—I mean, another way to look at it is that other central banks are creating money. They don’t have to print it, obviously; it’s just electronic. We borrow that money and pay them interest for the privilege of using the money that they’ve just created from nothing, and that is part of the reason that the New Zealand dollar is being driven up.
Spencer  Part of the reason, yeah.

McClay  Big part of the reason? Small part of the reason? Or just a part of the reason?

Wheeler  It’s certainly a significant part of the reason.

Norman  It’s a significant part of the reason. So they print the money, we borrow it from them, and we pay them interest for doing that, and then that drives up. That’s one of the imbalances.

So, looking at your numbers, you’re saying total employment 2013 is to decline by 0.5 percent, so bad news on the employment front.

Wheeler  That’s already happened. I think March years, aren’t they?

McDermott  Those are March years. So that’s effectively already happened.

Norman  So then we’re talking about the current account balance, minus 4.8 going out to minus 6, but you give a scenario where it gets a lot worse than that, right—the minus 8 current account deficit in your box B, where you kind of explore the impact of the dollar. So it could get a lot worse if we keep with the high dollar. It could go out to minus 8. Then household savings rate is declining to minus 1.1 percent of disposable income. At the same time as we’ve got housing price bubble developing at 12 percent.

Isn’t this exactly the wrong thing we want to happen in all of those dimensions? Isn’t it the whole thing going in the wrong direction? Household savings are getting worse. Unemployment’s getting worse. The current account deficit is getting worse. Housing price bubble—

McDermott  Well, over the forecast horizon the unemployment rate actually improves.

Norman  So it’s minus 0.5 in the 2013 March year.

McDermott  So we have an unemployment rate in the table of 6.7—it’s currently a little bit higher now—and it runs down to about 4.8.

McClay  So unemployment’s tracking down, you were saying?

McDermott  A big part of the story for New Zealand is the huge rebuild that is needed in Canterbury. So that will take up a whole amount of job creation. In addition it’s a massive investment that New Zealand needs to take place. It’s some $30 billion. Unfortunately, New Zealand hasn’t saved enough for its own investment purposes for many years, and that will require a gap between savings and investment, and, by definition, that will manifest itself in a higher current account deficit.

Norman  Yeah, and so a current account deficit that’s heading towards dangerous levels, like previously, because under the previous Labour Government the current account deficit went to 8 percent of GDP, and potentially under your scenario in box B it could go to 8 again.

Spencer  Under that scenario, yes, it could.

Norman  And that’s related to the overvalued New Zealand dollar?

Spencer  Well, it’s the same pie, yes.
I.3I MONETARY POLICY STATEMENT, MARCH 2013

Norman OK—which is being pushed up in parts because other central banks are printing money, but we’re not. [Interruption] Well, that’s just what the governor’s telling us.

What I wanted to ask you about was looking through inflation in the Canterbury rebuild. So when the Government increased GST, there was an inflationary spike and you guys rightly said: “We’re going to look through it.” Why don’t you take the same attitude towards the earthquake rebuild, in the sense that it’s a one-off event, it’s time delimited, in terms of its impact, but you do seem to be taking it into account when you’re talking about the level of the OCR?

McDermott An important part of the story in this Monetary Policy Statement is that we will see higher prices in Canterbury, and we’re already seeing that. What we’re saying is we don’t want, or don’t expect, those higher prices in Canterbury to spill over to the rest of the country and we’ve made that assumption. If we’re wrong on that, it would require a further monetary policy response. So in fact we’ve actually moderated what might be a typical monetary policy response, by the assumption.

Norman And so to what extent though—what I’m trying to figure out is what exactly have you factored into your concerns about—because it seems to me the obvious thing to do was to lower the OCR when you look at all the external imbalances, you want lower interest rates, to put downward pressure on the New Zealand dollar, but obviously one of your concerns is inflation coming out of the housing sector, which is what all the complementary tools hopefully, maybe, will deal with, but one of your other concerns is the Canterbury inflationary impact. So how much is that affecting your thinking about the OCR?

McDermott Well, the important thing is we’re concerned about inflation, not relative price changes. So there will be some relative price changes in Canterbury—that’s inevitable. In fact, from an economic point of view it’s actually desirable because you want to draw resources into that region, and that’s the part that we would look through.

Norman So you will look through the full inflationary effect of the Canterbury region?

McDermott The relative price change in Canterbury. So higher prices in Canterbury—that’s what we expect to see, and it wouldn’t engage in a monetary policy response.

Wheeler To the extent, for example, that you see real wages increase, and in Canterbury for certain professions it’s a good thing, and if it tracks more resources into that sector. Where we would become concerned in terms of monetary policy if there was a spill over, that the relative price effect moved into more generalised inflation pressures, that’s where the monetary policy concern would develop.

McClay I’ve just got a supplementary on an earlier part of Russel’s question and it’s around unemployment figures. I guess my question is on the employment market—is it as weak as the HLFS has suggested?
McDermott  I’ll pick up on that one. Obviously we’ve been struggling with the specific numbers over the last few quarters. They’re very volatile, and to a degree we can’t rely on those numbers by themselves. We can look at other indicators, like the QES, we can look at the benefit numbers. Our position, once you take all those indicators in, is we’ve got a relatively weak labour market and we’d say unemployment around about 7 percent feels right. But that would be an appropriate assessment.

Peters  If you look at your GDP growth projections, there’s only one year—2014-15—that would be of a level able to employ, for example, tertiary or school-leavers. So your unemployment figures going down—does that suggest, do you think, they’re going to be parked off overseas?

McDermott  So the question could be are there assumptions about participation or whatever.

Peters  You know, 2.1 doesn’t cut it in terms of employing people who leave school in a given year; 3 percent starts to get there. But your figures go down because your projection for 2015-16 is 2.1, so I suggest you’re just surely factoring in something else called emigration of a workforce. Is that a fact?

Wheeler  The more you forecast out, if you like, the uncertainties increase, and as I said in the opening comment, we’re balancing a large number of forces if you like in thinking about the forecast growth and output in employment, and also balancing those same forces and thinking about monetary policy. If you look at output growth over the last three decades in New Zealand, it’s averaged about 2.25 percent. We think that with this sort of output growth that’s forecast here over the next 2 to 3 years, we will end up with unemployment probably at a pretty low level in terms of what might be the traditional definition of full employment, which is roughly around perhaps 5 percent.

Peters  Yes, but how much in all those figures, the calculations that you’re working on, are you factoring in the trend to depart this country?

McDermott  So we’re assuming a net inflow of the population.

Spencer  They’re not based on an assumption of outward migration.

Peters  Well, I find it very hard—

McDermott  And what can change those numbers round quite significantly is the participation in the labour market.

Peters  OK. How about you telling me this: the OECD and IMF say that the dollar is overvalued by 15 percent. Is that your view?

Wheeler  The IMF and the OECD say it is overvalued by 15 percent. My personal view is that it’s probably overvalued by somewhere between 10 and 15 percent.

Peters  So you don’t think it’s as overvalued as they do?

Wheeler  No, they talked about 15 percent roughly, so I would say it’s in the range of 10 to 15 percent.
Tell me, if you’ve got the US issuing money, especially out of thin air, and having it spent here, what is your problem with issuing money here and having it spent here?

You can’t say that.

I’m not saying this is my position. I’m asking what your problem with it is.

That’s a fair question, of course. If you look at the quantitative easing, what these countries do is they are responding to the problems that they face. In the US if you take median real household net worth, for the median household in the US it fell 38 percent—38 percent—in 2008-10. Now the average was about 14 percent, because the top deciles had different adjustments, and this is a country that’s 20 percent of world outputs, so this is just enormous. Interestingly, in terms of household wealth, the US has got back there now, to where it was in 2007, but with a completely different composition. The big fall was in house prices. There’s been some recovery in house prices, but, of course, stocks and equities have recovered so strongly that household wealth is back again. But the US were responding to a massive adjustment in most people’s balance sheets across the US. If you look at Europe, the unemployment rate in the eurozone is about 11.7 percent. Germany probably has the most favourable exchange rate in the world, as part of the eurozone. Their unemployment rate is quite low at this point, so if you take out German unemployment, the eurozone’s unemployment rate is over 14 percent, so it’s roughly twice and even perhaps more than twice what our unemployment rate is.

Then if you look at another country that has been adopting quantitative easing, which is Japan, it’s had stop-start recoveries for two decades. Its price level in Japan, the current price level, is back to where it was in 1995. So these economies have massive, massive problems and our situation is really quite different from that. We’ve got the reconstruction, a massive reconstruction of our second-largest city. We’ve got different forces operating on our economy, but unfortunately we’re suffering from the spillover effects of the policy reactions required or considered necessary by the authorities in those countries to address just deep-set balance sheet problems that we don’t have at this point.

Switzerland has a 3.4 percent unemployment rate—I just googled it while you were talking. Switzerland has embarked on this process to drive down the value of the Swiss franc, and it worked. It’s been very effective. They now have very large foreign currency reserves, which you apparently talked about previously, and that’s possibly being buying up New Zealand Government bonds at the moment with effectively that freshly printed money. They don’t have the problem you talk about. They more have the problem that we had, which was an overvalued currency, which they have responded to by issuing more Swiss francs. So how do you contextualise that example, when you say that the only countries that have been engaged in QE are those that have got huge output collapses or very high unemployment?
McDermott Two features in Switzerland that are important are not present in New Zealand. One is that at the moment inflation in Switzerland is negative, so they need a very stimulatory monetary policy, and the second is they have zero interest rates. So if you could move interest rates in the negative territory, the standard monetary policy response would be to take them further. Now, of course they can’t, so they need to do something else. So to try and stimulate their economy to get inflation back into a positive zone, what they’ve chosen to do is quantitative easing, and the specific assets that they’ve chosen to buy, because it’s Switzerland, are foreign currency assets. So from their domestic point of view that makes sense, in terms of stabilising output and inflation.

Peters This is a fascinating discussion. It reminds you of some 16th century meeting of the church where any thought of a certain comment looks like it’s going to invoke an allegation of heresy at any moment. Never mind. Can I just ask you, do you think that the Reserve Bank or in fact the system itself has nearly enough elementary knowledge of, say, the Auckland house market, its componentry, what’s driving the prices, where the money is coming from, or do you think that maybe our research is deficient?

Wheeler I think we’ve got a pretty good feel for what’s driving the market. We know the demand impacts that are there, through very accommodating monetary policy and the lowest mortgage rates for 50 years. We know quite a bit about the supply side characteristics that are up there, and some of the regulatory issues. What we don’t know a lot about is to what extent foreign money is coming into that market. We know a lot about the loan-to-value ratios that banks are adopting. We know what share of the market is by and large first-home buyers, but we don’t know a lot at this point, unless my colleagues do, about foreign markets. Having said that, there was a bit of information that came available on the screens this morning. Did you want to cover that, Grant?

Spencer This was actually a BNZ survey of agents. For the country overall they have 24 percent first-home buyers, 19 percent investors, and 9 percent offshore buyers. This is not a full survey of all sales. It’s a survey of real estate agents. For Auckland it’s higher than the national average at about 11 percent offshore buyers.

Cunliffe The output gap is still negative at around about minus 0.5 percent, and there is a forecast 3.25 percent contraction cumulatively on the fiscal balance. We are running at, in your words, close to a recessionary level of unemployment. What would be the bank’s estimate of the impact of this 3.25 percent fiscal contraction on unemployment levels, relative to the counterfactual of a zero percent fiscal contraction?

McDermott Right now the fiscal contraction that’s planned for the next 2 to 3 years is roughly being offset by the expansion we’re seeing in Canterbury.

Cunliffe The question was very specific, which was relative to the counterfactual.

McDermott I’m just setting the scene. If, all those things being equal, we still had the expansion in Canterbury but the fiscal policy was different, we would get a
different pressure on demand and a different inflation pressure, so what would be offsetting to deliver the same output gap, and hopefully the same inflation profile we have here, is a different monetary policy.

Cunliffe I’ve asked you what would be the ceteris paribus, all other things equal, what is the bank’s estimate of the impact on unemployment rates of the 3.25 percent fiscal contraction relative to a zero percent fiscal contraction. Of course you can offset it with changes to weather, changes to international conditions, changes that you can control to monetary conditions, but the question is more specific than that. You must have modelled a baseline with no fiscal changes.

McDermott The aim of the Monetary Policy Statement is to show how we would get back to 2 percent inflation.

Cunliffe If I can rephrase it, and Chair this is not my second question, would it be likely to make perhaps a greater or less than half a percent difference to the unemployment level of that, cumulatively over the next 3 years, all things being equal?

McDermott We haven’t run that specific exercise, but you can mentally go through it with the tables here because you’re talking about a 3 percent adjustment—

Cunliffe 3.25 percent.

McDermott —assuming we didn’t respond to that.

Cunliffe That’s what I’m assuming.

McDermott Right. So that’s roughly going to be about 1 percent adjustment in GDP per year, and that roughly translates one for one to the labour market, so you’re going to get a labour growth forecast that’s approximately going to be about 1 percent less than otherwise would be the case.

Cunliffe Per annum?

McDermott Per annum.

Cunliffe All things being equal. So it therefore follows that a more accommodating monetary stance would offset that to some extent. The second question is around the macro-prudential instruments. I wonder if you could give us any estimates of the OCR equivalent value of the macro-prudential instruments that are in your discussion document. The reason for asking is that you’ve held out the document, or the measures in the document, as having a potential to lean against the housing price bubble that we’re already seeing. What is the OCR equivalent value of those measures if fully implemented?

Spencer They’re not huge multiples. When you apply some of these instruments some of them will work on the cost of funds, then it depends on what the banks do in terms of their actual pricing. The cost of funds may be increased in the order of, you know, 10 to 20 basis points for one of—

Cunliffe Cumulatively, across the four tools?
Spencer: No, well I’m talking about, say, a capital overlay. The order of magnitude is probably less than an OCR increase, as opposed to multiples of an OCR increase.

Cunliffe: But if it’s—

Spencer: Sorry, could I just finish. Three of the tools will tend to operate on pricing, the cost of funds. The fourth tool, the LVR restrictions, is more of a quantitative nature that would affect the quantity of credit, rather than just pricing, and therefore it’s a slightly different animal.

Cunliffe: I’m going to ask the next question, then, with a degree of hesitation because I’m a homeowner, not a young person seeking to buy a home. But if there is 12 percent house price inflation currently in Auckland, where I live, and in Christchurch—

Peters: How much?

Cunliffe: —12 percent—and if there is no movement in the OCR until at least 2014, and if the combined impact of these macro-prudential tools is less than a 25 basis point OCR move, what do you expect will be the impact on house pricing inflation in the Auckland market next year and the year after?

Spencer: Well, we never have indicated that the macro-prudential tools will stop the housing market dead. I mean, the more Draconian measures, for example using LVR restrictions, would be more likely to have a significant impact. Using capital overlays or the core funding ratio is more operating at the margin, so you may slow it down. You’re still requiring for house prices to turn eventually as a result of more fundamental factors, cyclical factors—in other words, house prices get more expensive and they’re harder to buy, supply and demand, more supply coming on-stream, those sorts of factors will eventually turn the cycle.

Cunliffe: So can I then finally wrap by asking the governor a judgment question. Given that we are seeing another house price inflation cycle, which is quite a serious one, at the same time that we have an admittedly overvalued exchange rate and a tradable sector that is depressed, and high unemployment, is it your view that we’ve really learnt the lessons of history, or are we back to where we were a few years ago with a roller-coaster that is not assisting productivity?

Norman: The first time is tragedy; the second time is farce.

Wheeler: I think the situation is different from 2003 to 2008 to some extent, and let me expand on that—sorry, 2002 to 2007. We had the most rapid house price appreciation in the OECD during that period and you saw active investors, a lot of activity, you saw a lot of excessive consumption as a result of the wealth effects that were coming out of the housing market. Had the Reserve Bank had the tools available, then it would have applied macro-prudential tools. You know, what we’ve got at the moment is the situation where Christchurch house prices are growing at 12 percent, Auckland at 12 percent, and the rest of the country roughly at about 4 percent. The last thing we need, I think, given that we’ve got an overvalued exchange rate and we’ve got a drought that’s starting to, or could,
deteriorate quite significantly, and time will tell on that front, the last thing we need is a housing price bubble that gets out of control. That's one of the reasons why we've moved quite fast on these macro-prudential instruments, the consultation process, that—

Cunliffe Can I, just as a parenthesis on that, say that the Labour Opposition, with support from our Green colleagues, has been arguing for these tools for at least 2 years.

McClay Let’s take another question. I want to finish—I’ve got a supplementary on this. We’re almost out of time. It’s around house pricing. Governor, I think when you were with us previously, you mentioned that the interest rate wasn’t the only factor that’s having an effect upon increases in house pricing. If we take Auckland as an example, we’ve heard estimates that there were 15,000 sections available, and now 2,000. With the exception of Mr Cunliffe’s electorate and in Herne Bay there are very few sections available. What effect are supply and future building ability also having upon house pricing?

Wheeler The supply constraint, you know, is tremendously important. If you’ve got monetary policy, which, as I say, has been accommodating for quite some time—we’ve had the OCR at 2.5 percent now for 2 years, and our projections talk about the OCR remaining flat throughout 2013—you know, if you have a supply curve that doesn’t move, if it’s fairly rigid, if you like, you need to shift that supply curve. That is an important set of measures that are needed to do that.

McClay Thanks very much.

Peters Just one thing: BNZ, of all the forecasters, said they expect the dollar to go to 87c by the fourth quarter. You’d have seen all those projections, right?

Wheeler I’ve seen their statement, yes.

Peters What do you think of that?

Wheeler Well, I don’t claim to forecast exchange rates, and we’ve put a scenario down in here. You know, one of the issues around the US dollar is to what extent quantitative easing will continue in the US. What you’ve seen is Ben Bernanke pursue it really quite aggressively. The employment number that he got on Friday, 236,000, you know, was a pretty good number. It’s roughly consistent with the average of the last quarter of last year. So one of the issues is when can the US start adjusting to a more normal monetary policy. In the future the US dollar is going to be stronger, we do know that. I mean, it’s just undervalued, and it’s a hugely powerful economy. When that adjustment will take place is really quite unknown to anybody.

McClay Thank you, Governor. We’ll have to leave it there. Our new Speaker walks at a pace greater than our last Speaker, so my colleagues must get to the House. Thank you for your time today. We’ll see you again soon. Thank you.

conclusion of evidence
Reserve Bank of New Zealand's Financial Stability Report, May 2013

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Todd McClay, Chairperson)
June 2013

Presented to the House of Representatives
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Reserve Bank of New Zealand's Financial Stability Report, May 2013

Recommendation
The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Financial Stability Report, May 2013, and recommends that the House take note of its report.

Introduction
The Reserve Bank of New Zealand is required to report twice a year on the soundness and efficiency of New Zealand’s financial system. The following are the main points from its May 2013 financial stability assessment:

- New Zealand’s financial system remains sound and the economy continues to grow. However, the Reserve Bank is concerned that rising house prices and growth in credit are increasing the risks to financial stability.
- The mood in global financial markets has improved markedly over the past six months, but periodic bouts of instability are likely as the high debt levels of advanced economies still impede growth.
- House prices are overvalued on a number of measures. Prices in Auckland and Canterbury have been rising particularly rapidly.
- Household debt is increasing again, from a base that has stayed high relative to disposable incomes despite a period of better saving by households.
- Agricultural sector borrowing has also increased. Some farmers with high debt could be vulnerable after the recent drought.
- The New Zealand dollar continues to be pushed upward by international factors, including exceptionally low interest rates, high global liquidity, and investors’ confidence in New Zealand’s economic prospects.
- The overvalued exchange rate is hindering rebalancing, and the current account deficit remains a major problem.
- New Zealand banks’ balance sheets are in good shape, with fewer impaired assets and improving profitability.
- Responding to developments in the housing market, the Reserve Bank has announced measures to curb high loan-to-value lending, and will be firming up arrangements for other macro-prudential policy tools over the next two months.

The rest of this report discusses the main issues we considered during our examination of the financial stability report and in our discussion with the Governor of the Reserve Bank.
Exchange rate

The New Zealand dollar has continued to appreciate over the past six months. Several factors underpin this strength: our commodity prices are linked to the fast-growing Asian region, our interest rates are higher than the 0 to 1 percent in most developed countries, and our economic growth rate is comparatively strong. With huge increases in global liquidity—Japan, for example, aims to double its monetary base over the next two years—currencies like the New Zealand and Australian dollar are attractive to investors, including central banks and sovereign wealth funds.

The Reserve Bank has said for some time that it considers the exchange rate overvalued; it now describes it as “significantly overvalued” and says it sees potential for the New Zealand dollar to appreciate further in the current global situation.

We asked whether it intended to intervene in the foreign exchange market to try to bring the dollar down, as it has occasionally done in the past. The governor confirmed that the Reserve Bank had already intervened in the currency markets in the past month. The governor would not confirm the extent of the intervention, but said it would be evident from data in the Reserve Bank’s balance sheet, which it releases at the end of each month.

The governor said it was the intention of the Reserve Bank to take the tops off rallies. He also confirmed, in response to our questions, that it was the Reserve Bank’s intention to send a signal to the speculative end of the currency markets.

The governor noted that the OCR had limitations as a policy tool. He noted that the Reserve Bank of Australia recently cut its OCR by 25 basis points, but the resulting dip in its exchange rate was reversed overnight. Overall, the Australian dollar has remained high despite OCR cuts totalling 200 basis points over the past two years.

The Reserve Bank noted, however, that experience of exchange rate cycles has shown that market adjustments, when they occur, tend to be rapid and substantial. It was therefore important for New Zealand to seek to correct underlying imbalances itself, by continued effort to rebalance the economy toward productive investment and exports.

Housing market risks

Momentum has been picking up in the housing market. Although turnover is much lower than during the housing boom of the mid-2000s, average house prices have been rising by about 9 percent per annum nationwide, and are now about 5 percent above those of 2007. Prices have been increasing particularly rapidly in Auckland (13.5 percent) and Canterbury (10 percent), where supply is most constrained. These two cities account for over 50 percent of recent sales. As well as the problem of supply, pressure is also coming from pent-up demand, which is being fuelled by the lowest mortgage interest rates since the mid-1960s and strong competition among banks for borrowers.

The financial stability report discusses at some length why developments in the housing market are of concern for the Reserve Bank, creating risks for borrowers, for the stability of the financial system, and for the economy as a whole. The IMF, the OECD, and three international rating agencies have indicated they share these concerns.

The Reserve Bank notes that house prices are overvalued both historically and relative to those in many comparable countries. Although prices eased slightly over the past few years, they are still much higher relative to incomes than they were 20 years ago. This increases the risk that a correction in prices, when it comes, will be sharp. New Zealand has been
fortunate in avoiding the large falls in house prices experienced in several countries over recent years, but a correction could be precipitated by an external shock, as conditions in several of our major trading partners remain vulnerable.

Adding to this risk, it is likely that interest rates will rise at some stage from their current exceptionally low levels. Because average household debt is already high relative to disposable incomes, some borrowers may then find it difficult to service their debt. This risk is increased by banks’ greater willingness to lend against low deposits as they compete for borrowers. An increase in bad debt on banks’ balance sheets would place stress on the banking system and lead to a tightening of credit conditions. Reduced consumption and increased unemployment are likely consequences.

**Lending at high loan-to-value ratios**

About 30 percent of new lending has been at loan-to-value ratios (LVRs) of 80 percent or more, a steep increase since October 2011, when high-LVR lending represented about 23 percent of new loans. We asked whether the Reserve Bank considers such lending a sign of recklessness on the part of banks as they compete for customers. It told us it does not, but it has been reviewing the risk models of the major banks to ensure they are adequately covered for their growing exposure to a possible downturn in the housing market. As a first step, it has decided to increase the risk weightings applying to all current and new high-LVR housing loans for the four major banks; this will mean an increase of about 12 percent in the minimum capital these banks are required to hold for housing loans. The requirement will be mandatory from 30 September 2013, but banks will probably start to act on it immediately.

Because banks are currently well funded and hold larger capital buffers than required, the increased capital requirement will probably have only a small effect in dampening high-LVR lending; it will depend on whether banks seek to maintain the same capital buffer as before, over and above the new minimum. The Reserve Bank told us the main aim of the measure is to strengthen banks’ ability to weather a housing downturn, and encourage them to review the riskiness of their current lending.

**Possible further measures**

We discussed with the Reserve Bank whether the macro-prudential tools it is currently developing might help to ease house price inflation and curb housing lending, especially at high loan-to-value ratios. It believes quantitative restrictions on high-LVR loans would be the most effective of these tools, but the impact would depend on how the measure was designed. It is still consulting about possible approaches, such as whether to target specific regions, impose an overall cap or take a “speed limit” approach, and exempt first-home buyers. We note that an exemption for first-home buyers has been used in some countries, but since such borrowers account for almost a third of recent loans here, exempting them would limit the measure’s effectiveness in curbing demand for mortgage finance, and housing inflation. On the other hand, including them would make it harder for new buyers to raise an adequate deposit.

As to what other steps could be taken to correct the supply-demand imbalance in the housing market, the Reserve Bank said that supply could be encouraged through regulatory reforms and other measures such as those recommended by the Productivity Commission...
in its report on housing market affordability. Demand could potentially be curbed by tax measures, particularly in relation to speculative investment.

**Data about housing market trends**

We sought to gauge whether recent borrowing at high loan-to-value ratios has been predominantly by home-buyers or property investors, as there are rumours of a large element of speculative investment in Auckland property, with some foreign buyers. The Reserve Bank told us it has yet to gather firm data—it will be undertaking a comprehensive survey over the next two months—but believes much of the recent borrowing is for home ownership rather than investment, and that as much as 30 percent is by first-home buyers. It notes signs that home ownership rates may be increasing again, after several years when people chose to rent rather than buy. We will be interested to see whether this is confirmed in the results of the Reserve Bank’s survey.

We understand that in Australia a register is maintained of non-resident ownership of land and housing, but that no such information is collected officially in New Zealand. We recall that the Reserve Bank recently cited some data compiled from a limited survey by real estate companies, which indicated that overseas buyers accounted for about 12 percent of Auckland sales. We believe more comprehensive information could be useful in assessing the current demand pressures in the housing market. The governor said he would study the approach taken in Australia.

**The Reserve Bank’s toolbox**

For some time, the Reserve Bank has been developing a set of macro-prudential policy tools which could be used to build additional resilience in the financial system and to dampen excessive growth in credit and asset prices. On 16 May 2013 it signed a memorandum of understanding with the Minister of Finance about the use of four new tools: adjustments to the core funding ratio, a countercyclical capital buffer, adjustments to sectoral capital requirements, and quantitative restrictions on the share of high loan-to-value ratio loans to the residential property sector. Over the next two months it will be consulting further and working with registered banks to set up implementation arrangements so the new tools can be used as necessary.

We consider the new policy instruments worthwhile additions to the set of tools the Reserve Bank can use for maintaining financial stability.

New Zealand’s current circumstances involve the unusual combination of a high exchange rate, low interest rates, low domestic inflation, and high house price inflation. Because many of the contributing causes are international, including unorthodox measures in major economies since the global financial crisis, any measures taken here may have only limited effect. This situation creates a difficult tension for the Reserve Bank in its use of conventional monetary policy. Raising the OCR to try to take pressure out of the housing market could put further upward pressure on the exchange rate, creating difficulties for exporters, while a lower OCR could further inflate credit growth and house prices.

We believe this situation makes it all the more important that the Government and local authorities use what tools they have to address the imbalance between supply and demand in the housing market. We note that, a few days after our meeting with the governor, several measures to address housing affordability were announced in Budget 2013. Some of

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us, however, remain of the view that a capital gains tax should be instituted, and that such a tax would help by curbing speculative pressure on housing demand.

The banking sector

The mood in global financial markets has improved markedly over the past six months, as Europe and the US have taken policy steps to lessen the two immediate risks: a breakup of the Eurozone and the “fiscal cliff”, which would have entailed a sharp contraction in US fiscal policy. There is still likely to be periodic turbulence as major economies grapple with their underlying debt problems, but the lift in market sentiment has improved funding conditions for New Zealand banks, and their overall funding costs have reduced.

Over the past few years, low credit growth and better domestic savings have allowed New Zealand banks to strengthen their capital buffers. Banks’ profitability has improved as the economic recovery has reduced impaired assets. Banks have had little need to borrow from global markets, but have taken advantage of favourable conditions in funding markets to issue long-term debt. This position has started to change over the past year, however, with more rapid growth in lending, particularly for residential mortgages. If this rate of credit growth continues, banks’ reliance on overseas funding markets may increase once again.

We note that the improvement in banks’ profitability as lending has increased over the past year provides quite a strong incentive for continued growth in credit, and results in a reduction in asset quality as banks compete for borrowers. We are pleased to know that the Reserve Bank is sending a clear message in its communications with banks that it may need to act to curb credit growth if the banking sector does not exercise sufficient restraint voluntarily.

Implications for rebalancing

We are concerned that the present situation, with rising credit growth, an overheating housing market, and the tradable sector hampered by an overvalued exchange rate, is a repeat of earlier patterns. The household savings rate has again become negative, reversing the progress made between 2010 and mid-2012 to reduce debt and rebalance the economy away from leveraged property investment, toward the tradable sector. The Reserve Bank agreed that more work is needed to make rebalancing possible. It said this is one reason it has expressed such strong concern about the resurgence of credit growth for housing. If it continues and New Zealand banks have to return to borrowing funds from overseas markets, New Zealand’s net debt could return to pre-crisis levels. It agreed with us that the persistent current account deficit remains a significant problem.

The agriculture sector

Borrowing in the agriculture sector grew by about 5 percent over the past year. Debt levels are already high, having increased substantially since 2003 on the strength of strong commodity prices. With debt heavily concentrated in the dairy sector, the Reserve Bank cautions that the drought could leave some farmers overstretched, and vulnerable to a fall in income. The drought is expected to have reduced farming incomes and increased costs, translating into a reduction of GDP of about 0.7 percent overall.
Appendix A

Committee procedure
We met on 8 and 29 May 2013 to consider the Reserve Bank of New Zealand’s Financial Stability Report, released on 8 May 2013. We heard evidence from the Governor of the Reserve Bank, and received advice from our independent specialist adviser, Brendan O’Donovan.

Committee members
Todd McClay (Chairperson)
Maggie Barry
David Bennett
Hon Clayton Cosgrove
Hon David Cunliffe
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Kate Wilkinson

Evidence and advice received
Appendix B

Corrected transcript of hearing of evidence 8 May 2013

Members
Todd McClay (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Paul Goldsmith
John Hayes
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Hon Kate Wilkinson

Witnesses
Graeme Wheeler, Governor RBNZ
Grant Spencer, Deputy Governor and Head of Financial Stability RBNZ
Bernard Hodgetts, Head Macro Financial Department RBNZ

Chair
All right, Governor, welcome. Good afternoon, again, and thanks for coming to FEC. My apologies that we’ve detained you outside a little bit. We just had to move through a few issues of legislation that are pressing before us. We’re here to hear evidence from you on the Reserve Bank of New Zealand’s Financial Stability Report, May 2013. I offer you the opportunity to make comment.

Wheeler
Thank you very much. Let me say first up that I’ve got with me on my right Grant Spencer, who is the Deputy Governor and Head of Financial Stability, and on my left Bernard Hodgetts, who is the Head of the Macro Financial Department. If it’s helpful, I’ll make some opening statements for 2 or 3 minutes and then hand over to Grant.

Much of the focus in the bank’s Financial Stability Report is on the housing market. We believe that while the overall financial system remains sound, developments in credit markets and in the housing market are significantly increasing risks in the financial system. House price pressures are increasing from three sources: from pent-up demand, from supply constraints, and from the lowest interest rates since the mid-1960s. Housing pressures are especially strong in Auckland and Christchurch, where the supply constraints are the greatest. House prices relative to disposable incomes are high by international standards, and the banks are competing aggressively
for mortgage customers, particularly at high loan-to-value ratios. Household
debt is rising from a level that is already high, relative to incomes.

Our concerns about the financial stability risks associated with rising house
prices are also shared by the OECD and the IMF during their recent
missions reviewing the New Zealand economy. Those missions took place
over the past 2 to 3 months and similar concerns have been expressed by
the international credit rating agencies, by three of them, in the last 3
months or so as well. The strengthening in global financial sentiment in
recent months that helped to lower bank funding costs and make it easier to
obtain offshore funding has also contributed to our overvalued exchange
rate.

Reflecting our concerns around the housing market, we have been
developing our macro-prudential policy framework. We recently completed
a round of public consultations on this framework, and will soon be signing
a memorandum of understanding with the Minister of Finance to confirm
key elements of the macro-prudential policy. With your permission, chair,
I’d like to ask Grant to make some points.

Spencer
Right now we think the banks are in pretty good financial position, and
their balance sheets are sound, but looking forward we do want to ensure
that they’re well covered for this growing housing risk. So we’ve been
reviewing the risk models of the major banks, and as a first stage in that
review we have focused on the capital required to support high LVR
lending and we are increasing the capital required to back high LVR lending
as of coming September. That’s definite, though, and those conditions of
registration were put in place yesterday. The higher capital requirements will
amount to about a 12 percent increase in housing capital for the major
banks, and it will be required from September, but because all of the loans
that they’re writing between now and September will be affected by that
change, we expect it should have some impact pretty well straight away.

With regard to the macro-prudential policy, we’ve been consulting on that.
We’ve had a lot of discussions and we will be putting out a report on the
submissions on the macro-prudential policy. Overall, we don’t envisage
major changes to the framework that we put out in the consultation
document. There may be some changes. Over the next couple of months,
we’ll be consulting further on the detail of how these instruments would
actually work in practice. Thanks.

Parker
Thank you for your report. The report tells us that us that around 30
percent of bank lending is now on loan-to-valuation ratios at 80 percent or
above, I think—correct me if I’ve got this wrong—and that is quite a
significant increase on where it was a couple of years ago. I also understand
that in terms of the capital ratios of the banks, the banks are already ahead
of some of the minimum capital requirements that you impose. Does that
imply that the changes that you are imposing on their capital requirements
as a consequence of your recent changes aren’t going to have much effect
because they’re going to still be within their safe ratios anyway on your new
model because they’re over the odds now?
Spencer  That’s, I guess, to some extent, true. The banks hold an additional buffer of capital over and above the regulatory requirement. Now, if we’re increasing the regulatory requirement a bit, it’s a matter of whether they absorb it in the buffer, or say, no, we still need to hold the same buffer.

Parker  In respect of loan-to-valuation ratios, which you’re saying you might also impose, do you have any information or sufficient information to be able to assess whether the high loan-to-valuation lending is in the investment property sector or home-owned sector?

Spencer  We believe a lot of it is in the homeownership sector, and indeed a lot of it is in first home owners sector, because they’re the ones who are stretching on their deposit. But we don’t have hard data on that yet. We’re in the process of collecting it.

Parker  Can you be sure about that? Because if the overall trend is for declining rates of homeownership, or it seems to have been a long term trend, are you saying that that trend is reversing at the moment and going towards higher rates of loan homeownership? Because I would be a bit surprised if that were the case.

Spencer  I think that is happening, actually. I think in Auckland there are a lot of people from 2007 after the boom who thought prices were coming off, and they were coming off in the period, were holding off and continuing renting and holding off going for a new home. Then when the prices are now going up and people are telling them these are the lowest interest rates they’ll ever see, there’s a surge of people coming back into the homeownership market out of renting.

Parker  When will we know whether that is the case, rather than—there doesn’t seem to be any data in your report to support that. I’m not saying that your intuition is wrong; I just wouldn’t mind an evidence base for that.

Spencer  A lot of our information on the structure of LVR lending is from the banks, is talking to the banks, and from some pieces of information. We’ve got a comprehensive survey on this for high LVR lending, which we’re putting out at present, sorting out the template, and we’ll be collecting data in a couple of months.

Parker  So in terms of the two additional steps that you’ve outlined, which are possibly using LVRs and increasing capital requirements to back this sort of lending, do you think that that’s going to have a substantial effect on house price inflation or not?

Spencer  On the first one, the one about the base level of capital requirements for high LVR lending, we don’t expect that to have a huge effect. We’re just trying to make sure that the risk models are right—that there’s a right baseline. Those risk rates will stay in place on a permanent basis. But we don’t expect it’s going to have a major effect. In terms of the macro-prudential instruments, we’ve talked before about some of them involving capital overlays having price effects. It will have some impact, but not huge. The one that is likely to have more effect is the LVR restriction, as you say, and we believe that could have a significant impact on overall lending, given
that, as you said to start, 30 percent of new lending is at high LVRs. It would depend, obviously, on how restrictive our policy was in that regard.

Parker Now, all of this is being done, as I understand it, through the lens of the future financial stability of the banking sector in terms of its exposure to these sorts of loans, is that correct, rather than in terms of non-asset inflation or wider effects on the mix of investment in New Zealand?

Spencer It’s on the basis of, yeah, financial stability concerns around the financial system, the bank system, and, indeed, the private economy, the household sector, because if people get overstretched and go into delinquency, that puts stress on the household sector, as well as the banks themselves.

Parker It seems likely, although it is possible that these things can flip round quickly, that we are going to have relatively low interest rates by historic standards around the rest of the world for some time to come, and I think you’ve opined similarly, which means that for you to use the interest rate lever to curb some of these pressures, would, as you say, put further pressure on the exchange rate and perhaps harm our export and import substitution businesses. Before I move on, is that a fair comment?

Wheeler I think that is a fair comment. And in a sense, what we’ve said repeatedly is that we believe the exchange rate is significantly overvalued. The IMF, when it did its analysis about a year or 18 months ago, put a figure on it. It said it was overvalued in its view by around 15 percent, or between 10 and 20, but I think it mentioned 15 percent.

The problem that we have is, in essence, that central banks that represent two-thirds of world output, or in countries representing two-thirds of world output, have interest rates between 0 and 1 percent. They’re all the G7 countries, they’re all the 17 eurozone countries, which of course includes Italy, France, and Germany, and put in Switzerland and Sweden, and that’s two-thirds of world output. Put in also the fact that our economy, relative to the most advanced economies, is performing much better in terms of GDP growth and put in the fact that commodity prices are linked in to the Asian market where Asia is growing the most rapidly in terms of global growth polls, then you would expect that the potential is that the exchange rate could continue to appreciate. To the extent that interest rates were raised creates the potential risk that New Zealand would be seen to be in a tightening phase, it could put more pressure on the exchange rate.

Parker Well, then if there’s not much room to move in respect of interest rates, given those factors, we think there will be limited effect on house price inflation from the measures that you are proposing to take—not insignificant, but limited. Does that sort of point out how all the more important it is that you’ve got other tools within the tax system that push against some of this asset price inflation, notably a capital gains tax, recommended by the OECD and the IMF, amongst others?

Wheeler What you’ve got is a very significant supply-demand imbalance here in the housing market, particularly in Auckland and Christchurch. So anything you can do on the supply side, in terms of regulatory reform or looking at the
sort of recommendations that were in the Productivity Commission that can certainly help to increase potential supply. The measures—macro-prudential measures particularly, perhaps some form of LV ratio, if it were to be introduced—may help to constrain the growth in demand for mortgage finance. On the tax side, there may well be things that could be done to reduce the demand for investment speculation, for example.

Goldsmith Obviously there’s a lot of concern in Auckland and Hamilton around housing prices and affordability, and you note on page 18 about the important activity to increase supply of land and housing, and we all know that increasing supply either in greenfield or through intensification can be of a concern to the community. So I’m asking what do you see as the risks for current home owners, and the economy generally, of doing nothing, or sticking with the status quo on housing supply?

Wheeler I think if nothing were to happen on the supply or the demand side, the mismatch between supply and demand would be very significant, given the backlog in Auckland, and given the pressures in Christchurch as well. So that would potentially mean, given the fact that we’ve got the lowest interest rates for 50 years, you would expect house prices to continue appreciating, and possibly for quite some time.

Goldsmith The next one is around household debt rising from high levels compared with incomes—and you’ve made an emphasis on this on page 5—the graph shows that. When you compare that with the graph on page 46, which compares borrowing to assets, it doesn’t look quite so scary. So why doesn’t that give you more reassurance? Sure, households have got liabilities but they’ve got assets to match them, and it doesn’t look to be going completely off the wall there.

Hodgetts I guess the answer to that is that the debt’s been going up, but of course assets prices have been going up in recent times as well, so that the ratios have been held lower in terms of debt-to-asset ratios. But of course that masks the concern we have that asset prices themselves may be getting out of whack.

Goldsmith Because of the international situation that we face ourselves, and the relatively good New Zealand performance—economic performance, in relative terms; New Zealand has access to historically cheap money, which you keep referring to, since the 1960s—this is generally a good thing. I just wondered if you could just talk through the logic of why you seem to be seeing sort of a glass half-full on this. You’re focusing on the risks of that, but it’s good that we’ve got access to money and that people want to be investing in extending their houses. A lot of people in New Zealand of course have small businesses, and they borrow for their business through their house and so forth. This is a good time to borrow money and get on with things. You’re sure you not overemphasising the problems, as opposed to the opportunities that we’ve got here?

Wheeler Why are interest rates low in New Zealand? Partly because the inflation rate is low. It’s also because global financial sentiment has improved in recent months. The issues around Cyprus have abated to some degree. The
potential break-up of the eurozone is perhaps less of a threat than it was. On the other hand, you’re seeing potentially very, very considerable quantitative easing coming out of Japan over the next 2 years, as they’ve in essence set a target of doubling their money base in 2 years’ time. So all those factors, particularly the international factors, are pushing down interest rates. But by the same token, New Zealand is attracting very substantial capital flows, and that’s putting pressure on the exchange rates. So it’s a double-edged sword.

Peters Can I ask you—you emphasise GDP growth in our economy. In the last 4½ years, the per capita income growth for this country is just about nil, isn’t it?

Wheeler I’d have to check that.

Peters Surely the Reserve Bank understands that?

Wheeler I wouldn’t want to mislead you. I know the growth figures.

Peters Somebody have a bit of a guess, of the three of you. What do you think the per capita income growth has been for this country for the last 4½ years?

McClay You don’t have to guess. You can check and come back to it.

Peters OK. The second thing I want to ask is whether the Reserve Bank has written to the Government on the issue of the lack of information that there is available on, say, for example, the Auckland housing market, on which a lot of your predictions are based. In this sense, in Australia they have a register for domestic homes and land, as to its ownership. We have no such thing in New Zealand, and yet there is a significant amount of evidence suggesting that offshore buying of housing—far more than just one house—and developments, is having a profound effect on Auckland house price movements. Have you written to the Government asking them for better information base on that, than we’ve currently got?

Wheeler I haven’t written to the Government on that.

Peters Would you accept then, if you look at your report, that you’re making some substantial assumptions with a significant amount of information missing, which we all suffer from, because the information’s not gathered.

Wheeler As I say, I haven’t approached the Government on that issue, and I’ll study what the Australians do, following your comments. I will look to see what they do do. In terms of offshore interest, the information that we had—I think that the latest is a survey that was done by three of the big realtor firms in Auckland. They suggested that on average, overseas buying interest accounted, I think, for about 11 or 12 percent of the market at that time.

Peters I recall that report was, you’d have to say, pretty crude in that you just had the three realtors and the bank involved, and that was it. However, it’s a start. When you say that we are paying the lowest interest rates in 50 years, overnight the Australians reduced their official cash rate, effectively. We’re actually paying the highest, comparatively. The UK, USA, Europe, Japan, Australia—we’re paying the highest in 50 years, aren’t we, in comparison to
those economies? The differential is the highest it’s been in 50 years, for the
New Zealand borrower.

Spencer I don’t think that’s right.

Peters What are you paying in Japan, US, UK and Europe for a mortgage rate?

Spencer They’re very cheap. As Graham said, the official rates are between 0 and 1 percent, so their mortgage rates are 2 to 3 percent, in that territory. And those are very low.

Peters How does ours compare in real terms, because—you repeated this last time you were here, and it was raised with you last time, and we are back saying it again. My contention is that in comparison to the other economies that I’ve cited, we are paying the highest borrowing rates in 50 years.

Spencer The statement there is about our mortgage rates in New Zealand, which are now around 5 percent, as low as they’ve been for 50 years. That’s the statement we’re making—relative to where they’ve been in New Zealand. So people still think that even though they may be higher than the US, this is a pretty good deal.

Peters But you do accept that the monetary system is part of the global market? It’s your contention. The gap between that and what they are paying in the USA and Japan is five times.

Spencer Interest rates are different in different countries, for good reasons. In particular, our economy is stronger, and interest rates need to be higher: one, to constrain lending, which is still growing quite rapidly, and also to encourage savings. The Japanese will save at very low interest rates, at a very good savings rate. For New Zealanders, you’ve got to pay them actually a quite high interest rate to make it worthwhile for them to save. It’s a different culture, a different perspective on saving. Those are the things that affect the international differences in rates.

Peters Just one last thing then. I’m very curious to know what these new various instruments you are working on are, whatever they might be. The fact is there’s nothing to stop our dollar from going to US90c, is there, at the moment? And when are you guys going to become slightly concerned about this?

Wheeler We are concerned. I think we are on record several times expressing our concern about the exchange rate, and saying that we believe it is potentially significantly overvalued. And we’ve also talked about the pressures that are driving the exchange rate. We’ve been very explicit about that.

You mentioned the RBA cut rates. They cut them by 25 basis points yesterday. The market was 50:50 on whether the RBA would cut or not. What the RBA was weighing up was, on the one hand, they’ve got the potential, if you look forward, for capex around their mineral development programme starting to fall away, albeit it remains at still significant levels over the next few years, but it is starting to decrease.

One the other hand, they had very low house prices. House price inflation in Australia for the last quarter was 0.2 percent. It’s running 2 percent
annually, or thereabouts, but 0.2 for the last quarter. And they had an inflation number that was weaker than what the market expected. So they decided in the end they could cut rates. They were concerned about the exchange rate. They were concerned that it was staying up high even though commodity prices were falling. So they cut the rate, and in essence, our dollar appreciated 25 basis points pretty well straight away against the Australian dollar. And then that was gone overnight. They’ve cut 25 basis points, but it’s not clear at all, having cut 175 basis points before that, that they haven’t had an effect on the Australian dollar of any significance. They cut again last night. The 25 basis point cut basically evaporated overnight, in terms of the exchange rate effect.

Peters You said that, you know, that New Zealand people with money in the banks like high interest rates, right? Isn’t that because the foreigners who are lending money to this country like our exceptionally high interest rates as well?

Spencer Well, I think Graeme’s last comment is saying a lot of the money coming into New Zealand is not just attracted by high interest rates. I think it’s high terms of trade and it’s part of the Asia-Pacific story. It’s a growth economy. Sure, some of that money is purely on the basis of a higher interest rate—2.5 percent versus, you know, half a percent—but it’s a broader range of factors than that. And when the RBA has brought down their interest rates by, you know, 1.75 percent, this currency, the Aussie dollar, is still hanging up there because it’s still seen as an attractive currency. So it’s not just the interest rate that’s causing that.

Norman Has the economy rebalanced? We all said this was our objective. Has it?

Spencer If it’s in terms of have you got the tradable sector performing as well as you would want in an economy like this, then the answer is no; there’s more work to be done. And part of the problem is the high dollar, as we’ve talked about, but the persistent current account deficit in New Zealand is also of significant concern. It’s something that’s been there for the past three decades. On some forecasts it’s likely to deteriorate in the next 18 months.

Norman Your forecast, if I recall.

Spencer Hmm.

Norman In terms of Bill English—I’ve just been revisiting some of Bill’s old statements when he used to care about this—he said in November 2010 that looking forward we’d see a continued shift away from leveraged property investment. Has there been a shift away from leveraged property investment since November 2010?

Wheeler I think from 2010 through to about mid last year that was happening—the rebalancing. But since then the Auckland market in particular has taken off and people are chasing that, leverage has started to increase again, and that’s one of the concerns we’re expressing in our statement.

Norman So the kind of attitude which perhaps I unfairly characterised Mr Goldsmith as, “borrow and party”, where will that end us? If we carry down this path where we say there’s lots of cheap money available internationally—and
there is—and we just say: “Well, why not? House prices go up and we feel good because our houses are worth more.”, where does all this end up if we go down that path?

Wheeler Well, I think if it carried on in perpetuity there would be a correction, and you would probably see the following things happen. If it carried on in perpetuity, then house price inflation would start to increase, it would potentially through wealth effects start to spill over into more spending that creates inflationary pressures, you would probably see construction costs rising in areas of shortages such as Christchurch, you would see the current account deficit blow out, the debt figures deteriorate, and you would probably see an exchange rate adjustment and growth slow-down.

Norman An exchange rate adjustment means that at some point people will get leery of lending us more and more money, and so the kind of the appetite for New Zealand dollars will drop off and the value of the currency will drop off.

Wheeler Yeah. If you look at, say, the last three exchange rate cycles since the mid-1980s, you tend to see overshooting and a very substantial, quite rapid correction when it comes. And in your scenario, I think that’s what we would see.

Norman And so the kind of choices we have are that we rebalance ourselves, or someone else will eventually rebalance for us.

Wheeler Eventually the markets would make an adjustment—

Norman And that could be pretty painful.

Wheeler—led by foreign investors.

Norman I mean, that could be a pretty painful adjustment if we don’t sort ourselves out.

Wheeler Correct.

Norman So in terms of the “borrow and party” attitude, we’re going to end up with a bit of a hangover if we don’t intervene, and what you’re proposing to do is an intervention on the housing market, no less. That’s what it is, isn’t it.

Wheeler If we proceed with the macro-prudential instruments in terms of implementing, if that were to be the case—because we haven’t made final decisions at this point—then in essence one of the instruments, such as LV ratio, if it were applied, would ultimately, we believe, have some effect on slowing the demand for mortgages.

Norman There’ll be those people that say this makes housing more unaffordable or more unavailable in the short term for those who are trying to borrow money with low deposits. I mean, what’s your response to that?

Wheeler Well, there’s lots of ways these things potentially could be designed. I mean, they could be designed as a sort of quota. In other words—well, they could be designed as they are in some overseas countries as an outright prohibition, if you like, of LV lending, but it may have some exemptions. It may exempt first home buyers. That’s what happens in some countries.

Wheeler: In terms of thinking about potential design if we were to proceed, then that’s one sort of issue that in terms of the consultation that we’ve just had with the public, it’s one of the issues that’s being raised. But, you know, you also, I think, need to accept or recognise that, you know, a substantial part of the lending that’s creating a potential house price pressure is also coming from first home buyers. They account for, basically, a third of the new lending.

Norman: Right. In terms of your previous discussion, I found, about the RBA, what I thought was interesting was you almost suggested—and maybe I’ve got this wrong—that if we had lower house price inflation in New Zealand, we could have a lower OCR. Have I misread you in my interpretation of your discussion of the RBA decision?

Wheeler: What I think I would say is that we’re concerned about house prices—one, for the potential inflationary threat in terms of spillovers into the wealth effects that I just talked about, but, two, the financial stability risks that we think are growing. And if you did have, for example, that risk taken away and house prices were growing much less rapidly, and you did face a situation where the exchange rate continued to appreciate, for example, then you may well be in a situation where you could lower interest rates.

Norman: So, basically, there’s macroeconomic benefits if we can intervene to control house price inflation, because it creates some space for you, potentially, to give us some relief on the exchange rate—some downward pressure on the exchange rate by having downward pressure on the OCR.

Wheeler: What it would do is it would create—I mean, there’s a tension between house price inflation, or the house price risks, and the exchange rate risk. Both have overshot, if you like, right? So to the extent that one used interest rates to try and deal with housing demand, it would put upward pressure on the exchange rate. Similarly, if you had strong upward pressure on the exchange rate and you tried to cut interest rates, you would probably exacerbate the housing price inflation. But, as I said before with the RBA example, I mean, you know, they’ve cut now by 200 basis points if you include last night, and haven’t had any material effect on their exchange rate.

Parker: You must be worried that we’re sort of going back to where we came from in that, you know, because of low interest rates overseas relative to New Zealand, the banks can make more money lending in New Zealand than they can overseas. So they borrow cheap offshore and they lend into New Zealand through the banking channel to increase their profitability in a way that has distortionary effects in New Zealand in that we’re pumping yet more money into our property sector at the expense of our tradable sector. Isn’t that where we’re at?

Spencer: Just to clarify that, the banks are not lending uncovered here. They’re not borrowing in US dollars at half percent and lending at 5 percent.
Parker I understand—

Spencer They hedge it into New Zealand dollars so they’re in the New Zealand dollar game.

Parker I absolutely understand that, but they’re making a buck by, even after those exchange rate hedges are paid for, borrowing overseas and lending more money into the property sector in New Zealand, which is both harming our tradable sector and increasing our exposure on the property—isn’t it déjà vu?

Spencer Yeah, well, we’re just about at déjà vu. I mean, they haven’t actually needed to borrow a lot offshore in the past year or so because the flow of money coming in through deposits is so great, but we’re now getting to the point where credit growth is starting to get above deposit growth, and so, if this continues, they are going to have to do more offshore borrowing, and then it starts to look more like back pre-crisis.

Parker It still seems to me that we get to the end of this cycle, and we wait until the end of the cycle, we’re further in the crap in terms of our net international investment position as a consequence of our prolonged current account deficit, and we’ve still got no cure except a sudden fall off the cliff, which really doesn’t lead to long-term investment stability in the tradable sector.

Bennett Following on from question lines, you’ve got the agricultural sector and the commercial sector, which in your report, you know, you’ve got similar circumstances—banks seem to have money to lend and are more engaged in those sectors—and yet they’re not seeing the asset price rises that you’re seeing in the housing market. Can you give a reason why, with the same circumstances, you’re not seeing the same results in those markets?

Hodgetts Well, I think in the case of the agricultural sector, we have to remember there was a very, very significant increase in debt, particularly in the dairy sector, from around 2003 onwards, so when we look at the leverage of the agricultural sector now compared with what it was 10 years ago, it’s much, much higher. We are actually starting to see a small turn-round in borrowing from that sector at the moment, but so far it’s been relatively modest. I think part of the reason for that is that, you know, as I say, so much debt was taken on previously that the capacity to keep borrowing at the rate that the sector was, is probably less.

Bennett And you don’t envisage they would have the price rises that you are going to get—that you’re having experienced in the housing market, for example?

Hodgetts I mean, that’s always a possibility, I guess, if circumstances change. If, for example, the terms of trade, commodity prices were to sort of resume a significant upward trend, then you could certainly always see some of that spilling over into the agricultural sector in terms of farm prices and borrowing, but to date we haven’t seen that happen in terms of the credit trends in the sector.

Peters Mr Bennett will tell you, because he’s from a dairy farming background, you’ve had record commodity prices, yet the farming profits have taken a
serious dent. So the phenomena which you say should emerge, there’s no chance of it emerging at all, is there?

Bennett With the housing market, then, what options do you see Government or the Reserve Bank having to deal with that increase at the moment?

Hodgetts The options we outlined in our consultation document included the possibility of capital overlays for housing lending. So this would involve an additional capital requirement for housing lending or, as Graeme mentioned, loan-to-value ratio restrictions. We outline a couple of options there that could be used, including the outright restriction or the speed limit approach, where we would limit the proportion of high LVR lending that the banks could do. So there are a number of options there on the table. We’re still working our way through which of those might be best.

Hayes I have a double question. The first part of my question is: the economy is fundamentally in good shape, is that correct?

Wheeler Well, in terms of output growth, output growth is picking up. I mean, a lot of it is being driven by Christchurch, amongst other things. But it does have a significant current account problem that I talked about.

Hayes The second question I’ve got—and really following on from what Winston is saying, and I see it in my own electorate—is that there’s quite a bit of capital flowing into property. It’s no different to the problem that Hong Kong faces. What they did in Hong Kong earlier this year was to put a charge or require a different ratio on money coming in from particularly the mainland to buy property in Hong Kong. The problem is identical. Have you had a look at what’s going on in Hong Kong and the success or otherwise of that policy, which is probably anti-WTO?

Wheeler We have been looking at macro-prudential adjustments in a number of countries, and we’ve been looking at what’s been happening in Canada, Hong Kong, Norway, and Sweden, as well.

Norman But it is specifically about foreign buying of housing—

Hayes Specifically about non-residents—

McClay Colleagues, John, draw that to a conclusion and we have to move on.

Spencer In Hong Kong a lot of the pressure in the apartment market was coming from mainland China money. So that’s where they were trying to target their sort of macro-prudential instrument.

Hayes Did their policy succeed?

Spencer It had limited success. In fact, I was talking to someone from the HKMA just last week. They thought they’d had some success, but it’s always hard to tell what the counterfactual would be.

Cunliffe A short line around some of the incentives or drivers on the expansion of bank credit. Figure 5.11 at page 30 would appear to indicate an expansion of the gap between 2-year mortgage rates and total funding costs, which would now appear to be significantly wider—i.e., a higher level of profitability than pre-crash. Is that a fair interpretation?
Spencer No, on figure 5.11, the profit margin is the gap between the red line and the grey.

Cunliffe Yes, that’s what I meant—total funding costs. So the white area is now wider than it was pre-crash, if you look at 2007—

Spencer Certainly in the 2005-07 period there was a lot of competition and profit margins were reduced, but if you go back further, I wouldn’t say the current margins were particularly abnormal.

Cunliffe They’ve certainly widened, for example, since we did the banking inquiry in the previous term of Government, which showed that total funding costs had eaten up some of that margin. I’m going to the difference between the OCR and lending rates. Figures 5.5 and 5.6 on page 27 show banks are strengthening their balance sheets. But, notwithstanding that, figure 5.2 shows the banks and their interest margin is now above pre-crash levels and bank profitability is rising—in fact, it’s now at pre-crash levels, as well. What would be the average gross margin among the four major banks over, say, the last 6 months’ reports? You’ve had a couple of major banks report recently; I don’t want to name them individually, but roughly what’s an average gross margin?

Spencer Well, it’s about 100 points on a mortgage.

Cunliffe I was meaning a gross margin on a bank’s balance sheet. I think one bank had a gross margin above 50 percent on its total costs. So its total costs were less than 50 percent—its profit margin at a gross level was above 50 percent of its total revenue. That’s quite a significant level of profitability. I’m not saying there’s profiteering going on. What I’m getting at is that there is a very high level of incentive on the retail banking sector to expand credit growth, a matter that you are drawing attention to. Therefore, it logically would seem to follow, and I seek your comment, that the bank is going to have to do more than jaw-boning to slow that down. The question is whether the LVR instrument and the other things in the macro-prudential package are going to be enough, or whether you’ll signal today to the banking sector to listen to you now because you are sending, it seems to me, some pretty strong signals that you are not happy with the expansion of credit growth in general and high leverage property lending in particular. Is that a fair summary?

Wheeler I think that’s a fair comment. We’ve been talking with the chief executives of the banks, the chief financial officers, the chief risk officers, the chairmen of the boards—the four boards—talking about the risks associated with high LVR lending. We’ve been talking a great deal.

Cunliffe So if the banks don’t exercise some voluntary restraint, despite opportunities for short-term profit growth, it would be logical that the bank would have to muscle up with some more significant interventions?

Wheeler Yes, I think, you know, what we’re doing at the moment is signalling our concerns quite pointedly. We’re indicating that we’ll go back in terms of the consultation process that we’ve had on macro-prudential instruments, and report back on the feedback and what we think about that.
Due process but fair warning.

Correct. We’ve also indicated that we will be going back to the banks and having a public consultation on the operational arrangements associated with each of these instruments. We’ve also indicated that the Minister of Finance and the Governor of the bank will be signing an MOU in probably the next few days.

Just teasing out a couple of the macro implications: obviously we’ve got a drop in the household savings rate, matching the expansion in credit growth, and this is exacerbating some of our current account issues. On the exchange rate, we are now well above levels on a TWI at which the bank has previously tactfully intervened in the foreign currency markets, and without any expense to the taxpayer—we note the excellent performance of the bank in that regard. You can’t say, obviously, at what level precisely you would intervene, but would you rule out future spot intervention in currency markets to send a signal to those markets if the exchange rate were to continue to increase? Or has your framework changed so that you’re ruling out such intervention? Again I’m getting the same thoughts—jawboning—

We’ve indicated on the record that we are prepared to intervene in the exchange rate. We’ve also indicated that we would not expect, given the strength of the flows, that intervention would materially change the level of the exchange rate. But we could take, potentially, the tops off rallies. In terms of activity, there has been some intervention.

So, Governor, just on that particular point, is it also fair, therefore, to say that you would be intending, should you decide to do such intervention, to send a signal to the speculative end of the market that this is a jurisdiction where speculation that has effects not in the national interest will not go without response? Is there a signalling component to potential future intervention?

 Didn’t he just say there had been some intervention?

Yes.

He did say that they’ve been intervening.

Yes, I did say that.

So you have been intervening?

There has been some—

In recent periods—like, recently?

Well, it will become evident in the data—our balance sheet numbers that come out at the end of each month. So we don’t want to be more specific on it, but, yes, we acknowledge there has been some intervention.

Within the last month you’ve been intervening?

Is it fair that if the appreciation of the TWI continues, you would reserve a right to undertake future interventions?
Spencer  Yes, we’ve said that.

Wheeler  Yes, we’ve indicated that.

Cunliffe  Is that, therefore, to send a signal to the markets that the speculative end of the market will face consequences?

Spencer  That’s part of the signalling, that’s right, particularly when the price is getting stretched—when you’re getting those peaks and you’re getting short-term sort of speculative flows. But I would add that in respect of a lot of the flows actually over the past year or so, a lot of them have related to official sector flows. In other words, central banks and sovereign wealth funds around the world are diversifying out of the major currencies and into currencies like Aussie and Kiwi.

Barry  I have a question just around the impact of the Government’s plan to get the books back into surplus by 2014-15. Is that making—what impact is that having on your interest rates?

Wheeler  In essence, to the extent that the Government improves its fiscal position and is therefore less active in debt markets in terms of trying to finance a deficit, then that’s all to the positive.

Barry  And the rural sector as well: you point out that there’s a lot more borrowing from farmers. How much impact do you think the drought is going to have on their financial situation? Have you been able to estimate that?

Wheeler  Maybe my colleagues can estimate that in terms of farm incomes. I mean, in terms of output, in terms of the effect of the drought on the economy, we think probably it’s of the order of about 0.7 percent of GDP. Farm incomes are affected differently because dairy prices increased very rapidly, etc., and the calculus gets complicated because feed costs went up and slaughtering increased in advance of when it normally would, but, overall, we think probably between 0.5 and 0.75 percent of GDP.

McClay  Governor, thanks very much. Thank you for your time today and for your patience.

**conclusion of evidence**
Reserve Bank of New Zealand's Monetary Policy Statement, June 2013

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Paul Goldsmith, Chairperson)
July 2013

Presented to the House of Representatives
Recommendation
The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, June 2013, and recommends that the House take note of its report.

Introduction
This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, June 2013, and the central issues we discussed with the bank in our examination. Our approach to considering the statement, our membership, and the transcript of the hearing of evidence are set out in the appendices to this report.

The June 2013 Monetary Policy Statement announced the decision of the Governor of the Reserve Bank to maintain the Official Cash Rate (OCR) at 2.5 percent. As at the last review in March, the governor indicated that he expects the OCR to remain at this level throughout 2013.

Reserve Bank’s reasoning
The decision to keep the OCR unchanged reflects the Reserve Bank’s judgement about the balance between the various forces shaping New Zealand’s economy at present. Particular features are the gathering pace of post-earthquake rebuilding, and rapidly rising house prices in Auckland and Christchurch—both of which are exerting upward pressure on inflation—and the sustained strength of the New Zealand dollar, together with the Government’s programme of fiscal consolidation, which are moderating the effect of these forces on prices and economic activity. The result is that inflation remains subdued, at 0.9 percent, but the Reserve Bank expects it to rise to about 2 percent by 2016.

GDP growth is picking up, but unevenly. The Reserve Bank expects it to rise from its current 2.5 percent to about 3.5 percent by the second half of 2014. The main driver is the Canterbury rebuilding. The drought is estimated to have reduced growth by 0.5–0.75 percent of GDP. The unemployment rate is forecast to fall below 5 percent over the next few years.

The New Zealand dollar is expected to remain elevated, acting as a headwind against the economy’s recovery. The Reserve Bank projects that it will moderate gradually in the medium term as the outlook for the major Western economies improves and they return to more orthodox policy settings. The current account deficit is projected to increase to about 6 percent of GDP in 2014/15.

Alternative scenarios
The Reserve Bank’s central projection assumes that both house price inflation and the exchange rate will moderate from early 2014. However, the monetary policy statement explores two alternative scenarios: one where domestic demand, including house price inflation, turns out to be stronger than assumed, and one where the exchange rate remains
higher than assumed, for reasons other than an improvement in the New Zealand economy. In the first scenario interest rates would rise more quickly than in the central projection, which would cause the exchange rate to appreciate further, and the current account deficit to increase. The second scenario would see interest rates reduced; this would stimulate household consumption, including imports, and would boost momentum in the housing market. The current account deficit would also deteriorate in this scenario.

**Policy tools**

We note that recently elements of both of the scenarios described above have been occurring simultaneously, with overvaluation of both house prices and the exchange rate. The opposing pressures on interest rates have been cancelling each other out, avoiding the need for an OCR adjustment, but nevertheless causing deterioration in the economy’s underlying balance. In particular, they make it difficult to counter the inevitable increase in the current account deficit that will result from post-earthquake rebuilding.

We believe this situation increases the importance of other policy measures by both the Government and the Reserve Bank, as monetary policy poses a dilemma for the Reserve Bank at present: increasing interest rates to dampen the housing market would risk further currency appreciation, while lowering the OCR could fuel consumption.

The Reserve Bank has been continuing to develop macro-prudential policy measures, including possible restrictions on high loan-to-value ratio (LVR) lending, for addressing risks to financial stability stemming from the housing market. We understand it will decide about the possible use of these measures after it finishes consultation with banks in July.

We asked the Reserve Bank whether such macro-prudential measures are still considered unorthodox. The governor said thinking has changed considerably since the global financial crisis. The view that central banks should not intervene to prevent housing bubbles, but should simply stand by to pick up the pieces when they burst, has largely been discredited. Macro-prudential tools are being used in at least five countries—Norway, Sweden, Korea, Israel, and Canada—generally in the form of restrictions on loan-to-value ratios. In the Reserve Bank’s view, they are now seen as important complementary tools that should be available to monetary authorities.

**Rebalancing savings and investment**

The current account deficit—in effect, a measure of the shortfall between New Zealand’s savings and investment—is projected to rise from 4.7 percent of GDP at present to about 6 percent of GDP in 2014/15. The monetary policy statement notes that the need for capital from overseas to fund this shortfall underpins the high value of the New Zealand dollar. We asked the Reserve Bank whether this leaves New Zealand in a vicious cycle, as the dollar’s strength reduces export earnings, making it harder to clear the deficit.

The Reserve Bank said that current account deficits of 5 percent of GDP or more, and a relatively overvalued dollar, have been a worry for New Zealand for some 40 years. While it believes the financial markets will continue to be prepared to finance the deficits needed for Canterbury’s reconstruction, the problem will need to be addressed for the longer term. In its view, monetary policy is not well suited to addressing such issues, as they are structural rather than cyclical. Resolving the problem will require changing people’s incentives to save and consume, relative to New Zealand’s investment needs.
We asked whether the projected widening of the current account deficit, combined with inflating house prices, is repeating earlier patterns or whether the current situation is different, as the Minister of Finance maintains. The Reserve Bank said a key difference is that the previous cycle entailed a massive consumption boom: for every $1 a household earned, it spent $1.09. The balance between consumption and savings has been improving; at present, the savings rate is just slightly negative, and the bank is projecting that it will stay at about zero over the next three years.

The bank observed that a difficulty in reducing the current account deficit is that much of the investment required to rebuild Christchurch will be in buildings, both residential and commercial, and in infrastructure, that will not deliver a financial return.

### The housing market

House prices have increased 9 percent nationally in the year to April 2013. This average is based on rapid rises of 14 percent in Auckland and 11 percent in Christchurch, with increases averaging 4 percent in other regions. At our hearing with the governor we heard that Auckland prices are currently growing at 15 percent.

In its central projection, the Reserve Bank expects the rate of increase to peak soon at 10 percent nationwide, assuming no use of macro-prudential policy tools. However, it describes the possibility of stronger house price inflation as a key risk in its forecasts.

#### High loan-to-value lending

The bank has expressed concern for some months about the property market heating up, and particularly about the willingness of banks to lend against low equity. It has been talking with banks in the hope that they will voluntarily limit the amount in new mortgages they lend at high loan-to-value ratios. We are concerned by reports that in the March quarter, 71 percent of new mortgage lending by one of the major banks, with significant exposure to the Auckland market, was at high LVRs. We asked the Reserve Bank if this suggests its efforts at persuasion are not working.

The Reserve Bank told us it does not discuss the behaviour of individual banks, as it concerns itself with risks to the banking system as a whole. In its view, it is not unusual for intense competition among the four major banks to mean that in any given month one or two of them will adopt more aggressive tactics to gain market share. Taking the industry as a whole, however, it said the average remains fairly constant among the major banks—30 percent of new lending tends to be at LVRs of 80 percent or more—although they differ in the stock of high-LVR loans on their books. What is of concern is how this low-equity lending has increased from an average of about 23 percent 18 months ago. The Reserve Bank says it does not keep regional data, but it appears that most recent high-LVR new mortgage lending is in Auckland.

We asked the governor to explain why such lending is of concern, if borrowers have the capacity to service and repay their debt. He said both debt-servicing capacity and the loan-to-value ratio are important; the former affects the likelihood of a borrower defaulting on a loan, while the latter determines how much a bank would get back in the event of default. While banks take both into account in assessing the level of risk in their portfolios, the Reserve Bank looks at the market in aggregate, to see how such lending is affecting the level of risk in the financial system as a whole, and therefore its stability. The governor said the Reserve Bank’s aim is to avoid the type of situation the US found itself in after the
crash of the late 2000s, when fully a quarter of the country’s 50 million mortgages had negative equity.

**Policy measures to ease housing pressures**

As in our last meeting with the governor in May, we explored the likely effectiveness of various policy measures to cool house price inflation and bridge the gap between supply and demand.1

The governor said analysis by the IMF indicates that restrictions on high-LVR lending can help to slow the rate of house price increases, but cannot prevent or cure a bubble in the housing market. He recalled that OCR increases amounting to 325 basis points had been required to cool the last housing bubble in the mid-2000s. He noted that the gap between supply and demand is large: the Auckland Housing Accord estimates that roughly 13,000 houses are needed annually over the next three years. With construction running at about 4,500 a year, he noted, any other measures to bridge the gap, such as proposals by the Productivity Commission to improve productivity in the building sector, would be helpful. He also supports proposals in the Auckland Unitary Plan to free up more land outside the city limits and allow infill housing.

Some of us drew attention to the OECD’s recommendation of a capital gains tax, and asked the Reserve Bank to provide an estimate of the amount of change in the OCR that would be needed to equate to the effect of a hypothetical 15 percent capital gains tax on properties other than the first home. The Reserve Bank responded after our hearing that countries with formal capital gains taxes do not seem to have been any more immune to large cycles in house prices than those without, such as New Zealand. If such a tax were introduced, it believes that in the transition period there would be some dampening impact on house price inflation, and on short-term inflation expectations; this effect would be larger if the upward pressure on house prices was led by investors, and smaller if it reflected underlying population and supply pressures.

**Foreign ownership of housing**

We followed up our previous discussion with the bank about data indicating the extent to which purchases by non-residents are influencing the housing market. We were told that the available data comes from surveys of real estate agents; its usefulness and reliability are very limited, as it includes purchases by New Zealanders currently living overseas, and foreigners coming to live in New Zealand, as well as more speculative purchases by non-residents. The proportion of non-resident ownership of housing appears to be about 2.5 percent nationwide, and 5 to 10 percent in Auckland. We understand there is no firm evidence to support reports of a significant element of Chinese investment. The Reserve Bank said it appears that Europeans account for a fairly high proportion.

Some of us consider that, rather than relying on data from real estate agents, a land register should be established to record more accurately the extent of foreign ownership. The governor told us he has no strong view on the issue.

**Canterbury reconstruction**

Consistent with the Treasury’s projections in the *Budget Economic and Fiscal Update 2013*, the monetary policy statement now expects $40 billion to be spent on repairs and reconstruction in Canterbury, up from $30 billion in the March statement. This would be

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1 See our report dated June 2013 on the *Reserve Bank of New Zealand’s Financial Stability Report, May 2013.*
equivalent to 20 percent of GDP, spread over a decade, with activity rising to a peak in about 2015/16, when it would contribute about 2 percent to the GDP growth rate. The bank notes that the extent to which the rebuilding will increase inflation is uncertain at this stage; it will depend on the efficiency and flexibility of the construction industry, and how well the work is coordinated. While its central projection assumes that construction will proceed in an orderly way, it notes that the inflationary impact could be much larger if demand pressures are allowed to accumulate.

**Construction costs**

The monetary policy statement shows that construction costs in Canterbury increased by about 12 percent in the year to March 2013, compared with less than 2 percent in Auckland and about 3 percent nationwide.\(^2\) We were told that the bank is not concerned about such relative cost increases, as shifts in relative prices are a normal way the market signals incentives for labour and resources to move to where they are most needed. As well as Christchurch, Auckland will also see major construction activity over the next decade. The bank would, however, be concerned if price increases spilled over into other regions as more generalised inflation.

Some of us remain concerned that the decision to use Fletcher Construction as sole project manager for the Earthquake Commission’s rebuilding programme will inevitably contribute to cost increases as it is, in effect, a legalised monopoly. The Reserve Bank said the Ministry of Business, Innovation and Employment is the more appropriate agency to comment on such matters. It understands that the ministry is examining costs of construction materials and the potential for more providers. Some of us believe the ministry should seek a Commerce Commission inquiry into the lack of competition in building supplies.

**Lending to smaller businesses**

We are interested in access to credit for small and medium-sized businesses. The monetary policy statement notes that banks’ funding costs have been reduced, and their profitability has been improving. We recall that in the wake of the global financial crisis banks introduced a “term liquidity premium” on their business lending. We asked the Reserve Bank whether banks have been passing on the reduction in their costs by lowering this premium, or whether this is one reason for their improving profitability.

The Reserve Bank said it is not unusual for SMEs to pay a risk premium on top of banks’ base rates. While the risk spreads charged by banks widened after the financial crisis, they have returned to more normal levels. It considers that small business lending is growing at a reasonable rate. We sought more information, as we have heard that some SMEs have been finding it very difficult to access credit, even with prepaid export contracts. The Reserve Bank agreed that it can be difficult to secure a loan against cash flows; most SME borrowing is secured against property. Following our hearing, the Reserve Bank informed us that recent data suggests that system-wide SME lending growth has been low, with average monthly growth of 0.2 percent over the last six months, compared with 0.6 percent for the previous six months. It told us this reflects the fact that some businesses are continuing to de-leverage, which is at least partially offsetting the growth in lending to business borrowers seeking new or additional funding.

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\(^2\) *Monetary Policy Statement, June 2013*, p. 21, figure 4.20.
Deposit insurance and open bank resolution

We asked whether the Reserve Bank has revised its views on deposit insurance, noting that the OECD’s recent country report recommended that New Zealand should adopt an insurance scheme to limit depositors’ losses in the event of a bank failure. It described the Reserve Bank’s open bank resolution policy as a novel approach, but did not consider it a complete alternative, suggesting that deposit insurance was important as an additional safety valve. The Reserve Bank said it has always acknowledged that there is a case for deposit insurance, but it is not clear-cut. There are also arguments against deposit insurance from the point of view of moral hazard. The Reserve Bank’s policy is that open bank resolution will help to reduce such risks, and that deposit insurance is not appropriate at this point.
Appendix A

Committee procedure
We met on 13 and 26 June 2013 to consider the Reserve Bank of New Zealand’s Monetary Policy Statement, June 2013. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O'Donovan.

Committee members
Paul Goldsmith (Chairperson from 26 June 2013)
Maggie Barry
David Bennett
Hon Clayton Cosgrove
Hon David Cunliffe
John Hayes
Hon Todd McClay (Chairperson until 25 June 2013)
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Jami-Lee Ross (from 26 June 2013)
Hon Kate Wilkinson
Appendix B

Corrected transcript of hearing of evidence 13 June 2013

Members
Paul Goldsmith (Deputy Chairperson)
Maggie Barry
David Bennett
Hon Clayton Cosgrove
Hon David Cunliffe
Paul Foster-Bell
Claudette Hauiti
John Hayes
Dr Russel Norman
Phil Twyford
Andrew Williams

Witnesses
Graeme Wheeler, Governor
Grant Spencer, Deputy Governor
Dr John McDermott, Head of Economics

Goldsmith Welcome, Governor, and your team to the committee, and we are very keen to hear your summary of the situation and then to have an opportunity for members to question you. So, welcome.

Wheeler Thanks very much indeed, Chair. I will be brief, but first let me introduce John McDermott, who’s the Assistant Governor and Chief Economist at the bank, and on my left is Grant Spencer, who’s the Deputy Governor and the Head of Financial Stability.

There are multiple forces shaping the New Zealand economy. The major ones are the changing global economic outlook, the scale of the Canterbury rebuild, the impact of the drought, the programme of fiscal consolidation that the Government has under way, the high exchange rate, and the buoyancy of the housing market in Auckland and Christchurch. We think the New Zealand economy is currently growing at about an annual rate of around 2.5 percent, but activity is very uneven across sectors. A key driver behind the growth is the Canterbury rebuild and the expectation that we will see more residential construction in Auckland.

Despite having fallen in recent weeks, the New Zealand dollar remains overvalued and is creating headwinds in the tradable sector. We’re seeing rapid house price inflation in Auckland and Christchurch, and we don’t want to see financial or price stability compromised as a result. Our
forecasts suggest that the economy will be growing at around 3 to 3.5 percent annual rate by the end of 2014, the unemployment rate would be around 5 percent, and inflation around the midpoint of the 1 to 3 percent target range.

So, given this outlook, we expect to keep the OCR unchanged through the end of the year. Thanks very much.

Cosgrove GDP figures appear to be relatively flat going forward. Do you have any comment on that?

Wheeler They appear to be—

Cosgrove Relatively flat or stable going forward. Do you have any comment on that?

Wheeler GDP growth—well, you know, we think the economy, as I say, is growing at around 2.5 percent at an annual rate. It was growing at around 3.5 percent in the second half of last year. We think that it’s slowed down primarily because of the drought, which we think is probably around a 0.5 to 0.75 percent impact on GDP, but we anticipate that a number of factors will cause the economy to grow more rapidly towards the second half of next year.

Cosgrove Those factors being?

Wheeler Well, we’re anticipating that by the middle of next year the economy will be growing at around 3.5 percent in real terms.

Cosgrove And those factors being?

Wheeler Well, the factors that are pushing it are the Canterbury rebuild, which is very significant—it’s 20 percent of GDP, $40 billion in real terms, spread over, perhaps, a decade. But by 2015-2016, we’re probably at a peak level of activity there, so we’re building up towards that peak and that will be contributing, we believe, something like 2 percent of the growth that we will see.

The other thing is, you know, we’ve got low interest rates, the lowest mortgage rates in 50 years. We’re seeing some expenditure effects coming from the rising house prices that are starting to come through into consumption. So there are several factors, and, more recently—and it is recent, but nevertheless welcome—we’ve seen some reduction in the exchange rate.

Cosgrove Could I ask you a couple of questions around bank lending rates—the LVR. You expressed a pretty vigorous view last time that you were talking with banks to ensure their LVR levels were heading to an appropriate level—heading south. The advice we have is that ASB is somewhere in the 71 percent range, while others are moving south. Can you give us a view on that? Is the jawboning not working—no disrespect? Why are they different from the pack?

Wheeler Well, I think if you look at it overall in terms of, say, the four major banks, the high loan-to-value ratio lending above 80 percent represents about 30 percent of total lending. Now that’s increased from around 22 to 23 percent
of total lending 18 months ago, and we think that very intense competition for high loan-to-value lending is really putting some upward pressure on the house prices. I mean, you’ve got Auckland house prices currently growing at 15 percent.

Cosgrove No, but specifically I’m talking about ASB, because they seem to be the outlier. Others are moving south; ASB appears to be moving north—

Wheeler Let me check with Grant on individual—

Spencer We prefer not to talk about individual banks, individual names. We’ve never done that in the past, and we prefer to stick to that. We talk about the banking system and what’s happening in aggregate, but not individual banks.

Cosgrove I take your point, but it is out there. It is public knowledge, and you have been reasonably vigorous, you told us last time, in engaging with the banks to ensure those levels are appropriate. We’re advised there’s one outlier—one’s heading north, that is the ASB; it’s not a State secret—and the others are heading south. I’m just struggling as to—is the jawboning not working? Is ASB not listening?

Spencer I wouldn’t say there are any particular outliers amongst the major banks.

Cosgrove So my hypothesis is wrong and I’ve been badly advised, because what I am advised is that the other majors are heading south and these guys are heading north and it’s around the 71 percent—

Spencer If you go and look at the statistics over, say, the past year, you’ll find that in any given month, one or two banks will be more aggressive than the others. So they’ll tend to take market share for a couple of months and then back off a bit. So that mix of aggression, if you like, in the market between the banks varies from month to month.

Cosgrove Could you tell me if I’m correct—without naming the bank then, although it is all out there? What’s the gap between that particular entity, if it’s around 71 percent in outlier in terms of LVR?

Spencer In terms of LVRs, you know, they’re all —

Cosgrove What’s the average, then?

Spencer Well, the average is 30 percent. For the industry, as Graeme said, 30 percent of new lending is high LVR. In terms of differences between banks, the main difference is on the existing book—the LVR proportion in the existing book, as opposed to new lending. And there are some differences there between banks. But at the margin they all have around that 30 percent mark of new lending.

Hayes Could I ask you, please, could you please lay out what your concern is, because if you look at life from the point of view of a banker and you’re loaning money, you’re concerned about the borrower’s ability to pay, and it doesn’t matter a damn whether it’s a high or a low LVR; the issue is, is the person going to honour the obligation of paying back the money? So why are you targeting high LVR, when, actually, surely, the borrowing is
dependent on the borrower’s capacity to repay the money they’ve borrowed?

Spencer Well, the debt service capability, I agree, is certainly a significant factor in assessing the risk of a loan, but the loan-to-value ratio is also a significant factor. In particular, debt service will tend to influence the probability of default, but once a loan is in default, the amount of money you’re going to get back, from the bank’s perspective, is very much dependent on the LVR, because if there’s been a downturn you may not get all your money back. So both are important risk factors.

Hayes So isn’t that a commercial risk on the part of the bank, when they’re going into the market?

Spencer Definitely, they’re taking both of those factors into account. What we’ve said is that, you know, while the banks are managing their own risks from their own individual portfolio perspective, they don’t actually see the effect on the whole system. They don’t see the effect of their behaviour on the whole market, which is then coming back and affecting the risk of all of the banks. That’s our job.

Wheeler Maybe if I could elaborate on that. We’ve got a situation here where house prices in New Zealand are overvalued. The IMF says it, the OECD says it, the central bank says it. You’ve got a challenge with house prices in Auckland growing at 15 percent and in Christchurch at 11 percent. This increases the financial stability risk for the banking system as a whole. I lived in America for 15 years and I watched house prices go up quite substantially over the period 2003 to 2007. The global financial crisis came along. America has roughly 50 million mortgages, right—50 million mortgages—and 25 percent of those had negative equity a year or two after that crash. That is what we need to avoid in this country—the risk that that could happen, depress household incomes, and put the economy into serious damage.

Hayes We had it here in 1987.

Cosgrove I won’t labour the point, but I suppose I’m just seeking some factual checking here, and maybe you aren’t at liberty to give us an explanation now and you could provide us with something in writing, but I’m still struggling with the 71 percent of one bank when others are heading south. I don’t quite understand. What I’m trying to seek from you is a view as to, one, is that correct, and, if it is correct, where you see that, given the average is around 30 percent, why is there an outlier? Either I’m not correct—but that’s the advice we’ve got—or, if I am, I am seeking an explanation about that.

Wheeler We’ll come back to you in writing if we need to, but let me indicate what my understanding is. That is, for the system as a whole, amongst the four major banks, the average of high LVR lending is 30 percent of total mortgages. That tends not to vary a great deal between individual banks. What does vary is the stock of their portfolio of high-value lending. So they’re at different levels in terms of the stock that they have currently on
the books, but the flow in terms of mortgages that they’re writing is 30 percent currently in terms of annual mortgages that they’re printing, and that tends not to vary much between the four banks, because they compete aggressively.

Bennett Perhaps just to help Clayton—

Goldsmith Is this a supplementary question?

Bennett Yes, to help Clayton. On a regional basis, do you do any differential there? Do you see the rates in the Auckland region quite different from, say, the Wellington region? Do you notice any of that change?

Spencer Well, we don’t collect that data specifically on a regional basis, but, from talking to the banks, it’s pretty clear that a high proportion of the high LVR lending is in Auckland.

Cosgrove Thanks for that, I’m always gratified. Just in respect of the term liquidity premium that SMEs pay, plus their margin, do you have a view as to whether that’s being rolled out ad infinitum or is it supposed to be there as a stopgap, as it were? Are SMEs being dealt to in terms of the term liquidity premium?

Spencer To my knowledge of the pricing, it’s not unusual that the SMEs are paying a risk premium over and above the base rates.

Cosgrove That’s generally in times of difficulty. Do you have any evidence where this is being rolled out just because the banks can get an extra margin?

Spencer No, I don’t see any unusual behaviour in this regard. I mean, post the GFC, I think there was a big increase in risk spreads and there were concerns that they were being pushed out too far, but now that lending is getting going on a more normal basis, and small business lending is growing at quite a reasonable rate, in fact—

Cosgrove Could I test you out on that, because the feedback—and others may have different feedback—I get from SMEs is that unless you’ve got bricks and mortar, as it were, it’s extremely difficult for SMEs, and even those larger SMEs, to access capital from banks. They just don’t want to know; it’s too risky. I could give you a couple of examples of where exporting SMEs have got prepaid contracts, out of China, in one respect, and they wouldn’t be looked at—they wanted a million bucks, which, you know, in the scheme of things wasn’t huge money. They have a track record; they’re not a fly-by-night. They are not inventing some new invention. This is an established SME, as in one example, and they find it almost impossible to access capital.

So do you have any figures, if SME lending is going up—can you give us any figures, either now or later, as to the amounts, percentages, and the size, nature, and scale of the SMEs that are being lent to?

Spencer Well, I would only just say that you’re right, that most of the SME lending and growth in lending now is collateralised, effectively, on property. And you’re right; it is more difficult to secure a loan on a cash-flow basis.
Cosgrove  Could you provide us with some data?
Spencer  We don’t have data.
Wheeler  We’ll get you what we’ve got.
Norman  Just briefly, on the housing stuff. I guess what you’re trying to do is manage a soft landing, in a sense, for housing. You talk about in America, essentially they had a hard landing for the housing market, and you’re trying to use the tools you’ve got to target the housing market so you get a soft landing there, without using the OCR to damage the broader economy. Is that a fair summation of what you’re trying to achieve?
Wheeler  Yes, that’s, I think, fair comment.
Norman  My question is about the relationship between the current account deficit and the dollar. You had some interesting comments in your report that I don’t think I’d really thought through properly before. You said: “The demand for capital from offshore required to finance this saving shortfall”—with regard to the current account deficit—“underpins the high level of the New Zealand dollar.”
So the fact that we’re running large current account deficits, which need to be serviced, which mean there’s all this money coming in, actually pushes up the dollar, but the higher dollar, in turn, makes it harder for us to deal with our current account deficit, because the tradable sector is undermined by the higher dollar. How do we not end up in a kind of very malign feedback around this, because it sounds like it when I read your paper?
McDermott  It’s a good observation, and it’s been a longstanding issue for New Zealand—some 40 years’ worry about our current account deficit. It means, as a country, we haven’t saved enough for our own investment purposes. That means to finance that we have to attract foreign inflows. As that money comes across the border, it puts pressure on the exchange rate. So it’s been a longstanding issue, where we’ve had what feels like an overvalued exchange rate. It’s not just a current-day position, although it can go up and down. This is not something monetary policy is well suited to deal with, because this is a structural issue, not a cyclical issue. If we really wanted to change things, we would have to change the incentive for people to save and consume, relative to our investment needs.
Norman  Would it also mean—we had Mr English in front us yesterday, wasn’t it, in front of the FEC, comparing this current account deficit problem with the one in the mid-2000s. His argument, and I hope I don’t misrepresent it, was this one is different because more of the incoming flow is going into investment in the productive sector, whereas in the mid-2000s it was going into housing, I guess. But looking at the housing bubble that clearly has emerged, do you have evidence that it is different in the sense that more of the inflow is going into productive investment versus just housing, or is it actually similar to the last one?
McDermott  No, I think that’s a reasonable description. Clearly, there was a massive consumption boom in the last cycle, so we had household savings rates of minus 9 percent. So for every $1 the household was earning, it was
spending $1.09. Right now we’ve got a household savings rate that’s close to zero—slightly negative. For the next 3 years we think we’ll be around about zero. That’s the sort of different nature now relative to the previous cycle.

Norman But do you have evidence about where the inflows are going? I guess that’s the question: if the inflows are ending up in the productive sector, then you can see that, OK, we’re borrowing money from the rest of the world, but we’re investing it so we can trade our way out of a hole. Do we actually know where that money is going and if it is going to help us trade our way out of this hole?

McDermott One of the challenges—it is investment, but it’s often investment in residential activity. One of the big players here—one of the big factors—is Christchurch. The fact is that there’s a lot of investment required to put in new buildings, both residential and commercial, and also infrastructure. Those are necessary to rebuild Christchurch after the earthquake, but, of course, a lot of those won’t deliver a financial return.

Goldsmith Could I just ask a supplementary question on that. With this graph on page 16, related to the value of house sales and credit growth, I’m just wondering where this money is going. This gap has opened up between the value of sales and credit growth. How do you explain that? Is that related to where investment is going, or what?

Spencer The relationship you see there did change after 2008, after the GFC. It basically reflects what John was saying about the changed savings behaviour. Following the GFC, a lot of people were paying off loans and reducing their debt, so the net effect of new lending less the repayments gave you much lower rates of growth of overall credit, which is that blue line you’re seeing in the graph. So that relationship between the overall house sales and net credit growth was altered.

Goldsmith So if we maintain that gap for longer, then there’s an element of rebalancing going on.

Spencer That’s right. It reflects improved savings behaviour.

Norman I guess what we’re seeing in that graph is credit growth taking off again, and the gap starting to narrow again as the housing boom takes off again.

Just, if I may, just one other. My concern about what we’re seeing currently in terms of GDP activity is that we’ve got GDP activity clearly picking up, but at the same time we’re developing these huge external—well, huge is obviously a value judgment—large external liabilities associated with the growing current account deficit. Is it really a sustainable period of economic prosperity if it seems to be so overwhelmingly funded by borrowing offshore?

Wheeler Let me come back to the earlier point first about where the portfolio flow is going—John indicated, but they’re also going into the equity market and into Government fixed-income market. If you look at foreign ownership of Government securities, Government bonds on offer, that ratio is now up to 69 percent, so a lot of foreign portfolio flows are going into there.
In terms of the current account, I mean, you know, New Zealand has lived with a current account deficit of the order of 5 percent of GDP for three decades. I think it’s a concern if the current account deficit were to widen, and our forecasts indicate that that current account deficit will probably increase to around 6 percent over the next year or two. You know, can capital markets still finance those and not be worried about debt ratios? I suspect they can in New Zealand’s case, but there comes a point when you can get big discontinuities and big adjustments, and that very quickly gets reflected in falling exchange rates and rising interest rate premia. So it’s something that New Zealand needs to address over time, and, as John said, it’s very much a structural imbalance, particularly in terms of the savings-investment ratios.

Barry

My question is around foreign ownership of housing, which is something I’ve asked you about before. Have you been able to collect any data for us on what’s happening in Australia, for example, or China even?

Wheeler

In terms of data on Australia, no, we haven’t got anything specific. What we have done is tried to get a feel for foreign ownership of New Zealand houses. It’s pretty hard to get data, but as best we can tell from various sources, we think foreign ownership, in terms of the housing stock—so looking at the entire stock of housing throughout New Zealand—probably somewhere around 2.5 percent would be in foreign ownership. That includes New Zealanders who are overseas, so sort of non-resident holdings is the definition, so New Zealanders who have gone overseas and have a house would be included in that non-resident definition.

When we’ve looked at Auckland, our feeling is—and the data is hard to put together, it really is; I don’t have huge confidence in this data. But in terms of non-residents holding houses in Auckland, we think it’s probably somewhere between 5 and 10 percent. But that, again, includes New Zealanders who are overseas, and it also includes foreigners who may have bought and who may intend coming to live to New Zealand, so there’s a lot of uncertainty around the data.

Barry

So you have regional breakdowns and city breakdowns of the general terms, obviously not distinguishing between New Zealanders living overseas and foreigners directly buying, but there is a breakdown by region?

Wheeler

Well, the Auckland data came from some realtors that had put together some data.

Barry

Barfoot and Thompson.

Wheeler

They were one of them, I believe. Do you have anything to add, Grant?

Spencer

Yeah, it was based on the sort of survey-type information by real estate agents, so it’s not particularly robust.

Barry

And given it was Barfoot and Thompson, they were speaking to us in the Parliament last night and indicated that there was no proof that there was, you know, a significant amount of, for example, Chinese buyers coming to the Auckland market. There’s been a lot of talk around that.
Wheeler  Well, in fact, from what I’ve seen of the data—and again, you know, I don’t believe it’s sort of robust data in that sense—a lot of the foreign ownership is, in fact, European.

Cunliffe  Governor, thanks for your report. I guess, having been down this road before and some similarities, it’s now quite clear what the problem is. Just checking in with you—low inflation relative to target, relatively high exchange rate, therefore a reluctance to cut interest rates right now. On the other hand, a real and growing issue with regional house price inflation, housing affordability, and potential knock-on effects for consumption and saving effects, which don’t help rebalancing the economy. So that’s our central dilemma.

The question is how do we address it, and your report makes clear that your first tool now is not the OCR; that you’re wishing to explore the use of a package of macro-prudential measures pursuant to the MOU that you’ve signed with the Minister. And you’ll get no argument from the Opposition, the Labour Party, on that. On the macro-prudential tools, would you describe them now as unorthodox?

Wheeler  No, I don’t think you’d call them unorthodox. I mean, there’s been just a huge growing interest in these tools post the global financial crisis because what you saw in the lead-up to the financial crisis in many countries, you saw inflation that was under control—for example, in Europe, in the US—but you saw very rapidly increasing housing prices in the US, for example. And so the debate amongst central bankers used to be, well, you know, shouldn’t you be doing something to try and prick these asset bubbles? And the view of Alan Greenspan, which tended to dominate among central bankers, was that you’re there once it gets pricked, and you pick up the pieces, etc.

That view, I think, is discredited, and so there’s been a substantial look to see what macro-prudential tools can do. I’m aware of five countries that are currently using them. Norway, Sweden, Korea, Israel, and Canada have used these tools, mostly loan-to-value ratios of some form.

Cunliffe  Would you say, therefore, that in the absence of macro-prudential tools, New Zealand would have the optimum or world’s best practice monetary policy settings, or are they now seen increasingly as an important complementary tool in the toolbox?

Wheeler  I think they’re seen as an important complementary tool that central banks, or the monetary authorities, should have.

Cunliffe  I think that does show us, Governor, how much the world has changed over the last 2 years since the Labour Opposition’s been calling for their use, and we appreciate that. Governor, the—[Interruption] Well, you know, it was the Minister of Finance who said in the House that we had the policy. That’s his quote, which you’ve contradicted, and I appreciate that. That was some time ago. That was 6 months ago, before he signed the MOU.

Goldsmith  Let’s go on, David.
Right. So, look, the next question is, taking the macro-prudential toolbox as a whole, including the loan-to-value ratios, how much do you think it’s worth in terms of cooling impact on the Auckland property market, say, relative to a basis point increase in the OCR and that market? We’ve had some rough prior estimates, I think, from the Deputy Governor that it might be adding up to around 25 basis points. Now that we’ve become closer to implementation, is there any sense of where that estimate might be?

I think if you look at could tools such as setting a speed limit, for example, on LV ratios, be effective in trying to cool the housing market, the evidence overseas—and it’s not extensive, but the IMF did some work on this quite recently. Their analysis suggested that, yes, it can have some impact in trying to reduce the rate of price increase. You know, we wouldn’t say that this is a panacea that’s going to stop the housing market. I mean, the supply-demand imbalance in Auckland is very large. The backlog’s 20,000 to 30,000 houses, 13,000, roughly, needed each year, and we’ve been doing 4,500 or thereabouts. So that’s the problem we face.

If you look at interest rates, in terms of the interest rate hikes, if you like, that were needed in the last housing boom, in 2003 to 2007, you know, that was partly driven by other factors. Migration was very strong. But, you know, the interest rate increases were 325 basis points.

Which would have a detrimental effect both on our exchange rate and on our growth settings and employment.

Yeah, I believe so.

I’d like to come to the end—

So, final question, if I can, Chair. So there’s obviously a gap, which, presumably, might be filled by measures like an extensive house-building programme; taking the OECD’s advice, a capital gains tax. I’m wondering if you have a view on that, and, given the savings gap implication that others have referred to—Dr Norman—presumably a pretty strong savings policy. Would those be potential elements of a broad-based menu to assist the rebalancing going forward?

I think in terms of the supply-demand imbalance, anything that can be done on the supply side would be important, so meeting the objectives in the accord—the 39,000 houses over 3 years—would be helpful. Anything that could be done in terms of improving the productivity in the building sector, like the Productivity Commission’s report referred to, would certainly be very helpful.

On capital gains tax, you know, it’s really a very interesting one, because most countries that have a capital gains tax end up exempting residential housing, at least the first home, in any event—the first home. And you then say, well, you know, if somebody is buying multiple homes and trading in that, then the IRD will pick them up. It’s if they hold on to them and get around the trading clause, that’s when a capital gains tax could be—
On that, Governor, the IRD’s getting about $7 out for $1 in return on investment in chasing speculators, which means they haven’t reached the marginal cost equals marginal return point on the—

I wasn’t aware of those figures, so thank you. But, you know, you look at many other countries that have capital gains taxes, and you’ve seen housing booms in many of those countries.

No, nobody’s arguing it’s a whole solution on its own.

Governor, figure 4.20 in relation to regional construction cost. You mentioned in your comments before, you said 20 percent of GDP is as a result of Canterbury. When you look at those figures and the growth in regional construction cost passing 12 percent in Canterbury, while in Auckland they’re declining and have gone to under 2 percent and on a downward decline, doesn’t that raise huge alarm bells that much of this GDP growth and much of the fuelling of the economy is actually because there’s extraordinary extortion across the building and construction going on in Canterbury, and, as we’ve alluded to, there seems to be a bit of a rort going on.

You mean a legal monopoly, don’t you?

A legal monopoly.

You need to build a lot of buildings in Christchurch. We need as a country to move resources to that region. The one way the market allows that to happen is to give bigger incentives for people willing to either work there or move materials into there, and that’s what we’re seeing. This is what we would expect to see—higher prices where there is more demand. What would be of concern for monetary policy purposes is if that spread to the entire country—so we saw people putting up prices in Timaru simply because of what was going on in Christchurch. We are not seeing that, so for the moment this is positive news from a monetary policy point of view.

But would you not agree that if the competition in Christchurch is significantly limited through certain major players who control the markets, essentially, and you seeing this sort of percentage, it would be an indicator that we should perhaps be opening up to much wider competition to try to address that staggering percentage in construction costs?

I think you have an interesting point. The point I think that John’s making is a really important one. If you want to shift resources, you need relative price increases to create the incentive to shift. So we’re not too concerned about the relative price shifts that are occurring in Christchurch at this point, but we would become very concerned if it spreads into generalised inflation. I think it would be concerning if there were monopoly practices or there was insufficient competition, and my understanding is that MBIE are doing some work on that in terms of looking at the costs of certain materials and the potential for more providers.

And the other elephant in the room about this staggering figure that up to 10 percent of Auckland property could be owned by non-residents, compared to 2.5 percent nationwide average, and you say you’re not too
sure—it could be 5; it could be 10. Would this not be a very good reason to have a land register, so once and for all we could work out who owns the land in this country? Rather than you relying on Barfoot and Thompson and others—

Goldsmith
Feel free to answer that in so far as your capacity—

Wheeler
To be frank, I don’t really have a strong view about that.

Cosgrove
Just on my colleague’s issue about monopoly issues in Christchurch. You are aware, of course, that there is a legalised monopoly in terms of certain large-scale project management work—namely, Fletcher’s—because the Government took the view, somewhat strangely, that if you have one provider for project management work rather than one plus a number, that is competition; if you have no competition, prices would be forced down. My fifth-form economics tells me differently, but maybe I am wrong. Given that you’re going to have a look at monopoly practices, will you specifically have a look at that legalised monopoly and how it’s reacting, because that may well be a factor in relation to this graph?

Wheeler
Sorry, let me correct a misunderstanding. The central bank won’t be looking at monopoly practices. What I did say is MBIE—

Cosgrove
Sorry?

Wheeler
The ministry are doing it.

Cosgrove
OK. Do you have a view, then—for me—on the impact of that monopoly practice in what is the biggest construction site in New Zealand?

Wheeler
No, but what I would hope does eventuate is that you’ve got 10 years of really intensive construction taking place in Canterbury. You know, a considerable amount of repairs has been done. The new building required on building new houses and building the central business district very much still lies ahead—

Cosgrove
As does most of the residential.

Wheeler
Right. And Auckland has a very substantial building programme ahead of it, as well. Now one would hope that that creates an opportunity for new entrants to come in and say “Look, there is a decade or whatever or very intensive construction in these two regions of the country.”

Cosgrove
I accept that, but surely that proposition is hampered whereby a legalised monopoly is permitted in one large particular area of construction in Canterbury.

Wheeler
I don’t have the details to comment.

Twyford
We’ve been a little bit critical of the Government’s very tight focus on land supply as a response to the housing crisis, and I think everyone recognises in Auckland that land supply’s a very significant factor. But as the Productivity Commission pointed out, there is quite a long list of factors that are causing the current problem. I wonder, in light of the earlier question, whether the bank would consider referring the issue of lack of competition in the industry supplying building materials—whether you
would consider referring that—to the Commerce Commission for investigation or an inquiry, given what a significant factor that is in the price of houses?

Wheeler I’m not sure that the central bank is the right body to do that. I was talking to the head of MBIE the other day, just 2 days ago, and we were discussing this issue and to what extent competition can come into the market, and is that likely to happen. So I think probably MBIE is the central point on all that.

Twyford The Auckland Unitary Plan is a comprehensive approach to opening up more housing construction—much more comprehensive than the accords bill that you mentioned earlier. Have you looked at the unitary plan? Do you have a view about how useful it would be in terms of dealing to the overheated housing market in Auckland?

Spencer Well, the plan focused a lot on inbuilding—you know, more intensive building within Auckland—and I think that’s a sensible solution, as well as making land more readily available around and outside the municipal limit. So I think the mixture that they are talking about in the accord is a sensible one.

Twyford Would you support the unitary plan being speeded up?

Spencer Yes.

Twyford You would.

Goldsmith Thank you very much.

Cosgrove Hang on, just taihoa. There’s 5 minutes on the clock, with respect. We don’t sort of leave work early.

Goldsmith Right. We need to have time to get in there for question time, and we’re 2 minutes away.

Cosgrove No, no, this meeting is constituted till 2 o’clock.

Bennett You don’t know; we’ve still got other business to do.

Cosgrove You guys can leave if you want to. We’re quite happy to carry on.

Goldsmith No, no, we’ve got general business to move on to. So thank you very much for coming in—

Cosgrove Point of order, Mr Chairman. We have one very minor item of general business that you and I have just agreed to hold over, and we have 5 minutes on the clock, and we have members who want to ask questions. You cannot guillotine a meeting when the agenda says its going to finish at 2 o’clock. It’s out of order.

Bennett So you’ve agreed—

Cosgrove You can’t guillotine a meeting, and we’ve always met—

Goldsmith Speaking to the point of order—

Cosgrove —up until the ringing of the bells finally stopped.
Bennett  Point of order. Clayton, we're not aware of that. We're just aware that there's another point of general business.

Cosgrove  It's been disposed of.

Bennett  Well, perhaps we dispose of that now, then we're sweet.

Goldsmith  If you want to move to dispose of that matter now and then we can carry on.

Cosgrove  No, you and I just agreed that we'd hold it over, and we're wasting time.

Bennett  So it's going to be held over, then.

Hayes  I move that we hold over Clayton Cosgrove's letter until our next meeting.

Goldsmith  Very happy to do that. Does anybody want to speak to that? We're happy to do that. OK. Right. Thank you.

Cosgrove  Peter Dunne will be back by then.

Norman  Open bank resolution and/or deposit insurance—right. The OECD's country report on New Zealand said “You should have deposit insurance.” It said “Your OBR, well, it’s very novel and interesting.” and that deposit insurance is an essential component, because, basically, at the end of the day, everyone expects that we’re going to bail out the banks anyway, regardless of what we say now, because that’s exactly what we did last time, because it’s a very concentrated banking sector, they’re too big to fail, and the Government will have little choice but to step in. Do you agree with the OECD or are you sticking to your guns against deposit insurance? Because the OECD agrees with me, for once, and capital gains tax.

Spencer  We've always said there are arguments for and against deposit insurance, so it's not a black and white issue—we agree with that. But the current policy is that deposit insurance is an issue from the point of view of moral hazard and that it is appropriate not to have deposit insurance at this point in time.

Norman  Are you worried that we have that moral hazard regardless, given what happened during the last GFC when we bailed them out?

Spencer  The OBR policy itself will contribute to reducing the prospect of moral hazard.

Cunliffe  Given the shortness of time, this is probably best dealt with as a supplementary information request. You’ve talked about the gap between the OCR equivalent suppression needed to cool the house bubble—325 basis points last time. We know that the macro-prudential stuff’s worth around about 25 basis points. There’s a big gap. Could you come back to us with a rough estimate on the OCR equivalent impact of a hypothetical, flat-rate capital gains tax on properties, excluding the first home, of a 15 percent flat rate—just a ballpark. How much of that gap will it fill?

Spencer  I think we should just clarify your opening comment with regard to the 25 basis points. My comment at an earlier meeting was with respect to the three of the four instruments—in other words, the price-based instruments,
such as the capital overlay. On the other hand, an LVR restriction or speed limit will have a greater impact than the equivalent of 25 basis points.

Cunliffe  Could you come back with any estimates of the relative impact of the LVR speed limit—that will be really helpful. But I guess even with that—and we very much welcome that—

Goldsmith  Can we just wrap it up, please?

Cunliffe  Could you please estimate, roughly speaking, the value that might be derived—

Bennett  Point of order. We’ve run out of time, and at the end of the day that’s not an appropriate thing to ask for.

Cunliffe  Speaking to the point of order. Sorry to detain the meeting, but the Governor, in response to a previous question, answered in the affirmative that a range of potential policy measures that might help address the gap, without prejudice, included strong savings policy, various measures to improve housing supply including the housing accord proposed by the Government.

Cosgrove  Governor, are you prepared to supply that information?

Goldsmith  Have you got enough information to understand what you need to reply for?

Wheeler  I believe we’ve got enough information.

Goldsmith  Thank you very much and thank you for coming in today. We very much appreciate it.

conclusion of evidence
Reserve Bank of New Zealand's Monetary Policy Statement, September 2013

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Paul Goldsmith, Chairperson)
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Presented to the House of Representatives
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Reserve Bank of New Zealand's Monetary Policy Statement, September 2013

Recommendation
The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, September 2013, and recommends that the House take note of its report.

Introduction
This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, September 2013, and the central issues we discussed with the bank in our examination. Our approach to considering the statement, our membership, and the transcript of the hearing of evidence are set out in the appendices to this report.

The monetary policy statement announced the decision of the Governor of the Reserve Bank to maintain the Official Cash Rate (OCR) at 2.5 percent. It has been at this level since March 2011, and the decision to keep it unchanged was generally expected. As the governor has previously indicated, he expects to keep the OCR at this level through 2013.

Reserve Bank’s reasoning
The forces influencing New Zealand’s economy remain broadly unchanged from those outlined in the June monetary policy statement. The most significant are high house-price inflation in Auckland and Canterbury, spending on post-earthquake rebuilding, continued strength in the New Zealand dollar, and the Government’s commitment to fiscal policy tightening to return the operating balance to surplus. While housing demand and rebuilding activity are exerting upward pressure on inflation, the elevated exchange rate and fiscal consolidation have been dampening prices and economic activity.

These opposing pressures have avoided the need for an OCR adjustment, but the Reserve Bank thinks that OCR increases are likely to be required in 2014 as growth strengthens. The amount and timing of increases will depend on exchange rate movements and on whether momentum in the housing market and construction sector spills over into broader inflationary pressures. The Reserve Bank’s projections imply about 200 basis points of tightening by the end of 2015.

The Reserve Bank expects the restrictions it is introducing on high loan-to-value ratio mortgage lending to help curb price inflation in the housing market, allowing interest rates to be about 30 basis points lower than they would otherwise have been.

Overall, New Zealand’s economic recovery continues to strengthen, and inflation remains very low, at 0.7 percent. The Reserve Bank envisages annual GDP growth increasing from 3 percent over the past year to about 3.5 percent by mid-2014. As Canterbury’s rebuilding gathers pace and spare capacity is absorbed, the Reserve Bank expects inflation to rise gradually, but to stabilise by the end of next year at about 2 percent with the help of tighter monetary policy. The projections in the monetary policy statement envisage the 90-day interest rate rising from 2.6 percent at present to 4.4 percent by 2015/16, half a percentage point higher than in the June monetary policy statement.
Internationally, the prospects for New Zealand’s major trading partners are moderately good and export commodity prices remain high, but there are risks of spillover effects on our economy. Growth in Australia and China has slowed somewhat, and speculation over when the US Federal Reserve will unwind its quantitative easing policies has put pressure on the currencies of several emerging market economies. Unrest in Syria also increases the risk of higher oil prices.

**Restrictions on housing lending**

The Reserve Bank recently announced that from 1 October banks will be subject to restrictions on the amount in new residential mortgages they can lend against low deposits. Banks will be required to limit new residential mortgage lending at loan-to-value ratios (LVRs) of over 80 percent to no more than 10 percent of the dollar value of their lending for new housing.

The Reserve Bank estimates that these “speed limits” on high-LVR mortgages will subtract 1 to 4 percentage points from annual house-price inflation over the next few years; its central projection uses the mid-point of this range, 2.5 percent. The bank assesses that the restrictions will also reduce annual growth in household credit by 1 to 3 percentage points. With these reductions in inflationary pressures, the Reserve Bank projects the 90-day interest rate being about 30 basis points lower over the coming year or so than it would otherwise have been.

We asked the Reserve Bank how effective the restrictions are likely to be, and when they might be lifted. The governor told us the projected effects, as outlined above, take into account some disintermediation. That is, some house buyers are likely to get around the restrictions by finding alternative sources of finance besides banks to supplement their deposits. The Reserve Bank does not expect this to become a problem, but it will be monitoring behaviour closely. Its projections assume that about 10 percent of borrowers will be affected by the limit. The governor said he expects the measure’s main impact to be in the first year, but it will be well into 2014 before it can be assessed properly. The bank will monitor progress and comment on it in its six-monthly financial stability reports, on which we report to the House.

The governor said removal of the LVR restrictions will depend on their impact; the Reserve Bank expects to lift them when there are signs of better balance in the housing market and the bank is confident that their removal would not lead to resurgence in house-price inflation. He could not say when this might be. He noted that the moderation of house-price inflation forecast by the bank is the combined result of the LVR restrictions, increased housing supply, and monetary policy becoming less accommodating.

**Targeting the restrictions**

We asked why the Reserve Bank decided to impose the limits on high-LVR mortgage lending across the whole of New Zealand, since—leaving aside the understandable post-earthquake pressures in Canterbury—house-price inflation is largely an Auckland problem. The Reserve Bank told us the possibility of applying the measure selectively had been considered but rejected. While technically possible, such ring-fencing would be extremely difficult in practice, and could well create distortions and unwelcome opportunities for arbitrage. The bank also sees signs of house-price inflation in other areas around the country.
We suggested that when the time comes to lift the restrictions, the bank might consider doing so selectively, retaining them longer in Auckland than other regions. It could also consider lifting them from first-home buyers before others. The Reserve Bank said it had not considered sequencing specifically, but as first-home buyers make up a large proportion of high-LVR borrowers, exempting them would defeat the purpose of the measure.

We asked whether additional macro-prudential measures might be needed in Auckland, where house prices have been rising at an annual rate of 16 percent over recent months, compared with 9 percent nationally, especially as the projected deflationary effect of the LVR restrictions is only between 1 and 4 percentage points. The Reserve Bank said the projected effect of the LVR restrictions was a nationwide average; the effect is expected to be greatest in Auckland, where lending at high LVRs has been most prevalent.

**Trends in net migration**

One of the factors fuelling Auckland’s housing market has been higher net inward migration than expected. The Reserve Bank told us it pays close attention to such flows because of their implications for aggregate demand and house prices. The last 12 months have seen a large turn-around, from a net outflow of 4,000 from around the country to an inflow of 11,000, mostly to Auckland. The bank notes that this was mainly the result of more New Zealanders returning from Australia, and fewer people leaving.

**Policy objective and tools**

The governor said the main objective of the restrictions on high LVRs is financial stability. The measure may also have monetary policy benefits if, by slowing the rate of house-price inflation, it eases the rate of consumption growth, thus reducing inflationary pressures on product prices. There would then be less need to counter such pressures by raising the OCR.

The governor emphasised that the LVR limits are primarily a means of dealing with the financial stability risks associated with over-inflated house prices, which can create risks for the economy. The effects of such risks, he noted, were clearly evident in the US when house values fell sharply in 2009–10, leaving a quarter of mortgage-holders owing more than their homes were worth. Household savings rates in the US have increased in recent years as people have had to rebuild their wealth. The Reserve Bank’s concern is that, with New Zealand interest rates likely to increase over the next year or two, the stresses on homeowners and banks will increase; so they need to avoid over-stretching on their mortgages.

Some of us note that the Reserve Bank appears limited in the policy tools it has available to counter the current housing pressures in Auckland. Of the factors relevant to housing demand, only the availability and cost of finance would seem to fall within the Reserve Bank’s mandate. Some of us consider that this increases the importance of the Government’s fiscal policies for addressing other factors, such as income and employment levels, tax settings, and migration flows. Asked about the possible effect of a capital gains tax on the Auckland housing market, the Reserve Bank said it would depend greatly on how such a measure was designed. If first homes were excluded, and second properties ended up being held for 15 years or so, the effect of a capital gains tax would probably not be great.
International markets, exchange rate, and exports

In general, the Reserve Bank expects a gradual increase in the growth rates of New Zealand’s main trading partners over the period of its projections, supporting demand for New Zealand’s exports. The major developed economies continue to recover, and New Zealand’s commodity prices remain high. However, the high exchange rate, constraining New Zealand’s export and import-substitution industries, remains a key challenge.

Developments in international markets

The Reserve Bank is watching developments in international markets closely, as there will be important implications for the exchange rate, and for our economic outlook generally.

Since the June monetary policy statement, attention in world financial markets has focused on when the US might begin to unwind its policy of quantitative easing by “tapering” asset purchases. Global investors have started to anticipate this development by rebalancing their portfolios toward developed economies, causing the currencies of several emerging economies to depreciate sharply. Australia’s currency was affected because of its close links with emerging markets; the New Zealand dollar less so.

As the Reserve Bank has noted repeatedly, the financial imbalances caused by quantitative easing in developed countries have contributed significantly to New Zealand’s elevated exchange rate. It is therefore to be hoped that the unwinding occurs smoothly as the US economy improves, allowing the pressures from our high exchange rate to be relieved.

We will also watch developments in China’s economy with interest, given its importance as a market for New Zealand’s exports. China’s growth rate has slowed recently, but remains very strong at about 7 percent, after a remarkable average of nearly 10 percent over the past 30 years. The Reserve Bank sees several underlying reasons why it should continue to grow steadily, supporting growth throughout Asia and Australia.

We are aware of plans in China to encourage households to shift from their current high savings rates toward more consumer spending. At present, consumption is only about 35 percent of incomes. We asked the bank about this prospect, as it would seem that a slowing of China’s overall growth rate might be of less significance if demand for our exports was sustained by a rebalancing of China’s growth toward their consumers. However, the Reserve Bank told us it is uncertain how quickly China might address such structural adjustment.

Some of us conclude that New Zealand could continue to struggle with an overvalued exchange rate for some time yet.

Inflation forecasts and the exchange rate

It is of interest that inflation over the past few years has been lower than the Reserve Bank expected, partly because of lower world inflation and a much higher than expected exchange rate. The Reserve Bank has acknowledged, with hindsight, that it probably would have been appropriate for the OCR to have been lower than it has been. We discussed with the governor whether this might have led to a lower exchange rate. The governor said that in theory reducing interest rates would be expected to result in a lower exchange rate, but this can by no means be guaranteed. In Australia, he noted, OCR reductions amounting to 225 basis points had little impact on the exchange rate, given the larger influences on global markets from policies adopted in the US and other developed countries after the global financial crisis.
In the Reserve Bank’s view, lower interest rates over the past few years could have led to an even greater supply-demand imbalance in the housing market, with even stronger house-price inflation. It is likely that the OCR would already have been increased. The governor also emphasised the importance of market expectations: to the extent that the markets might have expected a monetary policy response to such inflation, their expectations of future interest rate increases might in fact have pushed the exchange rate higher.

**Economic growth and employment**

New Zealand’s economy currently ranks among the fastest-growing developed economies of the OECD. (Some developing economies, with lower per-capita incomes, are growing more rapidly.) It is currently growing at about 3 percent, and the Reserve Bank projects the rate increasing to about 3.5 percent in a year’s time, before moderating. The governor explained that the main drivers have been strong residential investment, strong consumption growth, and terms of trade that are close to a 40-year high. He said there are good prospects such growth can be sustained given the expected reconstruction activity in Canterbury over the next few years and necessary residential building in Auckland, provided that the inflation pressures this activity will generate can be kept in check. The efficiency and flexibility of the construction industry will be important in this regard; the bank’s forecasts assume that reconstruction will proceed in an orderly way.

The Reserve Bank expects unemployment to fall gradually over the next two years, to about 5 percent, and wage growth to remain soft. It acknowledges that the manufacturing sector and tourism have been particularly hurt by the dollar’s continued strength. However, it expects increased construction activity in Christchurch and Auckland to have flow-on benefits for manufacturing: for every dollar spent on construction, manufacturing output increases by roughly 40 cents.

Some of us are concerned that the headwind of the high exchange rate leaves jobs in the manufacturing sector largely reliant on post-earthquake reconstruction activity. It is also of concern that the expected tightening of the OCR could put further pressure on households, in the absence of stronger growth in jobs and wages.

**Rates for rental properties**

We sought the Reserve Bank’s view on the fact that rental rates in Auckland have not increased at anywhere near the same pace as property prices. The bank attributes this to a combination of factors, particularly pent-up demand. It believes many of those now buying homes had previously been renting while prices fell, so the relative demand for rental properties has reduced. In inner Auckland some previously rental accommodation is now owner-occupied, with people now renting further out of the city where rents are cheaper. Some landlords may also be choosing not to put up rentals, in the expectation of future capital gains.
Appendix A

Committee procedure
We met on 12 and 25 September 2013 to consider the Reserve Bank of New Zealand’s Monetary Policy Statement, September 2013. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O’Donovan.

Committee members
Paul Goldsmith (Chairperson)
Maggie Barry
David Bennett
Dr David Clark (from 25 September 2013)
Hon Clayton Cosgrove (until 25 September 2013)
Hon David Cunliffe (until 25 September 2013)
John Hayes
Hon Shane Jones (from 25 September 2013)
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Jami-Lee Ross
Hon Kate Wilkinson
Appendix B

Corrected transcript of hearing of evidence 12 September 2013

Members
Paul Goldsmith (Chairperson)
Chris Auchinvole
David Bennett
Paul Foster-Bell
John Hayes
Gareth Hughes
Andrew Little
Hon David Parker
Katrina Shanks

Witnesses
Graeme Wheeler, Governor
Grant Spencer, Deputy Governor and Head of Financial Stability
Dr John McDermott, Assistant Governor and Head of Economics

Goldsmith Right. Well, welcome, governor. We’re very pleased to have you here before the committee. We’ve got your Monetary Policy Statement, so we’re very keen to get a summary of that and have plenty of time for questions.

Wheeler Well, thanks very much, chair. [Introductions] Maybe just a couple of minutes of opening comments if that’s helpful. The global economic outlook is mixed. We’ve seen weaker growth in China, Australia, and some emerging markets, and stronger growth in Japan, the eurozone—the 17 countries of the eurozone have now come out of their 18-month recession—and there’s moderate growth in the United States. Despite the rise in long-term bond yields that we’ve seen since 22 May, global financial conditions are still very accommodating.

Back home the economy is probably growing at an annual rate of around 3 percent, and the recovery is becoming more broadly based. It’s been driven by rising consumption, stronger investment, and the high terms of trade. Inflation has been very low over the past year, the unemployment rate has declined, and the current account deficit has improved a little. But there are still important challenges. House-price inflation remains strong in Auckland and Christchurch. Although our forecasts build in some moderation as supply increases, monetary policy becomes less accommodating and loan-to-value restrictions have some impact.

The second major challenge is the exchange rate remains high and is constraining our export and import substitution industries. We’re forecasting annual inflation to increase to around 2 percent by the end of next year, and we will be watching the inflation pressures closely. We expect
to increase the official cash rate next year, but the extent and timing of the increase in the OCR will depend on the impact of exchange rate movements and the degree to which momentum in the housing and construction sector spills over into demand and inflation pressures in product markets. However, we expect to keep the OCR unchanged in 2013. So thanks very much.

Goldsmith  Thank you. All right. We’ll come to some questions.

Parker  Thank you for your report and appearing before us. The news report from Morgan Stanley following the press conference you gave earlier in the day opined what you’ve now admitted, that you’re using loan-to-valuation ratios as a monetary policy tool and not merely as a financial stability tool. Do you agree with that or accept that assessment?

Wheeler  Well, we’ve been very clear, I think, in terms of the on-the-record speaking that we’ve been doing, and we’ve been doing a lot around macro-prudential policy. We see this primarily as an instrument for dealing with the financial stability risks associated with overinflated house prices and the potential risk that poses to the stability of the financial system and also potentially to the broader economy. But one of the benefits of, if you can, slowing the rate of house and credit growth and our forecast building an assumption about that, or if you can slow the rate of house-price inflation, then, in essence, as house-price inflation slows, then you might also expect the rate of consumption growth to ease, and that will reduce the potential product price inflation pressures. So there is a potential monetary policy benefit as well, but this has mainly been introduced for financial stability reasons.

Parker  Can I ask you about the different demand side responses that are available to the combination of you and the Government in respect of rampant house-price inflation, which is clearly concerning you? It’s been said by some that demand side issues are largely the purview of the Reserve Bank. That’s not coming from the Reserve Bank; it’s coming from others. And I want to find what your view of that is, noting that the Productivity Commission, when they look at issues relating to household affordability, list on the demand side income and employment; availability and cost of finance; tax concessions; population and demographic change, which obviously includes migration flows; returns on other investment; and a host of other factors. In respect of those demand side factors, the only one that you’ve got ability to control seems to me to be the availability and cost of finance. Do you agree with that?

Wheeler  Well, the problem that exists in the housing market in respect of Auckland and Christchurch is the supply-demand imbalance, and in many respects it’s a supply side issue. But the demand is also important because we’ve, until recently, had the lowest mortgage rates for 50 years, so there is a demand-side aspect to all of this, and, as you say, migration is also a factor. But the main instrument, or the traditional instrument, for dealing with, affecting the rate of growth of housing credit and potentially house-price inflation, the traditional instrument has been through interest rates. But also fiscal
policy can affect the rate of demand growth in an economy, so it’s important that you get sound fiscal policy as well.

Parker I’m not disagreeing that supply is really important; I’m just wanting to tease out this issue that of the demand responses, with the responses to increasing demand for housing, you’re limited in the levers that you can pull, but there are a lot more levers that are open to Government that are beyond your purview, like tax structures, migration policy, taking two as examples.

Wheeler There are a lot of issues that can affect the supply-demand imbalance, yes. A lot of them will work—

Parker I’m currently only just talking about demand. I’m not trying to catch you out here; I’m just trying to be specific and say in respect of the demand responses—and we can deal with supply differently—there are a number of demand responses that can go to attacking inflation and, therefore, you know, moderating house-price inflation and then removing or reducing pressures on you to act.

Wheeler Well, they are traditionally, as I say, from the central bank’s perspective, and I’ll ask John or Grant to see if they want to add comments—traditionally, it’s the interest rate or policy rates. The macro-prudential tools can also have demand effects, as well, but let me see if—

Parker That’s within the Reserve Bank tool kit.

Wheeler That’s within the Reserve Bank tool kit.

Parker And the point I’m making is that there are lots of other tools that aren’t open to you, which none the less have an effect on demand.

Wheeler Yes, and some of those are more an element of fiscal policy.

Goldsmith Can I just have a supplementary on that, if you don’t mind? You say there’s a supply issue, which everybody seems to agree with. I just wonder how do you explain the big gap between rents and property prices in Auckland, particularly? The rents don’t seem to—if there was a shortage of supply, you’d expect the rents to be going higher than they are.

McDermott Yes, a sort of interesting question. You’d expect the two would follow each other.

Goldsmith They’re diverging hugely, yes.

McDermott In the past, and in previous cycles we’ve seen this before, and one of the things landlords may well be saying is: “Well, I don’t need to demand as much rent if I can get the capital gains.” So there are various dynamics that would sit in a housing market that can allow a divergence between the actual price of the house and the future rental incomes that people might be getting.

Spencer One of the factors, I think, is there’s been a pent-up demand. Since the crisis a lot of people were holding off buying houses, particularly first-home buyers, because prices were falling, and they think: “OK, we’ll wait for prices to pan out.” Now that prices are starting to pick up, interest rates are
essentially at the lowest level they’ve been for 40 years. Then a lot of people have decided to stop renting and get out there and buy a house. So there’s been a shift from renting to potential ownership, and I think that is one of the big causes of the pressure on prices, which, of course, keeps rents low because people are moving out of rental into purchasing. We see that as one of the key drivers.

Wheeler I think possibly one of the other things that’s happening is the housing in the centre of Auckland has been in high demand so the rental accommodation to some extent has moved into owner-occupied homes and people perhaps are renting further out where the rents may be not rising as rapidly.

Parker You’ve said—and this is not a criticism—with the benefit of hindsight you’ve underestimated what inflation would be, and if you hadn’t, interest rates would probably have been lower but by now would be on the rise again. Have you modelled what the effect of that would have been on the exchange rate?

McDermott Things you’re always asking all the time—and, again, the exchange rate market will be thinking about what’s going to happen in the future. So if you simply, in a model, take the interest rates is lower, you might anticipate an immediate drop in the exchange rate, but by the same token, had we been showing a drop in the interest rates with a future higher increase, the exchange rate market may be responding to that and which way it will go, on balance, who knows.

Parker I didn’t understand you as saying that you would have had a future higher increase; it might have just been that they would have been on the rise again now. Are you saying that the interest rate in response to getting inflation right and therefore having a lower OCR would have been higher interest rates in the future? I didn’t understand that to be what you meant.

McDermott OK. That’s a possibility, clearly.

Parker Well, if I go back to the question, then, because you are saying that our exchange rate’s elevated, that although our current account deficit’s come down a little it remains a problem and is forecast to go up again. If your interest rates had been lower, what would have been the effect on the exchange rate, do you think?

Wheeler It’s interesting. You know, if the interest rates had been lower—you’ve seen in Australia, for example, that they’ve cut rates now more than 225 basis points, and until recently, until you started seeing the comments about tapering and the exchange rate pull back in a number of countries, you know, they had very little effect on the exchange rate. It just hung there at about $1.04 versus the US. But you expect prima facie that if you got lower interest rates in terms of just economic relationships, you would normally expect to see a lower exchange rate. But you would also expect with lower interest rates and the supply-demand imbalance that we’ve got in the housing market, you would arguably have seen stronger house-price inflation. To the extent that the market believes that monetary policy will be
one response to higher house-price inflation, then those interest rate expectations of further increases may well put the exchange rate up.

Parker One last question. We’ve now got LVRs. I’ve seen commentary in response to your press conference this morning; someone asked you the question as to when they will end, and your answer was that that depends on how well they work. Is that a fair characterisation of the answer that you gave them? And, secondly, given that these are a new tool and there are some criticisms being made that because of an Auckland and Christchurch housing price bubble, the Christchurch one really being pretty explicable because of the earthquake but the Auckland one being more problematic, you’ve pulled a lever across the whole of the country, including in a way that inhibits activity in provincial areas that aren’t doing as well and aren’t suffering that high house-price inflation.

So two questions: how are you going to assess when you should pull out LVRs, and even before you pull LVRs out of everywhere will you consider restricting them geographically?

Wheeler We’ll be looking carefully to see how well the LVR restrictions are doing their job, and then we’ll be reporting to the Finance and Expenditure Committee in terms of the Financial Stability Reports that are coming out. So I’m sure there’ll be lots of oversight from the committee.

In essence we hope that these will work well. We’ve built in assumptions in our forecasts about the extent to which they may restrain housing credit growth and slow down house-price inflation. But we also know that there’s disintermediation potential out there, like any regulation—that smart people will try and find their way around these sorts of instruments. So therefore we’ve talked about the spirit and the letter of the instruments in terms of our engagement with bank chief executives and the boards and so on. But in essence, when might they be removed? They would be potentially removed if they don’t work, if the disintermediation becomes a problem. We don’t believe that it will but will monitor to make sure. But we would remove them when we’ve got a better balance in the housing market, when we’re confident that their removal won’t lead to a resurgence in house-price inflation.

Parker And the issue of geographic limitations on them?

Spencer Well, technically speaking, that would be possible. We considered that. There were a lot of suggestions around trying to ring-fence Auckland, but, one, I think there are pressures in some areas other than Auckland and Christchurch, and, two, really just operationally it would be incredibly difficult and would potentially set up arbitrage and distortions around the perimeter we were trying to draw the restrictions.

Parker Can I just push you a wee bit on that. Well, that’s true—as you say, there are disintermediation risks. There are risks in respect of any regulation that’s got a regulated limit. You’ve created the opposite risk, haven’t you, in that you are having an effect beyond Auckland even though it’s essentially, largely an Auckland problem?
I.3. Monetary Policy Statement, September 2013

Spencer: Well, we still think most of the impact of the policy is in Auckland because that’s where, because the prices have pushed up so far, people are having to stretch the furthest. So if you’re buying a house in Invercargill, there’s less likelihood you have to move into the high LVR range to be able to do the deal.

Parker: Are you able to provide us with data as to what is the regional breakdown of high LVR lending?

Spencer: No. We’re really just going on anecdotal data. We don’t have a regional breakdown.

Parker: I was in Ōāmaru the other day and a local lawyer and businessman was complaining to me that it’s having the effect of suppressing demand for a place that is already very flat.

Hughes: Just on the regional thing, given your modelling that LVRs are only going to have an impact around 1 to 4 percentage points and the Auckland housing market is increasing 14 to 16 percent, are there any other regional macro-prudential or other regional tools you could take to Auckland?

Wheeler: The 1 to 4 percent is a range that affects house-price inflation for the whole country, so while you’ve got Auckland growing at around 16 percent and Christchurch at 10 percent in terms of, say, the last 3 months, over the last 3 months of the comparable period last year, for the country as a whole, they’re growing at around 9 percent—in fact, about 8.5 percent. So the 1 to 4 percent that we’ve built into our modelling is bringing down the national average by 1 to 4 percent, and we’ve assumed something of the order of 2.5 percent.

McDermott: Can I add one thought. One observation we’ve seen from the change is that the banks’ response is to differentiate pricing on low-risk or high-risk loans, and that most of the concentration of the high loan-to-value ratio is in Auckland. We see a higher price in Auckland, so, actually, Auckland will actually bear more of the cost if they’re having more of the burden.

Bennett: Thank you, governor. In your report you note that there’s good GDP growth coming up and that possibly will have some inflationary pressures and therefore possibly some monetary policy issues. What would be the effect if there was a substantial ramping up of Government expenditure at the same time? We’ve heard a number of our Opposition colleagues making quite large promises—

Parker: No, you’ve heard the National Party mischaracterise them.

Bennett: —and what would be the impact of those promises, or a large Government spend-up on top of those inflationary pressures, and what would be the impact on monetary policy then?

Wheeler: Well, the economy is growing at around 3 percent at this point, we think, and possibly in a year’s time it may be growing at around 3.5 percent. The output gap—what we describe as the difference between potential output and actual output—will be negative at that point. And one might argue that it’s negative or close to negative now. So if in that situation you did have a
large Budget deficit appearing, if that were to be the case, then that would create excess demand pressures in the economy and would probably be reflected in higher inflation pressure and a bigger current account deficit.

Bennett And that would mean higher interest rates?

Wheeler Yes.

Bennett And so that would be quite a significant interest rate increase, because if you’ve already got that pressure for an interest rate increase now on top of that, you would be having a more significant one, wouldn’t you?

Wheeler Well, we’re talking about a counterfactual here, so it depends very much on the degree of fiscal stimulus that applied.

Bennett But if you had a large fiscal stimulus, you’re looking at higher interest rates, aren’t you?

Wheeler If you had a large fiscal stimulus on top of an economy growing at around 3.5 percent, and with Christchurch construction peaking in calendar 2015 and 2016, then that would certainly add to the problems the central bank faces.

Bennett Yeah. And higher interest rates.

Goldsmith All right. Just following up on the 3.5 percent growth, I’ve seen elsewhere you’ve put New Zealand as one of the world’s strongest-performing developed economies. What were the factors behind that assessment?

Wheeler Well, if you look at the 34 countries in the OECD economy, then we’re growing faster than any other economy in the OECD that has a per capita income at least as high as ours. So there are some, if you like, less affluent countries that are growing a bit faster.

What’s doing it? Well, some of it’s tied in with the very strong increase in investment on the residential side that you’re seeing. Residential investment is up about 35 percent over the trough in 2011; you’re seeing the terms of trade are close to a 40-year high, and they’re about 25 percent higher than the average of the 1990s; and you’re seeing strong consumption growth. So they’re the factors that, in essence, are driving the growth in the economy.

Goldsmith And you see that as reasonably sustainable, tapering away in the next few years, but what are the factors, do you think, that would see that coming down or staying steady over the next 2 or 3 years?

Wheeler Well, if you look at the international forecast, for example, the IMF and the OECD, they’re forecasting that international growth will start to accelerate next year. Currently, global growth’s around 3 percent. The IMF are forecasting something closer to 5 percent next year, calendar 2014. They see world trade volumes picking up. As I talked about just a moment ago, you look at the construction activity in Canterbury peaking in 2015 and 2016 calendar. You look at the potential supply side response tied in with residential building in Auckland and other things. So there’s good prospects that this can be sustained if, you know, inflation pressures are kept in track and the supply-side measures that are absolutely necessary, that they work.
Goldsmith: Very good. And just finally, the last few reports we’ve had, we’ve had grave concerns about Europe and potential problems there. There’s not much of it now. Has it all come right, or you’re just having a bit of variation as to what you’re going to worry about?

Wheeler: No, I think there’s still—

Goldsmith: I mean, the fundamentals haven’t changed a great deal, have they?

Wheeler: I think there’s still plenty to worry about in the eurozone. I mean, the 17 countries there were in recession for 18 months. They’ve just come out of recession, but no one’s forecasting rapid growth in the eurozone area. And some of the countries face real problems—France in terms of its export markets, productivity, and other relationships in many of those countries as well. If you look at per capita GDP in Italy, which is the third-biggest country in the eurozone, it’s back to where it was back in about 1997 or 1996. So there are some huge problems there, and the banking system has not reformed to the extent that it has in the US and, to some extent, even the UK.

Auchinvole: Just to switch back to housing for a moment, governor, when I last checked, New Zealand still has a high number of shifts per family during a sort of career span. It’s quite common for people to move several times. I recall when I was young—it was a while ago—we simply used to arrange a solicitor’s interest-only loan. Are they coming back in, and are banks engaging in that type of lending?

Hayes: You mean secondary market?

Spencer: Interest-only loans are not very common, and we’re not particularly keen on seeing that from a prudential point of view. I think in the agricultural sector is where we see a bit of that, but the banks are tending to now pull back on that, and I would say with our encouragement in terms of reducing the amount of interest-only lending.

Parker: You said in response to a question from David Bennett that you thought that the output gap might be negative now. I just want to clarify that that’s certainly not true in respect of the tradable or productive sector when you’re saying that there are already challenges posed by the exchange rate. And if I quote you from the report: “The high exchange rate will dampen the export receipts and soften demand for New Zealand’s service exports [as well], which are expected to remain low as a share of GDP. By lowering the relative price of imports the high exchange rate will continue to encourage substitution away from domestically produced goods and services.” And then your table shows the trade-weighted index staying at well over 70 to the end of the forecast period, so output gap we might have, but it certainly ain’t in the tradable sector. Is that right?

Wheeler: Yeah, I think the way I’d put it is the exchange rate has certainly affected many industries in the traded goods sector, particularly manufacturing. Tourism, especially, has fallen away quite dramatically. So it does affect the import substitution industries and the export sector, and is a significant concern. I mean, one of the things that will be quite beneficial in terms of
employment is the relationship between the manufacturing sector and the construction sector. If you look at what’s called an input-output ratio or an input-output coefficient, basically for every dollar spent on construction, the associated increase in manufacturing output is roughly 40c. So to the extent that the Auckland rebuild starts to accelerate—let’s say that the Accord starts to meet its targets—and you’ve got Christchurch, particularly the CBD area, starting to get more momentum in future, then manufacturing will get a pick-up. But I agree, the exchange rate’s been a problem.

Parker  That highlights that construction-related manufacturing effectively swamps the manufacturing performance index, particularly post-Christchurch earthquake—would that be fair?

Wheeler  Yeah, the linkage between manufacturing in terms of durable goods production and housing and construction is a very strong one. You know, you just saw some manufacturing figures come out a couple of days ago, which showed the impact of the drought on meat processing and, you know, those manufacturing figures were really quite weak.

Hughes  You’ve said the LVR might be removed when the housing market’s more balanced, which, I guess, is as clear as mud for many. You’ve said the major impact’s going to be in the first year. Are you thinking it’s going to go more than, say, 2 years, or 5 years? Can you give us more of a steer how long you expect it to be in place?

Spencer  Well, we can’t put the time profile on it, no. The governor said that we thought that most of the effect would be in the first year, but that’s not a guarantee that it’s on or off. After a year’s time we’ll have to assess it in terms of the impact on the housing market, on house prices—assess that against the supply response and, you know, we have to be careful that we don’t prematurely remove it, if there’s pent-up demand that’s going to cause a resurgence of house-price growth.

Hughes  And given many first-home buyers are really going to struggle under the LVR to get together a deposit, and you’ve said there’re too significant share of the market, around 40 percent, to exempt them, have you considered maybe removing them first, while leaving the rest of the 60 percent under a LVR regime?

Spencer  Yeah, we considered all those options. Basically, if that exemption was made, it would be so large as to effectively make the restriction ineffective. So there wouldn’t be much point in putting it on.

Hughes  That’s right, but it could be removed first as a priority, seeking it removed.

Spencer  Well, we haven’t really considered that sequential type or complication, but I doubt if we would. I think if we removed it, it would just be removed for everyone.

Hughes  Have you modelled what impact a capital gains tax, maybe over the last 5 years, would have had on, say, the Auckland housing market?
There’s been work in Treasury, I believe, looking at capital gains taxes. We’ve done a bit of analysis at times, but nothing tremendously comprehensive in the last couple of years, from memory—although maybe John can correct me if I’m wrong. You know, if you look at—there’s a debate here about capital gains and could they be beneficial. You know, you look at housing crises or housing cycles that get great buoyancy in other economies, and a capital gains tax doesn’t prevent that. I mean, you’ve seen many examples of countries with a capital gains tax and housing price booms. If you say “Well, if a capital gains tax was introduced, would it change the expected return on housing investment?”, it would. But then you start saying: “Well, OK, what do you assume about the rate of capital gains tax, and how widespread is it—so is it on first homes or just second properties, and things like that—and how long will the investment be?”. So if you’ve got, say, hypothetically a 15 percent capital gains tax on a second property that someone buys and then maybe keeps for 15 years, then the impact on the expected return, when that person makes the decision, is probably not that great, but it depends on, you know, what the rate of tax is, and incentives for holding, and for what period.

In answer to a previous question, Dr McDermott commented that in Auckland, particularly, perhaps rental rates are at a lower rate than one might expect and that was attributed to being partially due to landlords hoping to realise a capital gain on their property. So, just to put a counterfactual to you, if a capital gains tax was to be introduced, could we expect to see higher rentals as a result of that?

That’s a purely hypothetical—I mean, who knows?

We’re not sure.

Goldsmith In response to a question earlier today about first-home buyers and the difficulty they’re having, you referred to the American experience of the GFC, which saw 25 percent of Americans with negative equity—or 25 percent of mortgage holders. I wondered whether the message you were basically saying was in general it’s prudent to have a decent deposit and that you’re really not very keen on low equity purchasing generally. Are you making a strong statement along those lines or is this just a short-term issue that you’re wanting to get through for stability purposes?

What I was trying to say is that the American economy, like a lot of other OECD economies, was growing very rapidly in that period of 2002 to 2007. So there was house-price inflation in many of those economies and it was particularly strong in New Zealand because we had the highest rate of house-price inflation in the OECD during that period. But in the States you saw in places like California a huge proportion of the house purchases on interest-only loans and those sorts of things. The end result is when the global financial crisis came, you saw a very significant adjustment in house prices. Basically, America has 50 million mortgages thereabouts and 25 percent of them had negative equity in about 2009-10, and that number has gone down quite slowly. So it just creates enormous human distress, not to mention all the output and the employment issues as well, seeing people
with very low deposits just wiped out by major house-price adjustments. And what you saw is the US household savings rate started to rise because people have to rebuild their wealth. And, you know, that’s one of the reasons why the US Government tried such a large fiscal stimulus, which then got into bipartisan problems in Congress, but it’s why the central bank quickly went down to the lower bound and then adopted quantitative easing. It was trying to build levels of personal wealth in the economy again.

Shanks You hear from financial advisers—they say that the reason that they can’t get families and people to invest in their future and save is because they’ve become slaves to their mortgages because they’ve borrowed up to the maximum that they can possibly borrow and there’s never any money left over, apart from paying off the mortgage. Do you have a view on that?

Spencer Well, we have a view from the financial stability point of view. I mean, at the end of the day, if households get into trouble, then the banks and the financial system get into trouble. So the two are closely interrelated. So if debt service ratios get too high, yes, we’re concerned. I mean, right now, overall debt service ratios aren’t that high, historically. Loan-to-value ratios are getting up there, but because interest rates, mortgage rates, are historically low, the debt service ratios are moderate. This is one of the reasons the banks have debt service ratio hurdles, but it’s easier to get over when you’ve got a low interest rate. Our concern is that, you know, interest rates are likely to increase over the next year or two, as made very clear in this document. And that’s going to put pressure on anyone who has a mortgage. Even if it’s fixed rate, it only lasts so long before you’re back on the floating rate and you’ll be affected by the interest rate increase. So the banks and individuals need to take that into account.

Little The question is somewhat related to Katrina Shanks’ question, but your forecast rate—the rate of unemployment over the forecast period—still is not forecast to go below 5 percent, and you describe in your report that wage inflation, as you describe it, is soft. And then we’ve just had a discussion about potential impact on households next year, particularly those with debt—pressure on them. Are you concerned that a tightening of the OCR, which you talked about in your comments, is going to have a somewhat compounding effect on both jobs and incomes and the pressure that households will already be under with your forecast increase in interest rates?

McDermott Yeah, it’s an interesting question. I mean, the actual forecasts allow the economy to grow slightly faster than its potential because inflation’s at a very low starting point, and it allows inflation to catch up and get to the midpoint, and that’s all despite the fact that interest rates are rising. So the assumption here is that, actually, the unemployment rate will fall through the projection period, even given those interest rate increases. If that was not to be the case, the monetary policy outlook would actually be very different.
I.3L MONETARY POLICY STATEMENT, SEPTEMBER 2013

Little  Well, it’s still a comparatively modest decrease in unemployment. I mean, you’ve still got soft wage inflation. A further tightening I can only see is going to compound the situation and put further pressure on households.

McDermott  What these projections presume is a roughly 200 basis point increase, so that’s our falling unemployment rate, even with these higher interest rates.

Hayes  Have you factored in Fonterra’s latest payout in your calculations?

McDermott  There are two things with that. One is that the actual news came after we’d finalised these particular numbers, so, very specifically, the answer is no. But, of course, some of the forecasting team putting together the numbers were thinking about the likely payout. I think we were perhaps slightly more optimistic than some of the market commentators. So partially we were thinking about the prospect that this might happen, but—

Hayes  My second sort of general observation and question would be if we’re at the head of the queue of everybody in the OECD—that’s our level of GDP or north—then isn’t it a pretty fair assumption that the country’s being quite well run in Government?

Parker  How much of that’s insurance proceeds?

Wheeler  I’d leave it for you to decide how well the country’s—

Goldsmith  One more question for me—in your box A, when you’re looking at the LVR lending, so you’ve come up with this conclusion that it’s likely to lower annual house-price inflation by 1 to 4 percentage points. I mean, is there a quick summary you could give us of how you’ve reached that conclusion and whether it’s a guess or how scientific that guess is?

McDermott  Well, you can imagine lots of staff have spent time trying to figure this out. Look, there’s no history to go back on to really look at this, but what we’ve done is said: “Who will be impacted by the restriction? Who’s exempted from the restriction?” And then you ask for those impacted by the restriction: “Who could escape it, if you like, by borrowing from somebody else?” And you get to a point where you think about 10 percent of borrowers may be impacted and not be able to escape it, and then you translate that level of activity into the sort of 1 to 4 percent price. And that’s the exercise and thought process we went through.

Goldsmith  Because, presumably, if people are having to get around it by borrowing from a secondary market or if the impact is that, basically, you have a slightly higher interest rate for that group who are seeking to do higher lending, that, effectively, has the same impact as slightly higher interest rates for that section of the house-buying public.

McDermott  Yeah, I think that’s correct, yeah.

Goldsmith  And will lead to a—so your guess or your assessment is between 1 and 4 percent. Right?

Wheeler  Yeah, and we built an impact of 2.5 percent into the main forecast, and a 2 percent slowing in the rate of household credit growth, which is probably
somewhere in the range of the 1 to 3 percent, we thought, that we used to—

Goldsmith  And how quickly do you think you’ll have an idea of whether you’re sort of accurate on that? Will we know within 6 months, do you think, or a year? How will you measure it?

Spencer  Within 6 months certainly we’ll have an indication, but, you know, there are transitional issues in terms of the banks, and we’ve given them a 6-month period initially to conform with the new restriction. So, you know, it’ll be well into next year, I’d say, before we’ll be able to start making fair assessments of the full impact.

Parker  Just on the demand side pressures, you said that one of the surprises that have perhaps pushed along house-price inflation in Auckland has been higher than expected net migration, which, continuing on patterns that have been around for a while now, is heavily weighted towards Auckland. Population migration is out of New Zealand from lots of different places but the inward flows are concentrated into Auckland. Do you have any discussions at all with Treasury as to what are the challenges caused by that? Because I know you’re pretty quick to opine as to what would be the effect of looser fiscal policy, but other effects on demand, like migration, seem to be—they don’t seem to have quite as much attention paid to them. Do you have a view on that?

Wheeler  We do pay a lot of attention to the net permanent long-term migration. I mean, it’s up about 11,000 to this point in time over the last 12 months.

Parker  And concentrated in Auckland.

Wheeler  And concentrated in Auckland, yes, compared with an outflow of about 4,000 the previous year. So it’s a big turn-round. If you look at what’s causing it, it’s two factors, mainly. It’s New Zealanders returning from Australia, but, importantly, it’s fewer people leaving for Australia. That’s been a quite a volatile series, and there’s been a marked turn-round in the number of people who have remained here rather than left. So we do think about the effects of this on two things: one, aggregate demand in the economy, and, two, what does it do in terms of house-price pressures? Whether there are specific discussions with Treasury—let me ask John.

McDermott  None that I can recall specifically, sorry.

Parker  One final question, and it’s a question that’s been suggested by one of our advisers, which is an interesting one, and he says: “Is the rotation of growth in China towards their consumers trying to shift towards more domestic consumption in China?” perhaps a more important story for New Zealand than the China slowdown story, slightly lower growth rates in China being less important than increased consumption?

Wheeler  Well, it’s a very good question. If you look at China, say, for the last 30 years, its GDP growth has averaged 10 percent—about 9.9 for 30 years. I mean, it’s the biggest economic adjustment the world’s seen for a long time. And that seems to have slowed to about 7 percent. You can argue is it 7 to 8 or whatever. But I don’t anticipate that it will slow down in the
foreseeable future, at least not in the next few years, to anything like 4 or 5 percent, because even though China’s labour force is now starting to decline, its rate of urbanisation is still only around 50 percent, so it’s still got a lot to catch up with the sort of advanced economies.

We also look at technology uptake in China. If you look at international surveys of, say, corporate China and corporate rest of the world, China ranks well down those surveys—around 70th or 80th in the world. So its potential for catch-up technology in its corporate sector is huge—it’s just huge. And it’s still got an investment ratio of around 48 percent, so it’s going to continue to grow quite steadily, even though its labour force is now starting to decline.

What I’m less confident about, I guess, is how quickly they will move to try and change their savings behaviour. You know, their consumption-to-income ratio is still only around 35 percent. That’s fine. You know, if an economy’s growing at 10 percent, it means real consumption’s growing at 10 percent, so that’s a lot of potential import absorption for New Zealand, if you like, that consumer class can take. But I guess I’m less confident about how quickly they will address the structured adjustment reforms that will lead to much stronger consumption growth and rebalance the economy away from investment and manufactured exports.

Parker Which is another way of saying that the challenges faced by an overvalued currency, given what’s happening in China, could be with us for some time under current settings.

Wheeler The overvalued currency is a problem, and we would certainly in the central bank like to see a weaker currency.

Goldsmith Right, well, thank you very much for coming in. We appreciate your time.

**conclusion of evidence**
Reserve Bank of New Zealand's Monetary Policy Statement, December 2013

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Paul Goldsmith, Chairperson)
February 2014

Presented to the House of Representatives
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**Reserve Bank of New Zealand's Monetary Policy Statement, December 2013**

**Recommendation**

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, December 2013, and recommends that the House take note of its report.

**Background**

Our hearing with the Governor of the Reserve Bank about the December monetary policy statement followed shortly after our consideration of the bank’s November report on the stability of New Zealand’s financial system, and the 2012/13 financial review of the Reserve Bank. Our report on those items of business provides some useful background, as our discussion covered several of the same topics.1

**Introduction**

This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, December 2013, and the central issues we discussed with the bank in our examination. Our approach to considering the statement, our membership, and the transcript of the hearing of evidence are set out in the appendices.

The monetary policy statement announced the decision of the Governor of the Reserve Bank to maintain the Official Cash Rate (OCR) at 2.5 percent. It has been held at this level since March 2011. The governor has previously stated that OCR increases are likely in 2014; the Reserve Bank’s forecasts now suggest that the OCR will need to increase by around 2.25 percent over the next two and a quarter years.

**Reserve Bank’s reasoning**

New Zealand’s economy has developed considerable momentum. GDP is growing at an annual rate of over 3 percent, driven by high export prices, strong growth in private consumption, and increasing investment, particularly in Canterbury’s reconstruction and residential building elsewhere. The resulting increase in domestic demand is being offset to some extent by the high exchange rate and the Government’s fiscal restraint, but growth has been fast enough to absorb most of the spare capacity in the economy, so inflationary pressures are now growing.

While the rate of inflation remains modest, the Reserve Bank is watching closely to see how its momentum develops. The Consumers Price Index rose to 1.4 percent in the year to September, after sitting below 1 percent for the previous year. House prices continue to increase rapidly in Auckland and some other regions. The Reserve Bank expects its recently-introduced restrictions on new mortgage lending to help dampen prices, but says it is too soon to predict by how much. It expects inflation pressures to increase in the non-tradable sector. In the tradable sector, pressure on prices and activity is being dampened by

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the high exchange rate, although strong terms of trade are helping some exporters to offset this headwind, particularly in the dairy sector. The overall strength of the inflationary pressures will depend on movements in the exchange rate and commodity prices, and on the extent to which increases in house prices and construction costs from Canterbury’s rebuilding feed prices in the economy as a whole.

The Reserve Bank concludes that with signs of GDP growth becoming self-sustaining, it is becoming unnecessary to maintain the stimulus of a low OCR, and interest rate increases will be necessary to counter growing inflationary pressures and maintain inflation near the 2 percent mid-point of the target range. Its forecasts suggest the OCR will need to increase by about 2.25 percent over the next two and a quarter years.

The housing market

There is still not enough data for the Reserve Bank to judge the effectiveness of its restrictions on high loan-to-value ratio (LVR) mortgage lending, which started on 1 October. It has said that it expects the measure to slow annual house price inflation by 1–4 percentage points over the next year, and overall credit growth by 1–3 percent.

The number of new loans over the past three months is about 9.5 percent lower than a year before, but the value of new mortgage lending has not changed much, continuing to average about $4.5 billion a month. This suggests to us that high-LVR lending is being replaced by bigger loans on larger deposits, either for more expensive houses, or possibly for purchases of multiple properties.

We asked whether any other measures are being considered to contain the growth of credit to the housing sector. The Reserve Bank told us it is not considering other macro-prudential tools at this stage. However, it has signalled clearly that it expects to use traditional monetary policy from next year, and expects higher interest rates to help moderate demand for credit.

We note that numerous increases in the OCR were needed from 2002 to 2007 in an effort to cool the last housing bubble, and asked whether similar efforts might be necessary this time. The Reserve Bank said that experience demonstrated the importance of dampening inflationary expectations early in a housing cycle. By introducing the LVR restrictions it hopes to moderate expectations before they build too far and turn a boom into a bubble.

The Reserve Bank noted that the Government would complement such measures by moving from deficit spending to fiscal balance, taking pressure off the current account deficit. Working with regional authorities to increase the supply of housing and remove regulatory barriers to construction would also be an important help.

Migration trends

Population changes have contributed to the pressure on house prices. The monetary policy statement notes a marked increase in net inward migration since September, mainly the result of fewer New Zealanders leaving and more returning from Australia as the outlook for the labour market here improves. The past year has seen a major turn-around in migration flows, from an outflow of 4,000 around mid-2012 to an inflow of 18,500 in the year to October 2013. The Reserve Bank notes that such flows are hard to predict and can change swiftly; it is projecting a gradual decline from the current rate of about 7,000 net arrivals per quarter.
Auckland’s housing shortage

The Reserve Bank says the extent of Auckland’s housing shortage is less certain in the light of data from the 2013 census, which suggests it may be smaller than previously thought. Auckland Council has previously estimated the shortfall at between 20,000 and 30,000 houses, with about 13,000 new houses needed each year. On the basis of the census, some analysts now suggest the current shortfall may only be 5,000–10,000 houses. However, if net inward migration continued at its current rate, this would add significantly to the demand for housing.

Other regions

We remain concerned about the effect of the restrictions on house-buyers in regions other than Auckland and Canterbury, and questioned the Reserve Bank closely as to why the measures are not focused on areas where price pressures are strongest. We pointed out that a number of regions have declining populations, and their housing markets simply do not have the same problems as in Auckland; in some regions, house prices are actually falling. The bank remains of the view that price cycles tend to spread nationwide, and says there is already evidence of house price inflation in several other regions. The governor told us it would be impossible—a “nightmare”—to target the restrictions at specific regions; he did not know of any country that had succeeded in such ring-fencing. However, he said the nature of the restrictions means their effect will be felt most in the areas where prices have been rising the fastest. The alternative to the LVR restrictions, he noted, would be higher interest rates, which equally do not differentiate between regions.

Housing data

We are concerned by the lack of reliable data from which to assess housing trends. The Reserve Bank uses information about mortgage transactions from banks, and sales figures reported by real estate agents. It acknowledges that the data is not particularly robust, but believes property purchases by foreigners represent less than 10 percent of total turnover, and are not driving the increase in housing prices.

Some of us are particularly concerned that the extent of foreign ownership is likely to be under-represented by such data, as cash transactions using funds borrowed overseas would not be picked up in banking data, and surveys of real estate agents may not reveal the full extent of sales to foreign buyers. Anecdotal reports suggest some overseas buyers have been purchasing multiple properties at a time in Auckland’s expensive suburbs, sometimes without even viewing them. Some of us would like to see New Zealand legally require property purchases by foreign buyers to be registered, as they are in some other countries.

Lifting the restrictions

The Reserve Bank reaffirmed that it sees the restrictions on high-LVR lending as a temporary measure, and does not envisage them remaining for years. They will be lifted when there is evidence of better balance in the housing market. The governor would not say how such a balance would be measured, but pointed to several indicators of the present problem: over the past two years house prices have grown 18 percent, compared with CPI growth of 2 percent; relative to disposable incomes, house prices are 26 percent above the long-term average; relative to rents they are 66 percent above; and household debt is now 146 percent of average disposable income, compared with 100 percent around the year 2000. He said such a situation is not healthy; households are vulnerable to any economic shock, and may have difficulty servicing their debt when interest rates rise.
External conditions and the current account deficit

The external outlook for New Zealand is strong at present. The terms of trade are at a 40-year high, with dairy prices having increased by 50 percent during 2013. Global demand for New Zealand’s exports is robust, particularly from China. Overall, economic growth in New Zealand’s trading partners is expected to increase gradually from a moderate rate in 2013. Although China’s growth rate is expected to be lower than in recent years, it remains strong, at about 7 percent.

The Reserve Bank takes a cautious view, however, noting that such a large increase in export prices naturally raises the question of when they will revert to historic levels. It notes that global conditions can change rapidly, and sees risks in the high concentration of New Zealand’s trade, with China now accounting for 25 percent of dairy exports. Its projections assume that export commodity prices and the terms of trade will ease in the medium term, but it also acknowledges that they may not. The monetary policy statement explores a scenario in which the terms of trade remained elevated, a possible result of stronger consumer demand from China following proposed reforms there. This scenario would see New Zealand’s outlook and domestic demand strengthen, accompanied by stronger inflationary pressures, and by higher interest rates and exchange rates.

Some of us are concerned that the present exceptional conditions are not reflected in the current account deficit, which continues to be considerably worse than those of almost all the other OECD countries, pointing to New Zealand’s serious imbalance between savings and investment. The Reserve Bank said the deficit does not necessarily indicate a problem. Internationally and historically, a terms of trade boom tends initially to increase the current account deficit as it boosts both spending and business investment. This is not a bad thing if productive investment leads to higher export earnings, but can be risky if the spending is mostly on domestic consumption. Some of us consider that New Zealand is taking the second, risky, path, as statistics show far more investment in housing than in business, suggesting the country is unlikely to trade its way out of the problem.

The Reserve Bank agreed that New Zealand needs more business investment, and more export earnings, to improve its current account and debt positions. It said that some of the projected deterioration in the current account deficit is because the investment needed for Canterbury’s reconstruction, and for housing, is occurring at a time when limited growth in household savings is expected. It noted that a rise in interest rates could help the current account deficit by providing more incentive to save.

Revisions to current account deficit

Recent statistical revisions indicate that the current account deficit has been smaller than previously assumed. Statistics New Zealand has improved its methodology, resulting in historical data being revised downward; for example, the March 2012 current account deficit has dropped from 4.4 to 3 percent of nominal GDP. The Reserve Bank explained that the improvement in the base figures is less important in economic terms than the overall trends in the current account deficit, which have not changed. The newly-revised figures will be reflected in its next set of forecasts, for the March monetary policy statement.

The exchange rate

The Reserve Bank notes that the high exchange rate remains a hindrance to the tradable sector, but does not believe its strength is sustainable in the long run. However, it envisages
the New Zealand dollar remaining high throughout the period covered by its forecasts, which extend into 2016, reflecting New Zealand’s high terms of trade and comparatively strong economic outlook.

**Credit growth, debt, and savings**

We sought more detail from the Reserve Bank about the trends in private-sector credit growth. We heard that overall, private-sector credit is currently growing at an annual rate of about 5 to 6 percent, but there has also been a good deal of debt repayment, particularly by the corporate sector. If repayments were excluded, credit would have been growing at about 20 percent. Older people have tended to reduce household debt, while younger generations have been net borrowers. Overall, household savings continue to worsen slightly relative to disposable income—by about 0.6 percent in 2013. However, the Reserve Bank considers this a marked improvement on the boom years before the global financial crisis, when household debt was growing by more than 8 percent per annum. It notes that if the savings rate were sustained at around zero, debt-to-income ratios would improve over time. Also, monetary and fiscal policies would not have to be as tight as they might otherwise need to be to resist cyclical effects.

**Controlling credit growth**

We raised the possibility that controls on the growth of credit might be needed if New Zealand’s interest rates were to rise even further above those in other countries. A larger interest rate differential would encourage more inflows of financial capital, to which banks would be likely to respond by further easing credit conditions. This would run counter to the current efforts to control asset prices, and would carry risks for the wider economy, with more appreciation of the exchange rate and widening of the current account deficit.

The Reserve Bank said history has shown that credit controls are generally ineffective. Although used in some Latin American and Asian countries, they would be a highly unusual measure for New Zealand, which had deliberately opened its capital account to encourage producers to be efficient by making them compete internationally for capital. The Reserve Bank said its focus is on macro-prudential instruments and the use of interest rate policy. It believes the rise in interest rates it is forecasting will reduce the demand for credit, but it concedes that it may also attract foreign capital, pushing the exchange rate up. It sees New Zealand’s current account deficit as something to be addressed by changing New Zealanders’ behaviour gradually to correct the imbalance between the country’s savings and its investment needs.
Committee procedure

We met on 12 December 2013 and 29 January 2014 to consider the Reserve Bank of New Zealand’s Monetary Policy Statement, December 2013. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O’Donovan.

Committee members

Paul Goldsmith (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
John Hayes
Hon Shane Jones
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Jami-Lee Ross
Hon Kate Wilkinson
Appendix B

Corrected transcript of hearing of evidence 12 December 2013

Members
Paul Goldsmith (Chairperson)
David Bennett
Jacqui Dean
Paul Foster-Bell
John Hayes
Hon Shane Jones
Dr Russel Norman
Hon David Parker
Hon Kate Wilkinson

Witnesses
Graeme Wheeler, Governor
Grant Spencer, Deputy Governor and Head of Financial Stability
John McDermott, Assistant Governor, Head of Economics

Goldsmith Morning, Governor and deputy and assistant governors—afternoon, sorry. Welcome to the committee and thank you for coming in. We’re all here if you can give us just a quick summary, and then we’ve got plenty of questions for you.

Wheeler Thanks very much, chair. [Introductions] Let me also introduce four young men who are from Westlake Boys High School in Auckland. They won the Reserve Bank’s monetary policy challenge, which is conducted amongst this year 67 high schools. They’re basically required to assess the economic situation and then take some pretty tough monetary policy decisions. So we may need their help up here.

The economy is growing at an annual rate of over 3 percent. The strong momentum is driven by high export prices. Our terms of trade are at a 40-year high. Dairy prices are up 50 percent this year. Private consumption is growing strongly, as is investment, which is driven by reconstruction work in Canterbury and residential building elsewhere, and continued fiscal consolidation and the high exchange rate will offset some of the strength in domestic demand, but it’s fair to say that the economy has considerable momentum.

House price inflation remains high in Auckland and some other regions. We believe that the loan-to-value restrictions will help to slow house price inflation, but data on the impact of the restrictions is limited at this point in time. Consumer price inflation is currently running at an annual rate of 1.4 percent. We expect inflation pressures to increase in the non-tradable sector as capacity pressures intensify. How much and how quickly inflation
pressures rise will depend on what happens to the exchange rate, what happens to commodity prices, and the extent to which the increase in house prices and construction costs leads through into consumer price inflation. The official cash rate will need to increase to constrain inflationary pressures and keep future average inflation near the 2 percent target mid-point. Our forecast suggests that the official cash rate will need to increase by around 2.25 percent over the next 2¼ years. So thanks very much.

Goldsmith Thank you very much—very succinct.

Parker Other than loan-to-value ratios, are you at the moment increasing in any material way the capital ratios that would dampen the enthusiasm of banks to lend to the household sector?

Wheeler Not at the moment, but, having said that, what we did do, and Grant can elaborate, is that we raised the capital requirements associated with high loan-to-value lending. This was the sort of micro-prudential move that required banks to put aside more capital against this sort of lending. We did that about 3 months ago.

Parker Presumably, the banks want to maintain their throughput of new lending because of their profitability driver. You know, they don’t want their businesses to shrink. And, indeed, since August the total new commitments from banks are pretty flat. They’re $4.3 billion, $4.7 billion, $4.4 billion. So their total new commitments haven’t changed much. Is that correct over that period?

Wheeler That’s mortgage lending you’re talking about.

Parker Yeah.

Wheeler Yes, it’s roughly around $4.5 billion a month.

Parker So in terms of the bank leverage going into the property market, despite the change in mix between high to low-value loans—because high LVR loans have dropped—the total lending by the bank has not changed materially in those months?

Spencer Well, in the October numbers that we had reported you’re right. There was some substitution of a high in terms of greater low LVR lending. But the aggregate and the commitments were still down a bit in October.

Parker Well, it’s still more than it was in August. I mean, it’s $4.3 billion in August, $4.7 billion in September, and $4.5 billion in October. There doesn’t seem to be much significant change in total commitments. As you say, what seems to have happened is that the high LVR lending has been replaced by low LVR lending.

Wheeler I think there’s some truth to that. If you take the number of loan approvals over the last 3 months and compare it to where it was for the same period a year ago, then the number of loan approvals is down around 9.5 percent. So the volume of lending is declining, but you’re probably likely to be seeing more expensive loans in terms of demand for mortgages from people with higher deposits buying more expensive houses.
Parker  Or spreading their loans over more than one property if they’re multiple owners.

Wheeler  Possible.

Spencer  Could I just say that the expected impact of the LVR restriction was to have a moderating effect on the growth of credit and the growth of house prices, but not to actually reduce credit. So we’re still expecting credit to grow but at a slower rate.

Parker  So in terms of the relative effects on prices, how do you think LVRs are going to compare with the effects of this high rate of net migration that we’re having into Auckland?

Wheeler  I think there’s now a fair amount of uncertainty as to what the actual housing shortage is in Auckland. I mean, the council some time back were talking about a shortage of 20,000 to 30,000 houses and a requirement of 13,000 houses to be required annually. But if you take the census data, in terms of, say, the population increase that’s been in Auckland, you then look at what the average residency is per household, if you like—the number of people in the household—and you then look at the number of houses that have been built over that time, then some analysts suggest that perhaps the housing shortage might be something like 5,000 to 10,000 houses or thereabouts. But if that was the shortage at a particular point in time, the fact that you’ve got net inward migration or permanent long-term migration of 18,000, a big turn-round from a 4,000 outflow, then that, of course, creates greater demand going ahead.

Parker  So how long do you think you’re going to keep LVRs—years?

Wheeler  No, we have always seen them as a temporary measure to try and, as we’ve talked about many times, reduce the systemic risk associated with the housing market. We don’t see these on for several years, no.

Jones  The last time we had a discussion with you, Governor, you picked a figure as to where you’d like to see house price growth retreat to. It was a general exchange. But what you didn’t give us is what exactly is the criteria that you’re going to rely upon to either judge how successful this intervention has been or when it’s no longer needed. I think, from the dialogue that’s been both in this committee and public, that’s probably the glaring omission. I mean, do you have a criteria?

Wheeler  Well, let me talk a little bit around it for a minute, because it’s not something that I think has a direct, straight answer. We’re concerned about house prices, without question. I mean, it was only 3 weeks ago that the OECD came out and basically said New Zealand house prices relative to household income are 26 percent—26 percent—above the long-term average. They also said that New Zealand house prices relative to rents were 66 percent above New Zealand’s long-term average. We’ve had house prices growing 18 percent over the last 2 years when inflation has been probably 2 percent over that period. And we also know that household debt as a share of disposable income has increased from, essentially, around 100 percent at the beginning of the millennium to 146 percent now. So the
potential risks there are substantial. So in terms of removing these LV ratios, one, we don’t see these as permanent in any way.

Jones I beg your pardon?

Wheeler We don’t see these as permanent in any way. We see them as temporary. And we would want to take them off when we sense that there’s better balance in the house market.

Goldsmith Would that be a sort of—sorry—would the reduction in household debt be a key measure in that it would give you reassurance?

Wheeler Well, I think one of the things would be you’ve got house prices in Auckland currently running at 15 percent. The REINZ data is out for November today, but it jumps around month to month. So if you take, say, the last 3 months up to November over the same period last year—which gives you a much better feel for what’s happening with house prices, I think—then Auckland’s up 15 percent, and inflation is running at 1.6. That’s just not a healthy situation.

Jones You seem to be hinting that, really, further intervention may be needed, and perhaps borrow some ideas from overseas, where various Governments have actually limited citizens’ rights to buy X number of houses.

Wheeler Well, I think the instrument that will help constrain demand for housing will be the rise in interest rates. That, I think, is almost sure to follow.

Peters Look, if you look at your housing market and domestic demand statements, there are two things that are glaringly missing. One is that nothing from the regions or the cities, towns like Wanganui and Kaitāia—or any explanation as to why they should be affected by LVR problems.

The second one is seriously glaring. There is no analysis of the number of offshore buyers and their buying in the Auckland market. Now, if you haven’t got that information, then one’s got to sort of ask the question, well, what are you basing your analysis on?

Wheeler Well, let me address the first question, which was in a sense a question, I think, about why are some of the other provinces in the country paying for Auckland’s excesses, if I interpret it that way. We thought about ring-fencing Auckland, whether it was possible with LV ratios. We also knew that house prices were rising rapidly in Christchurch. Wherever you put any form of regulation, you’ve got a water’s edge problem in terms of spillovers and distortions that go with any regulation, be it tax or loan-to-value ratios. So we knew we would have that sort of problem about what happens just outside the ring-fence.

But we also felt that, look, this is just not going to be an Auckland-Christchurch problem—that house price inflation would start increasing quite steadily and perhaps even rapidly outside of those two areas. So if I take, for example, the 3 months to November over the same period last year, the data that I’ve got here shows Taranaki house prices up 11 percent; Otago-Lakes are up 10 percent; Waikato, Northland up 6 percent; a lot of
buoyancy in places like Nelson and Hawke’s Bay. It just wasn’t going to be a problem that’s going to be contained in Auckland and in Christchurch.

Parker Well, except that those levels of house price inflation in the past have never caused you to act in Auckland. Auckland’s off on this already high base and going even higher at higher rates than the rest of the country. With some very limited exceptions, the rest of the country has lower house prices and lower house price inflation. So there’s a magnitude of difference between what’s been happening in Auckland of late and, in effect, what’s happening or what might happen elsewhere.

Wheeler That’s correct, but other provinces are catching up.

Parker You have to concede that point because it’s true. Doesn’t that mean that there is something in Winston Peters’ question that, really, the only strong justification you can make for including the regions is that you think there will be boundary issues as between it and Auckland?

Wheeler No, but I also said that we felt that house price inflation just wouldn’t be contained to Auckland and Christchurch, and, indeed, what we suspected has happened. There are several regions in the country where house prices inflation is starting to accelerate.

Parker But off a far lower base. Are you seriously suggesting that the problems in house price inflation in the regions are of a similar magnitude to those that we face in Auckland?

Wheeler Well, the regions are highly variable in their situations. Some of them have got falling house prices, for example.

Jones Yeah, there is deflation. But if I could just make a small observation as a supp, you’re telling us that inward migration is an issue. Well, Paul Spoonley and a host of other number crunchers are lamenting the fact that the regions, population-wise, are dying.

Goldsmith One’s gone backwards.

Jones Taihoa. And the census showed that there’s a growing trend towards more metropolitan living. So kind of over the medium to long term, it sort of gives impetus, doesn’t it, Mr Governor, to have exempted the regions.

Wheeler Well, I don’t see it that way. I think, as I say, there’s a number of provinces where there is increasingly house price inflation. The alternative is to raise interest rates, and you don’t differentiate regionally on interest rates.

Parker But you could have differentiated regionally for this. You could—

Wheeler No, I don’t agree. I don’t believe that was possible.

Parker You don’t think it was possible—

Wheeler No.

Parker —to have regional carve-outs?

Wheeler No, not at all.
Parker: How can that be right? The securities for these places are known by the banks. They know where the security is that their lending upon.

Wheeler: I think you’d find yourself in an incredibly messy situation if you basically said: “We’re going to ring-fence particular parts of the country with quite stringent regulation and basically exempt other parts of the country.” I think you quickly get into a nightmare.

Parker: Well, taking Shane Jones’ point, why should the rest of the country bear the consequences when some of those areas are flat or declining for house price inflation in Auckland?

Wheeler: Well, I think the issue is that we had a situation where banks were very aggressively competing for first-home buyers in Auckland and elsewhere and were, essentially, lending up to about a third of their total lending book to people with low deposits, and we felt, given the situation that there is with current prices and the history of those prices in the past, that we felt that we really needed to act on that. And loan-to-value ratios struck us as the best instrument to deal with demand and try and address the systemic risk. I don’t believe it’s possible to ring-fence regionally. I don’t know any country that has done that successfully.

Peters: I’ll take a question. I asked him two—one was about: where is his analysis of the offshore buying, which is widespread in Auckland of all sorts of real estate.

Goldsmith: We’ll get an answer for that one.

Peters: This will tell you what’s going on, but there’s no analysis of it.

Spencer: Well, as you know, there’s not good data on that. There’s a lot of anecdotes. There’s an awful lot of stories about, you know, how it’s the foreign investors who’re pushing up Auckland house prices, but what survey information there is suggests that most of the investors in the market are New Zealand investors, not offshore investors. OK, there are some offshore there, but, you know, the surveys suggest 10 percent or less. So they’re not driving the market. They’re not driving the market growth in the past 2 years. It’s been a much more across-the-board phenomenon.

Peters: Well, with respect, you haven’t got the information to come to that conclusion, have you? If you look at the Grey Lynns, the Ponsonbys, the Herne Bays, and parts of the Shore and everywhere else, and you go to those auctions and talk to real estate agents, they’ll tell you some of them are being shut out because they haven’t got the clientele, with the low interest rates, capable of paying the price. These guys jump in, into the auction, at the last moment whenever everybody else, every New Zealand buyer’s exhausted, because they’ve got the money and they’ve got 1 percent of interest rates or less secured offshore, and it is serious. I do not think you can say it’s 10 percent or whatever, but at the top end of the market, you cannot explain the Ponsonby—all around Auckland, the house price movement there. It’s colossal, and—

Goldsmith: You’re referring to “these guys”. Who are “these guys”? 

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Peters: Well, we all know, because ask the real estate agents who’s turning up with the money. Half of them come from one part of the world—over half—and their clients are not here. Their clients are still in Beijing, but the person buying, and it’ll usually be a female, is buying on their behalf and buying countless homes. I’ve had agents tell me of one where they bought 15 homes sight unseen. If that starts getting to the market, then a percentage, whether it be 10 or 15 percent, nevertheless has a profound effect at driving up the price. And to say “Well, the majority of New Zealanders”—what the hell does that mean? Of course, they’ll be New Zealanders, but who’s got the money and the influence at the top end of the market is what I’m asking and why don’t you know? Because that’s—

Goldsmith: Right, got the gist of the question.

Peters: Yeah, but the quality of data is what I’m asking, and we asked it last year, and we’re still waiting around. I mean, how did you come to your conclusion, or did you decide you’re going to go get the data somehow?

Goldsmith: I suppose to paraphrase, I suppose one thing you could be asking is do you think it’s good enough to say that we don’t have good data, or is there any way we could get better data?

Spencer: Well, the data we have is either through the banks or through surveys of the market through the realtor community, and, clearly, if they’re not going through the banks, if they’re cash buyers, we’re not going to get—you know, we can always get more detailed information on credit, but in the broader market it’s obviously more difficult and we are reliant on that for survey information.

Peters: Well, your LVRs are going to have no effect on these guys. You’re never going to see the information because it’s not the New Zealand banks they’re dealing with.

Goldsmith: Right, OK, we’ll come to another question, but I’ve just got a—

Peters: My point is that there are countries that make sure they have that information because the law requires it.

Bennett: Those other countries that Mr Peters is referring to, like Australia, and like even in parts of California now they’ve had massive price increases in their houses in the last year, haven’t they?

Wheeler: Australia’s a bit mixed. I mean, I think Sydney house prices—I mean it varies a lot around Sydney, but for Sydney as a whole I think they’ve been up about 13 or 14 percent. Melbourne’s closer to 9 or 10. The US—across the US it’s roughly around 11 or 12.

Bennett: Yes, so, those are comparable to Auckland?

Wheeler: Well, Auckland’s running at about 15, 16, or so.

Bennett: Yeah, and they’ve got those rules, so it doesn’t stop that, does it?

Parker: And it’s running at 5 to 8 percent less.
Goldsmith: All right. OK. Now, I've got a question. I just want to look at this question of the current account deficit. You've got this graph on page 29 of your report where, I suppose, the broader question is last time we had a big boom, did it lead to high inflation, high interest rates, and a very bad current account deficit around 8 or 9 percent of GDP? There's been a lot of concern about that current account deficit starting to pick up again, but we've had some interesting updates in terms of the numbers. And so you're talking about the last year's now being revised so it's a March 2012 for it to go from 4.4 back to 3. So that's a 30 percent change. And then the year to March 2013, which you don't seem to have in here, reduced from 4.5 to 3.9 percent. Then I look at your graph on page 34, and it doesn't seem to necessarily match those figures. So the latest figure I'd heard for 2013 was 3.9, not 4.5. Are you adjusting those figures in your projections? How do you think that's going?

So two questions are: are we on track to at least have a better result in the current account deficit than the previous cycle perhaps? And then, secondly, are the revised figures that you're seeing, are you expecting that to lead to an impact on your projections?

McDermott: Let me just pick up on a technical issue. So we had information from Statistics New Zealand in the middle of putting together these forecasts. So the box here that—box D—is referring to the information that we have on nominal GDP. So we don't have any real figures. So we're just warning that there will be some revisions coming. We'll have those in the new year. These numbers are the revisions to the nominal figures. What's shown in all the tables is the information that we had at the time, which is all the real GDP figures, do not reflect the current information Statistics New Zealand have, because that information's incomplete and we didn't want to show a set of inconsistent forecasts showing some nominal figures that didn't match the real figures elsewhere. So the box here is really just to highlight to financial market participants that there'll be some future revisions and this is the kind of nature it will look to. So you can see that on the current account it just tells us that we weren't quite as bad as we thought, through history.

Goldsmith: Thirty percent difference—4.4 back to 3.

McDermott: In some periods.

Goldsmith: Not insignificant, I wouldn't have thought.

McDermott: Yes, but the trends largely haven't changed. It's just the level position that we have has just been altered through data revision, so it's not anything substantive in economics. That still was whatever it was. Just the quality of the data has improved.

Norman: My question really is just—we've got terms of trade that are the best in 40 years, we're running a current account deficit that's one of the highest in the OECD. When you put those two simple facts together at the same time, does that not suggest in your mind that we've got a major problem on our hands? Because you would think that if we've got the best terms of trade in
40 years, we would be able to trade our way out of this, and yet, clearly, we're not.

McDermott: It's not always the case. One of the things that you look for—across history and across lots of countries, in terms of trade boom, two things happen: one is you generate incomes that are liable to be spent, and also you create a better investment environment. So if those high prices were to continue into the future, that makes very good prospects for businesses. So what you get is you don’t get any change initially in your savings rate, but you get a lot of demand for investment. Actually, that widens the current account position. Now, if you’re spending on investment that’s very productive, for the future that’s a good thing. But it is also risky if you consume in excess and terms of trade subsequently decline. Then you find yourself over-consuming. Some countries do it well, and some countries don’t.

Norman: In relation to that, if we look at gross fixed capital formation, we’re finding nearly 20 percent growth in residential, 6.6 percent growth in business. This is exactly the wrong kind of investment that we need. We're throwing it all into housing.

McDermott: We’re building up debts and we need the capacity to repay those debts some time in the future. I wouldn’t disagree with you, absolutely.

Norman: Then how do we repay debts by investing in housing? I mean, seriously, surely we are—

Wheeler: You repay debts by, essentially, generating greater market share in international trade.

Norman: And so we’re not doing the kinds of things, or the kind of investment, based on these numbers, that we would need to get out of this thing. Then on top of that, as you’ve indicated, interest rates are predicted to increase through the next 12 months, which one would think would put even more pressure on the tradable sector than it’s already under, and we’re already running a very high current account deficit compared to our OECD comparator nations—not compared to 2008, but compared to the current situation.

McDermott: It should also change incentives to consume on durable items and give it a greater incentive to save, therefore leaning against the current account position.

Wheeler: The current account deteriorates primarily because household savings are not projected to increase very much, and investment is expected to increase quite considerably, tied in with the reconstruction and a lot of house building, plus also some business investment. Now, we need the house building to address some of the supply problems and also to help the situation in Canterbury, but if you say “Do we need more business investment in this country that basically can compete on international markets and generate export revenue?”, the answer is yes.

Norman: So—and this is very relevant to our previous conversation because we’ve supported the LVRs, with certain kind of qualifications—because it seems to me that one of the drivers for you increasing interest rates is your
concern about what’s happening with the housing market. And, like you said, if one thing, hopefully, you would imagine would affect the housing market, it would be interest rates. But the history from the last asset bubble in housing was that you really had to escalate interest rates very considerably before you had the kind of effect you were looking for in terms of dampening house prices, which would suggest—if history is repeating itself, and it certainly appears to be—that interest rates could go considerably higher before you dealt with the housing asset bubble.

Spencer: I think in the last boom there was very high inflation expectations around asset prices. One of the reasons we introduced LVRs—I mean, a lot of people said “Well, credit growth hasn’t actually taken off yet.” We’re actually trying to anticipate the boom and try and moderate the housing boom before those expectations get too built up. Because once you get the expectations, once it becomes a bubble, it does become very hard to stop through higher interest rates, as you say.

Goldsmith: I suppose two things the Government can do, presumably, is to do everything it can to increase housing supply, in order to take pressure off house prices, and separately keep control of Government spending so it’s not adding to the overall—

Wheeler: Yes. I mean, if the Government—

Goldsmith: That’s a contrast, potentially, to what was happening in the mid-2000s.

Wheeler: If the Government reduces its deficit spending and moves to a fiscal balance, say, for example, then it takes pressure off the savings investment imbalance, which is, in essence, the current account deficit, so that’s helpful. And anything it can do along with regional authorities to increase housing supply and address the regulatory issues is clearly important.

Bennett: Just going back to what I think the Greens asked earlier—you said that the opportunity to repay debt in that situation that Russel outlined, and you said that credit growth hadn’t increased to a great extent. So that must indicate that you would expect that there is quite a bit of repayment of debt going on in the economy, in the private sector. Have you got any numbers on that or any feel for—probably in the last quarter, with the agricultural prices coming through in that sector as well. Are you seeing much of that happening at the moment?

Spencer: Certainly, debt has been repaid in terms of, particularly, older generation—or baby boomers, shall we say—repaying debt at the same time as younger people are increasing debt. So it’s a bit of a give and take. Overall, debt ratios have not reduced substantially. They have come off from the GFC, and now they’re sort of levelling out. And that applies to household debt and farm debt as well.

Bennett: And commercial?

Spencer: Commercial debt has come off. Corporate debt has reduced substantially. The banks have seen this. The overall private sector credit growth is in the order of 5 or 6 percent net. If you took out the repayments, it would be
growing at like 20 percent. So there’s a lot of money going out of the banks at the same time as people are still repaying, paying down mortgages, etc.

**Norman** But none the less, I mean, we’ve only had one year, 2011, where there was actually household saving, and every other year there’s household dissaving. Smaller, I’ll give you that. We were minus 8.2 percent.

**Goldsmith** That’s a huge improvement since the early 2000s.

**Norman** That’s right. And now it’s minus 0.6 percent. But given that we accumulated large amounts of debt, we actually need to have—household savings needs to be part of the solution. There is no indication that we’re going to have that going forward, according to these numbers.

**Spencer** The level—John may have further comment—is hard to pick because you get statistical revisions and it can be a bit higher or lower, and recent revisions have actually made it look a bit better. But the key is that it has improved from, as you say, it was a negative number back in the previous boom and through to when the GFC started. There’s been a significant improvement. OK, it looks like around zero in actual terms of household savings rate, but if that improvement is sustained, then that makes a difference over time, and eventually the ratios in terms of debt to income, etc., will start to come off.

**Norman** If income keeps rising.

**Spencer** Yeah.

**Norman** The issue about Government debt—the chair raised the fiscal position of the Government. My recollection through the last housing boom is that the Government was a net saver during the last housing asset bubble. I mean, the previous Government was actually a net saver, so even if the Government becomes a net saver, as you suggest is a positive effect, that didn’t stop us from the last time we went through this massive current account deficit, overvalued exchange rate, high interest rate, housing asset bubble kind of scenario that we appear to be entering into again. So I’m not sure that’s the way out. I’d be interested in your thoughts about that, given that it didn’t save us last time.

My second point is that in terms of the housing market, are you also thinking about the demand side, other than LVRs? The reason I say that is because some of us here are advocates for a capital gains tax, which has some influence on demand side, and also the constraints on foreign buyers. It is an unquantified because there aren’t proper statistics on it. But we are interested in looking at what is going on on the demand side as well in order to take some of the heat out of the housing market, as the LVR does, obviously, as part of that equation as well.

**Spencer** In terms of the fiscal situation in the last boom, you’re right. There were net savers, the Government was a net saver, through to about 2006, and then it turned around. So it wasn’t contributing to the early parts of the boom, but then it probably did contribute to the perpetuation of the boom through 2007 into 2008 before the GFC sort of brought everything down. There was a big turnaround in the fiscal position at that time. On the demand
measures, I think, essentially, we have the LVRs in place. We’re not considering other macro-prudential tools at this time, but, clearly, as in this document, we are talking about a traditional monetary policy tool to help moderate demand next year.

Peters You’ve got your inflation band. You’ve clearly indicated in this paper that you intend to be under 2, right.

Wheeler We said in a press announcement that we believe inflation pressures are increasing and that our objective will be, on average, to be at the mid-point of the band going forward.

Peters Why did you pick the mid-point?

Wheeler That’s a requirement under the policy targets agreement.

Peters For you to pick the mid-point?

Wheeler It’s an objective to have average inflation going forward to be as close to the mid-point as possible.

Peters If you go to page 5, in the last paragraph you say “growing demand and inflation pressure should warrant a withdrawal of stimulus beginning in 2014”. That’s election year. Do you think that’s going to happen?

Wheeler If the question is will the central bank, in the face of an economy that’s growing currently in excess of 3 percent but over the next 12 months to be growing at around 3 percent, when the potential output growth is probably around 2.25 to 2.5—and by potential output I simply mean what’s roughly the full employment rate of growth that’s possible without inflation pressures. So if we’re growing faster than potential, then we’re potentially building up inflation pressures. If the question is will the central bank lean against those inflation pressures, irrespective of an election cycle, the answer is of course.

Hayes Just thinking about your comments and answers going back to the question raised about how do you pay the money back and, well, you pay it back by earning more overseas. OK, so terms of trade have recently increased quite substantially in our favour for the first time in a long time. But I’m just wondering about the broader question of how does monetary policy and fiscal policy interact to avoid the sorts of things that our colleagues are concerned about.

Wheeler Well, one way it can help is in the following context. As I say, you’ve got an economy that’s growing with a lot of momentum now. So it’s growing—over the next 12 months we think it’ll be growing at around 3 percent—and as I said that’s faster than the potential rate of output growth. So what would be damaging would be if the Government, for example, made a decision to increase its fiscal deficit in that situation. If that decision were ever taken, then that would put more demand pressure into the economy, and in order to offset it the central bank would have to work harder and would have to raise interest rates more. It would end up putting not only higher rates but also a higher exchange rate.
Hayes  But the Government’s been quite clear that it’s not going to do that because it’s going to get itself back into surplus. So what other areas are there that you can explore in terms of providing the right sort of economic framework so things don’t get out of control. Because it’s sort of interesting. If you look at the Wellington City Council, they’re busily coming in and saying “Let’s have a working wage.” and it’s not an undesirable objective. But that surely has got to add inflationary pressures irrespective of Government policy.

McDermott  A sort of broad-ranging macro-frameworks. The first answer is: “What are the current conditions on where we’re going?”. And you compared with the last cycle, so an interesting question is why didn’t fiscal policy seem to work in the last cycle? Because we had all those problems. If you look through the information we have here, it was more than offset by what the household sector was doing and the expectations about what was going on with their income and their claims. So the savings rate got down to—we now know it was minus 8 percent; at the time we thought it was minus 14 percent.

So that was a situation where if you’d asked fiscal policy to do all the work, it would have had to run not a surplus of 4 percent, which it did at the time, but it would have had to almost been double that. So that’s a very hard thing to do. When you’re talking about the coordination between fiscal and monetary policy, you probably have to push both ways. So, again, you had tight fiscal policy running with extremely tight monetary policy in that cycle and it took an awful lot even to moderate that cycle.

So part of the lesson is to perhaps not let expectations run ahead of yourself, because we have an inflation target band between 1 and 3 percent, but with inflation expectations running right to the top of that band, and that gives an environment for businesses where you think that if price increases are normally running at 3 to 4 percent and that’s what my competitors are doing, that’s simply what they will do. And that becomes the norm and the standard and it’s very hard to lean against that. So one of the lessons is not being too late in the cycle to manage that.

Foster-Bell  Just on the export sector—very positive, obviously, that we’ve got good terms of trade and better measurement of tourism spending. So it looks like there’s still a lot of strength in the tourism sector. But what are the big risks you can see to the export sector over the next year or so, if any?

McDermott  There is the nature of tourists—one, is the activity and the markets we are selling. So for the moment the international scene seems calm. We’re seeing probably slightly better numbers coming out of the US. Europe’s probably not improving but it’s dealing with very big structural issues—but at least it’s not getting worse at this point. We’re seeing emerging markets with some volatility, but, again, reasonable prospects. All that can change in a moment. There’s a lot of leverage in the global system and so we have to monitor very, very carefully.

The other element we’re looking at is prices. So, again, our export prices are very strong at the moment at 40-year highs. Every time you get to that point
Wheeler Dairy prices are up 50 percent since the beginning of the year, and that’s a massive increase. One thing that’s a concern is how much of our exports are now concentrated with China. I mean, China basically accounts for pretty well the largest market for all our agricultural exports except beef, where it’s No. 2. So that’s a high concentration in one particular part of the world—

Goldsmith It’s 20 percent of the population of the world, though, isn’t it.

Wheeler That’s correct and they’ve got roughly 25 percent of dairy exports or so—that’s a lot.

Parker We’ve got already quite high interest rate differentials between the rest of the world. Interest rates are higher in New Zealand. We’ve got this huge flush of credit still being created in the rest of the world. And we’ve got New Zealand interest rates over the next couple of years going up another 2 percent and the prospect of probably an increase in the interest rate differential between New Zealand and the rest of the world. And we’ve got the history of when we have high interest rate differentials of a financial interest in the banks to take advantage of that margin and lend more money into the New Zealand economy.

I wonder whether, given the trends that we’ve got with asset price inflation—and I know you’re trying to push against them and this prolonged current account deficit—whether you’re looking at whether you’re going to have to introduce some form of controls on the growth in credit. Is there any work being done by the Reserve Bank to consider whether it should be controlling credit growth?

Wheeler No, not at this point. Credit growth will start to slow, one would think, as a result of the rise in interest rates that lies ahead. But you’re right. It’s quite possible that the interest rate differentials with many of the advanced countries widens, and that’s the concern, potentially, on the exchange rate side and the capital inflows that might follow from that. You know, we’re an economy that is, by and large, growing faster than most of the OECD economies. The US economy’s probably growing as fast as New Zealand—has been in the last 2 or 3 years, on average—but the huge difference is that they’re had massive fiscal stimulus and three bouts of enormous quantitative easing to generate the same growth.

The market, I think, is now expecting the US to move to start the tapering process probably in March or April, maybe even in January—the market’s pretty split on that. But once it does start, then there may well be some reaction in long-term interest rates, there may be some exchange rate adjustment, but your key point, which I think—

Parker But given that we seem to be entering into a repeat of earlier cycles, it seems entirely possible that with this differential driving credit flows, we know the
banks are already well within the capital adequacy ratios that you’ve already beefed up and they have already met and are already on the right side of it, we know that you’ve already introduced loan-to-value ratios. If we’re to face the prospect of this cycle getting worse—I’m not saying you should deploy credit growth controls, but I would have thought you’d be doing work as to whether and how you would apply them if the need arose.

Wheeler  We’re doing work in looking at macro-prudential instruments. There were four of them that were in the tool kit, for example, and some of them are employed in terms of the loan-to-value ratios.

Parker  But that’s all from a financial stability viewpoint, isn’t it?

Wheeler  Yes, but some of those do have an impact on the demand for credit, and so will the rise in interest rates that we’re forecasting will take place will also affect the demand for credit. A corollary, however, is that it may attract some foreign capital into the country and put exchange rate pressure up.

Parker  So my question remains. If that starts to happen aren’t we going to be caught unprepared again if you haven’t done the work as to what alternative measures would be to prevent that cycle occurring again?

Spencer  We’ve learnt from history that credit controls generally don’t work. This is why countries through the 1970s and 1980s moved back to using interest rates, because when you have an interest rate policy, that affects the whole market. If you try and contain credit, say in the banking system, then you’ll contain it for a while, but eventually if you hold it on long enough then the pressure will be there, the money will flow around the sides through other instruments.

Parker  Exactly the same criticism can be made of LVRs, and yet you’re trying that.

Spencer  That’s right. That’s why it’s a temporary instrument. That’s why we say it will only be a temporary instrument, not permanent, because the longer you leave it there, then the more that will happen.

Parker  Well, I’m not saying that capital controls should be permanent instruments. I’m just surprised that given that we’ve got this—

Wheeler  I’m just going to answer Mr Parker, if that was fine, but if we’re out of time, I’m happy to leave it.

Goldsmith  If you want to just finish the answer—

Wheeler  You see capital controls introduced in some of the Asian countries and some Latin American countries from time to time. It’s very unusual for a country that’s opened its capital account like New Zealand has to introduce capital controls. An open capital account is probably the most powerful, in a way, the most powerful economic reform that any country can do, because it’s basically saying to the producers in that country that you have to be efficient in world terms in order to attract capital, be it coming from domestic sources or foreign sources, because the capital account’s completely open.
I.3M MONETARY POLICY STATEMENT, DECEMBER 2013

Parker: I understand that and we have seen countries like Chile put a wedge on inflows of capital because they thought—

Wheeler: —and Brazil.

Parker: —and Brazil. Are they—

Wheeler: Latin American countries and I said some Asian countries had done it, but I don’t believe you’ll see that in Western Europe or in the States or Canada.

Parker: Don’t you see this as an outlier already in terms of our net international liabilities? You don’t see our net international—

Wheeler: They’re high and that’s a question of savings investment imbalances and how you can change that sort of behaviour. But it’s not an answer about capital controls.

Parker: It’s a very chicken and egg argument, though, isn’t it?

Goldsmith: It’s an ongoing discussion that I’m sure will continue in the next meetings. Thank you very much for coming in and we appreciate your time.

conclusion of evidence
Budget policy statement 2014 and Half-year economic and fiscal update, December 2013

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Paul Goldsmith, Chairperson)
March 2014

Presented to the House of Representatives
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Budget policy statement 2014 and Half-year economic and fiscal update, December 2013

Recommendation

The Finance and Expenditure Committee has considered the Budget policy statement 2014 and the Treasury’s Half-year economic and fiscal update, December 2013, and recommends that the House take note of its report.

Introduction

The Minister of Finance’s Budget policy statement 2014 was published on 17 December 2013 with the Treasury’s Half-year economic and fiscal update, and stood referred to the Finance and Expenditure Committee. This report summarises the key points from the two documents, and from our hearings with the Minister of Finance and the Treasury.

Summary of Budget policy statement 2014

The Budget policy statement outlines the Government’s plans for Budget 2014 and subsequent years. Four current priorities will be maintained: managing public finances responsibly, making the economy more productive and competitive, delivering better public services within tight financial constraints, and rebuilding Christchurch.

The Government’s operating balance before gains and losses is forecast to be $86 million in 2014/15, a slight improvement on the $75-million surplus forecast in Budget 2013. Thereafter, surpluses are forecast to increase, to $1.7 billion and $3.1 billion in the following two years, with debt starting to be reduced. Net core Crown debt is expected to peak at 26.5 percent of GDP in 2014/15, well below the 30 percent ceiling set by the Government, and to fall to 16.9 percent in 2019/20.

The Budget policy statement reaffirms the Government’s intention to keep a tight rein on its spending. As in previous Budgets, the priority for new spending will be given to health and education, with most other areas expected to remain within existing baselines. The operating allowance for new initiatives in Budget 2014 will be $1 billion. New capital spending will be funded by reprioritising existing capital expenditure, and from the proceeds of Government share offers which are now expected to raise between $4.6 and $5 billion. Budget 2014 will provide details of allocations of these proceeds from the Future Investment Fund for investment in priority public assets.

Beyond 2014/15, the Government intends to continue to restrain and reprioritise spending in order to pay down debt and rebuild buffers against shocks. Contributions to the New Zealand Superannuation Fund are projected to resume in 2019/20, a year earlier than envisaged in Budget 2013.

The Budget this year will be delivered on 15 May 2014.

Economic context

The Treasury’s economic and fiscal update indicates that New Zealand’s economy is well placed at present, exhibiting a relatively strong upturn in growth, and falling
unemployment. GDP grew by 2.5 percent in the year to June 2013—one of the higher growth rates of OECD countries—despite the effects of the drought in the first half of 2013. GDP is forecast to grow by 3.6 percent in the year to March 2015, and by an average of 2.3 percent thereafter. The unemployment rate is forecast to decline to below 5 percent by 2018.

The main factors expected to drive growth in demand are rebuilding in Canterbury, strong terms of trade, and rising incomes from a strengthening labour market. Real wage growth is forecast to average 1 percent a year. Higher net migration than expected is also expected to boost demand in the short term, and to add later on to the economy’s supply potential. Continued fiscal restraint by the Government is likely to dampen demand slightly, but will also help to free up resources for activity elsewhere, and should allow interest rates and the exchange rate to be lower than they might otherwise have been.

The Reserve Bank is expected to begin increasing interest rates in 2014. The 90-day bank bill rate is projected to rise from 2.7 percent to 3.6 percent in the year to March 2015, and to around 5.2 percent by March 2018.

The exchange rate is expected to remain elevated for several years. While this will hinder export and import-competing industries, exporters should nevertheless benefit from terms of trade that are likely to remain close to historic highs over most of the forecast period as global demand for New Zealand’s commodity exports increases.

New Zealand’s economy is expected to average stronger growth over the next four years than many other developed countries, including the Euro area, the US, the UK, Japan, and Canada. While the outlook for growth in developed economies is better than previously expected, emerging economies may be more volatile, especially as monetary authorities in major economies start to unwind quantitative easing measures, which have offered a stimulus over recent years. Generally, however, the prospects for New Zealand’s trading partners are described as “benign”.

**Risks in the forecasts**

The economic and fiscal update highlights several variables which could either speed up or slow economic activity. They include the scale and pace of work on Canterbury’s rebuilding, the extent of the current turnaround in migration flows (higher immigration would add to short-term housing market pressures), movements in the terms of trade and the exchange rate, and households’ caution in their spending and saving. Global risks include slower growth in the Australian economy as mining investment falls, and potential volatility in China and emerging markets.

The Budget policy statement also notes that the Government’s fiscal balance will be strongly influenced by fluctuations in the financial and commercial components of the Crown’s balance sheet. Changes in profits from state-owned enterprises, interest rates, and the investment earnings of the New Zealand Superannuation Fund and the Accident Compensation Corporation could all significantly affect the result for the operating balance.
Summary of the Treasury’s economic forecasts

The following table sets out the Treasury’s principal forecasts.

<table>
<thead>
<tr>
<th>March years, %</th>
<th>2013 Actual</th>
<th>2014 Forecast</th>
<th>2015 Forecast</th>
<th>2016 Forecast</th>
<th>2017 Forecast</th>
<th>2018 Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic growth</td>
<td>2.7</td>
<td>2.7</td>
<td>3.6</td>
<td>2.7</td>
<td>2.0</td>
<td>2.2</td>
</tr>
<tr>
<td>Consumer Price Inflation</td>
<td>0.9</td>
<td>1.4</td>
<td>2.4</td>
<td>2.4</td>
<td>2.3</td>
<td>2.2</td>
</tr>
<tr>
<td>Unemployment rate (March quarter)</td>
<td>6.2</td>
<td>5.8</td>
<td>5.6</td>
<td>5.4</td>
<td>5.2</td>
<td>4.7</td>
</tr>
<tr>
<td>Current account (% of GDP)</td>
<td>(4.5)</td>
<td>(4.2)</td>
<td>(5.5)</td>
<td>(6.3)</td>
<td>(6.5)</td>
<td>(6.4)</td>
</tr>
<tr>
<td>Current account excluding Canterbury rebuild investment (% of GDP)</td>
<td>(3.8)</td>
<td>(3.1)</td>
<td>(3.9)</td>
<td>(4.4)</td>
<td>(4.5)</td>
<td>(4.7)</td>
</tr>
</tbody>
</table>

The challenges ahead

With this positive outlook, and especially the boost over the next few years from Canterbury’s reconstruction, some commentators have dubbed New Zealand a “rock-star economy”. The Treasury cautioned that while the short-term outlook is certainly enviable, prospects in the medium term are more modest, and care will be needed to ensure the projected results are actually achieved.

Both the Minister of Finance and the Treasury emphasised that continued restraint in spending will be needed for several years, even after the Government’s books return to surplus. With the economy likely to be operating at full capacity or beyond over the next year or so, excessive government spending would risk driving interest rates higher than they would otherwise need to go. In turn, this would put upward pressure on the exchange rate and undermine the export-oriented sectors which are crucial to raising overall living standards for the country.

They stressed that lessons should be learned from the last decade, when governments and households overextended themselves with debt-fuelled spending and runaway asset prices, and felt the effects when recession struck. With the economy now expanding, there is a golden opportunity to build the platform for sustained growth over the longer term. To do so, the focus should be on the challenges of improving educational outcomes, lifting productivity, strengthening international connections so businesses can access emerging markets, and pursuing productivity in the public sector.

Improving international competitiveness

The Government’s strategy for lifting growth and incomes continues to focus on improving New Zealand’s international competitiveness, and rebalancing the economy toward the tradable and export sectors.

The Minister said that numerous microeconomic reforms under the Government’s business growth agenda are starting to bring about some improvement in productivity and competitiveness. The tradable sector has grown by about 11 percent since 2009, compared with 6.5 percent for the non-tradable sector. He acknowledged, however, that there is still some way to go. Rebalancing will require several more years of effort, he said, including

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1 Budget policy statement 2014, p. 3.
efforts to improve the efficiency of the housing market, and to reduce government spending as a share of GDP, so that resources are freed up for productive investment in the export sector.

Some of us consider that the rebalancing strategy has failed, as the non-tradable sector continues to absorb a growing proportion of GDP, and the current account deficit is increasing. The Minister said the process of encouraging the moving of resources from the domestic and government sectors into exports entails a major structural shift. It is a long-term process and would take time to show results, but he believes the policies are pushing in the right direction. He emphasised that consistent effort will be needed, avoiding stop-go economic policies.

**The current account deficit**

The current account deficit is lower than previously projected, at around 4.5 percent of GDP, but the Treasury forecasts it to increase to about 6.5 percent of GDP by 2017.

It should be noted that the Treasury’s figures overstate the current account deficit, as they were prepared before recent changes in the methodology used by Statistics New Zealand resulted in historical data for the current account deficit being revised downward. However, the trends indicated in the forecasts remain relevant.

The Minister said he is more optimistic about the prospects for the current account deficit than the Treasury, noting that their forecasts have consistently tended to overstate the deficit for several years. We heard that no specific differences between the assumptions of the Minister and the Treasury had emerged; it was more a matter of their respective degrees of optimism.

Some of us remain concerned by the size of the current account deficit, which is one of the worst in the OECD. Along with renewed house-price inflation, it appears to indicate a failure in efforts to rebalance the economy, and a repeat of previous problems.

The Treasury pointed out that the projected deterioration in the current account deficit reflects the imports needed for post-earthquake rebuilding. As shown in the summary table above, their projections separate out the portion of the current account deficit attributable to Canterbury’s rebuilding—about 1 to 1.5 or 2 percent of GDP each year—since it can be viewed as investment expenditure, rather than simply consumption. The remainder, about 4 to 4.5 percent of GDP, is more indicative of the gap between New Zealand’s income and its expenditure. The Treasury agreed that closing this gap is crucial for New Zealand to grow sustainably. This was why the Government was focused so strongly on improving international connections, and was reviewing all policy settings to see how New Zealand’s education, infrastructure, trade, and overseas investment, both inward and outward, could support the country’s connections with the rest of the world more effectively. Much work was also going into finding ways of lifting productivity and encouraging innovation.

**External liabilities**

We note that a recent report by the rating agency Moody’s Investors Services commented that New Zealand’s main vulnerability is its longstanding reliance on foreign savings to finance relatively large current account deficits. The Minister told us he does not believe New Zealand’s external liabilities represent such a high risk. Most are on the balance sheets of Australian banks, he noted, and with low interest rates at present from a glut of global savings, he believes it makes good sense to use other people’s savings by borrowing
externally. He also noted that the analysis by Moody’s used current account data which has since been revised downward.

**The exchange rate**

Treasury’s projections indicate that the exchange rate will remain elevated for some years. Asked whether the Government would consider intervening to stop any further appreciation, the Minister reaffirmed the Government’s longstanding policy of not intervening in the currency market. He noted that the Reserve Bank has the capacity to do so under certain conditions, but he believes the Government can help the currency best by promoting a competitive economy through sound microeconomic policy and careful management of its own spending. He also observed that there are always two ways of viewing the dollar’s value. Its strength over recent years helped to cushion New Zealanders during the recession, giving them their best purchasing power for a generation.

**Fiscal management**

The Minister told us he is reasonably confident about controlling spending and reducing debt as the Government’s fiscal policy is focused on controlling the long-term drivers of spending. Through welfare reforms and the better public services programme, it is seeking to ensure public services address underlying problems and needs. He considers this more effective than broad programmes based on universal entitlements.

Some of us are concerned about the likelihood of reining in government spending if the cost of national superannuation continues to grow by $500–600 million a year. The Minister said he does not believe the ageing population will have such a negative impact as people fear. In his view, the economy copes with demographic changes reasonably successfully, for example accommodating a dramatic rise in the number of single-parent households over the last 20 to 30 years. Rather than focusing policy on the single issue of pensions, the Government has chosen to address welfare dependency and growing costs in health and education spending, which together exceed the growth in national superannuation.

**Tax policy**

Challenges posed by the rapidly-growing digital economy attracted much interest at the recent World Economic Forum in Davos, Switzerland—particularly the way the internationalisation of businesses tends to erode the tax paid in countries where goods and services are actually consumed. The Minister said he shares concern about such developments, but believes New Zealanders’ growing fondness for internet shopping is as much responsible for erosion of the Government’s tax base as avoidance of tax by multinational corporations. He said the Government is taking all the steps it can to protect its tax base and enforce New Zealand law, but believes the most effective action New Zealand can take as a small country is by working in concert with other economies, through groups such as the G20.

Some of us consider the Government could be doing more to protect New Zealand’s tax jurisdiction, and suggest it should tax international companies at the banking level through a turnover tax. The Minister said the issue was far more complex than it might appear, and he does not support a turnover tax.
***Government support for businesses***

As asked whether he and other Ministers thought governments should intervene to support specific industries, the Minister said the Government adopts a fairly balanced, pragmatic policy. In general it believes industries should try to be as competitive as possible and not rely on the Government to prop them up. However, it has long provided support for businesses’ research and development work; this spending has had mixed success, and efforts are being made to target it more effectively.

As to the criteria it uses, for example in deciding to provide support for the film industry, the Minister said sometimes the historical background was relevant; sometimes providing support brought related opportunities—for example, the promotion of New Zealand through the *Lord of the Rings* films; and sometimes support was provided to foster technological innovation, to help diversify New Zealand’s predominantly agricultural economic base. He recalled that with the film industry, it had become clear quite suddenly that the competitive effect of other countries’ subsidies could have killed off the industry; there was no intention of subsidising it long term, but a trade-off had been necessary while the industry adjusted its business models.

***Regional development***

We discussed with the Minister the economic disparities between New Zealand’s regions. Some of us are concerned about the empty shops in many small towns, and believe the Government could assist by providing incentives for industry to move away from metropolitan centres and to invest in struggling regions; there particularly seems to be scope for helping the forestry sector in areas like the volcanic plateau, Southland, and the far north, with benefits for the environment, catchment, and jobs.

The Minister said data shows that growth in the far north and East Coast has lagged behind; most other regions are doing reasonably well, with growth strongest in Taranaki, and increasingly Southland. He believes the difficulties facing main-street retailers are not because of a lack of income in their communities, but because of a structural shift in shopping patterns, in favour of online shopping.

As for industry incentives to support regional development, the Minister said history shows that such interventions generally do not work. Without a strong economic base, subsidised industries tend to falter after a time. Some of the forestry subsidy schemes launched in the 1990s were still running in modified form on the East Coast, but both there and in Southland plantations were often too widely dispersed for large-scale processing companies to be interested in investing. In his view, new thinking is needed on Government interaction with communities in the far north, as traditional policies over the last 30 years may have disempowered rather than helped people.

The Treasury added that it has been working with the Ministry of Business, Innovation and Employment on policies to encourage more even growth across New Zealand’s regions. There was obviously a focus on Christchurch at present. Decisions taken about Solid Energy had factored in its importance for the West Coast, and the potential impact on Southland’s economy of closing the Bluff smelter had been a factor in dealings with Meridian and Rio Tinto.

Some of us see clear evidence of market failure in some regions, and believe there is no alternative to substantial Government support for regional industries if certain regions are to survive economically. Some of us suggested that the Treasury develop policies for a
more activist state role in such regions. The Treasury said it does not actively promote specific policies, but has always maintained that there is a case for government intervention where there is evidence of market failure. It sees its role as indicating a range of policy options and analysing their potential consequences, to assist the Government of the day in making decisions.

**Housing market and capital gains tax**

The Minister said that unjustified restrictions on supply have been the main factor behind house-price escalation. He said it has taken time to determine what the problem was, and to reach agreement with councils on more flexible regulations to improve supply. He believes there is now more cooperation from councils, but still some way to go to make housing more affordable for the long term.

Some of us take a different view, agreeing with the OECD that the absence of a capital gains tax in New Zealand is one reason there is so much unproductive investment in the housing sector. Some of us are disappointed by the Government’s reluctance to adopt a capital gains tax, and reject the argument that such a tax would need to apply to all housing to avoid distortions, noting that most Western countries tax capital gains on rental housing, but not on owner-occupied dwellings.

The Treasury said it has not done any detailed design work on a capital gains tax; however, the papers accompanying its 2013 statement on the long-term fiscal position included a summary of various tax options and the trade-offs they entailed. Some of us suggested that, in view of the forthcoming general election, the Treasury would do well to carry out some preparatory background work for such a policy.

**Income inequality**

We discussed with the Minister the issue of income inequality in New Zealand, and sought his comment on a submission from Caritas Aotearoa New Zealand expressing concern that poverty and inequality have increased in recent years. The submission suggested that economic growth would worsen the situation in the absence of specific policies to address poverty.

The Minister said he does not agree that income inequality has worsened in New Zealand. He observed that various measures are used to assess income inequality, and all show the trend to be flat or improving. We note that analysis from the Ministry of Social Development appears to indicate that the long-term trend has generally been flat, with one measurable decrease in inequality in the mid-1990s attributable to the Working for Families tax policy.

The Minister accepted that income inequality in New Zealand has been above the OECD average, but believes the gap is lessening. The Government has been focusing on removing potential barriers to social mobility, such as persistent educational underachievement, low immunisation rates, and dependency on social housing. It believes that reorganising public services to address issues such as these will improve New Zealanders’ prospects for better incomes over the long term.

Some of us remain concerned that New Zealand’s wealth is being concentrated in fewer hands, and see the decreasing rate of home ownership in cities like Auckland as evidence of rising inequality, which a capital gains tax could help to improve. The Minister said he does not see a tax on successful businesses as the answer. With the housing market, he considers
the biggest source of inequality to be planning rules that deliberately drive up the price of inner-city housing, forcing low- and middle-income housing further out to areas where access to work and education is difficult. He said the Government is working to change this.
Appendix A

Committee procedure
We met on 29 January and 5 March 2014 to consider the Budget policy statement 2014 and the Half-year economic and fiscal update, December 2013. We heard evidence from the Minister of Finance and the Treasury.

We received two submissions, from Federated Farmers of New Zealand and Caritas Aotearoa New Zealand.

Committee members
Paul Goldsmith (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
John Hayes
Hon Shane Jones
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Jami-Lee Ross
Hon Kate Wilkinson
Appendix B

Corrected transcript of hearing of evidence 29 January 2013

Members
Paul Goldsmith (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
John Hayes
Hon Shane Jones
Dr Russell Norman
Hon David Parker
Rt Hon Winston Peters
Jami-Lee Ross
Hon Kate Wilkinson

Witnesses
Hon Bill English
Dr Girol Karacaoglu (Deputy Secretary, Macroeconomics, International & Economic Research, Chief Economist—Treasury)
Bill Moran (Deputy Secretary, Strategy, Change and Performance—Treasury)
John Crawford (Deputy Secretary, Commercial Transactions—Treasury)

Goldsmith Welcome, Minister, to the committee, and happy New Year to you and all of your officials, and to the media here as well. So I welcome you to give us a bit of an update first, or your summary of the Budget Policy Statement. And then we’ll have some time for some questions.

English Thank you, Mr Chairman. The half year update and Budget Policy Statement confirm that the Government’s programme to build a faster-growing economy with more jobs and rising incomes is contributing to some positive results for the economy. The updated forecasts show a relatively strong upturn, with growth reaching 3.6 percent in 2015, and the unemployment rate falling. While the recovery here is gathering momentum, the global environment still remains uncertain.

There is likely to be better than expected growth in developed countries, developed economies, but a bit more uncertainty and volatility in the less developed economies. In this environment, it is important to maintain clear and credible economic and fiscal policy, as this certainty and predictability will help create new jobs, raise incomes, and help families get ahead. The latest forecasts show the Government posting a modest operating surplus before gains and losses of $86 million in 2014-15, similar to the $75 million surplus forecast in Budget 2013. Surpluses are then forecast to increase to $1.7 billion and $3.1 billion in the following 2 years. Debt is forecast to begin falling, with net Crown debt expected to peak at 26.5 percent, significantly below the 30 percent ceiling that we’d set, before falling to 16.9 percent of GDP in 2019-20.
The Government remains committed to responsible long-term fiscal management, as the Budget Policy Statement says. In particular, it is important through the positive part of the cycle to maintain responsible fiscal management. Improving public sector performance will continue to assist an ongoing spending restraint beyond 2014-15. I would emphasise that regardless of surpluses, we will continue to work on our better public services programme, focused on results, rather than spending more money. This will allow us to pay down debt in nominal dollars from 2016-17, and begin building a buffer against future shocks.

There is still a lot of work ahead to make these forecasts and projections a reality. In this year, the Government is borrowing a net $78 million, on average, every week, in dollar terms, and net debt will peak at $64.5 billion in 2015-16. It is also important to avoid the mistakes of the mid-2000s, when large increases in Government spending and a booming housing market drove interest rates and exchange rates to higher than necessary levels, and eroded productivity, and, in fact, tipped our export sector into recession before the global financial crisis. So we will continue to address these significant economic challenges, including a sustained rebalancing towards those sectors of the economy that compete internationally. That will certainly involve continued work to improve the efficiency of our over-priced housing market.

A broad range of targeted micro-economic reforms are currently under way through the Business Growth Agenda, focused on lifting our competitiveness. Since mid-2009, the tradable sector has grown by around 11 percent, after going into recession in 2005. At the same period, the non-tradable sector has grown by about 6.5 percent. This is something of a start on rebalancing, but successful rebalancing will require consistent and positive change over several years.

So New Zealand is well placed compared to most countries. On average, wages are increasing faster than inflation. Business confidence is reasonably high, and in terms of trade remains high. There are over 53,000 more people employed now than a year ago, and the unemployment rate is dropping, although still not as fast as we would like to see. As set out in the Budget Policy Statement, Budget 2014 will continue to focus on the Government’s priorities: responsibly managing its own finances and returning to surplus, pushing ahead with micro-economic reforms, driving better results in our public services, and supporting the rebuilding of Christchurch.

I can announce to the committee today that the Budget this year will be delivered on Thursday, 15 May. It will further focus on supporting more jobs and higher incomes. Providing we stick with our programme, New Zealand is well placed to take advantage of the many positive factors supporting the economy at the moment to help lay a platform for taking the significant opportunities we have over the next 5 to 7 years. I’m happy to take questions.

Thank you, Mr Treasurer. A key part of what features in this bland Budget Policy Statement is an assertion on your part that public sector productivity is going to be dealt with as a part of reining in expenses, and you’re going to deal to longer-term drivers of Government spending. How on earth can that be
true when you remain disinterested in dealing with the rising costs of our pensioners?

English We don’t remain disinterested in it. I mean, there’s a set of policy positions that have been laid out there—the Government has a position, the Opposition has a position. I think those are well understood. But in general terms, superannuation is actually a straight-forward issue. If you want to spend less on it, you pay less money or you pay it to less people, and maybe both. That’s very simple. The fact that the Government’s taken the view that it has around super means we haven’t continued what’s been I think for the last 15 to 20 years something of a policy obsession with the ageing population. In my view, it’s not going to be as negative an experience as everyone thinks. But it has enabled us—

Jones Why is that, Bill? Why don’t you think it’s going to be negative?

English Oh, just because in open economies we deal with demographic changes all the time reasonably successfully. So the rise of the sole parent household has been quite dramatic, actually, in demographic terms in the last 20 or 30 years, but we’ve accommodated it. The rise of the single person household—these are things that have been happening under our noses and because we haven’t really noticed them we haven’t spent a whole lot of time trying to make policy to accommodate them. So an ageing population is just going to have another set of changes that ripple through the economy, which I’m sure we’ll handle.

But the point that I was going to make is that it’s enabled us to focus on all the other long-term drivers, which are much more complex to deal with. So the issues in the justice system—there’s no doubt that there is a feeder system there, particularly from children in State care right through to young people who go off the rails into a very expensive justice system—and at times an inefficient one. And understanding those drivers and how to intervene will make a significant difference to our expenditure, as it will with the welfare reforms focusing on long-term dependency, where we’ve now got very rich information about who’s there and what we can do to help them. So that’s why we’re confident.

Jones But when you look at key drivers in terms of the Crown accounts—money going out to our fellow New Zealanders—each year the amount of dough going out to meet our senior citizens grows inexorably.

English Yeah, it goes up 5—

Jones Are you imagining that, on the strength of a growing economy, we’ll just support it indefinitely?

English Well, look, it goes up $500 million or $600 million a year. So it is a growing impost. Other costs are going up as well. The combination of unchecked welfare dependency and growth in health costs and the growth in education spending that has not led to much shift in achievement until recently exceeds the growth in national super. So all I’m saying is in the policy world it’s been seen as the one big one, but actually it’s just part of a picture of changes in the composition of Government spending, and we’ve been focusing on all the other ones.
Jones: I’ve got a slightly different question, if I can ask it now. I’m from the far north and you’re from the south, etc., and I just don’t accept your assertion that regional New Zealand is recovering. Everywhere I go there are empty shops, there are people unwisely still going to Australia. And really you seem either disinterested or incapable of focusing the State’s attention really on resuscitating some of our regions. Is that a deliberate strategy—that it will all flow out from metropolitan New Zealand?

English: I disagree with a fair bit of what you’re saying, but not all of it. There are a couple of regions where—we’ve got quite a lot of regional information now around GDP and the make-up of it, and what shows out is that the far north and the East Coast lag quite a bit. Taranaki is at the front end and Southland is getting up there, and most of them are doing pretty well. Now, you’ll know as well as I do from knowing these areas that there is a combination of things going on. And you’ll have more of this in the north than we have in the south, but, for instance, the structural shifts in retailing are putting more pressure on our main street shopping, even though the total incomes in our regions are better than they’ve been in a long time. One is offsetting the other. So if you go to Balclutha there are empty shops; if you go to Winton—in my electorate—it’s a thriving town but it does have some empty shops and it’s been quite a while since it had empty shops. But that’s not to do with lack of income; that’s to do with the shifts in shopping patterns.

Jones: Why have you not seen it worthwhile to actually incentivise industry to either relocate or invest in those regions and try and reduce, for example, the exportation of a lot of our raw material?

English: Because I think the track record of those sorts of interventions show that, generally, they don’t work—that unless an industry has a pretty strong, sustainable economic base, it’s going to last for a while and then disappear. It’s been difficult—Government has had a crack at that—but it’s been difficult. If you think of the marine cluster in Auckland, where Government put a lot of money into it over the last 15 years, it just hasn’t worked because the economics of it have made it pretty difficult. So I think it’s a matter of pragmatism. It’s hard for subsidised industries to get a grip. It’s not to say that there aren’t possibilities of focusing more of our business support in ways that favour the regions—that’s possible.

Jones: My final point: I think about something, for example, in the days of—and I’m being quite serious when I say this—of the days of Falloon and others, when they did employ the resources of the State to incentivise forestry, for example. Southland, after the volcanic plateau, is actually the largest forestry estate, and then there’s us in the north. Why have you not thought about directing incentives or resources in that sense to actually achieve catchment outcomes, environmental outcomes, and actually mahi—jobs in these areas—which are becoming both lawless and totally neglected?

English: Well, I think all of those things have been thought about. In fact, the forestry subsidy scheme begun by John Falloon is still running on the East Coast, in modified versions. Again, the economics of these things are pretty tricky. So even down south, where we’ve got more favourable geography than the north
for forestry, the plantations are too widely dispersed for a really large-scale processor to be able to aggregate sufficient supply. In fact, now there is apparently a shortage of logs for framing timber. We’ve got large-scale processes there, like the fibre-board plant. So, look, in the far north, it’s got its own particular challenges. But I think the models of Government intervention that have applied there over the last 30 years have probably disempowered them rather than help them much. My own view is that we need to rethink how Government interacts with the far north much more along the lines of sort of sound development economics rather than traditional Wellington bureaucracy policy.

Jones Well, on the latter I agree with you, but I certainly disagree with you in terms of incentivising industry in those parts of New Zealand where there is bugger all happening, and we don’t seem to be governing for the entirety of our country.

English Well, I don’t agree with the conclusions you’re jumping to, but reasonable people can disagree over the way Government interacts. All I’d say is that decades of intervention in the north by Governments don’t seem to have worked. We seem to have a culture and a climate there where aspirations have been killed off by the way the Government has dealt with them.

Barry The annual credit analysis, the update to investors, was released today by Moody’s. We’ve got a triple A rating. The economy and the Government finances are deemed by that group to be very much on an improving trend with a stable outlook. In the detail of their credit analysis today were there any helpful things that you are going to take on board in terms of managing the economy?

English I haven’t had a look at all the detail of it. It’s kind of an assessment rather than a rating. They’re not even confirming the rating; they’re just giving their view about New Zealand. The bit that Moody’s, like the other rating agencies, always focus on is New Zealand’s external liabilities. I’ve always found their analysis of it a bit unsatisfactory—and I’ve had this discussion with them—and by that I mean that a big chunk of New Zealand’s external liabilities are actually on the balance sheet of Australian banks, as a kind of intermediary. So the sort of sense of riskiness is, I think, a bit less than perhaps the rating agencies might say.

The second thing is that when you’ve got a glut of savings in the world, as we have—90 percent of developed country GDP is on interest rates of 0 to 1 percent—it actually makes a lot of sense to use other people’s savings. And you can argue that in the financial crisis the diversification of our funding sources turned out to be a protection rather than a risk. Others, like Ireland and Spain, discovered that concentration of funding sources through your banking system was actually a very big risk. It can stuff your sovereign capacity. So that’s an ongoing discussion I’ll have with Moody’s.

The one good piece of data related to their concern about the current account deficit is if you look going back through Treasury’s forecasts of the current account deficit, they have been—it may be cyclic. This may be a sort of cyclical forecasting effect. But it has turned out just a bit better than they expected for
the last 4 or 5 years. If you combine that with the revisions by the Department of Statistics, which have been consistently positive for our current account deficit over the last 3 or 4 years, the picture is a wee bit better than what’s lodged in Moody’s mind, which is 7 to 8 percent current account deficits from the mid-2000s.

Parker Not that much better though, because even taking into account those revisions through the data series, which were revised downwards, both for historical and projected current account deficits, they’re still projecting the current account deficit in your economic outlook and Budget Policy Statement to widen to 6.4 percent from 2014 onwards.

English Well, they’ve been projecting that for the last 4 or 5 years, and we’re running under 4 at the moment, lower than nominal GDP, which is not a bad place to be. So this is just a point of disagreement.

Parker Are you saying you think your own department is out by 50 percent and we should believe you rather than your department?

English Well, they have been, yes. In fact, I’ve been right by taking a more optimistic view about New Zealand’s adjustment. They’ve turned out to be less accurate.

Parker Haven’t they already revised their historical statistics to take into account your optimism, Minister? Are you seriously saying that you think your department is out by 50 percent in their projection of the current account deficit and therefore we ought not to worry about it?

English No, that’s jumping to conclusions.

Parker Sounded like that.

English All I’m saying is that I consistently have taken a view that New Zealanders aren’t stupid and we need a much better understanding of why they make the decisions they do that affect the current account deficit. Policy makers in Wellington have taken the view, consistently, that New Zealanders might be stupid. And I don’t think that’s the case. So this is just an ongoing debate we have. But in terms of forecasts, the out-turns have been a bit better than Treasury has forecast, pretty consistently now.

Parker Well, in respect of the behaviour of New Zealanders, which is not stupid but does respond to economic signals that are set by the Government, the OECD say that one of the reasons why we drive so much non-productive investment into the speculative housing sector is the absence of any tax on capital income, or the very narrow level of taxes on capital income compared with overseas countries. Yet you refuse to move on that, notwithstanding these enormous increases in house prices and those rental increases that were reported year to year in the likes of Mt Roskill of over 20 percent.

English I think, as we’ve discussed before, in our view the main influence on the escalating house prices has been unjustified restrictions on supply. That’s why the Government has focused pretty strongly on working out how to make supply regulation more flexible. We’ve had a lot of discussion and cooperation from councils, but I think we’ve got some way to go. It’s going to require—

Parker Five years on it hasn’t worked so far.
English  Well, the actual lead legislated changes came into effect about 3 or 4 months ago.

Parker  After the horse had bolted.

English  Well, you can argue that, but it took a while to get to the bottom of the issue, develop the tools, and get them in place alongside the political agreements with the councils. So, yes, it could have happened faster. On the capital gains tax issue, if you argue that tax is a significant distortion in this case—and, of course, some people argue that it’s not—then surely the answer would be to tax the whole thing, actually tax the housing market. I don’t think anyone is proposing that. They’re proposing to tax some of it.

Parker  Virtually no one in the Western World does that, but virtually everyone does it in respect of rental housing as opposed to owner-occupied housing. Are you saying the Governments of the rest of the world are wrong on this one and that you’re right: we should tax everything?

English  The argument that it will fix housing prices isn’t borne out by the evidence. The evidence is that the one thing that has an impact in the long run on affordability of housing is—

Parker  I didn’t say that. I was talking about the influence on the shape of the economy and the current account deficit. I didn’t talk about housing prices. Can I move onto the issue of the fairness of our tax system. One of the two submissions that we’ve received on your Budget Policy Statement comes from Caritas, and they say: “Poverty has grown and inequality has increased in recent years. The Treasury forecasts and the Budget Policy Statement predict a gradually improving economy. Priorities should be to ensure that economic growth reaches and benefits all New Zealanders. Unless specific attention is given to addressing the issues of poverty, economic growth will simply reinforce and worsen inequality.” Do you agree with that?

English  No, I disagree with just about every statement in that submission.

Parker  So you don’t think that inequality is increasing in New Zealand?

English  No, it isn’t. And it doesn’t matter which measure—this isn’t often the case—but it doesn’t matter which measures you use. It’s either flat or improving.

Parker  Are you then referring to the income inequality of taxable income as measured by the Gini coefficient? Is that what you’re relying upon as your statistic?

English  It doesn’t matter whether you use the Gini coefficient or the 60 percent of median income or 80 percent or the 80:20 or the 60:40. They all show the same thing.

Parker  How do you explain the decreasing rates of homeownership, especially in Auckland, census to census, if it’s not the concentration of wealth in the hands of fewer people?

English  My view about that is it’s related to the lack of thought given to the regulation of housing supply in Auckland. Over the last 12 or 18 months we’ve had very fruitful discussions that are helping to clarify what they think they’re trying to do.
Parker Well, that might be an answer as to what is the total level of supply of housing in Auckland, but not who owns it. So can you answer my question again? How do you explain decreasing rates of homeownership in the likes of Auckland if it isn’t a measure of rising inequality?

English I don’t know why it would be—I don’t see any logical connection between changes in homeownership levels and inequality. In fact, there isn’t rising levels of inequality. By any of the standard measures that are applied, the data shows it’s either improving or flat.

Parker Is the Gini coefficient, which is the measure that you prefer of income inequality, at the highest that it has ever been in New Zealand?

English It’s not a matter of what measure I prefer. I don’t have a preferred measure, because there isn’t one way of measuring inequality.

Parker I’m trying to pin you on measures. It seems to be the one that Mr Joyce and Mr Key have relied upon as reference to the 80:20 percentile of the Gini coefficient. Is that the highest that it’s ever been in New Zealand’s history?

English Well, I can’t answer that specifically. What I do know is the trend line around the Gini coefficient shows that it peaked around 2005 and it has been flat, with the exception of one tweak up related to the recession, and then it has dropped back down again.

Parker So in terms of the long-term trend, then, of income inequality as opposed to wealth inequality, which is different, do you accept that the only substantial decrease in that inequality was caused by the Working For Families tax package, which your leader called “communism by stealth”?

English Ah, no.

Parker And that since then it has remained flat?

English Ah, no, I do not agree with that, necessarily.

Parker So are you aware that income inequality in New Zealand is above average for the Western World, the OECD countries?

English It has been, but the OECD—they are tending to converge. And the point about this is not so much—I mean, you can argue about the measures, and I’ve told you what the data actually tells us. We unashamedly take a view—

Parker No, you haven’t told us what the data’s showing. You won’t be pinned on a measure.

English Well, I have. You can look at any measure. MSD do a report initiated by the previous Government every year on this, and you’ve just got to have a look through it and look at the data. But in any case, whatever the measuring of it—and we’ve got a whole class of educated measurers—we are putting a strong focus on dealing with those things we believe are barriers to mobility. And there’s a number of them. One has been a social housing system, which has been a significant barrier to mobility. It has locked people into dependency. Another has been persistent educational underachievement. Another has been persistent health issues—things like low immunisation rates and incidence of rheumatic fever. Solving those issues is quite complex, and we’ve unashamedly
focused on public accountability for those with our published results and then reorganising our public services in a way that is going to lead to success rather than feed off failure. We believe, in the long run, that’s going to have real impact for real New Zealanders and their prospects of better incomes.

Parker But despite having, according to the OECD, higher rates of income inequality, which feeds in over time to higher rates of asset inequality, you don’t agree with the OECD recommendation that you start taxing capital income for both economic and fairness reasons?

English Well, as you know, there are quite a lot of taxes on capital income. We don’t think that the capital gains tax of the sort that is being proposed, which is effectively a tax on successful businesses, is the answer.

Bennett Is the Labour policy around capital gains actually the equivalent of the OECD policy on what a capital gains tax would look like?

English Well, no, and almost no actual policy reflects the OECD’s recommendation, which has its own logic, which says you should tax all forms of income across the whole tax base, and that includes taxation of increase in value of the family home. The capital gains taxes that are in place tax the growth in value of businesses and the growth in the value of investor housing, which is, at the most, a third of the housing market, so it leaves out what is arguably—if you believe that growth in housing values are a generator of inequality—the biggest generator of inequality, which is domestically owned homes. I actually think in the housing market the biggest generator of inequality are planning rules that deliberately drive out low and middle-income housing and deliberately drive up the prices of housing so that we can have nice-looking apartment blocks in the so-called liveable city, not those messy low and middle-income people. That’s dominated the heart of our dense city ideology, and it is very unfair. It is locking a whole lot of people out of the housing market, or pushing them into parts of the market to make access to work and education difficult. We need to change that.

Norman So, just the rebalancing issue, which you’ve raised before quite rightly—I’ve got the Parliamentary Library to update tradable versus non-tradable, which I’m sure you’re aware of, which I’m happy to make available to other members. There are multiple copies here. The issue is that the relationship between the tradable and non-tradable sector—you just haven’t been able to fix it. You raised it quite legitimately as a concern for New Zealand. Do you accept that in spite of your best efforts, this imbalance in the New Zealand economy hasn’t been fixed so far?

English I certainly wouldn’t claim it to have been fixed. I think you can have a discussion about various measures and indices. Treasury has, and I know there’s work been done in other countries around how you split it out. But I would agree that we have got some way to go as an economy, to have the right balance, to get a healthier balance between the tradable and the non-tradable economies. Big chunks of the non-tradable economy are Government and housing, and despite the fact that we’ve had a significant recession, the housing market is still moving along faster than we’d like it to, Government is shrinking
as a proportion of GDP gradually. If we can maintain that, that will certainly help.

Norman But if you look at the graph, the tradable sector has pretty much flat-lined now from the beginning of 2012. It kind of bounced back after the recession and stuff, but the non-tradable sector just keeps powering away. So currently the gap between the two is growing, and unsurprisingly the current account deficit is growing as well. I mean, do you think it’s sustainable to keep expanding the gap between the tradable and the non-tradable sector, as is currently happening in New Zealand?

English It depends on the reasons for it, doesn’t it? So you’ve got a Canterbury effect, just because it’s large, and it’s going to wash through both GDP and wash through these figures, so it’s not going to be a source of growth for ever, only for another 2 or 3 years. That is big enough to make a difference to patterns of investment and employment, which are focused on non-tradable-type investment and employment. So that may be one reason why at the moment that graph shows what it shows. In the long run, I think we all agree that we want to be making more of our living from selling stuff to the rest of the world. Getting the shift of resource from the domestic and Government sector into the export sector is a long-term structural job, and we think we’re pushing in the right direction. We happen to think a number of your ideas would push it in the wrong direction.

Norman And I happen to think the opposite, but that’s politics. But these are the stats, and they’re produced by GDP numbers that the Department of Statistics produces. What they show is that your policies aren’t working. So when do you expect that the economic activity we’re seeing in New Zealand, which you no doubt will be lording through this year and the election year, will actually deal with the problem that the old Bill English used to talk about a lot, which was the rebalancing need in the New Zealand economy, because clearly you are failing to do it. Are you going to spend the year talking about the fact that we have failed to rebalance the economy, or are you going to spend the year talking about economic activity being great?

English No, I’ll spend the year talking about the ongoing efforts to rebalance the economy. That’s all set out in the Business Growth Agenda. So, like everyone else, you have the opportunity to contribute the kind of ideas that you think are going to speed up that process. We happen to think that a process that focuses on competitiveness for exporters, smaller Government through better Government, getting a housing market working more efficiently will, in the long run, give us that shift of resource.

Norman Just going to that economic strategy, there’s obviously kind of a debate between you and Steven Joyce—or it seems from the outside—about whether you pick winners or not, because you used to say “We don’t pick winners,” and Steven Joyce spends his whole time picking winners. Which do you think is the right strategy for a New Zealand Government? Because at the moment it seems to be a bit incoherent because the two of you have such a different approach to whether you should be intervening, which is the Steven Joyce
approach, or not intervening, which used to be what you used to say. Which is
the right approach?

**English**

I don’t agree with that characterisation at all. I mean, the Government runs a
pretty what I think of as a kind of pragmatic, balanced policy—that is, the New
Zealand Government has always run an aspect of its policy around supporting
industries, supporting research and development and so on. The tricky bit with
that is—which is currently $1 billion or something—you don’t quite know
what will work. Some of it does, some of it doesn’t, and there’s plenty of
evidence from the past about the mixed results of that process. It’s just too
hard to predict. So we’ve persisted with that, tried to tidy it up, get it a bit more
focused, at the same time as dealing with the vast bulk of New Zealand
businesses on the basis of what we think of as sound microeconomic policy,
and that is not having industries relying on the Government propping them
up, and making sure they’re as competitive as possible. So there’s a bit of a mix
there. I don’t think it’s confusing; I think it’s just clearly running a portfolio of
policy, most of which is non-interventionist, some of which is interventionist
on the basis of experience.

**Norman**

Can you tell me, then, what are the criteria for spending large amounts of
Government money to support particular industries or businesses, such as the
most recent grant to the film industry? What are your criteria when you decide
to agree with such very large spending of Government money?

**English**

Well, it is a mixture of historical involvement by Governments. So I can recall
when the initial Lord of the Rings proposals were put up. At the time, the
Government was looking at shutting down particular tax structures, and an
exemption was specifically made that allowed Lord of the Rings to get up and
going, because the contention was at the time that if the Government had
applied the rules to them the same as everybody else, they wouldn’t have got
started. Anyhow, in retrospect, I think most people would say we were better
to have had that up and going in New Zealand than not have it, from the point
of view of international promotion of the country, whatever industry benefits
you would see. So I would say it is a mixture of historical stuff. Sometimes it’s
just opportunistic. The other main criteria has been around innovation in
technology, so we have shared to some extent—New Zealand Governments
have had for 30 years that being the only developed country with a
fundamentally agricultural base, you need to persist with fostering
diversification of that economic base. I would say sometimes that hasn’t
worked very well; sometimes it has.

**Norman**

So the criteria are if we did it in the past—I’m not sure why that’s a criterion,
but that’s what I hear you saying—and, secondly, technology and innovation.
And yet around the film stuff, Mr Joyce persistently said he was opposed to it
and gave no business case around innovation or anything else, and then
suddenly seemed to flip, which looked more like a political decision than a kind
of rational decision based on looking at innovation and technology, and there
didn’t seem to be a lot of papers that had been presented by Treasury or MED
that talked about innovation and technology. It just suddenly seemed to flip, as
if it was a rather more arbitrary or political decision than one based on a
reasoned approach around technology and innovation. Where are those papers?

English  You’d need to talk directly to Mr Joyce about all that.

Norman  But you had to spend the money and you’re supposed to be controlling the spending.

English  Yes, well, about the fine detail of the decision-making process. But, look, when the Government gets involved with an industry, you’ve got to deal with the dynamics of it as it is, not how you would like it to be. In the case of the film industry, it became clear reasonably suddenly, I suppose, that the pipeline was empty and that the competitive effect of other countries bidding up the subsidies was biting with a potentially fatal effect. So there’s a trade-off there between some kind of ongoing assistance at the same time as the industry recognising that in the end it might have to change its model to stand on its own two feet, because you can’t subsidise these things for ever.

Goldsmith  I might just ask a question. Now that you’ve just come back from Davos, can you give us a quick summary on what you think are some of the main things that you picked up there in terms of the future outlook for the global economy and the consequences for New Zealand?

Peters  Can we get to that when we’ve finished the matters before us now? I mean, Davos is fascinating and everything else, but why are you—

Goldsmith  I’m entitled to ask my question. We’ll come to you next. Don’t worry.

Peters  Well, why don’t we just focus on the actual figures that matter now, and you can have your Davos experience at the end, rather than at this point in time.

Goldsmith  Thank you. Well, when you get a chance, you can chair it next time.

English  I’ll be very brief. The developed economy is looking a bit better than expected. The emerging economy is going to be more volatile, because as the developed countries wind down their money printing, it’s a bit unclear how asset pricing’s going to resettle, because we’ve been in an artificial environment for 5 years, and getting out of it is going to have some unpredictable effects. So it means that economies like Indonesia or, say, India will be a bit less certain about what their growth patterns are going to be, but in the long run they’re on a positive growth pattern. If there was anything else to come out of it, it was just the speed at which the digitising economy is changing skills, tax bases, value of investment, and the big possibilities—in our case, particularly for the Government to take that opportunity to a greater extent to provide better public services.

Goldsmith  Yes. And on the rapid changes of the digital world and tax bases and so forth, we’ve got a lot of problems with Facebook and Google and so forth. Do you agree with the suggestion of somebody that maybe it might be simplest just to shut it down?

English  Well, as I said yesterday, you can do it, because they’ve done it in North Korea, and they’ve come up with their own social network. They won’t know how good it is because they don’t know any better, but New Zealand knows what
Facebook is and I think the Government alternative may not meet their expectations.

Parker Why, short of shutting them down, are you doing nothing to stop the gaping tax hole being caused by multinational tax avoidance undermining the New Zealand advertising market and therefore the important fourth estate from being able to service their overheads? We know from public records that Facebook, Google, to name but two—Twitter, Apple—are taking enormous revenues out of New Zealand but are paying no tax, whereas their competitors in New Zealand who are New Zealand-based do? Why has the Government not moved on that?

English It's not that it's not moved. The Government does everything it can, given our weight in the international tax system.

Parker You could tax them on a turnover basis. Why don't you do that?

English Because we don't think that's a sound basis for taxing a business.

Parker So you could do it, but you don't want to is really the answer that you just gave me.

English Well, we think it's a very bad idea, that's actually why.

Parker So you'd rather do nothing and let the New Zealand corporates that compete against multinationals be undermined with the loss of jobs and loss of tax base so that other taxpayers have to pay their tax for them?

English No, we are keen to protect the tax base and the combination of—I mean, the other factor that's eroding the tax base isn't nasty foreigners; it's hard-working New Zealanders doing online shopping. So I don't think we should get too emotional around who's undermining the tax base. The fact is, tax law is coming under pressure, particularly from the digitising economy. As well as that, what have been long-running issues of how multinationals shift their income around. But I think anyone who has looked at it hard knows that, particularly if you are a small country, the effective action is the action you can take in concert with other economies, because everyone has got to play the game. That'll be a matter of discussion this year. It was pretty clear, for instance, from the speech by the chairman of the G20, Mr Abbott, that that's one of his top priorities. So we'll see how far that gets this year.

Parker So the Sovereign Government of New Zealand says there's nothing we can do about it on our own?

English No, we're saying we will do our best to enforce New Zealand law. We will look at any change in the law which we believe is consistent with good tax policy, that's going to preserve our tax base. It's just a bit difficult to find those changes.

Hayes Would a US-New Zealand double taxation agreement impact on our ability to tax American-based companies?

English I'm not an expert on the double taxation agreements, but you do have to keep in mind that we've already got in place a set of bilateral tax arrangements with all sorts of countries, and we can't breach those without the agreement of
those other countries. As we know, because the US is big and we are small, they are able to enforce their taxation law all over the world, and we can’t enforce ours outside New Zealand.

Parker But we could enforce in the New Zealand jurisdiction through turnover tax at the bank level. Why don’t you do that?

English If the member inquires into it, he might find that there are different definitions of what amounts to jurisdiction, particularly on the internet. In fact, it’s one of the key challenges, defining your jurisdiction. Our versions of it are geographical, and on the internet it’s digital.

Parker There’s money being paid by New Zealanders out of New Zealand bank accounts, amounting to hundreds of millions of dollars every year, to multinationals that you could tax if you wanted to, but you just refuse to because it’s the big end of town and too hard.

English No. In fact, as I said, the most urgent issue is not the big end of town; it is the small end of town. I think that’s where you might want to watch just how far your rhetoric takes you. It’s hard-working mums and dads shopping on the internet that’s having the biggest impact, and will have the biggest impact, on our tax base. So you have to be able to resolve both of those issues because they overlap. Right? The New Zealander who buys something from Amazon—who is the criminal here?

Parker That’s an additional issue; it’s no excuse for not moving on the first, Minister.

English Well, we’re not moving to turnover taxes. There would need to be a very good reason. You’ve got to find people willing to collect those sorts of taxes. If it was simple, we would have done it. I can assure the member of that.

Peters So you’re telling the committee that you and your department are doing everything you possibly can to preserve our tax base?

English Yes, and, actually, often getting criticised for it, for trying too hard.

Peters So with all the due diligence and speed that the emergency requires, you’re doing everything possible to preserve the tax base?

English Yep, consistent with sensible and sustainable tax policy.

Peters Well, no policy at all is neither of those things, is it?

English Well, no, there’s a set of rules that apply to the taxpayer—

Peters Well, it doesn’t apply to Google and Facebook. No policy at all applies to them. So tell me which part of those two things, sensible and sustainable, applies to no policy at all.

English The tax law applies to them in the same way as it does to everybody else who operates in New Zealand.

Peters OK. So they’re not paying any tax, the rest are, but it’s applied in the same way.

Goldsmith Is that a question or a riddle?
Peters: Well, I just want to follow the logic of that statement. You contend from the question today that wealth is not being concentrated in fewer and fewer hands in New Zealand.

English: We haven’t talked about measures of wealth. We haven’t talked about measures of wealth inequality. We’ve talked about income inequality.

Parker: No. I tried to and you wouldn’t.

English: I did. I quite specifically said—

Peters: I just want to get it. If your thesis, and presumably that of your colleagues, is that wealth—unlike in the UK, USA—wealth is not being concentrated in fewer and fewer hands in New Zealand. Is that a fair conclusion I can get from your statement?

English: I haven’t made a statement about that, because I have not got the figures here in front of me.

Peters: You’ve got no idea.

English: Well, it may be. But the assumption is being made that income is more focused, and actually it’s not. Income inequality is not growing in New Zealand. I haven’t seen any information about wealth. I could make some assumptions. The single biggest driver of wealth in New Zealand households is the planning law that restricts the supply of housing. That does favour insiders in the housing market, and it keeps low and middle-income households out of homeownership. That is unfair, unjust, and unnecessary, and we’ve set about changing it. And we expect your support on that.

Peters: So you’re going to go about that with all diligence, but the foreign purchaser effect on key parts of the Auckland market, what are you doing about that?

English: Well, there is argument over what the effect is. You know, there’s been dodgy surveys done, and then there’s anecdotes about people driving round in buses buying lots of houses or whatever. We don’t believe it is a big influence. It probably has some influence, and, in any case, the dominant influence on that Auckland housing market is lack of supply. That’s starting to change. Not fast enough, but we’re going to pursue that issue.

Peters: Well, supply issues are affected by too many potential buyers, artificially increased by overseas interests being able to buy against the market. So you’ll never get on top of it while you allow the world to buy, will you?

English: Well, we believe there would be problems with—we think there’s benefits from allowing offshore investment into your economy.

Peters: What would they be for housing?

English: You’re focusing on the costs, and we think taking the step of excluding foreigners would be a step too far.

Peters: All right. Look, you seemed to be or your colleagues were going around talking about a rock star economy because you got above 3 for 1 year in your forecast. New Caledonia has been going at about 3.5 for the last 7 years, so why would you be a rock star economy just for 1 year?
We don’t talk about the rock star economy. I think it was one of your bank economist mates that used that term. We just talk about an economy that’s got moderate and steady growth, lifting incomes, creating more jobs, but we need a lot more of it.

Yesterday you were expressing—a rather familiar phrase—your concern about the New Zealand - Aussie dollar parity potential. Now, do you think an official cash rate rise will not worsen that?

There’s two theories about it just at the moment, in the short term. One is that one of the reasons it’s high is because of the strong expectation that interest rates are going to start rising here in the next 3 months. Another theory is that it’s not built in and that the money that’s getting shaken loose from emerging economies could start chasing the New Zealand dollar because interest rates go up. I’ve heard both theories. As with exchange rates, you never know.

This has been asked of you before, but at about what level the New Zealand dollar and the US dollar and the New Zealand dollar and the Australian dollar would you actually take some action?

Well, as you know, the Reserve Bank has the capacity to intervene in the actual exchange rate market, and does so under circumstances, conditions, that are published. Those are fairly particular because it’s got limited capacity to influence it, but they argue that at times they’ve done it and it’s been effective. It’s more to do with the peaking of the exchange rate than any particular level. Our view about it is that if we run a—to the extent Government can influence it, it’s about a competitive economy with sound microeconomic policy and, in the current cycle, careful management of Government spending. That’s the best thing we can do not to send the exchange rate any higher than it may otherwise go.

So the answer is—that’s not an answer to me as to when you’ll do something.

I think we would stick with the policy New Zealand Governments have had since they floated the exchange rate, and that is that the Government’s not going to intervene in the market. Bear in mind here there’s two sides to this equation. The 82c or 83c against the US, 95c against Australia, has given New Zealand households the best purchasing power they’ve had in a generation. That has helped cushion them through the recession at times when households in other countries, such as the UK, took big cuts in real incomes. And New Zealand purchasing power over and above—well, alongside—real income increases has actually kept our households in pretty good shape. So when people talk about going round and dropping the dollar, what they are actually saying to households is “We’re going to force your cost of living up.”

Well, can I conclude then that you’re not concerned? Well, I conclude from that, your defence of it, that really you’re not really concerned much at all. But I want to know this: I look at that $86 million so-called surplus. That will be the most flimsiest forecast since 1990 by Caygill, when he had an $82 million surplus, which blew out to $3.2 billion deficit. You recall that, don’t you? Now, last year you underspent foreign aid—outside of the Budget forecast, you underspent overseas aid by $92 million. Why would that have happened?
English Well, you would want to talk to the relevant Minister directly, but my impression of it is that with a strong focus on getting the aid budget to support sustainable economic growth in the places where we’re delivering aid, they just haven’t been able to spend all the money they had and maintain the quality of the projects.

Peters Well, that’s one way of looking at it. But if I wanted to artificially inflate my forecast surplus, if I hold back enough spending, like you did in foreign aid and in other areas as well, I will get there, despite what I told the country in the Budget I was going to spend.

English Well, there’s no doubt that—well, firstly, you can’t pick on any particular item because no item is at the margin.

Peters Well, that’s one of them. That’s a pretty big item.

English You could say that the drop in welfare forecasts actually enabled the last $80 million, so that generates the surplus. And, secondly, yeah you do get surpluses from not spending. That’s how we do it.

Ross Minister, in the Budget Policy Statement there’s a graph of net core Crown debt showing a stark difference between the December 2008 update and the half year update 2013. What primary measures would you say have you taken and will continue to take to ensure that that debt track is maintained?

English The one we’re on?

Ross Yes. Not the December 2008 one.

English We’re actually reasonably optimistic about being able to hold to something like that debt track, and that is because we are focusing on the long-term drivers of Government spending. In that context, the welfare reforms are very important, but so is the broader better public services programme, because what’s come out of it is that solving the problems is actually a lot more to do with Government organising itself to focus on the kind of problems that drive our expenditure, not throwing more money at it. In fact, often, throwing more money at it means that the people involved stop thinking. We can all look like we care. The recipients of the cash might feel a bit better, but the long-run drivers of our costs remain in place. So, in fact, we’ve got much better focus on the core issues that drive expenditure by not having a whole lot more money to spend.

Ross What reports of alternative approaches have you seen to Government spending and debt projections, and how would that hamper New Zealand’s long-term debt projections, and what impact would that have on the wider economy?

English Well, we would expect that—well, in election year you’re going to see people talking about throwing a whole lot of money around. I will just give you an example, actually—a small one that hasn’t had a lot of publicity. There was some report yesterday about expanding free entitlement to early childhood education because investment in early childhood education is good for kids and therefore good for the economy. Well, actually, the evidence doesn’t show that. What the evidence shows is that for the children for whom early
childhood care is the one place where they are safe, warm, and get a decent feed, and an opportunity for a bit of learning, it makes a big difference for them. But they are hard to get to. So it’s not nearly as sexy, but that’s where you make the biggest difference—not from increasing broad universal entitlements.

Ross Have you seen any evidence that families earning $150,000 a year are in need of welfare benefits?

English No, and I don’t think they think that either.

Ross No.

Parker Are those the same people, over $150,000 a year, who got the majority of the tax decrease from 39c in the dollar to the lower tax rate?

English No, that’s not correct. And in any case I am looking forward to hearing the policy announcement that all tax rates are going to go up because the tax package was unfair. In fact, when we released that tax package we produced the distribution analysis, which was not contested by anybody, which showed that it was distributionally neutral.

Ross You had better read the fine print when it comes out.

English I am waiting for this policy where all income tax rates are going to go up because that’s how we’ll make the country fairer. You’d like to think people have the courage of their convictions, don’t you.

Peters Mr English, are you concerned about the portion of our GDP which appears to be focused so much on consumption?

English Am I concerned about it? Well, look, it is what it is.

Peters Well, that’s true. I mean, we started with that.

English The only reason that you would worry about it is because a net result means we have higher external liabilities through the current account deficit, and so we’ve set out with a goal of lifting the proportion of GDP that is exports. Actually, it is quite challenging to change those patterns. In fact, what’s remarkable about those macroeconomic quantities, like consumption, export investment, the components, is how steady they are for decades. They have some cyclical fluctuations, but, you know, China is going to have a huge problem shifting from investment to consumption. We need a clearly profitable, vigorous export sector in order to attract money out of other areas like housing, or other forms of investment—the amount of investment the Government does that displaces what should be productive investment in the export sector.

So, yeah, I’m concerned about it. Shifting it needs persistent, quality policy for a long time. One of New Zealand’s challenges in the last 30 years has been its stop-go economic policy. If we could just stick at it for a while, and I think those objectives are all agreed—everyone here wants to achieve them—if we could stick at the kind of policy that is pushing us in that direction, well, eventually it will happen.
Goldsmith: Well, thank you very much for coming in, Minister, and we appreciate your time.

English: No problem. Thank you.

Goldsmith: Mr Deputy Secretary, I apologise that not so much media seem to be keen to stay on, but don’t take that as any indication of the committee’s enthusiasm for this important discussion. So would you like to just give us a quick summary of your views and then—

Karacaoglu: Yes, please. Good afternoon. First of all, apologies from our Secretary, Gabriel Makhlouf, who is overseas. That is the only reason he is not here. I just want to introduce my colleagues. We are all three deputy secretaries at the Treasury. [Introductions] If I may, I just want to take 4 or 5 minutes to make an opening statement to put in context some of the key themes that are in the Half Year Economic and Fiscal Update in light of some recent discussions about New Zealand’s economic outlook.

It’s no secret that New Zealand is right now in an enviable economic position. Our short-term economic outlook is very good compared to most other countries we benchmark ourselves against. The “rock-star economy” seems to be the phrase on everyone’s lips. That makes great headlines, but it only really reflects our short-term economic outlook. It is true that we expect to see a period of higher growth over the next few years, but the Half Year Economic and Fiscal Update forecasts growth to be more moderate after that.

We’ve already seen some of the risks identified in the Half Year Economic and Fiscal Update start to materialise. On the domestic side, demand has been stronger than originally forecast and, on the international side, the global environment will continue to be volatile. It will be important, therefore, to be responsive to these factors.

If we want to achieve the kind of long-term sustainable economic growth that will consistently raise living standards in New Zealand, then for New Zealanders, we need to focus on three areas in the future, in the short to medium future. First of all, learn the lessons of the last decade. Secondly, show restraint as the economy hits a new gear. And, finally, use the opportunity of higher growth in the short term to expand the economy and create a platform for sustained growth over the longer term.

Lessons over the last decade—the developed world went into the 2000s with a belief that in many respects we had answered the question of how to achieve stable long-term economic growth with steadily rising incomes. We were wrong. Governments and households overextended themselves, asset markets became overvalued, and extra revenue wasn’t sufficiently used to pay off debt. Then it all came tumbling down. For the last 5 or 6 years everyone’s had to take their medicine. New Zealand was better placed than many other countries but has still felt the impact of the great recession.

With things now looking up, this is the time to show we’ve learnt. The question is what path will we take this time? Showing restraint—over the next few years we expect the Crown’s day-to-day finances to improve as the economy picks up. The temptation might be to spend more. With the
economy operating at or above capacity over the next year or so, too great an increase in Government spending risks driving interest rates up higher than they would naturally rise at this point in the cycle. In turn, this will put upward pressure on the exchange rate and undermine the dairy export-oriented sectors that we want to support our higher living standards.

Instead, the Treasury’s view is that we need to stay restrained in our spending. In particular, we need to tightly manage the Crown’s investments in the Christchurch rebuild, to avoid logjams, cost escalations, and extra spending. We need to keep pursuing efficiencies in the public sector. We can tighten Government spending if household spending is higher than expected, and we can keep steadily reducing debt over time.

Having room to move on the Crown’s balance sheet was crucial to New Zealand’s ability to support demand in the economy during the downturn. It also meant we could deal with the cost of a large earthquake. We need to rebuild the buffer against potential future crises using this opportunity. But while short-term choices about how we manage the Government’s finances are important, the real prize is long-term economic growth.

As the economy shifts into a new gear, we have a golden opportunity here to pursue lasting gains by lifting our productivity. In this context the Treasury welcomes the recent public discussions around how to improve educational outcomes. Other areas we see as priorities include strengthening our international connections so that New Zealand businesses have better access to emerging markets, encouraging companies to invest in productivity improvements—for example, there are some signs, early signs, of a lift in productivity in the construction sector that could make a real difference to how we manage the economic cycle if they can be sustained—and pursuing productivity gains in the public sector.

To make headway in some of these areas, we will need to address some complex and persistent challenges. That will require innovation, and within reason we can afford to take some educated risks. We just have to be measured and invest wisely with an eye to the long term. We might be a rock star economy in the short term now, but we do not want to be a one-hit wonder.

Thank you. Happy to take questions.

Peters That wasn’t a bad finish, actually.

Clark Thank you and thank you for the presentation. A couple of questions—just the first would be that the Minister talked about Treasury projections being 50 percent out, in his presentation, and he seemed to be saying that he thought the Treasury had got it wrong. What advice has the Treasury provided to the Minister—you know, challenging his view?

Goldsmith On the current account deficit?

Clark Yeah. Why does the Treasury think the Minister is wrong?

Karacaoglu We have in our HYEFU a clear forecast on the current account deficit going forward, and when we then look at why the current account deficit over the next period of time is staying at the level we are projecting—we decomposed it slightly and looked at the Christchurch rebuild impact, if you take that out,
we’re talking about 1 to 2 percentage points lower than the 6 to 6.5 percent we are talking about. The context for that is important because the Christchurch rebuild is an investment, and to the extent that the current account deficit reflects the gap between our expenditure and our income, if it’s going into investment, it can help.

So those are really the basics that are in our projections. So the current account deficit—6.5 percent is what we’ve put into our projections, and the Christchurch impact of that, which is primarily an investment expenditure, is about 1 to 2 percentage points. So that’s where we are.

Clark  Sorry, I don’t—

Karacaoglu  So, we are going, if you take that out to 4, 4.5 percent kind of level.

Clark  Sorry, I don’t quite understand how that relates to my question—maybe I’ve missed it—but what are you saying to the Minister? Where do you think the Minister’s wrong in his forecast view?

Karacaoglu  We don’t think the Minister is right or wrong. We are professional advisers to the Government, and our advice is based on our forecasts—

Clark  So my original question, what advice have you—I mean, there’s got to be a point of difference in there somewhere.

Karacaoglu  This is not an advice—this is not an advice. This is simply forecasts and our forecasts are on the record, and we explain where they come from. They are based on our models and all kinds of other inputs that come into it.

Clark  So what in your model—I mean, you make the assumptions for the model. What in the model is different from the Minister’s assumptions? Surely you’d tease that out, because your job is to advise the Minister so he is best informed for forming his own view. Where do the differences lie in the assumptions that you’re making as to the assumptions he’s making?

Karacaoglu  We haven’t compared the detailed assumptions—

Clark  Really?

Karacaoglu  It’s a matter of relative, maybe, optimism on how the overall export sector and such like will play.

Clark  So it’s a bit of guess, essentially. I mean, it’s not a scientific—there’s no scientific comparison possible between the assumptions you’re making for your model and the assumptions that the Minister is making. It’s just a guess, essentially. His view is a more optimistic one.

Moran  Shall I answer this? The Treasury economic and fiscal forecasts are our best independent forecasts, which are reviewed by an external panel. In my experience Ministers of Finance test the forecasts to understand the assumptions. This Minister does this, as did Dr Cullen before him. But we don’t get Ministers giving us their forecasts.

Clark  Ministers will test the assumptions, won’t they? I mean, that’s my experience in the past—that Ministers will say “Why have you made this assumption?” or “I disagree with your forecast. Why have you made that assumption?” or “I
disagree with your forecast. I agree with this assumption.” And there are explicable points of difference generally. If a Minister is conscientious, he or she is going to delve into the detail of the assumptions of the forecast to test whether they really—and so are the independent reviewers. But what I’m looking for is to understand the difference—where the Minister gets his optimism from, which assumptions does he not buy into that the Treasury is making.

Karacaoglu: We haven’t, as I said before, had a detailed comparison of assumptions. We run a series of economic models—it’s an independent forecast—and the Minister may disagree on components of it, but we haven’t sat down and had a detailed discussion of where exactly the gap is.

Clark: Can I just be clear—the Minister hasn’t asked for or challenged the assumptions in the model?

Karacaoglu: The Minister has asked for our economic forecast. We brief him in great detail, and we give him all the assumptions that we make, but we have not had a detailed discussion on which assumptions he disagrees with.

Parker: There is advice from the IMF, the OECD, to name but two. And your own advice to the Government has been that we need a broad-based tax system. Capital tax—as you would be aware that Opposition parties have proposed capital gains tax, you would be aware that other commentators including, you know, the former Chair of the Reserve Bank, Arthur Grimes, and others have recommended forms of capital tax or land tax. And you’ll also be aware that Opposition parties have no policy resource funded by central government and very low funding bases.

You’ll be aware that there’s a 3-year political cycle and that when Governments take over, if they do change, they have to do things quickly, and that unless the policy work is done to ensure that you get the best possible policy outcomes, you’ll get what’s delivered up by an Opposition party if they move into Government, because they’ll be moving very fast. Which is a long way of asking do you guys do any policy work outside of existing Government parameters so that in the event that there is a Government change you get a better policy outcome than it would be if you relied upon the hacks in the Opposition to do the work for you?

Karacaoglu: A very good example of work that has been done quite outside the current policy focus is in the long-term fiscal statement. That’s a very good example where we independently look 40 years ahead, identify the challenges faced by New Zealand, and then look at—using our living standards framework—all kinds of policy options in that context and show the costs and benefits, potential consequences of that. So that’s an example where we have done work.

On the capital gains side we have consistently said that we would support a comprehensive accrual-based capital gains tax. That’s in the records. We have also warned that if there are exclusions, then there are all kinds of unintended potential consequences.
Parker: It’s very easy to say that as a sentence; it’s quite hard to implement in practice. Is there a level of detail that would enable your nirvana to be implemented were there a Government willing to do so?

Jones: That’s right. Stop. Have you got a secret recipe for us?

Karacaoglu: There are no secret recipes, but there are all kinds of areas Treasury have done work in the past, and this is one area where our advice, actually, is on record.

Parker: My question is the advice that’s on record is pretty superficial. I’m not saying it’s wrong, but what is on the public record seems to be pretty general. I just wonder if the Treasury sees as its role in pursuit of long-term stable outcomes for New Zealand that are of a quality nature—that you do for our country what Opposition parties can’t do.

Moran: We haven’t done any detailed designs for a capital gains tax. There are a number of papers on record that assess different options. Some of them were summarised in a long paper for the long-term fiscal statement which was part of a suite of 40 papers which show the offer trade-offs between different policies.

Parker: I suppose I’m giving you a nudge.

Goldsmith: I just wonder if you could just touch on the outlook for interest rates as you see it, in terms of how the Government programme is assisting with helping us continue to keep them as low as possible for as long as possible, and what part of the programme is helping in that area.

Karacaoglu: We have published a—we have the economic and financial forecasts, which do include an interest rate track. What we are seeing is the 90-day bank bill rate—if we are to take an example—going from about 2.7 percent gradually to 2.7, 3.6 in the year March 2015 on to around 5.2 by March year 2018. In order for that track to be maintained, of course there are assumptions about fiscal and other policies. To the extent that there is any deviation from the current policy, then there will be further pressure on those kinds of rates.

Goldsmith: And in crude terms, a significant increase in Government spending would be to flow through to higher rates.

Karacaoglu: Not only that; it would also have an impact—as I said in my opening statement—on the exchange rate because in our forecasts we see a gradual decline in the trade weighted index going towards the end of that period. That would compromise what everyone is trying to pursue—namely, a sustainable growth rate that’s based on more export-driven international connections, yes.

Barry: Moody’s analysis came through today. It’s a new report—I don’t know whether you’ve had an opportunity to see it. But it confirmed that New Zealand is on a good track and we’ve got a stable economy and so forth—gave a sort of a broad picture. I wonder if you share any of their concerns around some of the risks to the economy, including a high dependence on foreign institutions for capital and that sort of thing. I’m not sure if you’ve seen the report from this morning if you have a comment.

Karacaoglu: Yep, broadly speaking, it talks about the four key factors behind their rating. It talks about New Zealand’s economic outlook being a positive, institutional
strength of the economy being a very high positive, fiscal strength being a very high positive. The susceptibility to event risk, which is typical for a small open economy like ours, being the negative that has been highlighted. That’s a broader risk management context for the New Zealand economy, and there is ongoing work on identifying and managing systemic risk for New Zealand. So, in that sense, that is being addressed, but other than that we believe that those positives are spot on, and they support our ongoing high rating and stable outlook.

Norman Two areas—the first is about rebalancing. So you are talking about the rock star economy, which seems bizarre for a Treasury official, but, none the less, there you go. So you’re talking about a very large current account deficit—the second worst in the OECD. And you think that’s a good thing, I guess, if you’re saying that’s a rock star economy. I want to know why you think having the second-worst current account deficit in the OECD is a good thing.

And then the rebalancing is getting worse. The gap between the tradable and the non-tradable sector is actually growing. Why do you think that is a good thing if you think this is a rock star economy? So can you explain to me why Treasury thinks it’s good that the tradable sector versus the non-tradable sector gap is increasing, and why having the second-worst current account deficit in the OECD is a good thing?

Karacaoglu First of all, I was very careful to point out that the rock star economy concept came from outside and that we did not agree with that concept, except maybe in the context of our immediate growth prospects being reasonably strong relative to our own recent history as well as relative to other economies we compare ourselves with. I made a deliberate statement saying when you go over the next 2 or 3 years the economic outlook is more modest and moderate.

The other point I want to make is that, as I said earlier, the current account balance, that 6.5 percent or thereabouts over the next 2 or 3 years, really reflects the pressures coming from the Christchurch rebuild, fundamentally. If you take that out, we are talking about 4.5, 5 percent, and I think we would all agree that we want the traded/non-traded goods sector balance to improve in favour of the traded goods sector. That’s why in my comments I also highlighted how critical it is that we work on international connections through all kinds of trade—people flows, capital flows—and also on financial variables, such as the exchange rate.

I think we all want New Zealand to grow on a sustainable basis. We all agree that it will come from productivity growth driven by innovation. International exposure is just a matter of just keep chipping at it and making sure we get there. The risk in the immediate run is that we may miss the opportunity created by the immediate positive outlook and get into a mode of possibly overspending, which would be a very sad outcome, given that we have a very good opportunity now.

Norman So given that that’s clearly exactly what we’re doing—in that this looks very similar to the last cycle, with very large current account deficits, out-of-control housing inflation—why isn’t Treasury waving big red flags instead of carrying on? Why aren’t you raising a big red flag that says we’ve got an out-of-control
housing market and a current account deficit that is very, very large; the gap between the tradable and the non-tradable is going in exactly the wrong direction—it is increasing? Why is it that all of a sudden you’ve become a cheerleader for the unbalanced economy? I don’t get it.

Karacaoglu I am not a cheerleader. Treasury is not a cheerleader. We did support the Reserve Bank’s attempts to cool down the housing price inflation through macro-prudential policies. We supported those. We thought those policies were in the right direction. We are also saying—and agreeing, I think, with everyone—that we want to do everything we can to build—which is our core strategic advice across several agencies I should say—on international connections through everything we do, whether it’s education, whether it’s infrastructure, whether it’s immigration, overseas investment, inwards-outwards. Everything that we are looking at is an attempt to connect the New Zealand economy better with the rest of the world so that we can grow faster but on a sustainable basis.

Norman But it’s not working. This is the graph that Bill English went around the country telling us was the most important graph—we all needed to look at it. He doesn’t do it any more, but he did. That’s the graph that was produced by Treasury, and it’s getting worse.

Karacaoglu That graph, if you take it back, it’s not a recent issue for New Zealand. The traded/non-traded goods issue has been around for some time. Our current account balance has been around for some time. The most recent kick-in, if that’s the right term, of the graph which is getting slightly worse is driven by the Christchurch rebuild for very good reasons. So what we’re all trying to do is to find ways of switching that in favour of traded growth, and that’s where—and sorry, I’m repeating myself—there’s a lot of work across a lot of agencies saying “How can we better connect with the rest of the world especially the growing part of the world, being, in the immediate, around Asia and China?”

Goldsmith So if we’re trying to make progress long term, would it then make sense to be opposing all free-trade agreements, which are about trying to get access to markets, and opposing developments in the tradable sectors, such as dairy and mineral exploration?

Karacaoglu Free-trade agreements are one mechanism through which we connect with the rest of the world. It would be wrong to resist that, provided those free-trade agreements take account of New Zealand interests, which, of course, we are doing as we go through that. Overseas investment, inwards-outwards, is another one. Overseas investment, especially outward-going, is quite a weakness for New Zealand, and we’re focusing on that as well. So anything that connects us to the rest of the world in a way that benefits New Zealand’s overall living standards is something that we need to keep working on.

Clark You’ve already said that Treasury is on record as being in favour of a comprehensive accrual-based CGT. That would be one measure that would adjust the current policy settings to improve this situation, arguably. Are there any other measures which you regard as bigger or more important than that that you’ve identified so far?
Karacaoglu In terms of our advice and our thinking on lifting the economic growth of New Zealand on a sustainable basis, a capital gains tax is not one of the areas we are focusing on.

Clark Sorry, I'm talking about the current account deficit.

Karacaoglu The current account deficit issue is absolutely a multidimensional intervention issue, and I don't want to bore you with my earlier answer but all those—in other words, what we need to do—

Clark I guess I had no specifics, so I'm interested in some specifics.

Karacaoglu —is to look at all our policy levers through the international connections perspective and say “What can we do in our education, in our infrastructure, in our overseas investment and trade policy, productivity growth, and so on, innovation support, in order to make that happen?” I guess that's the big theme I want to keep emphasising, which is extremely important because a small, open economy like New Zealand will not grow sustainably unless we connect better and more comprehensively, without losing our own interest and wider well-being, to the rest of the world.

Clark With respect, that's motherhood and apple pie and I find nothing to disagree with you on there—even in that long answer I agree with those themes. I'm asking whether there are any specific measures that the Treasury has identified that you think will contribute to addressing the current account deficit issue more than a capital gains tax would contribute—whether, you know, you said it had been an issue for a very long time and that lots of work had gone into it. I think we all agree it's an issue that ideally we want to address. Are there significant measures that the Treasury is proposing that would address that that are more significant, say, than the CGT?

Karacaoglu One area that we've definitely been working on very hard is to understand better the competitiveness of the New Zealand economy, what we need to do to lift our productivity, and the Productivity Commission is doing a lot of work on that. Another one I can highlight immediately is the huge amount of work we are doing on quality overseas investment, inwards and outwards. A third area would be if you look at the Business Growth Agenda innovation policy and all that, it's really all geared towards linking up to the rest of the world. So those are just three examples that I can—

Clark Those are areas of work. I guess I'm looking for specific initiatives that have been identified.

Karacaoglu Those are all specific areas where we are developing policy advice, absolutely.

Clark OK. I'm not hearing any answer to my question, but I'll leave it there.

Jones I posed the question to the Minister about what I see out in a number of—I'm not entirely sure who's interested in answering it—the regions of New Zealand. Obviously, you get political differences, but it seems to me that in terms of your statement that as growth rises we need to invest wisely—I mean, I've written down what you've said—why is it that from your perspective certain investments seem to be more useful to the economy than others? I refer here to obviously an investment in agribusiness through subsidising the
provision of water, New Zealand’s new preferential tax zone, Miramar, where the movies are largely made, yet there’s nothing for the regions of New Zealand—for example, where I come from. Why?

Karacaoglu We have been doing work on the regional economy. As you know, a recent report was published on regional economic growth. We have looked at the range of GDP per capita between the regions. We are monitoring what’s going on across the regions. We are looking at unemployment rates across the regions, and we have been working with the Ministry of Business, Innovation and Employment on various kinds of policies that can actually encourage more even regional growth. So those are all areas where work is going on. So it’s not an area that has been ignored. As you know, Minister Joyce has been very focused—

Jones Can you give me a couple of policies that Treasury is working on to try and generate growth prospects in the provinces?

Karacaoglu At the present moment, one of the big areas would be, of course, the focus on Christchurch. That’s a huge investment area, and I believe from an overall perspective, both in terms of the pressures going on in the north, in Auckland, for example, as well as for better balancing what’s going on in New Zealand, given our limited resources, probably that would one area that would benefit both Canterbury and the wider South Island. That’s just one example.

Jones The difficulty I see with that answer is, it’s beyond […] inaudible…] Obviously, Christchurch is a unique situation and it’s going to take a lot longer than any of us imagine to rebuild, and Auckland seems to have its own dynamic. But through other provinces and regions I’m beginning to sort of doubt whether or not in some areas they’re going to be viable. You have continual population drop-off, and you’ve only got to look at Paul Spoonley’s work in terms of the future of our population, and unless you’re focusing on those regions, are you imagining that the market is simply going to turn around the fortunes of some of those regions?

Crawford Perhaps I can come to the examples where the impact on regions did have an influence on Treasury’s thinking. In the work around recapitalising Solid Energy, the impact of Solid Energy falling into an insolvency regime, the importance of the West Coast. The importance of Solid Energy to the West Coast was certainly a factor in how Treasury though about Solid Energy, and, again, in our discussions with both Meridian and Rio Tinto, the impact on the Southland economy from the closure of the Bluff smelter was factored into the way we thought about it. So we do see the impact on regions when we’re looking at specific things.

Jones I just think that’s a policy that you’re working on. I would encourage you to see policy in a more activist role, as well. When we asked the question earlier of Mr English, the reality for our forestry industry and a lot of what we’re seeing in regional New Zealand now is traceable back to the steps taken by the Bolger Government in Falloon’s time. We got this sort of bizarre situation where many inward investors—I guess it meets your criteria of quality investment—are wanting to invest in secondary and tertiary processing in the forestry sector. And if I’ve met one, I must have met a thousand. But they really are
complaining about no long-term certainty and security. If you want an industry in a particular region, I can’t see an alternative than the State in some of those industries returning to having quite a significant role. Is that sort of regarded as heretical in your Treasury policy thinking?

Karacaoglu The issue around regional growth and making sure that New Zealand at large grows, and all people across the country benefit—regions and people—is certainly not theoretical. It is part of both MBIE’s, as we call it, the Ministry of Business, Innovation and Employment, and Treasury’s work. At a practical level, the kinds of things that can better balance regional growth. So that is work in progress.

Jones I guess what I’m really saying, though—what would be the role of Government in those policies, as an investor?

Karacaoglu We are not at a point where we can go to that level of detail. This is just preparatory background work. But I can assure you that work is going on between our two agencies.

Jones So the work would encompass quite an activist role for the State?

Karacaoglu No—sorry to interrupt—it doesn’t basically promote activist growth. But, like we did with the long-term fiscal statement, it provides options and says these are the various ways you can do it and here are the potential consequences, again taking a broader living standards framework, and leave it to the elected representatives of the people to decide which ones they want to—

Jones I guess the impression that we’re left with is—really, I might be a bit unfair here, but I probably regard what you’re saying as we’re best served by leaving things exclusively to the market. And I totally understand that, etc. But I have to assume that you are doing some work in some parts of New Zealand if we want to have a coherent nation State. There is market failure.

Karacaoglu There are areas of market failure, and where there are we have always argued that there is a case for Government intervention. The broader area of regulation, for example, is a clear case where Government is regulating in all kinds of ways. There are points of externalities, which we deal with in all kinds of policies. It is true that we do believe, as I think most policy makers do, that we need to get the basics right. I think everyone agrees with that through our institutions and market mechanisms and all that. But, on top of that, there are different levels of activist Government that can be implemented, but that’s a decision for the Government of the day. We do show those options, just like we did in our long-term fiscal statement. We painted a big picture, and then we said “These are the options, and these are the consequences.” We are working on those.

Goldsmith Are there any further questions? Thank you very much for coming in. We appreciate your time immensely.

**conclusion of evidence**
Reserve Bank of New Zealand's Monetary Policy Statement, March 2014

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Paul Goldsmith, Chairperson)
April 2014

Presented to the House of Representatives
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Recommendation

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, March 2014, and recommends that the House take note of its report.

Introduction

This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, March 2014, and the main issues we discussed with the bank in our examination.

The monetary policy statement announced the decision of the Governor of the Reserve Bank to increase the official cash rate (OCR) by 25 basis points, from 2.5 percent to 2.75 percent. The increase was the first change to the OCR in three years, and was widely expected. The Reserve Bank’s projections indicate that further increases amounting to 200 basis points are likely over the next two years, to counter emerging inflationary pressures.

Reserve Bank’s reasoning

The Reserve Bank has been saying for some time that it would cease to be necessary to maintain the stimulus of a low OCR as economic growth gains momentum, and that interest rate increases would be needed to counter growing inflationary pressures. The economy now has considerable momentum, with economic growth estimated to have been 3.3 percent in the year to March 2014. Growth is also becoming more broadly based. As well as continued expansion in construction activity, housing and consumer demand have been boosted by a rapid increase in net immigration over the past 18 months. Confidence is high among businesses and consumers. These factors mean that spare capacity in the economy is being absorbed, and inflationary pressures are increasing, especially in the non-tradable sector.

While the rate of inflation remains moderate at present (annual CPI growth was 1.7 percent in the March quarter), the Reserve Bank considers it important to contain inflationary expectations to ensure that economic expansion can be sustained. To do so, it aims to raise interest rates to the point where they are no longer adding to demand. The announced increase in the OCR begins this process of adjustment, with further increases likely.

The Reserve Bank’s assessment is that the OCR will need to be increased by about 2 percentage points over the next two years for inflation to settle around the 2 percent midpoint of the target range. The projections in the monetary policy statement signal that 90-day interest rates may rise to 5.2 percent in 2016/17.

Interest rate projections

The Reserve Bank’s projections now extend to the year ending 31 March 2017. They envisage 90-day interest rates rising steadily over the next few years, from an average of 2.7 percent for the year to March 2014, to 3.8 percent in 2014/15 and 4.7 percent in 2015/16,
reaching 5.2 percent on average for the year to March 2017. The Reserve Bank emphasised that the forecasts depend a great deal on assumptions about the terms of trade, movements in the exchange rate, households’ savings and consumption behaviour, and immigration patterns. They are therefore very uncertain, especially in the later years.

We note that the projections incorporate 100–125 basis points of interest rate increases over the coming year. Market swap rates were pricing in 110 basis points of increases during the 2014 calendar year.

**Effects of the OCR increase**

New Zealand is ahead of most other countries in recovering from recession, and is one of the first to tighten monetary policy. With interest rates in most economies very low by historic standards—generally 1 percent or less—and expected to remain so until sometime in 2015, this means the extent to which our interest rates exceed those in other countries is expected to grow. We questioned the governor about the implications for New Zealand’s economy. In particular, we would be concerned if the interest rate differential encouraged a surge of funds into New Zealand. Not only might this push the exchange rate higher, but it could encourage banks to loosen credit conditions, increasing upward pressure on house prices.

The Reserve Bank said it does not expect tightening of the OCR to have a significant effect on the exchange rate. Judging by rates for forward swap transactions, it believes the markets have already factored in the expected increases in interest rates to a large extent.

As for the effect on mortgage lending, the Reserve Bank said that in general higher interest rates would be expected to encourage saving rather than borrowing, so the demand for credit should be reduced.

**Price pressures on households**

We acknowledge concern about the pressure that higher interest rates will place on households. Some of us contend that many households are already struggling with rising electricity prices and rents, and wages increasing more slowly than prices. The governor pointed out, however, that many households’ incomes are picking up, with employment growth of 3 percent over the past year. He commented that central banks are often cast as the person who takes away the punchbowl just as the party gets into the swing. He suggested it could equally be said that the Reserve Bank had spiked the punch in the first place to get the party started. By reducing interest rates to their lowest level in 50 years, it had helped get the recovery under way. Now, after five years, it was a case of moving into a tightening phase, with the objective of sustaining the recovery for as long as possible by ensuring that real incomes and competitiveness are not eroded by inflation.

**Factors in the recovery**

Several strong impulses are driving the economy’s pace at present, making interest rate increases necessary. The terms of trade are at a 40-year high, averaging 25 percent above those in the 1990s; investment in Canterbury’s reconstruction is expected to be about $1.5 billion higher this year than last; and there has been a huge turnaround in net migration over the past 18 months, from an outflow of 4,000 to over 26,000 arrivals. In addition, business confidence is the highest it has been in 20 years, while consumer confidence is the highest in seven years. Investment in residential housing is also strong, having risen about 40 percent in two years.
As a result of these boosts, real GDP is growing at an average annual rate of 3.5 percent at present. Inflationary pressures are building because this pace is outstripping growth in potential output (the rate at which an economy can grow when resources are fully employed without generating inflationary pressure), estimated to be 2.5 to 2.75 percent per annum. The Reserve Bank expects price pressures to increase as the labour market tightens; it is projecting unemployment falling below 5 percent after 2013/14.

We asked to what extent the rising prices of housing and electricity, which make up about a third of the increase in the Consumers Price Index, have made the OCR increase necessary. In the Reserve Bank’s view, the strong economic growth caused by all the other factors would still mean interest rates needed to rise to dampen price pressures.

We note that the projections envisage GDP growth slowing after 2015, to 2.3 percent for the year to March 2017. The governor reiterated that the projections are less certain in the later years, but said that growth would normally be expected to slow as interest rates rose. He noted that the rate remained positive, at about the rate of potential output growth.

**Potential risks**

While the Reserve Bank considers New Zealand’s economic recovery to be strong and broad-based, it has given thought to factors that could slow or stop its progress. It has recognised four such possibilities: a major slowdown in world growth, a sharp drop in the terms of trade, macroeconomic mistakes such as reckless fiscal policy, or a spike in inflation. It considers all of these unlikely at present.

The Reserve Bank notes that most forecasters expect global growth rates to average about 3.5–4 percent over the next year or so. There is potential for disruption from China’s financial sector, which could spark a downturn in demand and prices for New Zealand’s commodity exports, but continued growth in demand is considered more likely. The governor accepted that both sides of the House are committed to returning to fiscal surplus, so there does not seem a high risk of fiscally irresponsible tax cuts or spending increases, which would need to be countered by sharp rises in interest rates. He added that a small, open economy like New Zealand’s will always face risks from external factors outside its control. Of those that could be addressed, inflation getting out of control was a common cause of trouble for such countries. This was why the Reserve Bank is focused on moderating expectations about New Zealand’s inflation.

**The housing market**

The Reserve Bank believes the restrictions on lending at high loan-to-value ratios (LVRs) are helping to moderate house-price inflation. It provided us with some data about the apparent effects, but said it will take another three months before the effectiveness of the restrictions can be fully assessed.

House prices have increased by 1 percent on average over the four months (to February 2014) since the restrictions were introduced; over the previous four months, house prices had risen by 4 percent. Banks appear to have been cautious in applying the restrictions: about 6 to 7 percent of banks’ mortgage lending has been at high LVRs; this is well under the overall limit (which allows for 5 percent of exemptions on top of the 10 percent cap). Modelling by the Reserve Bank indicates that if banks had continued at their previous rate, providing 25–30 percent of new mortgages to people with low deposits, the annual rate of house-price inflation would have been about 2.5 percent higher than it is now. That is, it
would have been closer to 11 percent than the current nationwide average of 8.4 percent per annum.

The Reserve Bank considers it is justified in applying the restrictions nationally, rather than targeting them to Auckland and Christchurch, as house prices have also been increasing quite rapidly in several other regions. Comparing the rate of increase for the three months to February 2014 with the same period a year earlier, house prices in Taranaki have risen by 9 percent, in Waikato by 8.5 percent, in Northland and Nelson by 7–8 percent, and in Hawke’s Bay by 6 percent. The governor says this is unsurprising, with mortgage rates having been at a 50-year low and supply being short in several regions. Some of us disagree with applying the restrictions nationally, and believe that LVR restrictions should not be applied in regions which have low house-price inflation. Some of us remain concerned about the effect on first home buyers.

In the Reserve Bank’s view, steps taken by the Government to increase the availability of housing, particularly in Auckland, are starting to have the desired effect. The number of building permits issued each month has increased from 4,000 to about 6,500, and up to 15,500 sections are being fast-tracked. However, it believes more work is still needed to achieve the necessary supply response.

**Regulatory “leakage”**

We are aware of the risk that unregulated second-tier lenders may enter the market and not be caught by the restrictions. The Reserve Bank acknowledged this potential concern. It will be monitoring the situation; it is aware of one overseas company that has stepped up its lending activity, but said that such financial disintermediation is not significant at present. It noted that the availability of funding to second-tier mortgage providers would be restricted by their need to have a diversified portfolio, not one consisting solely of high-risk, high-LVR loans.

**The exchange rate**

The New Zealand dollar remains high, as a result of New Zealand’s comparatively strong outlook for growth (with an associated increase in inflationary pressure), and strong demand and prices for our commodity exports. The Reserve Bank is mindful of the difficulty the exchange rate presents for the traded goods sector, particularly for exporters of manufactured goods to Australia. It told us it would be concerned about the effects of any further exchange rate appreciation, but considers that the New Zealand dollar’s current strength is not sustainable in the long run. It does not expect the monetary tightening it has commenced with this OCR increase to cause further appreciation, as the change has been well signalled, and therefore already factored into the exchange rate.

The Reserve Bank predicts that the trade-weighted index will moderate steadily, to about 75.7 by March 2017. It would like to see the TWI fall further, but notes that favourable terms of trade—resulting from global economic conditions—make this less likely. It noted that the terms of trade tend to be the main driver of movements in the exchange rate.

**The current account deficit**

The current account deficit is projected to increase over the forecast period, from 3.2 percent of GDP in 2013/14 to 5.6 percent of GDP in 2016/17.

Some of us are concerned about the apparent contradiction of New Zealand enjoying the best terms of trade in 40 years but continuing to run large current account deficits.
Combined with rapidly-increasing house prices, this appears to suggest a repeat of earlier cycles entailing a debt-fuelled consumption boom. The Reserve Bank said it does not see any contradiction: the current account deficit simply reflects New Zealand’s investment needs relative to its savings. It agreed that the country needs to improve its savings, but notes that the household savings rate is considerably better than it was in the boom period around 2005.

**Outlook for exports**

Some of us are concerned that non-primary and manufacturing exports declined 6.5 percent in real terms over the past year, suggesting that New Zealand’s recovery is becoming more narrowly based on dairy exports. With the prospect of the exchange rate remaining strong for the foreseeable future, some of us conclude that New Zealand’s reliance on primary exports, especially to China, will continue for some time.

The Reserve Bank agreed that the headwinds facing manufacturing exporters are of concern. It acknowledged there is an issue with the mix of countries to which New Zealand exports. The governor observed that New Zealand is heavily dependent on exports to China; it accounts for about 21 percent of New Zealand’s exports, compared with about 3 percent a decade ago. However, the Reserve Bank notes that the consensus of global forecasts is for growth in the United States and Australia to improve to about 3 percent next year, which should increase export demand from these countries.
Appendix A

Committee procedure
We met on 13 March and 9 April 2014 to consider the Reserve Bank of New Zealand’s Monetary Policy Statement, March 2014. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O’Donovan.

Committee members
Paul Goldsmith (Chairperson)
Maggie Barry
David Bennett
Dr David Clark
John Hayes
Hon Shane Jones
Dr Russel Norman
Hon David Parker
Rt Hon Winston Peters
Jami-Lee Ross
Hon Kate Wilkinson
Corrected transcript of hearing of evidence 13 March 2014

Members
Paul Goldsmith (Chairperson)
Maggie Barry
Dr David Clark
Jacqui Dean
Hon Shane Jones
Dr Russell Norman
Hon David Parker
Rt Hon Winston Peters
Jami-Lee Ross
Hon Kate Wilkinson

Witnesses
Graeme Wheeler, Governor
Grant Spencer, Deputy Governor, Head of Financial Stability
John McDermott, Assistant Governor, Head of Economics
Geoff Bascand, Deputy Governor, Head of Operations
Bernard Hodgetts, Head of Macro-financial Department
Willy Chetwin, Manager Forecasting
Mark Perry, Head of Financial Markets
Jason Wong, Manager Financial Markets Research
Mike Hannah, Head of Communications, Board Secretary
Naomi Mitchell, External Communications Adviser

Goldsmith Welcome, Governor and your team. We are very pleased to have you here. If you can just give us a quick summary first and then there’s some questions.

Wheeler OK. Thanks very much.

Peters Forget the summary. We’ve only got three quarters of an hour.

Goldsmith Just a very short summary. We always have a short summary.

Peters We’ve all got the document, we’ve all got the briefing. We’ve only got 40 minutes max before we’ve got to go to question time. Now, I think we just get straight into it, if you don’t mind.

Goldsmith Well, if there’s anything burning that you would like to say, I’m very happy for you to have 3 or 4 minutes.

Wheeler I’m happy to go straight into questions, if that’s helpful.

Goldsmith OK, all right. We’ll go straight into questions.

Parker The forward guidance that you’ve given is for a slightly longer period and at the end of that period has the interest rates increasing by another half a percent, which some have said was a surprise to them. Now your forecast, I
think, goes out to 5.2 percent rather than 4.7. Is that because you’re worried about the long-term inflation outlook and you think you’re going to have to push it out higher at the end?

Wheeler In terms of our forecasting, at some stage we roll out for an extra year, so that’s a technical point, and you should also recognise that these are conditional forecasts. They’re highly conditional in terms of assumptions about the terms of trade and the exchange rate and how households will react to certain things, such as interest increases, or what might happen to immigration. So the uncertainty increases the further you go out, and the same is true for the interest rate projection. But, in essence, we’re saying that in order to keep inflation on the track that we think is appropriate, that is the sort of increase at this point in time that we think would be needed.

Parker And is that driven by an expectation that world interest rates will be going up by that period anyway, or that you think New Zealand’s inflationary pressures then will require further interest rate rises?

Wheeler One would expect that world interest rates would be starting to rise by then. I mean, if you look at the US, you know, I think it’s probably fair to say the market has expectations that rates would rise around the second half of 2015. Probably the UK sometime in 2015 would be my guess.

Parker Can I turn to two other issues, briefly? The first is the interest rate differential between New Zealand and other countries has to date grown, although some of that will have already been factored into financial institution expectations. What effect do you think there will be on household saving rates of an impulse of credit into the country that might be trying to make a margin on that interest rate difference?

Wheeler Well, the interest rate differentials are increasing, as you note. I mean, if you look at interest rates in advanced countries—I mean countries that represent two thirds of world output, and that is the G7 and the eurozone countries, the 18 of them, and Switzerland and Sweden. Add them all up, they come to two thirds of world output, and their policy rates are 0 to 1. I would be surprised if we started to see interest rate increases in those countries in 2014. So our interest rate differential will rise. The issue is how much of that is already embedded in forward rates and we think a great deal of that is already embedded into the yield curve, given the OIS, or the overnight indexed swap information that we currently have. So we wouldn’t expect to see significant exchange rate effects from this tightening phase. We could be wrong, of course, but we wouldn’t expect to. In terms of interest rates, yes, you would expect—

Parker Credit flows was my question, not interest rates.

Wheeler Sorry, I thought you meant savings. Forgive me. In terms of the impact on domestic savings, you wouldn’t expect a substantial increase in household savings. I mean, the interest elasticity of savings is not particularly high in most countries.

Parker Is there a chance that the banks will be trying to lend more money as a consequence of this interest rate differential, which we know is going to be
there for some years, which will put further upward pressure on house prices?

Spencer  I think in general a higher interest rate is going to encourage domestic savings, not discourage it. So higher mortgage rates, I mean there is less demand for credit, and now actually there’s a huge volume of deposits that New Zealand public have in the banks and they are going to be remunerated at a higher level. That makes it more attractive to save and that incentive I’d say is considerably stronger now that it was say 10 years ago, because the growth in savings, the growth in deposits, has been substantial in recent years.

Parker  You’ve said that you think that the exchange rate effects of this increase are already factored into the exchange rate. How concerned would you be if the already record trade-weighted index climbs higher, in terms of its effect on the non-primary export sector?

Wheeler  I think that would be a concern, and we’ve expressed that concern for quite a long time. In each of the OCR statements we release, we indicate that the high exchange rate is certainly a significant headwind for the traded goods sector, particularly for those exporters who are exporting to Australia and they’re not exporting commodities. So the terms of trade, price, etc. has been strong. We’ve also indicated that we expect in the long run that this exchange rate can’t be sustained.

Parker  What do you forecast it going to then, within the next—like you know, I’m sure you can point me to the graph here, but just in general terms, when do you predict that it’s going to drop?

McDermott  We have it steadily falling down to around about 75.7 by the March 2007—

Parker  March 2007, did you say?

McDermott  Sorry, 2017. Apologies. It’s one where we’ve seen, given conditions in the rest of the world relative to New Zealand, an expectation that we want to see the TWI fall more than it has, but there’s been a very big persistence, and some of that has been due to the very good terms of trade New Zealand’s enjoyed. So we expect that resistance to stick around for quite a while.

Parker  So the increasing reliance that New Zealand has on primary exports, especially to China, is set to continue out to 2017 then, at least.

Spencer  We have it coming off—if you look at graph 5.3 on page 21, you see that there’s a very close relationship between the history of the exchange rate and the terms of trade. And as we note, the terms of trade are at record levels. The exchange rate’s high as well. So that’s the main driver. It’s not—you know, relative interest rates are a separate factor—they still are relevant, but the terms of trade is the main driver. We’re assuming the terms of trade will come off over the forecast track to some extent and that the exchange rate will come off in line with that.

Wilkinson  I’d be interested in hearing from you an update on how the impact of the LVR is going because it is relatively new in terms of first home, second
homes trends, regional trends—are you noticing any second-tier lenders coming into the market?

Wheeler Well, we believe the LVR restrictions are helping to moderate house price inflation, and we won’t know the full story, I think, or at least more of the story, probably till about another 3 months or so, but let me tell you where we think things are at this point. If you look at monthly house sales, they’ve declined 13 percent since September. In Auckland they’ve declined 15 percent. If you look at the seasonally adjusted Real Estate Institute data on house prices and you take the 4 months to February—so it’s the 4 months in which the LVRs were introduced—then house price inflation picked up 1 percent in those 4 months.

If you take the 4 months prior to that, then house price inflation was running at 4 percent instead of the 1 percent. We did some modelling work to see what would have happened—and there’s always uncertainties around the modelling—if the banks had continued to lend say 25 percent to 30 percent of their loans to people with low deposits. Instead of being where they are now, around the 6 percent to 7 percent, albeit the limit is 15—it’s 10 plus exemptions for 5—we think that house price inflation would have been about 2.5 percent higher. So nationally, it’s running at 8.4 percent now. We think it would have been around 11 percent.

Wilkinson Are you noticing any of those second-tier lenders coming in, because—

Wheeler No. We wondered and worried to some extent about what’s called financial disintermediation—would institutions that are not regulated come in and take a big part of the market. We’ve seen some of that but not a great deal. I mean, an offshore company has entered the market or accelerated, but it’s not significant at this point.

Wilkinson But it might, as time goes on, get more and more established clientele, if you like?

Wheeler It could over time and it’s something we’ll watch.

Parker So LVRs, you say, are working, but they’re working to fix a problem that doesn’t exist outside of Auckland and Christchurch, given that house price inflation outside of those regions is really about 5 percent or less. Do you still think that the curbs that you’ve placed on the rest of New Zealand have been justified by problems in house price inflation in Auckland and Christchurch?

Wheeler We didn’t think that house price inflation would be confined to Auckland and Christchurch. We felt that it would spread and—I mean, we had the lowest mortgage rates in 50 years and there were supply shortages in some parts of the country. We worried that the supply/demand imbalance could take a number of years to correct itself, and, in the meantime, house prices would rise rapidly. So if we take, for example, the 3 months to February over the same period last year—because the monthly data is too volatile, so take the quarter over the previous quarter a year before—and prices in Taranaki are up 9 percent, Waikato is 8.5 percent, Northland is 7 to 8,
Nelson is 7 to 8 Hawke’s Bay is 6. This is not just an Auckland, Canterbury issue.

Ross Just firstly, on Kate’s question about second-tier lenders and the number of mortgage brokers that are starting to assist with deposits—is that of concern to you?

Spencer Well, I think, as Graeme said, it’s at a very low level at this point. Brokers themselves are not funded, so there’s very little activity from the brokers themselves and their intermediaries. So they’re going to, sort of, mortgage originators who are funded in the markets and the availability of funding to those players is very much dependent on a diversified asset portfolio, so market funders are not interested in securities that are made up of all high risk or high LVR loans. So the volume of that activity has been quite restricted.

Ross The Government has taken a number of policy steps to try and increase land supply and housing supply, particularly in Auckland. Are your comfort levels around the number of building start-ups in Auckland, number of consents issues—are your comfort levels increasing on that housing question with Auckland?

Wheeler They’re increasing, but there’s more work to be done. I mean, the last permit data I saw, Auckland was running at around 6,500, maybe a little bit more now. That’s an improvement over 4,000, that’s for sure. It’s good that potentially 15,500 new sections are being fast tracked, but really we need to see a stronger supply response up in Auckland.

Ross What’s your current thinking as to how long the LVR restrictions will remain in place. Can you give us any indication?

Wheeler No, not at this point. We think the LVR restrictions are doing their intended job in terms of financial stability. We wouldn’t want to see the restrictions lifted if one was to see a response that led to a significant increase in house price inflation or further imbalances appearing in the housing market.

Ross When would you start consider removing them?

Wheeler Well, that’s something that we’ll work our way through. We’ll look at the housing data. We’ll look at many factors.

Norman Just looking at the components of the inflationary pressures. I mean, it’s very clear that it’s all the non-tradable sector and in fact the tradables has got deflation—presumably as a result of the high dollar, amongst other things. So looking at the housing market, I mean, we’re talking 8.8 percent nationally in the 12-month period, but in Auckland more like 15 percent, with an up-tick, actually, in the latest numbers, which is kind of interesting. If, instead of looking at 8.8 percent nationally over the last year, we were looking at a flat housing market, would you be raising interest rates or the OCR today?

Wheeler If the housing market was flat? Yes, we would.
Norman: So if you’d have zero inflation out of the housing sector for the last 12 months, you’d still be raising interest rates?

Wheeler: Yes.

Norman: And why is that?

Wheeler: Well, if you look at the factors that are driving the economy, I mean the terms of trade are at a 40-year high. So the terms of trade are 25 percent higher on average than they were in the 1990s. We see that in the dairy prices—43 percent up, for example. If you look at investment, residential investment’s up 40 percent in the last 2 years. If you look at Canterbury reconstruction, investment’s likely to be about $1.5 billion extra this year than what it was last year. We’ve seen a huge turn-round in migration from minus 4,000 to plus 26,000. These are very big things. And we’ve got consumer confidence the best in 7 years, business confidence the best in 20 years. I mean, this economy has got a lot of momentum and it’s starting to build up some of the inflationary pressure. So even if house prices had been zero, this economy would still be growing quite rapidly.

Norman: And so, just looking at the CPI, I think housing and electricity together make up maybe a third of the CPI increases. So even if the CPI was a third lower than it currently is, you would still be pushing up interest rates?

Wheeler: Yes, because we think the economy would still be growing rapidly. I mean, at the moment the economy’s probably growing at about 3.5 percent per annum. We think potential output, which is how fast could the economy grow at full employment without generating inflation pressures, is probably around 2½ to 2¾. So we’re growing faster than potential output. So inflation pressures will start to build up, particularly as the labour market tightens. We’ve got the unemployment rate falling below 5 percent, business utilisation capacity is increasing, so we will be seeing those sorts of inflation pressures. Some of the inflation pressures, you’re right, are coming through from the Government side in terms of tax increases as well.

Norman: And so looking at it from the point of view of the households, I mean, I’ve got someone here who’s had a letter saying that their electricity bill’s going to increase by 24 percent, and people all across the country are getting these letters at the moment, saying that their electricity prices are going up. At the same time we’ve got this very significant house price inflation pressure, and it’s also reflected in rents. On top of that, we’re going to increase mortgage rates as a result of this. I mean, how do you expect households to respond to those kinds of pressures on their capacity to pay their bills?

Wheeler: Well, household income, for many people in the economy, is picking up. I mean, employment growth over the last year has been 3 percent. Our objective in all of this is to sustain this recovery for as long as possible. I mean, central banks are often cast as taking away the punchbowl when things get interesting; the party gets into the swing. You know, people should not forget that the Reserve Bank spiked the punch, in a sense, to get this party going. To get the recovery under way, we reduced interest rates to the lowest level in 50 years, and basically we’re now into a tightening phase.
for the first time in 5 years. Our objective is to keep inflation under control so that competitiveness won’t get eroded, so that real incomes don’t get destroyed by inflation, and we can sustain the recovery for as long as possible.

Norman I appreciate that. So from a household level, however, this is going to look rather different, because labour cost index has lagged behind CPI, so wages are actually increasing less than inflation and CPI. And so the pressures on households are pretty extreme. But from a macroeconomic point of view, if I could just go on to just look at that, we’ve got this kind of interesting proposition where we’ve got terms of trade at record levels and yet got a very high current account deficit by current international standards, in the OECD. Would you say that terms of trade is a result of Government policy or are high terms of trade something external to Government policy?

McDermott Terms of trade is just the situation in which we can sell—prices of the things we make to the rest of the world.

Norman So, it’s a function of the global economy not of anything New Zealand particularly has done. So here we have terms of trade at 40-year highs and yet still we’re running over 4 percent of current account deficits. I mean, it kind of doesn’t get much better than this in terms of terms of trade. In fact, it hasn’t got better than this in 40 years, and yet still we’re running very large current account deficits by international comparison. Aren’t you concerned about that apparent contradiction between those two things?

McDermott But it’s not a contradiction at all. What you would expect with future prospects being very good is much more investment. That’s what you would expect to see, and the fact is New Zealand for a long time hasn’t provided enough domestic savings for its investment needs. We’ve seen the gap between investment and savings widen and that is reflected in the current account, and that’s what we’re seeing.

Norman And so it’s also reflected in the fact we’re also seeing household savings rates have gone negative as well.

McDermott They’re somewhat negative in the future, but it’s a lot less than it was in the previous cycle where we saw household saving rates some 9 percent of household incomes.

Norman Yeah, and so it’s turned negative. We have large current account deficit, we’ve got best terms of trade in 40 years, we’ve got house prices which are still rising at about 9 percent—does that not look to you like a similar kind of cycle to what we had last time, where we had this kind of debt-fuelled consumption boom?

Spencer The savings performance is still quite a lot stronger—a lot stronger than it was in the previous boom. That is what John is saying. So main cause of the deterioration coming up is the boom in investment, it’s not deterioration in savings. So it’s investment spending, which is obviously good for the economy, good for future growth; it’s not consumption-led binge that’s causing the deterioration in the current account.
Goldsmith: I see the figures that you’ve got there, actually 3.2 percent in the current year and all your figures have been better than they were in December, so they were only 3.7 percent the following year. How does that compare with the previous cycle we had in the 2000s and also how does it compare with Australia at the moment in terms of the current account deficit?

Wheeler: New Zealand and Australia have had large current account deficits by and large for 30 years. In our case it’s averaged 5 percent of GDP. You know, it’s correct to say look, with the terms of trade so high, why are we still running large current account deficits? I mean, that is a fair question. We are running a trade surplus, but the current account is still in deficit. Really the issue, as John said, is the current deficit is really a reflection of the difference between savings and investment nationally. That is what it reflects. The truth of the matter is that we need to have higher savings in this country. Australia has had large current account deficits over the last 30 years as well.

Goldsmith: Despite very different savings policy.

Peters: Look, gentlemen, it is slightly difficult to follow your logic, because you say that you have—again, you have repeated it—the lowest interest rates in 50 years. And yet where you are moving is going to see interest rates disparities between us and most of the world greater than they have ever been—more than five times what is happening in other countries. So why am I not entitled to come to the conclusion that, by comparison, in real terms we have the highest interest rates we have ever had?

Wheeler: Well, let me put it this way—

Peters: How about this way: was there ever a time when we were paying here four times the interest rates of international home buyers—mortgagors—were paying?

Wheeler: It’s certainly true, as I said, that interest rates in the advanced economies in the rest of the world, by and large, between nought and one, and we have seen $6 trillion of quantitative easing. We are sitting here with interest rates—policy rates—of 2.5, and we are raising them by 0.25 percent today. But let me put it in context. If you look at this recovery, the economy is growing really quite rapidly. There’s a lot of momentum and the recovery’s increasingly broad-based.

You say to yourself: “What could stop this recovery? What could turn it into a recession? What are the things?” One would be if the global economy went into recession. That could certainly do it. Most of the consensus forecasts are that the global economy will grow about 3.5 to 4 percent for the next year or so—about the average it has done for 30 years, except it’s still requiring this massive monetary stimulus to get there. There could be a terms of trade decline, a sharp one. You sort of say: “Well, what you trigger that?” Well, something in China could certainly do it, if it went pear-shaped quickly. Or it could be mistakes in macro policy—if the Government adopted a reckless fiscal policy, that would force us to raise interest rates rapidly. Or it could be a rise in inflation.
So when you look at small, open economies, why they get into trouble, in essence, if it is not due to the rest of the world or commodity prices collapsing or big policy mistakes, it’s because inflation starts to rise and get away on the central bank. That starts to erode the growth in real incomes, it starts to erode competitiveness. What we’re trying to do is to keep inflation expectations stable as best we can—try to keep inflation around 2 percent going forward—and sustain this recovery for as long as we can.

Peters But that’s my point. You see, you’ve got your global economy growing at a greater rate than New Zealand in the midst of what many are describing as a rock star economy, recovery. It was 3.4 last year, 3.6, you say, for the coming year—sorry, 3—then 3.5 for this year, the current year. Then 2.4 for 2015-16, 2.3 for 2016-17. Yet in answer to a question today you said: “Our intention is to sustain the recovery for as long as possible.” Well, this has become one of the shortest recoveries we’ve ever had, hasn’t it? Two years—that’s it.

Wheeler Not at all. The growth in the outer years—these are conditional projections, as I’ve said, and you would expect growth to slow down as a result of rising interest rates. But it is still positive growth, it is still about the rate of potential output growth. There is still 105,000 jobs being created over this forecast period.

Peters But, you know, in an answer today about—the question you were asked was what lessons do you draw from past experiences and what might stymie the recovery, and your answer was, you gave a summation of it before: drop in world growth, drop in terms of trade, macroeconomic policies such as reckless fiscal policy, sharp fall in house prices. But you never mentioned a serious rise in interest rates.

Wheeler Well, as I say, what we’re trying to do is to raise interest rates to contain inflation pressures. We’re not trying to surprise the market. We’ve talked extensively and on the record—speeches and in OCR statements—about our intentions here, our concerns.

Peters All right, look, we’re still in a situation where the only way to contain inflation is interest rates, right? That’s what you’re saying, isn’t it?

Wheeler That’s the way most countries contain inflation—through monetary policy.

Peters Yes, OK, but strictly interest rate rises.

Wheeler Yes, essentially.

Peters OK. In an answer today you said that we’re between the seventh and 10th most traded currency in the world. What is your explanation for that?

Spencer I think, it’s an internationally traded currency. One of the key drivers of this is the fact that we do take very little exchange rate risk, because we run a current account deficit, as we were discussing before. We do have an external debt and it’s effectively hedged in the Kiwi dollars. We don’t borrow in foreign currency. That’s very risky. So when you want to hedge that into Kiwi dollars, you have to convince foreign investors to take Kiwi dollar risk. They need to invest in New Zealand dollars. And a lot of them
hold Government stock, but they also hold other instruments, such as these kauri issues in New Zealand dollars. So when you require the world to hold New Zealand dollars, there’s a natural interest and there’s a natural market in Kiwi, and that tends to underpin this high liquidity and relatively high turnover for the size of our country in terms of the foreign exchange market.

Peters  A relativity of 35:1 currency means we’re—inaudible—That’s how it’s explained away?

Spencer  I guess what I’m saying is it’s not just the international market punting on the Kiwi because it’s a small volatile currency. It’s not actually a particularly volatile currency. It’s quite stable, relative to other currencies, but it is a relatively high volume of trade, and a lot of that trade is for hedging—it’s for removing risk, not adding risk.

Peters  Look, in terms of rises of falls in the currency, do you know any other currency in the world in the last 20 years that has risen and fallen like ours?

Spencer  Ah, yes.

Peters  I know the ones that have risen, I’ve known ones that have fallen, but which economy has the currency going up and down like ours?

Spencer  Well, as I say, if you get the measures, which we’re happy to provide, in terms of volatility of exchange rates over time, the Kiwi volatility is not out of line with any other currencies.

Peters  Well, I’m asking, do you know of any other currency that has been as volatile in terms of upward and downward movements as the Kiwi currency?

Spencer  Well, I’m happy to—there are certainly currencies more volatile.

Peters  Give me—

Norman  If you could provide us with that, that would be great.

Peters  Give me one.

Wheeler  We’ll provide the information.

Peters  No, no, look. Sorry, Mr Chairman. We’ve got three seriously experienced experts here. They must know one currency that’s been as volatile in upward and downward movements.

Wilkinson  Australia.

Wheeler  Well, take the Australian dollar, for example. I mean, back in May, the Australian dollar was 106 to 107 to the US dollar. It then fell rapidly to 89, for example. That’s a very significant—

Peters  Yeah, well, that’s a recent event. I’m talking about over a period of time where you could make a very good comparison.

Goldsmith  We’ll get that answer through. I think you’re—

Spencer  Jason, have you got any comment?
Wong I just think the Australian dollar’s an obvious one.
Peters No, it’s an obvious one for the last year and a half, but it hasn’t been for the last 10 years, has it?
Wong {inaudible}
Peters Well, I’d like you to provide the evidence—
Wheeler We’ll provide the data.
Goldsmith All right, thank you. Just before I go, we’ve got Maggie Barry then David Clark, then Shane Jones quickly. Just before I do those, you talk about one of the potential risks being reckless fiscal policy. What would you describe as reckless in terms of new spending? I know we’ve had about a $1 billion cap over the last few years. There was $3 billion towards the end of the last Labour Government, which led to very high interest rates. Is that what you were thinking of in terms of reckless fiscal policy, or did you have a particular figure in mind?
Wheeler It was a situation where the economy is growing very, very rapidly, and do you want the Government to be providing a great deal of extra stimulus to that economy. The answer is, at this point in time, absolutely not. It would not be warranted. So to the extent that a Government decided to give large tax increases or large tax cuts or large spending increases, then that would not help the economy. It would almost certainly be reflected in greater inflation pressures and higher interest rates.
Parker Given that we’re still currently in deficit and the Government’s going to have some difficulty getting back to deficit and both sides of the House seem to be committed to running surpluses, it doesn’t seem a very likely risk in the near future, would you agree?
Wheeler If the Government gets back to surplus, that would be very, very positive.
Barry Couple of quick questions on unemployment. It’s currently at 6 percent—
Parker Can I just comment that that was a pretty political answer. You know, I—
Wheeler It wasn’t intended to be.
Parker Because it sounded one-sided to me—
Wheeler No, no, I think I said—you asked about the Government—
Parker No, I said both sides of the House—
Wheeler If that was true for both sides of the House—
Parker Given that we are struggling to get back to surplus, it doesn’t seem that that’s a very large risk facing us at the moment.
Wheeler If that’s the case, then that would be very welcome, whoever’s in office. Sorry, that was not intended to be a slip.
Barry So 6 percent unemployment currently. Say it’ll go to 5 and perhaps below, how are the interest rate rises through the OCR going to impact on the unemployment figures?
Wheeler: Well, we’ve got employment growth of 105,000 extra jobs in this forecast period. So the unemployment rate falls to just below 5 percent. Now, that’s with this projected rise in interest rates, so that’s built into the forecasts.

Barry: One of the minor parties is running the line currently that the 1 percent rise in the OCR equates to 30,000 fewer jobs. What’s your view on that?

Wheeler: Well, that was a sort of bit of work we did in the bank which was a sort of hypothetical situation. Let us say that the monetary policy or the central bank suddenly provided a big interest rate shock—i.e., it’s unanticipated—what would be the effect on output and unemployment? That was a scenario that we ran. But, you know, as I say, we’re building in substantial interest rate increases and we’re talking about unemployment falling, and 105,000 jobs being created.

Clark: Governor, you’ve referred to an increasingly broad-based recovery, and I think that it’s fair to categorise that as largely consumption-based. Given last year there was a 6.5 percent real drop in non-primary and manufacturing exports, it seems in some ways it’s an increasingly narrow recovery—we’ve got more in the dairy basket, with the prices going up there. Are you worried about that drop in exports over the past year of non-primary—i.e., simply and elaborately transformed goods—and the potential for an increasing narrowing of our exports; and, if so, what policy responses do you have available?

Wheeler: I think there’s an issue in terms of the export mix that we have in terms of countries who we export to. We’re increasingly dependent upon China. I mean, 10 years ago China, I think, accounted for roughly 3 percent of our exports, and now it’s 21 percent. We account for a huge proportion—I think it is about 80 percent—of their imports of milk powder. So we’re very, very dependent upon China. Is it a concern that manufacturing exporters in particular are facing problems in exporting to Australia, and to some extent the States as well? Yes, it is.

Clark: I guess with the 6.5 percent real drop last year, it’s hard to imagine how that’s going to get better in the foreseeable future, and I guess—I don’t know; perhaps there’s no obvious policy response you’ve got at this stage?

Wheeler: Well, the US economy—at least, my personal view is I’m positive about the US economy. A consensus forecast for next year of about 3 percent growth. The same for Australia—about 3 percent growth.

Clark: So you’re anticipating a rise, then, in elaborately and simply transformed non-primary exports?

Wheeler: Well, what you’d expect is if real growth in those economies starts picking up along the lines of your consensus forecast, then that will increase the demand for our exports.

Clark: So you are anticipating a rise? I’ll come back to this next time round, if that’s what you’re saying.

Goldsmith: Very good. Well, thank you very much, Governor, for coming in and taking the time. **Conclusion of evidence**
Reserve Bank of New Zealand’s Financial Stability Report, May 2014

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Paul Goldsmith, Chairperson)
May 2014

Presented to the House of Representatives
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Reserve Bank of New Zealand’s Financial Stability Report, May 2014

**Recommendation**

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s *Financial Stability Report, May 2014*, and recommends that the House take note of its report.

**Introduction**

The Reserve Bank of New Zealand is required to report twice a year on the soundness and efficiency of New Zealand’s financial system. The following are the main points from its May 2014 financial stability assessment:

- New Zealand’s financial system is sound, and well placed to support growth in the economy. It is judged to be stronger now than it was from 1999 to 2007, before the global financial crisis.
- The banking system is well capitalised, with funding and liquidity buffers comfortably above minimum requirements. Non-performing loans continue to decline. Banks are less reliant on offshore funding after growth in domestic deposits over recent years.
- While risks to the financial system have decreased, there are still several areas of concern.
- Household debt remains high relative to incomes, and house prices are still significantly overvalued, making borrowers and the banking system vulnerable to changing conditions.
- Agricultural debt is also high, particularly in the dairy sector. While earnings are strong at present, there is a risk that prices for dairy exports and land could drop if international conditions deteriorate.
- If China’s fragile financial system reached crisis point, reducing its growth rate, there would be repercussions in the rest of Asia, and Australia.
- New Zealand remains exposed to international financial markets because of its external indebtedness and continuing current account deficit; this leaves banks vulnerable should domestic savings decrease or international debt markets deteriorate.
- Over the coming year, the Reserve Bank will undertake three important projects in its regulatory and supervisory roles: a stocktake of regulations covering the financial sector, stress-testing of the banking system, and devising a framework for supervision of the insurance sector.

The rest of this report discusses the main issues we considered during our examination of the financial stability report and in our discussion with the Governor of the Reserve Bank.
Housing market and mortgage lending restrictions

On the basis of the six months since “speed limits” on low-deposit mortgage lending were introduced in October 2013, the Reserve Bank considers that they are having the desired effect of moderating house price pressures and reducing the risk of a severe market correction. All banks have complied with the restrictions, and there is little evidence of avoidance or a shift to non-bank financial intermediaries.

The Reserve Bank estimates that house-price inflation is about 2.5 percent lower than it would have been without the restrictions. It expected an impact of 1–4 percent over the first 12 months. We note that the precise effect on house prices is hard to measure, as housing of different values is affected differently, with a bigger effect on lower-priced housing.

We explored whether the restrictions might in fact have been too effective. We note that house sales have dropped sharply, by 11 percent over the six months from October 2013 to March 2014, compared with an expected fall of 3–8 percent over the year to October 2014. The drop in sales has been particularly pronounced for lower-value houses, with sales under $400,000 falling 23 percent over the six months to March 2014. Banks appear to be taking a cautious approach to the 10 percent ceiling, with high-LVR lending averaging only 5.6 percent of total lending over the past six months—down from a high of over 30 percent. Lending exempted from the restrictions has amounted to only 1 percent of total lending, against the 5 percent allowed; the Reserve Bank does not consider this significant.

The Reserve Bank said banks were understandably cautious initially, as they risk penalties if they exceed the speed limit; larger banks in particular turned off the taps quite abruptly on low-deposit lending. Now that banks are more comfortable with their internal controls, the Reserve Bank expects them to increase such lending gradually up to about 8 percent of the total, still allowing a comfortable buffer. While banks responded more sharply than expected, the Reserve Bank does not conclude that the restrictions should have been implemented any differently.

Before removing the restrictions, the Reserve Bank says it would want to be sure that the housing market was responding to interest rate increases, and that immigration pressures were not causing renewed housing inflation. It believes the earliest it could judge this, and perhaps start to remove the restrictions, would be late in the year. It is still considering the best means of doing so; phasing them out gradually is one option, but it does not believe removing them from some regions before others would be viable.

Effect on first-home buyers and small businesses

We discussed the equity implications of the LVR restrictions. The Reserve Bank acknowledges that the policy has affected first-home buyers more than others: their borrowing as a proportion of total lending has fallen from 20 percent to 17 percent. It says that first-home buyers were not deliberately targeted, but have tended to be more affected as they make up a relatively large proportion of risky, low-deposit lending. It notes that with interest rates rising, debt servicing costs will increase. Buyers with low deposits could have become over-extended, so the measure protects individuals as well as the financial system against stress.

We also explored whether the restrictions are adversely affecting the ability of small businesses to access capital, as we are aware that they often mortgage their properties as security. We were told that credit to small and medium-sized enterprises is increasing,
particularly for commercial property. Such lending tends not to be at high LVRs, and so has been relatively unaffected by the restrictions.

**Data about investment in housing**

It is unclear to what extent speculative purchases by overseas buyers are fuelling housing pressures. The Reserve Bank acknowledges that the available data is limited, and that cash sales would bypass the banking system, and so be outside its sphere of influence. It notes that the data available suggests purchases by buyers based overseas account for less than 10 percent of sales; and this would include expatriate New Zealanders, and those returning from overseas. It is, however, aware of anecdotal reports of cash purchases of multiple houses in Auckland by non-New Zealand residents. It acknowledges that cash purchases are having some impact on the market, but believes the bulk of the market is credit-driven, with most buyers reliant on mortgage financing.

Some of us are concerned about such purchases, believing them to be a significant source of Auckland’s current house-price pressures. We asked the Reserve Bank whether it believes better data is needed. It told us it would be useful to have clearer information about the various buyer segments of the market, but obtaining such data would go beyond its powers. It would require some form of declaration by buyers of their residential status; how to gather such data would be a matter for the Government to decide.

**Financial risks from China**

The financial stability report contains a special section (pp. 15–17) discussing risks in China’s financial sector and the potential implications for New Zealand. It highlights three sources of risk: the “shadow” banking sector, local government financing, and the potential for a sharp downturn in China’s property market. It notes that the risks are substantial, but the Chinese Government has some capacity to manage them, and could intervene to stabilise financial markets and support the banking system if necessary.

The fragility of China’s financial system is becoming more widely recognised. The proportion of credit that has come from China’s unregulated “shadow” banking sector has grown rapidly, from 11 percent in 2006 to 32 percent in 2013. Such funding tends to carry higher risk, but is not always priced accordingly as there is a perception that banks implicitly guarantee the shadow products they distribute. Much of the shadow financing has been borrowed short-term to fund local government property developments and long-term infrastructure investments. China’s National Audit Office recently estimated local government debt to be 33 percent of GDP, with over half of it due to mature by the end of 2015.

The Reserve Bank told us the Chinese authorities are well aware of the risks, and recently announced plans for financial sector deregulation and liberalisation as a core part of an ambitious reform programme. The governor said that financial sector deregulation is difficult at the best of times, as it leads to rapid growth in credit outside formal channels. With China’s real output still growing by 7.5 percent a year, implementing the plans will be a huge challenge for the authorities, without precedent in any other country. However, he observed that while the risks involved are substantial, the Chinese authorities deserve credit for the country’s growth record so far: no other country has achieved anything like China’s 10 percent annual growth over the past 30 years. He also noted their willingness to seek advice from a wide range of sources, including the World Bank, IMF, US, and EU, before developing their own approach.
We will watch developments in this area with close interest.

**Implications for New Zealand**

If financial instability in China led to its growth rate slowing, it would affect New Zealand in two main ways: by reducing China’s demand for our exports, and by disrupting overseas funding conditions. While New Zealand could seek to maintain export volumes to other markets, global prices would be likely to decline, and economic spillover from China could weaken other Asian countries, and Australia, reducing their export demand as well.

The effect on global financial markets is less certain, but the Reserve Bank notes that a loss of investor confidence in the Asian region could result in outflows of capital from New Zealand. Even though the New Zealand banking sector’s ability to weather temporary disruption has improved since the global financial crisis, it remains vulnerable because of the need for access to funding from overseas to finance continuing current account deficits.

**Reliance on overseas borrowing**

We note that better private-sector savings since the global financial crisis boosted the domestic deposits held by New Zealand banks, making them less reliant on overseas funding. We asked the Reserve Bank whether New Zealand’s vulnerability to developments in financial markets overseas is likely to worsen if rising interest rates mean that savings are reduced. The Reserve Bank said this is a risk. It has not yet seen any let-up in the growth of domestic deposits, but it is forecasting growth in the current account deficit as the substantial infrastructure investment needed over the next few years will exceed the funds available domestically. The size of the gap to be financed overseas will depend on how well people retain the lesson from the global financial crisis about the need for caution in borrowing and spending.

**Export concentration**

We are aware that China’s share of New Zealand’s exports has grown enormously over the past decade—from about 4 percent to 21 percent of total exports, and about 30 percent of dairy exports—and that it overtook Australia in 2013 as New Zealand’s largest export market. We asked whether the Reserve Bank is concerned about the increasing concentration of New Zealand’s exports on China. The governor told us there is no question that China plays a hugely important role in New Zealand’s economy. He considers it would clearly be in New Zealand’s interests to have more diversified exports, both in terms of products and of destination. He sees numerous opportunities for New Zealand to open up new trading contacts over time, given the rapid growth rates in middle-income countries and work around the world on bilateral and free-trade agreements, such as the proposed Trans-Pacific Partnership.

**The exchange rate**

Although there tends to be a strong correlation over time between New Zealand’s exchange rate and its terms of trade, we note that the 22 percent decline in dairy prices in recent months has not been matched by a fall in the exchange rate. We asked the Reserve Bank whether this reflects the increasing differential in interest rates between New Zealand and elsewhere, with higher rates here attracting funds from overseas where interest rates are lower. The Reserve Bank said it is likely that this “carry trade” inflow of funds will remain strong, and may increase. While it has signalled clearly the likelihood of future
interest rate rises, and believes the professional market will have already built this into expectations for the exchange rate, retail investors such as Japanese householders may react more to published interest rates day by day. This could underpin strength in the exchange rate.

Financial regulation and oversight

Over the coming year the Reserve Bank will undertake some important projects to check that New Zealand’s financial institutions, and its regulatory regime, are in good shape. It sees this as fine tuning, and does not expect major concerns or changes to emerge.

We welcome its plans to review legislative settings and to develop a framework for stress-testing the New Zealand banking system. The global financial crisis highlighted the importance of robust regulations, and of evaluating the resilience of individual banks, non-banks, and the system as a whole, in various potential scenarios.

Regulatory stocktake

Banks, non-bank deposit takers, and insurers in New Zealand have been adjusting over the last few years to several legislative changes made in response to the global financial crisis, and initiatives by the global financial community known as Basel III. The Reserve Bank plans to examine how well the new regulatory regime has bedded in. Its stocktake of financial sector regulation will consider the efficiency, consistency, and clarity of the rules, and look for ways they could be improved.

We are mindful that protecting the financial system from risks also entails compliance costs for institutions, which are ultimately passed on to their customers. We asked the Reserve Bank whether it will be evaluating the additional regulatory costs imposed on the system, to ensure they are kept to the bare minimum needed. We were told that the Reserve Bank’s prime concern is financial stability, but it also has a mandate to ensure the system’s efficiency. In considering how the new regulations fit together, it will look for any redundancy in the system, and whether the regulatory regime could be simplified or streamlined, with a view to ensuring costs are no greater than necessary.

Stress testing

The Reserve Bank also plans to examine how well banks and non-bank deposit takers are placed under the new system to cope with any future shocks. We heard that banks regularly use stress testing in their risk management. This exercise will seek to apply a more consistent, comprehensive, regular framework to all institutions, to help understand their capital adequacy and resilience. The bank intends to publish aggregated but not individual results, and says it does not expect any nasty surprises.

Insurance sector supervision

Now that all insurance companies have completed the three-year transition to full licensing under the prudential supervision regime introduced in 2010, the Reserve Bank’s focus has turned to ongoing supervision. It is developing a data collection and reporting system, and will be carrying out a review of risk governance in the insurance sector.

The financial stability report comments that the general insurance sector has been managing the substantial claims liability created by the Canterbury earthquakes, but needs to maintain urgency in resolving claims.
Appendix A

Committee procedure
We met on 14 and 28 May 2014 to consider the Reserve Bank of New Zealand’s Financial Stability Report, released on 14 May 2014. We heard evidence from the Governor of the Reserve Bank, and received advice from our independent specialist adviser, Brendan O’Donovan.

Committee members
Paul Goldsmith (Chairperson)
David Bennett
Dr David Clark
John Hayes
Dr Russel Norman
Simon O’Connor
Hon David Parker
Rt Hon Winston Peters
Grant Robertson
Jami-Lee Ross
Hon Kate Wilkinson

Evidence and advice received
Reserve Bank of New Zealand, Financial Stability Report, May 2014.
Corrected transcript of hearing of evidence 14 May 2014

Members
Paul Goldsmith (Chairperson)
David Bennett
Dr David Clark
Hon Clayton Cosgrove
Julie Anne Genter
John Hayes
Simon O’Connor
Hon David Parker
Grant Robertson
Jami-Lee Ross
Hon Kate Wilkinson
Andrew Williams

Witnesses
Graeme Wheeler, Governor
Grant Spencer, Deputy Governor, Head of Financial Stability
Bernard Hodgetts, Head of Macro-Financial Department
Geoff Bascand, Deputy Governor, Head of Operations
David Hargreaves, Manager Macro Financial Policy
Toby Fiennes, Head of Prudential Supervision
Naomi Mitchell, External Communications Adviser

Goldsmith Welcome, Governor and the Deputy Governors. Thank you very much for coming in. We’ve got, obviously, your report—if you could just take us through the highlights, and then we are very keen to ask you some questions.

Wheeler Thanks very much indeed, chair. [Introductions]. The main conclusions from the report are that New Zealand’s financial system is sound and well placed to support growth in the economy, that the banking system is well capitalised, that funding and liquidity is at comfortable levels, and that non-performing loans continue to decline. But there are several risks that we point to in the report that require continued focus. One is the level of household debt, which is high relative to household incomes. Several measures suggest that house prices are overvalued and financial stability could deteriorate if there were to be a sharp correction in house prices, especially if accompanied by a reduction in debt repayment capacity.

Debt levels are also high in the dairy sector. A reduction in farm incomes and an associated fall in land prices could place pressure on more highly leveraged borrowers. At the broader level, New Zealand is exposed to
international financial markets due to the high external debt and the ongoing current account deficit. However, strong deposit growth in recent years has helped to reduce the reliance of the banking system on offshore funding.

Just to finish—just to mention that over the coming year we will be undertaking three important initiatives. One is that we will undertake a stocktake of financial sector regulation, particularly applying to banks and non-banks, with the aim of improving the efficiency, the consistency, and the clarity of that regulation. The second thing that we will do is we will develop a comprehensive stress-testing framework for the banking system, so we will do a lot of work on that. In the insurance sector, having completed licensing, we are now developing a framework for ongoing insurance supervision. So thanks very much—happy to take any questions.

Parker I have one specific question for a start. Can you share with us any insights that you’ve had as to what’s happening to growth in small business credit and whether this has been affected by loan to valuation ratios?

Spencer Well, credit to SMEs has been picking up, and it’s not—we don’t think that has been particularly affected by the LVR restrictions. There’s quite a lot of SME lending secured on mortgage; there wouldn’t be a lot of high LVR SME lending. Most of the increase in SME lending is related to property—the commercial property component of business lending is picking up a bit faster than SME lending generally.

Parker So there’s more money going into property than businesses, is really what you’re saying?

Spencer The commercial property may well be related to business, their business.

Parker Can I ask a separate question? You’ve noted that dairy prices are significantly off their peaks, that there appears to be a continuing divergence between our exchange rate and the commodity price trend, in part because the carry trade seems to be increasing. Is that correct, or have I been putting words into your mouth? Is the carry trade on the rise?

Wheeler If you look at dairy prices, they’re down about 22 percent in recent months. There’s a strong relationship over time between the exchange rate and the terms of trade. So we would expect that the dairy prices will be reflected in the terms of trade in terms of future data. When we look at current other commodity exports—other than logs, which look to have come off just recently—it looks as if the other commodity exports are still retaining their current price levels. But it’s true that the carry trade is likely to still be quite strong and may well strengthen, particularly from Japanese investors.

Parker In fact your report says that “Further issuance of NZD securities by non-residents could be incentivised by the outlook for interest rates to rise to levels that are significantly higher than most other advanced economies,” You don’t resile from that, obviously?

Spencer It’s an interesting point. I mean, a lot of people in the market would say that the increase in interest rates, given how well we have signalled that it’s coming—a lot of that is already built into the exchange rate. But the part
that may not be built into the exchange rate is the response, particularly from retail investors like the Japanese households, who would be responding more to just the rate they see on the page comparing different countries. But at the professional level, the market level, a lot of the higher interest rate track would be built in.

Parker One final question, and that is—you note the increasing concentration of New Zealand exports to China, which I now think are approaching 30 percent of total exports—sorry, over 20 percent of total exports, but with dairy exports it’s close to 30 percent. Is that a worry for you or do you have a view as what could be done?

Wheeler Is the question about the share of total exports to China or dairy in particular?

Parker Both, actually.

Wheeler If you look at China’s share of our exports, it’s been quite a phenomenal development. It’s gone from about 4 percent to 21 percent in the last decade. China has now replaced Australia as the largest exporter, in terms of the most recent data. I think in the last Monetary Policy Statement we produced a graph showing the share of agricultural commodity exports going to China. There’s been a remarkable increase in the last 4 years—pretty well against most commodities—so that China now is our largest importer of agricultural produce except for beef, where it is second. So there is no question that China is playing a hugely important role in this economy.

Is it too concentrated? The risk around China is the fact that if China got into financial difficulty or economic difficulty it would spread its way quickly through the Asia region, because its biggest exporter partner is other Asian countries. It would quickly feed into Australia and also into New Zealand. So that is a potential concern. If you look at what’s happening around the world in terms of countries trying to negotiate free trade agreements or bilateral trade agreements, or if you look at what’s happening with the Trans-Pacific Partnership, and you look at what’s happening with middle-income countries, their rapid rates of growth, there is really lots of potential opportunity to open up new trading contacts over time.

Robertson With respect, I’m not sure you quite answered Mr Parker’s question, which is the extent to which we need to be moving more urgently around the diversification of markets. You’ve got quite an interesting section where you go through—I think Box B on page 15, 16, and 17—what the risks are. So it’s a two part question. One is, can we draw you out a little further on the importance of diversification, but, secondly, the risks that you highlight in Box B around both the potential impact on exports and on capital—what is the time line of risk? How quickly is this going to become a problem for New Zealand—I’m now making this a three-part question—and then the extent to which you think the Chinese Government will intervene to stop it becoming that.
Wheeler Well, if you say “Would it be in New Zealand’s interest to have a more diversified export basket in terms of products, countries of destination?” then yes. Yes, it would be. I think there are avenues that the Government can explore. In terms of the immediacy of the risk around China, it’s largely in its financial system. If you look at the reforms announced in the third plenum, they’re the most ambitious that have been announced in 30 years in China. Key to them is financial sector deregulation. The tricky thing the Chinese have to manage is to deregulate its financial sector quite comprehensively, particularly in view of the rapid build-up in debt in the last 5 years and also the size of the shadow banking system, which is on some measures about a third of the total banking assets.

Financial sector deregulation is tricky at the best of times because two things happen. One is you get a lot of financial disintermediation—so you get a lot of rapid credit growth outside formal channels—and, two, you get a lot of financial innovation, because the regulations have come off. That invariably leads to quite rapid credit growth in a lot of economies. We saw that in Europe, we saw it in our own economy when we deregulated in the 1980s. No country that I am aware of has ever tried this when they’re growing at 7.5 percent output growth. So that’s the tricky thing they’ve got to manage—how quickly and how robustly and in a least-risk way to deregulate their financial markets. That’s their biggest economic challenge.

Robertson That sounds like a very big challenge and one that—the risk of them not being able to complete it alongside that 7 percent growth level. I mean, you are saying in this that there a risk they won’t be able to do that in a way that prevents the impact on New Zealand’s economy?

Wheeler You’ve got to give the Chinese authorities credit for the fact that—you know, no other country in the 20th century has achieved anything like their growth record. They’ve had 30 year years of, on average, 10 percent real growth. It’s slowed down to around 7.5 percent at present. In all my years in the World Bank they looked for advice from any source—the US, the World Bank, the IMF, the European community—more than any other country. They’ll do it their own way. It’s their trip. But they do seek advice, and they’ve got a great record so far. But there are substantial risks—and they know, of course.

O’Connor I just want to touch on the whole LVR side, which seems to be working. You express it as “having the desired effect”. So, just looking for some further comment on that—what have been the key indicators to you that have given you that confidence? For me it’s probably two comments in terms of how that’s gone across the banking sector. I’m conscious that different banks have approached this more rigorously, or not, than others. Secondly, you talk around sustained moderation in house prices being a key condition. How do you understand, define, or benchmark what’s going to be that sustained moderation from your viewpoint?

Spencer In terms of credit reduction, all of the banks have complied with the requirement to be inside the 10 percent over the first 6-month period. So everyone has complied, even the small banks. Most of them—the large
banks in particular—made very sure they were going to comply by pretty well turning things off with a high LVR. As you say, there were different approaches to achieving that, but at the end of the day total high LVR lending is 6 percent, which is, you know, well under the 10 percent in that 6-month period.

That has fed through into broader slowed-down mortgage credit growth in the order of sort of 1 to 2 percent. House sales have certainly come off—they’ve probably come off more than we anticipated. They’re down from the peak by about 10, 11 percent. House price inflation we think has been reduced as well, which, of course, is the key indicator for the pressure in the housing market. The sort of analysis that we’ve done suggests that that effect has been about 2.5 percent over the 6 months since the LVRs were introduced. In other words, house price inflation would be 2.5 percent higher if we didn’t have the restrictions.

O’Connor I just wanted to follow up on that. So, obviously, you had your benchmark of 10 percent down towards 6. You’ll expect to see that progress back towards 10 percent. Would you imagine it’s going to sit at 8, 9 percent on average in the next 6 months?

Spencer Yeah, I would expect the banks to target around 8 percent to leave a bit of a buffer so that now that they have the internal controls in place to manage it carefully they’ll be able to do a more precise job of coming under the 10 percent without it turning it off totally.

Hayes Two questions. The first is just that the banking system is in good shape but it’s all Australian-owned. What the implications for our banking system that flow from the Australian Budget?

Spencer Well, I haven’t studied the Australian Budget in detail, but there’s nothing that’s popped out that I’ve seen that’s particularly relevant that will impact the Australian banks and will have a flow-on effect to our banking system.

Hayes So their Budget is not going to knock their banking system around—knock their economy around, reduce growth?

Spencer Well, indirectly in the sense if it’s a tough Budget and it slows demand down, then that may well have an effect on the overall business of the Australian banks, but that would be affecting their Australian business, not so much the New Zealand business.

Hayes The second question relates to local bodies, and I notice in your report that about a third of the risk—sorry, one of the significant areas of risk in China is their local government borrowing, which is something like 33 percent of the total GDP. It seems to me that one of the big impacts on house prices here is also the activities of our local bodies. Is the bank doing any work in this area in respect of the local body contribution to our economy and the taxes that it imposes through all sorts of fees and levies and imposts on land development?

Spencer Well, we have no influence or control over that sector, obviously, but with regard to the housing market, which we’re very interested in, we certainly monitor the activities of the main councils, in terms of the demand supply
nexus in the housing market. We know that there has been a supply shortage, particularly in Auckland and Christchurch, and some of that has come out of the planning, the consenting process, development costs etc. We know that significant changes have been made there, particularly with the special housing areas in Auckland, and we think that’s a pretty promising development, in terms of the number of sections, the land area that has been freed up for development, and the approach that the Auckland Council has taken to encouraging development in those special housing areas.

Hayes Which is not replicated through much of the rest of the country and their local bodies.

Genter This is somewhat related. I am interested in the risks to financial stability that are related to where the housing supply has been increased. So, in the aftermath of the GFC, one of the clear patterns that was observed in the United States is that subprime mortgages or mortgages failed first in areas that were far from jobs, where transport costs were incredibly high. So are you at all paying attention to where the housing supply has been increased and whether or not there is going to be a risk if it’s far away from jobs—that transport costs are going to increase and put those mortgages at risk?

Spencer Well, as I said, we know the shortages were mainly in Christchurch as a result of the earthquakes and in Auckland because of the slow supply response that’s been there since about 2008, or so post GFC there hasn’t been much building, but the population has continued to increase. So that’s where the work needs to be done. I mean, in terms of other areas, we know that there are excess supply situations in some of the regions where economic activity and population has been less pressured.

Genter Sorry, if I could clarify. I think specifically in Christchurch and in Auckland there has been a trend towards new housing being provided far from where jobs are in very car-dependent places and places not near public transport, for example, so those households, even though they have lower mortgage costs, will have higher transport costs, and that could put them at risk of default should transport costs like oil prices increase. Is the bank at all paying attention to where the housing supply is increasing?

Spencer Well, Bernard might have some comments on this, but the special housing area, there are certainly a lot of them within the what used to be called the municipal limit as well as the ones around the outside. So I think they won’t have any problem with transport costs but clearly the transport infrastructure and the plans for that is a very important part making the whole thing hang together. So, if you’re going to put new developments out west in Auckland then clearly transport development has to move in parallel with that.

Hodgetts I think it would be fair to say our overarching concern is more around the rate of house price increases that have been occurring. That’s really where our concern comes in, in terms of the capacity for house prices to become overly stretched, which clearly would have potential implications for serviceability. So that’s the overall focus that we tend to have rather than a
micro “Where are the houses being built specifically around Auckland?”

Genter Can I just ask one supplementary on that, which is you’ve noted that the ratio of house prices relative to rents is extremely high and so we are at risk of a house price correction already. To what extent can we curb house price inflation without crashing the market?

Hodgetts The LVR speed limits I guess are designed to try and limit certainly further stretch in house prices occurring, and I think the evidence, as Grant mentioned, suggests we’re having some success there. But there’s no doubt that house prices are elevated and that’s certainly the risk that we’re working on in terms of trying to prevent that stretch becoming—continuing.

Genter Doesn’t that suggest that perhaps there isn’t as great a lack of supply as what—I mean the fact that rents haven’t inflated to the same extent as house prices. Does that suggest that there isn’t such a problem of supply in some places?

Hodgetts Well, possibly not so much in the rental market, but I think the movement in house prices more generally in Auckland and Christchurch certainly does suggest that there’s a shortage of supply—yep.

Goldsmith It’s an interesting point why there is a gap between rental—in Auckland anyway—not going up quite so quickly and house prices are, so it would imply that there is less of a shortage of houses and more of a shortage of houses to buy. Are you seeing a distinction there, or how do you explain that gap?

Spencer If you’ve got both going up then it’s a stronger indicator of a genuine supply shortage, like in Christchurch where you not only have the houses that were affected by the earthquakes but you have all of the people coming in for the rebuild putting additional pressure on. So when you see a situation where the rents are moving, are flat or declining, then maybe it’s telling you something about the composition between investor demand and the people, the demand for owner-occupation. So, for example, if you’ve got a lot of potential first-home buyers who are renting, who are all desperately moving out, wanting to buy their first home, then you could have pressure on house prices while rents are actually moderate because people are leaving rental accommodation. So it can be that balance between the different segments that can affect that composition.

Wheeler I think also that there’s some uncertainty about the extent of the housing shortage in Auckland. Some of the comments perhaps a year, 18 months ago, were talking about a shortage of 25,000 to 30,000 houses. But in terms of the census data, if you look at the population figures that came out of the census, you look at the average residency per household or occupancy per household, and you look at the number of houses that were actually built, then some people might suggest the shortage is something closer to 5,000 to 10,000 rather 20,000 to 25,000. There are clear differences of view around that particular point.
Goldsmith: You’re talking about the stocktake of the bank and regulations and NBDT regulations and about improving efficiency. How do you measure the sort of regulatory cost that you’ve added to both the banking and the insurance industries? Ultimately that’s passed on to consumers so how do you measure that cost and, in particular, how are you aiming to keep that to the absolute minimum, recognising that there is a trade-off between the cost and the risks that you’re averting for the wider sector?

Spencer: The aim, obviously, is the stability of the financial system, but we also have a mandate for efficiency. After the GFC there were certain areas where we felt regulation was lacking—the lessons of the crisis. And a lot of those lessons were international lessons as well as ones we that learnt ourselves here. One of the key ones here was around liquidity and funding and so the prudential liquidity policy that we brought in in 2010, particularly with the core funding ratio, we think was a key lesson and a key new regulation.

But there are also a lot of regulations around the Basel III initiative, came out of the Basel Committee. Things have come out of the Financial Stability Board, so over the past 5 or 6 years there have been these different areas of new regulation that have come in over the top of what was already there. So we think it’s important from time to time to take a step back and say: “Well, how does it all fit together when you take all of that in toto? What are we trying to achieve, say, with capital adequacy? Is there some redundancy in the system? Are the costs greater than they need to be? Is this simple, straightforward regulation? Can we simplify it? Can we streamline it?”

Those are the sorts of questions we want to ask, and we’ll consult. We’ll go through all of our bank/non-bank regulation, maybe to some extent the insurance as well, but that’s much newer so we’re not envisaging huge change there. And then when we have some potential changes and options we’ll go out and consult with the financial sector and then try and come to a conclusion about where we can make improvements.

Goldsmith: How much effort do you put into measuring the actual cost?

Spencer: We do the regulatory impact assessments as we go. As we bring something in we will do a regulatory impact assessment.

Goldsmith: That’s before.

Spencer: That’s right. That’s ex ante and this is ex post, looking at the combined effect of everything. You try and have to assess if you could achieve the same objective with an alternative measure at lesser cost. It’s that incremental change. But the counterfactual of no regulation is always very hard to assess, but we do our best to estimate those costs.

Clark: The chief executive of Harcourts, the country’s biggest real estate agent, has described the LVRs as they’ve been applied as a failed experiment, as they’ve had little effect on Auckland or Christchurch prices, as they are continuing to go up, while first-home buyers in lots of the regions are down. So in my home area, 2.8 percent down in Dunedin since October. Rotorua, I think, is over 5 percent down—a lot of regional areas. And you yourself said that the housing supply issue is really focused in Auckland and
Christchurch, and in some other areas they’re oversupplied. The feature I guess I’m worried about is, one, the overall effectiveness of the policy, but, two, the impact on wealth distribution as people who would be socially mobile are shut out of the housing ladder with the advantages it offers currently in terms of gaining equity over time. Have you got a comment to make on that? Do you think the Harcourts chief executive is plain wrong?

Spencer Well I think he has sort of mixed interests in the issue.

Clark That’s a given. I guess I want to talk about the principle at this stage.

Spencer But, you know, in terms of looking at the numbers, as we said earlier, going through those different measures, we do think they have had an effect. It’s certainly true that the LVRs have had a bigger effect on the $400,000 and below part of the market, relative to above. We still think it has had an effect through the whole market, but it’s been relatively greater. First-home buyers have been a higher proportion of high LVR lending than the rest of the market, so they have been impacted more, but obviously that wasn’t the intent of the policy. The intent of the policy is to reduce higher risk lending, but it so happens, obviously, that first-home buyers tend to have a relatively higher proportion of that risky lending.

But it does mean that, for example, as interest rates go up this year there will be less of those people who maybe would have jumped in and gone up to the hilt in terms of stretching themselves to get the mortgage. They may have been under a real stress as interest rates go up.

Clark Is it possible that as you look at removing the speed limits over time, that you look at removing them by region, in terms of the intended effect of the policy?

Spencer Well, that’s not our intention, no, because we’ve been through this and we don’t think that it’s a practical approach. But even though I’ve mentioned that there are some regions where there’s an excess supply, there are also other regions outside of Christchurch and Auckland where there is strength, such as the Waikato, the Bay of Plenty, Otago, and some others. So there’s quite a bit of pressure in the property market in some areas outside of Christchurch and Auckland.

Hodgetts I should just add, too, that of the fall in sales that we’ve seen since LVR restrictions came in, much of that fall has been concentrated in Auckland, so Auckland has actually seen a larger fall in house sales than the country overall. So I think on that basis we tend to think we are having some impact on the Auckland market, although admittedly, I mean, house price inflation, to start with, was higher in Auckland than everywhere else.

Clark I guess I’m not concerned about those regions. I can see a vested interest for the Harcourts people in the Auckland and Christchurch areas.

Ross It’s similar to David’s question. I guess how perceptive they are is based on what your initial assumptions were. I put it to you that the effect of the LVR has actually been much greater than you expected. In the first year you estimated that sales would drop off by 3 to 8 percent. They have dropped off by 11 percent in 6 months. Inflation you indicated would be reduced by
1 to 4 percent in a year. It’s actually taken off about 2.5 percent in 6 months. High LVR lending, the restriction is at 10 percent. It’s actually down 5.6 percent. Exempt borrowing you expected would be 5 percent of total lending—down at 1 percent of total lending.

And as we’ve just discussed, the first-home buyers are the ones who have dropped off. Their percentage of total lending has dropped from 20 percent to 17 percent. So I guess I would put it to you that the LVR restrictions that you put in place have almost been too effective and had a result in a particular area that may not be desirable. So if you’re looking at the policy, what would your learning be from it, and if the Reserve Bank in future years were to consider an LVR policy again, what do you think the Reserve Bank could or should do differently?

**Wheeler**

It’s a long question, so let me try to put things in context. If you look at house price inflation, New Zealand had the highest rate of house price inflation of any of the 35 OECD countries from 2003 to 2008. Unlike many advanced economies, house prices didn’t come back much in the global financial crisis. We started to see household debt levels build up again, which were already at around 140 percent of GDP. So you had the highest house price inflation in the advanced economies, for about 5 years no real correction, no substantive correction, in house prices, and house prices start taking off again, partly because of housing shortages and partly because in order to try to get the economy into recovery mode, we cut interest rates to the lowest level in 50 years.

We then faced the situation where house prices were starting to pick up quite rapidly, especially in Auckland, especially in Christchurch, but we knew this was not going to be just an isolated Auckland/Christchurch thing. We knew that house prices would start increasing significantly around other parts of the country, and indeed that’s the case. You can look at five or six provinces in New Zealand, major provinces, where house price appreciation is somewhere between 6 percent and 9 per cent, for example.

So we faced the situation of, how do we constrain bank lending behaviour at this point in time, when by and large 30 percent—in fact, it got up to about 32 percent—of bank lending was taking place to people who were highly leveraged i.e. had low deposits, and that was providing further stimulus to the house price appreciation.

At that time the economy was growing probably at around about 1.5 to 2 percent. The exchange rate was strong, and measured inflation was 0.7 percent. So the central bank can’t raise interest rates at that point in time. We’d been trying to stimulate the recovery after all, and inflation pressures were low, so loan-to-value ratios were put in place and I think, by and large, they have worked very well in terms of seeing the moderation in house prices that’s occurred. We’ve seen the volume adjustments that, as Bernard said, a great deal of them have taken place in the Auckland market.

What would we do differently? We wouldn’t look to put regional loan-to-value ratios in place because by and large we think there are major problems with those, and we also think that the pricing pressures are not going to be
contained to specific regions. If you look at many other countries who have introduced LV ratios, there’s about 25 of them, by and large they avoid regional LV ratios. So we wouldn’t go there.

But what has turned out a bit different from what we’ve expected—it’s interesting to see how quickly the banks cut back from lending roughly around 30 percent of their loans to people with low deposits, to system-wise, on average, for the last 6 months, around 5.6 percent. So that’s been very interesting to see.

We’ve also seen that the exemptions that we put in place, the 5 percent, because the limit is essentially 10 percent plus 5 percent for the exemptions—very little of that has been taken up. We’ve also seen that financial sector disintermediation has been less of a problem than we thought that it could be, although we did not expect that there would be a major problem, given essentially the demise of the finance companies, etc. But it hasn’t proved to be a significant factor.

Ross Do you feel you’ve landed in the right place when it comes to the exemptions, given that you’re expecting about 5 percent of lending would be that exempt lending, currently at 1 percent, and the first-home buyer question is one that was raised a lot, publicly in the media and with us as local members of Parliament, as well?

Hodgetts Just if I could comment on the exemptions. I mean, the main exemption, I think, the use of which has proven weaker than we expected is in terms of refinancing of mortgages, where people essentially repay our mortgage and take another mortgage out with another lender. That is the sort of activity that has been weaker than expected. So I mean to that extent people are intending to stay with their existing lenders more than we expected they might, but I think overall it is not really an indication that the level of activity in the mortgage market is a lot weaker than we expected. It is more just that people are not turning over existing mortgages to the extent that they may have done in terms of our assumptions. So we are not particularly concerned that the use of exemptions is weaker than we assumed at the beginning of the exercise.

Williams Yeah, two questions—one: the Auckland markets and the LVRs and why you feel that that was going to try and address the issue in Auckland. How do you counteract the argument that a great deal of the Auckland market has been determined by people with cash who don’t need to go to the bank to borrow money and who are also bringing in cash from abroad? And simply the LVR mechanism in Auckland might be affecting first-time buyers and young families and all that sort of thing, but it’s not affecting the many thousands of wealthy people who are simply going and buying speculative property in Auckland.

Spencer Well, there’s always some cash buyers in the market. It’s a matter of how big an influence they are. But you’re right—to the extent that if the whole market was a cash market, we wouldn’t have any influence, because we’re working through the banking system and credit creation. So it’s a matter of how big that component is. I think the fact of the matter is that the market,
including the Auckland market, is driven very much by credit. The cash buyers are there, and people will always point to them, but if you didn’t have the credit system and the mortgage creation of several billion per quarter, the market would not be anywhere near where it is now.

There has been a big debate over the role of the foreign investors in particular who reportedly are cash buyers, and we don’t have good information on that particularly, but the information we do have is that it’s 10 percent or less of the market. That was the number coming out of the REINZ survey. That was the number that came out of the recently reported IRD data, although that was a couple of years old. So while there is the anecdotal evidence, we don’t yet have hard numbers that it’s a significant part of the market. Clearly, it is having an impact. It’s having an impact on the margin, but the rump of the market is a credit-driven market.

Williams Maybe if you lived in Auckland, you’d be more aware of it. But where you have a situation where cash buyers are buying up three consecutive properties side by side in a street, pushing the prices up by an average of $200,000 to $300,000 in a street and then removing the houses so that they can put six dwellings on the site of three, and every other young family in the area who are trying to buy into that area suddenly are confronted with perhaps one cash buyer having pushed up the whole value of that immediate and surrounding neighbourhood as a result of a speculative property deal to intensify the buildings. So, you know, if you go to the auction rooms in Auckland and you see the level of activity from some of these people who are simply paying cash to secure properties, and many of them over phones to people abroad, it is quite concerning.

Wheeler I looked at the data that came out of the BNZ REINZ survey for March. Now, that survey has been discontinued and it’s a survey of, I think, up to about 10,000 realtors, from memory, but I could have the number wrong. But the March data said that 6.4 percent of the buyers in the New Zealand market—and this is concentrated on Auckland, in particular—were from offshore. Now, that includes expat New Zealanders, and it also includes people who are deemed to be likely to shift to New Zealand. Now, of the 6.4, a quarter of them were said to be Chinese buyers, a fifth of them were said to be Australian buyers, and 22 percent were said to be buyers from Europe or the UK. So the figure was 6.4 percent for March, and as I say, that includes expat New Zealanders, and also people who are likely to shift to New Zealand.

Williams But do you get my point—that even at a lower percentage, if those buyers are going into a street, such as a street I went to last week in Sunnynook on the North Shore, and they are buying three houses side by side, at over the odds, up to $200,000 more than their valuations so that they can take out those three houses and put six or more dwellings in their replacement without any care for the remaining people living in the street, and the effect on the values of others trying to buy into that street, do you not see that therefore one buyer can have a huge effect on a neighbourhood and the surrounding area?
Goldsmith I think that was more a comment than a question, but yeah, OK.

Williams Obviously they don’t.

Genter So you have said that we don’t have really great data on the impact of foreign buyers, and given that there has been some research coming out which suggests that foreign buyers are a huge percentage of new sales in places like London, Vancouver and Sydney. Do you think it’s worth investigating and perhaps getting better data?

Spencer I think it’d be interesting, you know. It would be useful to know more clearly what’s happening in the market in terms of the different buyer segments, but it is a serious proposition in terms of how you get hold of that data. We certainly don’t have the power. Our data collection powers don’t extend to that, but it’s something that the Government would have to look at more broadly in terms of what the best way of collecting that data would be.

Wheeler If you were to collect that data, you would need some form of declaration on the part of the buyer as to their residential status. Now, that’s outside our data collection powers, so clearly that’s a matter for the Government if they wish to do it.

Parker You note that—these are your words—New Zealand has a longstanding vulnerability associated with a high level of net external liabilities reflecting a persistent gap between national saving and desired investment. You say that over the past few years, the private sector’s contribution to the current account deficit has been modest, owing to increases in private sector saving, in part. Elsewhere in your report you say that that private sector saving has in part been enabled through lower interest rates, which is undoubtedly true. But now we’ve got higher interest rates. Some of that private sector saving may reduce, or there’s a risk that it may reduce. I see the conundrum you have been dealing with, which you’ve well described to Jami-Lee Ross earlier, that you’ve been trying to stimulate the economy through lower interest rates and now are having to curb property price growth. It seems to me that you’ve pulled all the levers that are available to you and we still haven’t cured the underlying vulnerability. Does that worry you?

Hodgetts We certainly acknowledge in the document that the rise in private savings has been quite important in terms of reducing the risk associated with the external debt. I mean, a lot of that rise in private savings has been reflected in terms of an in-flow of deposits into the banking systems, which, of course, has in turn reduced the extent to which they’ve had to go offshore to borrow. To date we’re not seeing any real let up in the rate of deposit growth. There still seems to be a quite strong momentum there, so the banks are still able to fund their credit growth using domestic deposits rather than offshore funding. But, you know, we certainly highlight the risk that if there was some backsliding in the savings rate, that would tend to push the balance back towards the need to use offshore funding again, and potentially put upward pressure on the net external liability position. So it’s a risk.
Parker  Which you predict.

Hodgetts  Well, certainly, in the context of a growing economy, there’s a fairly strong likelihood that we will see higher current account deficits. That’s certainly our forecast in the latest Monetary Policy Statement. The question, of course, is to what extent that happens.

Spencer  I think it’s probably also important to note that, I think, the lower interest rates we’ve had have been more a result of the improved savings, rather than the cause. I think the cause of the improved savings since the GFC has been the lessons that people learnt from the GFC and the resulting increased caution that people now have about borrowing and spending.

Parker  Except for houses.

Spencer  Well, that’s picking up now, but they’re still not spending out of housing capital gains as they were back in 2003 to 2005. We’re not observing that.

Goldsmith  Very good. Well, thank you so much for coming in. We appreciate your time.

**conclusion of evidence**
Reserve Bank of New Zealand’s Monetary Policy Statement, June 2014

Report of the Finance and Expenditure Committee

Fiftieth Parliament
(Paul Goldsmith, Chairperson)
June 2014

Presented to the House of Representatives
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Reserve Bank of New Zealand’s Monetary Policy Statement, June 2014

Recommendation

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand’s Monetary Policy Statement, June 2014, and recommends that the House take note of its report.

Introduction

This report summarises the contents of the Reserve Bank of New Zealand’s Monetary Policy Statement, June 2014, and the main issues we discussed with the bank in our examination.

The monetary policy statement announced the decision of the Governor of the Reserve Bank to increase the official cash rate (OCR) by 25 basis points, to 3.25 percent. This was the third increase in the past three months: the OCR had been held at the record low level of 2.5 percent for three years, before being increased to 2.75 percent in March 2014, and to 3 percent in April. Following the announcement, the New Zealand dollar appreciated by about a cent against the US dollar, to 86.5 cents, suggesting that the markets had expected the Reserve Bank to indicate that it might slow the tightening of interest rates.

The Reserve Bank said that the speed and extent of subsequent OCR increases will depend on economic and financial data, and how inflationary pressures develop in response. Its projections for 90-day interest rates indicate that increases totalling 100 basis points are likely over the 12 months to March 2015.

Reserve Bank’s reasoning

New Zealand’s economic expansion has considerable momentum, with GDP estimated to have grown by about 4 percent in the year to June 2014, and growth of 3.5 percent expected over the coming year. Increasing construction has been a key factor in the recovery in domestic demand, along with strong immigration flows and high earnings from commodity exports. An extended period of low interest rates has also contributed. The Reserve Bank notes that such growth rates are well above New Zealand’s long-term trend, which has averaged 2.25 percent, and are faster than its “potential output growth” (the gauge of how fast an economy can grow at full employment without generating inflationary pressures), which is estimated to be 2.7–2.8 percent.

Although inflation remains low at present, with the CPI growing at about 1.7 percent, the Reserve Bank sees inflationary pressures building, particularly in the construction and services industries. With economic growth now becoming more broadly based, it no longer sees a need for interest rates to remain at the low levels that helped to stimulate the economy out of the recession. Moreover, among various factors that could potentially threaten the recovery, it views the main risk as inflation getting out of hand, as this would

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1 The OCR is reviewed every six weeks, with every second review accompanied by the more detailed Monetary Policy Statement.
start to reduce real incomes and undermine the competitiveness of New Zealand’s industries. By raising interest rates, it hopes to avoid this happening and help to sustain the recovery for as long as possible.

The Reserve Bank highlights several key economic drivers—export prices, the exchange rate, net immigration, the housing market, and construction—as having a particularly important bearing on inflation pressures, and therefore on the pace and size of future interest rate movements. It will be watching developments in these areas particularly closely.

**Future interest rates**

The Reserve Bank is projecting that interest rates will increase steadily over the period covered by its forecasts, with the 90-day bank bill rate rising from 3.3 percent for the June quarter 2014 to 5.3 percent by June 2017. It acknowledges that the forecasts are based on a number of assumptions, and because factors such as export prices and migration flows are particularly volatile, conditions may well turn out differently. The bank says it will be monitoring conditions, and adjusting the projected interest rate path accordingly.

We note that the bank has tested the judgements underpinning its forecasts, and their sensitivity to key areas of uncertainty, by running 1,000 simulations of possible alternative scenarios.² It has explored the outcomes if net immigration were stronger than assumed (its central projection assumes net immigration will decline later in 2014 as global economic conditions improve), and if world export prices were to decline by more than assumed. None of the simulations resulted in a scenario where interest rates fell over the forecast period.

**Comparison with other countries**

We had a wide-ranging discussion with the Reserve Bank about how New Zealand’s growth and interest rates compare with those in other countries.

The governor commented that a number of advanced economies would like to have New Zealand’s figures. It seems that New Zealand sits in between those countries still struggling their way out of recession following the global financial crisis—the USA, Britain, Japan, and Western Europe—and those such as China which are exhibiting the high growth rates and inflation typical of economies in their development phase. New Zealand, along with Canada and Australia, was less hard-hit by the crisis and has recovered more quickly. Our banks had some liquidity difficulties, but nothing like the wealth effects that left a quarter of US mortgage-holders having to rebuild their balance sheets from a position of negative equity in their homes.

In most advanced economies, the interest rates set by central banks remain close to zero and are likely to remain low into 2015. The Reserve Bank says this indicates the extraordinary situation since the global financial crisis, with the USA and others adopting unorthodox monetary measures in an effort to stimulate their economies. It has entailed a huge injection of liquidity, with about $6 trillion pumped into global markets. In the USA, where growth is picking up to about 2.5 percent, the monetary authorities are starting to taper off quantitative easing, but they have deliberately kept interest rates low in an effort to boost employment, which remains sluggish. We note that the Federal Reserve has a dual mandate to address both inflation and employment.

² Monetary Policy Statement, pp. 6–8.
In Europe, steps were recently taken by the European Central Bank to encourage banks to lend to households and small businesses, by cutting deposit rates to minus 10 basis points, effectively charging banks if they hold excess reserves. The aim is to get credit circulating in a financial system that has remained moribund since the crisis, and to avoid deflation.

Australia is in a different situation from New Zealand’s as its economy has softened after the mining boom. It is hoping to see housing investment increase to pick up the slack from mining, where investment at its peak reached 8 percent of GDP. Its official interest rate is now below New Zealand’s, at 2.5 percent, and will probably be held at that level into next year. However, the Reserve Bank is confident that Australia’s growth rate will return to its potential over time.

**Future growth rates**

Some of us expressed concern that although New Zealand is enjoying two years’ growth at 3.5–4 percent, it will taper off all too soon, with the Reserve Bank projecting growth abating to 2.3–2.5 percent in 2016 and 2017. To some of us, this does not seem like “momentum”, when growth of at least 3 percent is needed for New Zealand to provide jobs for those leaving school and tertiary education; even the “potential” growth rate of 2.7–2.8 percent would not suffice.

The Reserve Bank said its aim is to get interest rates back to a more neutral level so the pace of the economy’s growth can be sustained. Particularly fast growth of 4 percent was natural as New Zealand came out of recession; monetary policy had been particularly stimulatory for the past four years to encourage the absorption of spare capacity. As economic activity moves closer to its potential, however, it is appropriate to tighten monetary conditions. While this may result in slightly slower growth, it should be more sustainable. Meanwhile, data from the IMF and OECD shows global growth starting to accelerate from a current average of 3.75 percent, so the prospects for New Zealand’s earnings look very good.

**Potential output growth**

We asked about policies that could alter New Zealand’s growth potential. The Reserve Bank said the rate of potential output growth is not fixed permanently; it can be increased, but not through monetary policy. To do so requires structural change affecting factors of production like labour, capital, and technology. In the governor’s view, working to increase the skills of the labour force, improving the amount and quality of capital per worker through investment and better entrepreneurship, and increasing global trading links are important ways New Zealand could capture a greater share of global trade and lift its wealth potential over time.

Some of us expressed concern that New Zealand’s export profile appears to be going against such a prescription, with milk powder and raw logs representing an increasing proportion of exports, while elaborately transformed manufacturing exports have declined; one reason, perhaps, for the projected widening in the current account deficit. The Reserve Bank agreed that one way to improve prosperity is to increase the value added to raw materials; however, it said this is not something monetary policy can influence.

**The exchange rate**

The New Zealand dollar remains high by historic standards, with the Reserve Bank continuing to say that it does not consider the strength sustainable. Because of the
currency’s tendency to move in tandem with the terms of trade, the Reserve Bank expects the trade-weighted exchange rate to fall gradually by about 7 percent over the next three years, in response to weakening prices for export commodities. However, it acknowledges that the exchange rate has yet to respond to the 26 percent fall in dairy auction prices since February, and lower export log prices in recent weeks.

We note that the Reserve Bank has been describing the dollar as “unsustainably high” for some years. The Reserve Bank said this is partly because the terms of trade have been at their highest in 40 years. The other major factor has been extraordinary monetary conditions in most of the advanced world since the global financial crisis, with low interest rates and $6 trillion of cash pumped into the global economy by quantitative easing. Investors around the world have naturally looked for countries with higher-returning assets, including emerging markets, Australia, and New Zealand.

**Immigration**

Net immigration has increased rapidly, with 34,000 net arrivals in the year to April 2014 (including 31,000 of working age), compared with about 5,000 in the previous year. This is boosting demand and contributing to inflationary pressures in the short term, but is also expected to add to the economy’s productive capacity.

The monetary policy statement (pp. 24–25) notes that the flow differs from earlier cycles, as non-New Zealand-citizens make up a smaller proportion of the total, with about 8,000 more arrivals over the past year. The larger contributor has been changes in migration flows of New Zealand citizens, with 17,000 fewer departures over the past year and more people returning from overseas in response to New Zealand’s relatively favourable economic performance. The Reserve Bank projects the inflow to peak in mid-2014 and then to ease over the following three years, with about 70,000 arrivals of working age over the projection period, representing a 2 percent increase in the working-age population.

Of particular interest to the Reserve Bank is the effect of migration flows on the housing market. While it would normally expect net immigration to increase the demand for housing, creating short-term pressures, it may not do so to the same extent in this cycle. The situation this time is more a case of New Zealanders remaining; also, those coming for temporary work purposes to help with Canterbury’s reconstruction may have different housing needs from those arriving permanently.

**The housing market**

The Reserve Bank continues to watch the housing market closely. It considers that the loan-to-value mortgage restrictions are having an effect in moderating price increases, and reiterates that they are seen as a temporary measure. As to whether the restrictions favour landlords over those seeking to buy a house, it says that the measure may mean people take longer to save the deposit for their own home, but does not mean they can never afford to buy one.

Overall, the Reserve Bank expects annual house price inflation to continue moderating over the next three years as a result of projected interest rate increases, easing immigration, and high household debt, as well as increased construction in Auckland and Canterbury.

**Households and wages**

Some of us are particularly concerned about how households will cope with the pressures of rising costs and interest rates, noting that half of all wage-earners have not had a wage
increase in the past 12 months, whereas rising interest rates have added at least $1,000 to the annual cost of an average $250,000 mortgage. Some of us believe savings rates will worsen as people struggle to make ends meet, defeating the goal of improving New Zealand’s savings performance.

The Reserve Bank said that, on average, wages have increased by slightly more than inflation. However, it concedes that inevitably not all households have gained equally, and it notes that monetary policy cannot target specific demographics. It offers two reasons why wages have not increased as rapidly as would be expected in an economy growing at 4 percent, with particularly strong employment growth of 3.5 percent over the past 12 months. One is that participation in the labour market is at a historic high: more people are seeking work as employment conditions improve. The second factor is high net immigration: in addition to new arrivals, fewer Kiwis are leaving and more are returning. Together, these effects have increased the labour supply, eliminating the shortfall that would normally push wages higher as demand rises.

Regarding savings, the Reserve Bank acknowledges that in aggregate households’ consumption growth slightly outstrips growth in incomes, but it says this is still an improvement over the position before the global financial crisis, when the household sector was spending $1.14 for every dollar earned.
Appendix A

Committee procedure

We met on 12 and 25 June 2014 to consider the Reserve Bank of New Zealand’s Monetary Policy Statement, June 2014. We heard evidence from the Reserve Bank of New Zealand, and received advice from our independent specialist advisor, Brendan O’Donovan.

Committee members

Paul Goldsmith (Chairperson)
David Bennett
Dr David Clark
John Hayes
Dr Russel Norman
Simon O’Connor
Hon David Parker
Rt Hon Winston Peters
Grant Robertson
Jami-Lee Ross
Hon Kate Wilkinson
Good afternoon, Governor. Thank you very much for coming in. We’ve got your report. If you could maybe just give us the highlights, and we’re very keen to ask some questions.

Thanks very much for the invitation, Chair. The economic expansion has considerable momentum. Output in the economy has increased by around 4 percent over the past 12 months. Export prices remain high for most of our commodities. The dairy auction prices have fallen 26 percent since February, and log export prices have declined in recent weeks.

Economic growth is also being supported by an acceleration in construction in Canterbury and elsewhere, and strong net immigration flows. House price inflation remains high in many parts of the country but has moderated in recent months. The exchange rate remains high and has not yet adjusted to the weakening commodity prices, and we in the Reserve Bank do not believe the current level of the exchange rate is sustainable.

Overall, inflation remains low but inflation pressures are increasing. Above-trend growth has been reducing spare capacity, and pricing pressure is increasing in the construction and the service sectors. How much the official cash rate will need to rise will depend on future economic and financial data and how they affect inflationary pressures. Our goal is to keep...
future average inflation near the 2 percent level and ensure that the economic expansion can be sustained. So, thanks very much, Chair.

Mallard: Just doing a check—you’re looking at your 90-day interest rate charge. You’re picking them to, on the central scenario, roughly double over a 3-year period?

Unidentified: Chart number?

Mallard: Sorry—page 6, chart 2.2(b).

Wheeler: If you look at the Appendix A, which is the 90-day bank bill rate that’s on page 31, then you see that rate increase from 3.3 percent to 5.3.

Mallard: So 2.9 percent from the beginning of the year up to about 5.3. And it’s one of steady growth over that time. Have you done any more further out-year forecasting that way?

Wheeler: No, we don’t forecast out

Mallard: You don’t go out any further than 3 years?

Wheeler: No, we don’t forecast out more than 3 years.

Mallard: So, your predictions are for as long as you predict interest rates will keep going up.

Wheeler: Let me put that in context. If you look at this recovery, it’s got a lot of momentum, a lot of strength in the economy given you’ve still got high export prices for most of our commodities. You’ve got very strong construction growth, strong building activity. You’re seeing strong net migration. So the economy’s growing faster than what we call potential output, which is how fast the economy can grow at full employment without generating inflation pressures.

Then if you say “Well, look, what are the factors that could really stop this recovery? What could stop it?”, it would be if growth in the rest of the world basically went pear-shaped, if China got into difficulties, if our commodity prices collapsed, if house prices started to fall dramatically. No one’s forecasting those sorts of outcomes. The thing that could threaten the recovery is if inflation pressures started to increase and if they got out of hand, because that would start to reduce the competitiveness of our industries and it would also start to reduce the real income growth in the economy.

So what we’re trying to do here is very much balance a whole set of forces that are acting on the economy—the ones that I’ve just talked about—and try and keep inflation under control, meet our obligations in respect of the 2 percent target, and sustain this recovery for as long as possible. So that’s what we’re trying to do with these interest rates.

Mallard: I think, Governor, there might be a number of members of the committee who haven’t been involved in these discussions in the past, but I’ve got a series of questions, and if we can keep them relatively short rather than Economics 101, it would be good. What’s our margin at the moment over
and above like countries—the US, Australia—for our OCR and 90-day bill rates?

**Wheeler** Well, if you look at what’s happening—and forgive me; I’m not trying to teach Economics 101, but these are important points. If you look at what’s happening at policy rates in most of the advanced economies, then, basically, you have policy rates close to zero. You have forward guidance that indicates that those rates are likely to remain low for various periods, probably into next year some time, and you’re seeing US$6 trillion of quantitative easing, which is injecting massive amounts of liquidity into the global economy.

Now, what that’s also doing is lowering long-term rates. So what you’re seeing right now is you see 10-year bond rates in Spain, for example, or in France which are at 250-year lows. The 10-year bond rate in Spain, with all the difficulties Spain has had, is now lower than the US 10-year bond rate. So that gives an indication of just how extraordinary some of the monetary policies are in these countries.

**Mallard** OK. When was the last time that our rate was less than 2 percent higher than Australia’s?

**Wheeler** I’d have to check that and see if my colleagues know offhand.

**Spencer** Well, they’re at 2.5. We’re at 3.25, so—

**Mallard** It’s about three-quarters?

**Spencer** Yeah. And we were below them not so long ago—last year.

**Mallard** Yeah. OK. When do you predict that they will cross over with us?

**Spencer** Well, their current position is that they’re pretty much on hold until they see how their economy evolves. They got up to—3.5 percent is their peak and then as the mining boom, etc. came off, they’ve come off from 3.5 down to 2.5. And next steps—nobody’s expecting much action in Australia through the rest of this year, so probably some time next year.

**Mallard** Right. Same question with the US.

**Spencer** The US—the expectation is that the quantitative easing will finish in October and that the first interest rate increases will be mid—probably Q2 next year.

**Mallard** And that will be—what’s your current rate?

**Spencer** The current rate for the Fed is 25 points—quarter of a percent.

**Mallard** So that’s a margin of 3 percent?

**Spencer** That’s right. So all these developed countries, as Graeme just said, have very low growth. They’re still struggling to get out of the recession they’ve been in since the GFC. So they’ve still got very low rates, and a number of them are printing money through quantitative easing as well, whereas if you go to countries that have got some growth—in Asia, for example—you’ll find higher interest rates, just as we have higher rates. If you have higher growth and also higher inflation, obviously, then you will tend to have higher rates.
I.3Q MONETARY POLICY STATEMENT, JUNE 2014

Peters China and Japan?

Mallard Sorry, can we just have the Japanese figures?

Spencer The Japanese are at point—they’re close to 0—

Peters Well, for China?

Spencer —and they have quantitative easing. Anyone that’s doing quantitative easing will have rates close to 0.

Peters But you said “Asia” that were going up. Now, I’ll just give you China and Japan—what are their two rates?

Spencer Well, China’s up around—Jason, 6 percent?

Wong Ah, I would have said [Inaudible]

Spencer Right. Lending rates 6; policy rates 3. Japan is a different kettle of fish from China. China’s high growth, as you know; Japan’s been in recession since the early 1990s. So they’re very different.

Goldsmith Just a supplementary to that—so the US GDP figure is not that far behind ours in terms of growth, but there’s a huge gap. So that’s interesting. How do you explain that in simple terms?

Spencer The US Fed has a dual mandate of inflation and employment. The unemployment has stayed stubbornly high in the US, so even though they’ve had growth coming up, employment has not come up to the same extent. So they’re keeping very low rates in order to try and improve the employment situation so long as inflation doesn’t get out of hand, and inflation has stayed pretty low, so they’ve been happy to stay with very low rates. But everyone is anticipating they will come out of that, and they’re already doing their tapering of removal of quantitative easing. It’s in process now.

Wheeler Maybe just a couple of points, Chair, just on—if you take Japan, which has very low rates, as Grant said, when you look at the OECD or the IMF forecasts for Japan over the next 2 years, it’s for growth of around 1.25 percent, well below the sort of growth rates that we’re projecting. If you look at the US, then the US went through an extraordinary recession that basically—I think I might have mentioned once before in this committee that 25 percent of people with mortgages in the US had negative equity. And, largely because of the huge wealth effects and the effects on future spending and demand and employment, the Federal Reserve has kept its interest rates low for a long time and still pumped a lot of liquidity into the economy. So although it’s starting to pick up in terms of growth rates at around 2.5 percent or thereabouts, it’s still had to face this huge adjustment as people needed to restore their balance sheets.

Hayes Can you tell us about Singapore in the same context as—

Unidentified Is this a supplementary?

Goldsmith Yes, supplementary.

Spencer Jason, do you know what the rates in Singapore are?
Hayes  Singapore seems to be more an economy around our size.

Spencer  Yeah, and Singapore has strength, and so they do have positive rates. They move around a bit because they have a different regime where they have an exchange rate management regime. So I’d have to get back to you on the exact Singapore policy rate at present, but, yeah, it’s not down in the zero territory. It’s up closer into where we are.

Mallard  When was the first time that you told us that the currency was at unsustainable levels—about 2 years ago, or was it before that?

Wheeler  We’ve talked about the currency being high and that we would like to see it lower. We’ve been talking about that for the 18 months or so that I’ve been the Governor.

Mallard  Can your colleagues remember if it was mentioned before, by your predecessor?

McDermott  It’s been a long-running issue, and, as you well know, New Zealand has had a current account deficit for nearly 40 years, and one of the driving factors behind that is the fact that New Zealand continues to have a savings rate that’s insufficient for its own investment purposes.

Mallard  So we’ve got a savings rate that’s insufficient. We’ve got interest rates which are about 2 percent higher than a lot of our trading partners. We’ve got interest rates which are predicted, on 90 days, from this year to the end of the 3-year period, to double. Is this a system that’s working?

Wheeler  I think if you look at the growth rate of the economy, it’s growing at probably around 4 percent. It’s projected to grow at 3.5 percent over the next 12 months. Inflation is expected to remain low. I mean, there’s a lot of advanced economies in the world that, to be perfectly blunt, would like to have the sorts of figures that New Zealand has.

Mallard  But you’ve sort of predicted here that we’ve had the good times. We’re heading down again as far as the growth’s concerned? That’s what I’m reading from your figures—that we’ve peaked, effectively.

Wheeler  What we’ve said, and what I was explaining at the beginning of this discussion, was how our objective is to try and sustain this recovery for as long as possible, and that means keeping inflation pressures in check, which will mean an increase in interest rates. We’ve started that tightening process. We’ve indicated that our future adjustments will be looking very carefully at future economic data and future financial data, but our objective is to sustain this recovery for as long as possible. Now, that will mean some reduction in growth but still, we believe, a strong economic performance.

Goldsmith  Just a supplementary to that—the member mentioned our trading partners having much lower interest rates. Our two largest partners, China and Australia, have similar rates, don’t they? Can I just clarify that. OK.

Peters  When you talk about—going from Mr Mallard’s questions—the economy has a lot of momentum, now, seriously, here’s our projection going forward: 2.3, 2.5. Our partners offshore, trading partners: 4.2—4.2; almost twice. Now, every projection you’ve got here is of no growth, then all of a sudden
a spurt which lasts about 2 years max, and then back to no growth again. We need 3 percent just to employ the people who leave school or tertiary institutions. So why don’t we own up to the fact that there’s a massive failure going on here? How can you talk about “the economy has a lot of momentum”? For how long?

McDermott Shall I pick up on—there’s a couple of issues to reflect on that. When you’re comparing New Zealand to other countries, and particularly our trading partner economies, one of the important trading partners is China. They’re a developing nation. They can grow very fast just by employing factors of production, and that’s moving people from rural positions into the cities. That traditionally generates very fast growth. It can’t last for ever but it can last for a long time. So you can’t really compare New Zealand as an advanced economy to China as a developing economy.

When we’re looking at our own picture—

Peters I’m not doing that. What I’m trying to do is understand how you can come along to the select committee and not own up to the fundamental fact that two of the serious drivers, this Government has done nothing whatsoever: wholesale immigration and offshore buying.

McDermott I’ll just finish the points. There was one point comparing New Zealand to other countries, so that’s the relative benchmark. The second point is—

Peters Sorry, I noticed you didn’t use Singapore or Taiwan, did you? You referred to China, but these are three different economies.

McDermott Just turning back to New Zealand, one of the things that’s in our current profile, we have a very high growth rate at the moment for New Zealand standards. In fact, we’re going faster than our long-term potential could sustain. We’re going about 4 percent. And that’s quite natural because we’ve been in a recession, there was a lot of spare capacity in the economy, and we want to absorb that. So we’ve allowed monetary policy to be extremely stimulatory so that we can absorb that capacity.

As we get closer and closer to New Zealand’s potential, what we want to do is get interest rates to a more normal or neutral level for this economy—not for the world; for this economy—so that the New Zealand economy can grow at a sustainable rate, which we think is around about 2.7, 2.8, or thereabouts. Beyond that there’s nothing monetary policy can do to shift New Zealand’s potential. That sits somewhere else in the economy.
If you look at New Zealand’s average growth rate for the past three decades, it’s averaged about 2.25. Our forecasts have the economy slowing from, say, 4 percent, where it’s been over the last 12 months in terms of the increase in output, to roughly 3.5 over the next 12 months. As the interest rates deal with the inflationary pressures, then we get the economy slowing, but we’re also moving into a situation where global growth is expected to increase. You see that in the IMF, OECD forecasts. World outputs are currently growing at around 3.75 percent. It’s expected to accelerate from that. So the economic prospects, I think, for New Zealand, looking out into the future, are very, very good.

Well, can I ask this question. What does it take for this economy to perform and employ the people who leave tertiary institutions and schools in this country or, second, to stop our slide down the international First World of economies? Because anything under 3 just does not cut it, does it? And you’re resigning us and saying nothing can change. About 2.5 is all this country—or 2.8—can possibly expect. That’s not our country’s history. We’ve been through decades doing far, far better than that, and you say monetary policy can’t help in any way to change that outcome?

I mean, New Zealand’s potential isn’t fixed permanently at 2.5 or 2.6. It can move, but that’s where it is at the moment. That’s where we see it sitting for the next 2 or 3 years. Monetary policy can move some of the demand from today into the future or, if there’s weak demand, it can bring from the future into the present, but it can’t generate something that doesn’t exist. For that you need structural things to change. You need strong factors of production, you need to learn how to mobilise those factors of production, you need better productivity, a skilled labour force, education, and those are all things that monetary policy can never change.

If you look at, say, what’s the productive potential of the US economy, what’s their estimates—the Federal Reserve’s estimates, for example; potential output growth—it’s around 2.5 percent. If you look at it, the same measure, for Europe, it’s probably below 2 percent at this point.

Right, so we’re in good company on that score. Can I just ask—

Well, our potential output growth’s probably higher than those economies’.

The European Central Bank has brought out a negative deposit rate and charging commercial banks on their excess reserves—pretty drastic stuff going in the opposite direction to us. Just explain the fundamental differences there in drivers.

Well, what the ECB has done, it’s cut its main lending rate by 10 basis points, which is not very much, but it was low in any event. So they’ve reduced it by 10 basis points. They’ve cut their deposit rates by 10 basis points, from 0 to minus 10 basis points. So other banks, for example, if they leave deposits with the European Central Bank, they basically have to pay a cost, or a price, for doing that. And the other thing that they did was they introduced long-term financing operations of up to €400 million where, basically, they’ll provide a facility to lend to, basically, households and
businesses—not for mortgages but for small business and enterprises, SME lending, and things like that.

Now, what has been the effect of that? They didn’t go into quantitative easing at this point, and Mario Draghi has sort of reserved the right to go there if they need to at some point in the future. The impact has been to weaken the euro a little—not by very much—but what it has done is it’s reduced the spread on Government bonds. And that’s why I said before, if you look at 10-year bonds in France and in Spain, they’re now at 250-year lows, so it’s reduced the risk premia around risk assets, if you like, including government bonds. So that’s been the main effect so far.

Goldsmith And what do you think the long-term outcome of all that is likely to be?

Spencer They basically want to get banks lending. They want to say if the banks leave their spare cash with the central bank, they’re going to be charged for it. Therefore, they want them to go out and lend that money instead of leaving it at the central bank. So they’re trying to get the financial system going, which is still moribund 5 years after the GFC. So their aim is to get credit circulating and, quite frankly, to get inflation up a bit as well as activity, because they’re concerned about deflation. They’re concerned they might get into a deflationary situation.

O’Connor Just hoping for a bit of elaboration on, I suppose, two external factors on New Zealand. The first is around—you’re talking about the potential inflationary qualities here in New Zealand, but what we’re seeing, particularly in the OECD, is lowering inflation or deflationary pressures there, and to what extent do you reconcile those? And the second is around the monetary policy in Australia and New Zealand—we’re a bit out of sync, we’re out of phase at the moment—and what you see are any potential consequences there.

Spencer Well, the basic difference between developed economies, with all these still very low rates, and ourselves is that those countries were hit a lot harder by the GFC. The balance sheets of the households and businesses got out of whack. They made bigger losses. More banks failed, whereas countries that didn’t have that experience, or where they didn’t have fundamental problems—we had issues around liquidity in the GFC, but we didn’t have banks falling over. Countries like us recovered a lot sooner, including Australia, Canada, ourselves. So we now have stronger growth. We now have positive interest rates. We’ve come back to more normal activity, more normal trajectories, whereas the countries that were hit harder—namely, the US, Europe, Western Europe, and Britain—are still struggling, and they still have lower interest rates. So that’s the basic difference.

Wheeler If you take Australia, for instance, and monetary policy—I mean, the Australians have come off a very substantial boom in capital expenditure around the mining industry. At its peak it reached 8 percent of Australian GDP, which is large, because it’s normally around 2 to 3 percent of GDP. So it was a huge boom, and what they’ve got to manage is that decrease in investment that now takes place and to see what fills the void. And they’re
very much hoping that residential building will start to take up some of the slack. So they’re having to manage a softer economy.

Now, in the past—and this relates to interest rates settings in New Zealand—while we had the official cash rate at 2.5 percent for a long period, the best part of 4 years, the Australians, in fact, increased their interest rates by something like 200 basis points while ours were flat, and then they found they needed to reduce them again. So they took them up and then took them down. Our interest rates have been stable throughout that period until we’ve started the tightening.

O’Connor Obviously different approaches, but you’d say with the Australian contact when they get back into phase as we have traditionally?

Wheeler I didn’t understand—

O’Connor A bit too hard to, in terms of being—I would sense at the moment we are a little bit out of phase. You’ve obviously said there’s been a little spike or a different approach. Do you think we will link back in again in a similar form?

Wheeler Yeah, I’m very confident about the Australian economy—that it will come back and it will grow at potential output growth on average over time.

Norman Thanks for coming along again, Governor. I wanted to just start by coming at it from the point of view of households. So households are under a lot of pressure. Wages are flat for most people. I think it’s about half of all wage earners haven’t had a wage increase in the last 12 months, or something like that. At the same time, they’re facing significant pressures from increases in interest rates. I mean, I think we’re talking probably about over a thousand dollars a year extra, maybe $1,200 a year extra, because of the increase in interest rates for the average mortgage of $250,000—something like that. So how do you think households are going to respond to these increased pressures on them, whereby they’re facing increased pressures as a result of you increasing interest rates but they’re not getting any wage increases? They seem to be between a rock and a hard place.

Wheeler If you look at employment growth over the past 12 months, it’s been particularly strong. It’s been 3.25 percent increase in employment in New Zealand. Now, you would normally expect for an economy that’s growing, say, at 4 percent and getting employment growth of 3.25, to see wage growth start to increase, and that hasn’t. You then say “Well, why hasn’t that happened to the extent that you might have thought?”, and it’s two things.

It’s basically the supply response on the labour side. You’re basically seeing what we call participation at record highs, so it’s at historic highs, and that’s a lot of additional people actively seeking work given the employment prospects that are out there. And, second, it’s to do with the net migration being strong. So there’s been a big supplies response on the labour side that has meant that very strong demand for employment has not been reflected in the wage increases that we might otherwise have expected.
Norman So be that as it may, from the point of view of a household, wages haven’t increased but the pressures to pay their mortgage have increased. Do you think there’s some connection between that and the fact that you’re now recording household dissaving—so, negative household savings rates have gone negative again. So this pressure that households are under, where wages are flat, they’re still getting cost pressures because inflation is not 0, and, of course, interest rates that you’ve increased on them as well—is that one of the drivers for household dissavings, the fact people are now spending more than they’re earning because there’s so much pressure on households?

McDermott I wouldn’t say so. What you’re seeing is while wage growth has been very low, there is some—actually slightly more than inflation. So the household sector is actually doing some real wage increases, albeit very slow.

Norman That’s an average number.

McDermott Yeah, absolutely, yeah.

Norman If you look, half of households have had zero. So I think you need to disaggregate a little bit. Like, if you think about half of wage earners have had zero wage increase, the cost pressures don’t go like that. They don’t work like that. It’s going “Oh, I’ve had zero wage increase, so don’t increase my mortgage bills.” It just doesn’t work like that, right? So for that half of wage earners, they’ve got increased cost pressures, of which you are a contributor—and I’m not blaming you for this; I understand why you’re doing what you’re doing—but the Reserve Bank is contributing to those cost pressures on that half of all wage earners, but they’re not getting wage increases. What are they supposed to do?

McDermott Unfortunately, monetary policy can’t target particular households. It does work on averages, and that’s where we are. So if you take—there’s been some modest real wage increases, on average, yes. There’s certainly been employment growth. So the household sector as a whole has seen real household incomes increase, and, broadly speaking, the household sector’s probably increasing its consumption profile roughly in line or slightly more than its income growth. That’s where we are, which is actually a lot better position than we were prior to the GFC, where for every dollar the household sector was earning, it was at some point spending $1.14.

Norman At the worst of it.

Wheeler But you’re right that there will always be, unfortunately, a sector of the population, at least in most economies, that don’t enjoy the income growth that other households do enjoy, and there are many reasons for that. It’s often linked with prolonged or repetitive spells of unemployment. It’s linked to globalisation. So there will be people who have had no significant increase in wages and are facing higher costs. That’s true.

Norman But in this case it’s not just, like, some; it’s, like, half. We’re talking half of wage earners haven’t had a pay increase in 12 months. I mean, this isn’t just a little part of it, and we, as representatives of those people, sit here
representing all workers, half of whom have got increased cost pressures but no increase in wages. How are they supposed to respond to that?

Goldsmith
Right, OK. I think they’ve answered that question.

Norman
All right. Can I just ask a second question then, on a second issue.

Goldsmith
Well, yes, we’ve got some questions over here, but we’ll come back to you, definitely.

Mallard
Just a supplementary on the uneven effects on different households, the LVRs and their effect on, effectively, favouring landlords over people who want to purchase their homes, have you had a look at what the medium-term effect of that is going to be on keeping people in rental homes, and the cost to the economy both economically and socially of that?

Spencer
We haven’t done any particular work on that, but we do acknowledge that the LVR impact clearly has impacted the lower part of the market. We think it has had price impacts right through the whole market.

Mallard
Stops people getting into their first homes and it keeps them renting; effectively, therefore, favours landlords.

Spencer
That’s right. But, you know, the measure is intended to be a temporary one. That’s our intention. And it may mean for some of those people that they’re taking longer to save up the deposit to eventually buy a house; it doesn’t mean to say they can never buy a house.

Hayes
Just reflecting on what’s going on here is we’re dealing with your judgment, and I respect it, but there’s a couple of things I’m having difficulty following. First of all, coming back to two economies like our own, Singapore and Taiwan, the central bank interest rate in Singapore is 0.3 of 1 percent—I’ve just had a look on Google—and the 15-year housing rate there is 5 percent, the economic growth rate 3.8 percent. Go to Taiwan—similar sorts of figures and you’re talking growth of 4 percent. So we’re sort of in that league, and, yes, we manage our economies a bit differently and we’ve got different work ethics, and those sorts of things.

But the realities are here—that the pressure of people coming back into New Zealand through New Zealanders coming home, through reverse migration, the job situation here, which is not encouraging people to leave, means that inflationary pressure from the movement of people is negative. It’s pushing inflation down.

The second thing is, when I go through your forecast, dairy prices have dropped 26 percent and the forecast has dropped. So we can expect the mainspring of the economy to put less money into people’s pockets and into the main engine’s pockets. And if we listen to what colleagues are saying across the floor, the policy you’re talking about at the moment is it is going to push up people’s requirement to push money into the banking system through higher interest rates.

All of those things are negative pressures on inflation, and I’m just wondering if your judgment isn’t a bit overcooked in terms of pushing
interest rates up, because we are now way out of whack of our immediate Asian neighbours of similar size to ourselves.

McDermott Shall I pick up on the immigration one? It’s an interesting question. In the previous two business cycles that New Zealand’s been through, immigration was a big part of the story. It’s a complex issue. It has both the demand and supply side consequences of the economy but on net, given New Zealand’s stock of capital and infrastructure and housing, it has often been a short-term demand impulse. Certainly, when you increase the size of the labour supply, you increase the potential of the economy, and the new workers add to the flow of goods and services, but they also demand new goods and services, and that’s often a net on net.

But they also demand one thing in particular, which is housing, and even though a house provides a lifetime of services to the householder, you purchase it at one point in time and that creates that pressure point. So that’s what we’ve been managing in previous cycles, and we probably can’t escape those consequences in the next cycle, although we do have to be careful that things might be somewhat different.

The nature of the composition of who’s arriving and who’s leaving looks a little bit different this time. This is more a story of New Zealanders not leaving New Zealand. That changes the pressure on the housing market. And even those who are arriving, we seem to have more coming for work purposes rather than residency purposes per se, and so there’s different dynamics, and we will have to be careful watching about what are the impacts on the overall economy, because it might well be different.

The consequences on dairy prices—we’ve been warning for some time that we thought dairy prices were extremely high. The terms of trade was at a 40-year high, and we didn’t think that was sustainable. We were in good times, and they don’t last for ever, and we’re starting to see some of that come off. That said, some other commodity prices are actually increasing, including meat prices. And we’ve been pretty keen for some time that we have to save some of that benefit that we’ve been going through because the future won’t look quite as bright, even though we think New Zealand’s terms of trade will still be relatively high compared to the last decade or so.

Hayes Actually, if this Government is re-elected, it might look a lot brighter because what you’re also not factoring in is the impact of irrigation schemes on our net national income, because there are going to be steep jumps there. I come back to the question. I’m challenging your judgment and suggesting that the interest rates and the forecast of pushing them up another 100 base points over the next year are too negative and too depressing on the economy.

McDermott I’ll just add one thing. I mean, we can’t see the future with absolute certainty. We always know our forecasting conditions on very important assumptions. We try to be as transparent as we can, and in the document we lay out what are the key things that drive this, one of them being export prices, one of them being migration, and so on. Things could very well be different to the view we’ve actually laid out. A lot of these things are
actually quite volatile, and the important thing is we make these forecasts and then adjust if the world plays out differently. And the financial market participants understand how we play that, and if things are actually a bit worse over the next year, the interest rate path will be adjusted accordingly. You see there’s a scenario where we demonstrate that on export prices.

Bennett  You’re saying the economy has a base capacity of about 2.8 percent to grow that is sustainable in the medium future. What do you see as some of the potential changes in policy that could limit that and decrease the productive capacity? For example, if you brought in a carbon tax, which is a transfer from the productive to the consumption sector, would that influence that ability to hit the 2.8?

Wheeler  Let me answer it by not talking about the politics in the question. But, look, if you, say, look at potential output growth, right, and you look at the factors of production in New Zealand—labour, capital, technology, etc.—if you look at the labour force, you see New Zealanders work hard by international standards. You look at hours worked for New Zealand, compare them to a number of advanced economies, New Zealanders are hard-working people. You look at the PISA tests about educational attainment at age 15, New Zealand slipped down the ranks a bit in that, but, by and large, it is still one of the better-performing OECD economies. So you then say, well, you’ve got higher unemployment with Māori and Pacific Islanders, which is three times the European unemployment rate, and that is something which is unacceptable. But that’s where we are on the labour side in terms of labour quality, people’s hours worked, educational attainment, and that.

You then look at the capital side, and I think this matters quite a lot about the level of capital per worker in this country. If you want to raise productive potential in this economy, I think you need more investment, you need more capital per worker, and you need more recent vintages of that capital. So the level of capital and the quality of capital is really important. So is the quality of entrepreneurship, as well. Our future, to a significant extent, lies in capturing greater share of global wealth, of global trade. That’s where the economies of scale lie. That’s where the productivity benefits for New Zealand lie. But they’re the sorts of things—working on increasing the skill of the labour force, increasing capital, and increasing entrepreneurial and global links—the sorts of policies that will lead to higher potential output over time.

Mallard  If I gave that on the hustings, it’d be a very good political answer.

Norman  So just to follow up on that, because this is kind of where I wanted to go earlier, so, based on what you just said, then surely a simplification of the economy, or what I would characterise as a simplification of the economy, towards milk powder and raw logs—if you look at our export profile, the proportion of milk powder and raw logs has increased. If you look at elaborately transformed manufactures as a proportion of exports, it’s declined. Heading in that direction with lower value-add, how does that help? Because I tend to agree with a lot of your analysis, though the
Productivity Commission had a slightly different take on it, to be fair. They argued that it was about international linkages were some of the problems. There were some other issues that they kind of drew attention to. But it seems to me the overarching thing is if you’re going to have lower and lower value-add because you’re doing simpler and simpler commodities, surely that is going in the wrong direction if you want to solve this problem.

Wheeler Well, I think one thing I didn’t talk about but I think is generally accepted is the challenges of size and distance. So I deliberately didn’t refer to those. But you’re right. One way to increase prosperity for New Zealanders is to increase the value added around raw material processing so that you do enhance value and you sell that on international markets. I agree.

Norman But we seem to be going in the opposite direction to that. It may be too political a point for you to engage in—I don’t know—but it seems to me that we seem to be heading in the opposite direction to that with the simplification of our export profile.

McDermott And what could monetary policy do to change the direction, even if that was the case?

Norman I think that’s a fair point, but we’re engaging in a broader conversation about how to get out of the hole we’re in. Because based on your current account deficit figures, it just gets worse, because your projections forward on the current account deficit are only ever increasing.

Peters Could you tell me briefly—in 1764 Spain had a bond rate, right?

Unidentified Sorry, what year?

Peters In 1764—

Unidentified 1764?

Peters —yes—Spain had a bond rate. You said—

Unidentified You’ve been around a long time, Minister, but—

Peters No, no. You said it was the lowest in 250 years. In 1764 Spain had a bond rate. Can you tell me briefly how that worked. [Laughter] Well, if you’re going to make comparison, I’d like to know what the exact history is, because that’s news to me.

Spencer The European nations used to issue debt back in the 18th century.

Peters So they had a bond rate in 1764?

Spencer They did. Yeah, definitely.

Unidentified The Dutch had one in the 17th century.

Peters In Spain?

Spencer Yep. Governments used to raise money just like they do now, and they used to issue debt.

Peters OK. All right. Second question is we need to capture a greater level of trade, right? It seems to some people that, frankly, the problem with that is the Reserve Bank itself, because the high level of currency it constantly says
it is concerned about, but it offers nothing to stop it. And we are going on now year upon year upon year with the currency getting into levels no one ever thought would be possible—80, and now 85, 86, and higher. So when are we going to stop sort of expressing a concern and maybe suggesting a solution?

Wheeler  
I think if you look at what drives the exchange rate in New Zealand, there are several factors, but two are the most important. The terms of trade—there’s a strong relationship over time between the exchange rate and the terms of trade. While we’ve wanted to see the exchange rate lower, the fact is that our terms of trade, putting aside the recent decline in dairy prices at 26 percent, have been increasing and have been at a 40-year high. That’s been a major factor driving the exchange rate.

The second major factor has been the fact that you have central banks all around the advanced economies—in fact, in countries that represent two-thirds of world output, so pretty well most of the advanced world—where they in essence have been adopting unconventional monetary policies because of the reasons Grant mentioned, about the global financial crisis and how badly they were affected. So not only have they had low interest rates and made commitments in respect of future low interest rates, they’ve also injected, as I say, $6 billion of cash into the global economy.

So that’s led investors to look around and see where there are higher-returning assets, and they do look at countries like New Zealand. They do look at emerging markets. They were looking very closely at Australia until terms of trade fell dramatically. But even the Australian exchange rate has picked up from 87c to 93.5c since June.

Goldsmith  
Thank you very much. We appreciate your coming in and thank you very much.

conclusion of evidence
Petition 2011/49 of Aaron Cross on behalf of the Greyhound Protection League of New Zealand

Report of the Government Administration Committee

Fiftieth Parliament
(Hon Ruth Dyson, Chairperson)
November 2013

Presented to the House of Representatives
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   Appendix 12
Summary of recommendations

The Government Administration Committee recommends to the Government that it ask the New Zealand Racing Board to

- develop a system for monitoring the greyhound racing industry’s Rules of Racing (p. 6)
- review the service agreement between the New Zealand Greyhound Racing Association and the Racing Integrity Unit (p. 6)
- review the New Zealand Greyhound Racing Association’s implementation of the recommendations arising from the welfare review of the greyhound racing industry by August 2014 (p. 10).

The committee recommends to the Government that

- it ask the Department of Internal Affairs to establish and maintain a database of greyhounds, tracking their identity and their location from registration until death (p. 7).

The committee recommends to the Government that it ask the National Animal Welfare Advisory Committee to

- consider developing standards for the use of animals, particularly greyhounds, in racing (p. 8)
- consider developing guidelines on the breeding of greyhounds (p. 8)
- consider reviewing the Animal Welfare (Dogs) Code of Welfare 2010, with a view to specifying the circumstances in which dogs can be euthanased (p. 8).
1 Introduction

The petition
Petition 2011/49 of Aaron Cross on behalf of the Greyhound Protection League of New Zealand was referred on 21 February 2013, and requested that the House note that 1,590 people have signed an online petition requesting an inquiry into the injuries and outcomes for greyhounds in the New Zealand racing industry, that the findings be made public, and that the House support this request.

Background

Aaron Cross and the Greyhound Protection League of New Zealand
Aaron Cross is a Wellington animal rights activist, a greyhound owner of three years, and the co-founder of the Greyhound Protection League of New Zealand (GPLNZ). The GPLNZ is an animal rights group dedicated to the welfare of greyhounds, and opposed to greyhound racing.

Mr Cross, on behalf of the GPLNZ, proposes in his submission that greyhound racing be banned, or if this is not possible, new laws introduced enforcing high welfare standards for all greyhounds bred and imported for the racing industry, and compliance with the Dog Control Act 1996. He alleges mistreatment, drug-feeding, non-registration, and the euthanasia of greyhounds by the industry, and says that some dogs are unaccountably missing. The industry body, the New Zealand Greyhound Racing Association, challenges these allegations.

New Zealand Greyhound Racing Association
The New Zealand Greyhound Racing Association (NZGRA), using the trade-name Greyhound Racing New Zealand, is an incorporated society with 10 greyhound racing clubs registered as members. NZGRA is recognised in the Racing Act 2003 as the body representing the greyhound racing industry.

The NZGRA’s website says the association was established to promote and advocate greyhound racing, and the registration, safety, and welfare of greyhounds in New Zealand, and to formulate and administer rules and regulations governing these areas. It is also responsible for the conduct of greyhound race meetings.

The NZGRA established a registered charity, Greyhounds as Pets, to find homes for retired racing greyhounds. It has an animal welfare policy and also set up an animal welfare committee in 2012 to ensure “all greyhounds in New Zealand are protected and promoted by the adoption and development of sound animal welfare standards and practices.”

The greyhound racing industry
The greyhound racing industry is governed by the New Zealand Racing Board (NZRB), an independent body corporate established under the Racing Act 2003, and reporting to the Minister for Racing. The NZRB approves the NZGRA’s annual statement of intent and business plan.
The New Zealand Racing Integrity Unit, created in February 2011, is an independent organisation responsible for investigating and prosecuting breaches of the Rules of Racing of each racing code (including harness, thoroughbred, and greyhound racing). It is funded entirely by the racing industry. In 2012 the unit took control of race-day processes, including the provision of veterinary services. It has an integrity services agreement with each racing code. Under its agreement with the NZGRA, the unit is contracted to undertake unannounced periodic kennel inspections. A recent welfare review of the greyhound racing industry\(^1\) concluded that the agreement is inadequate regarding the enforcement of welfare rules, the levels of service provided by the unit, and service level reporting.

**Independent review of the greyhound industry in Great Britain**

We were interested to learn that a 2007 independent review of the greyhound industry in Great Britain proposed a new governing body, along with measures to improve greyhounds’ welfare, and better tracking of individual dogs. It also recommended research into breeding, better retirement provisions for greyhounds, and monitoring of track quality and the nature and cause of injuries. We note that these recommendations are similar to the findings of the NZGRA’s Independent Welfare Review, which we discuss later in this report.

**Recommendations**

We recommend to the Government that it ask the New Zealand Racing Board to

- develop a system for monitoring the greyhound racing industry’s Rules of Racing
- review the service agreement between the New Zealand Greyhound Racing Association and the Racing Integrity Unit.

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2 The petitioner's concerns

Tracking greyhounds in New Zealand

The petitioner claims that there is a lack of registration compliance, and no way to track each dog's movements. We are aware that no single body has a statutory mandate to enforce the registration of greyhounds involved in racing in New Zealand, and there is no independent database listing racing and non-racing greyhounds. Under section 29 of the Racing Act 2003, each racing code must make and enforce rules regulating the conduct of racing. In the case of greyhound racing, these rules may provide for the registration of greyhounds. Rule 120 of the Greyhound Racing Rules states that no greyhound can be nominated for a race unless it is registered. NZGRA keeps a database of greyhounds registered for racing, but acknowledges that it is not accurate.

We heard that under the Dog Control Act 1996, all dogs must be registered with the relevant local council. However, to complicate matters, some councils allow bulk licencing of dogs, where a person pays a registration fee for a number of animals. The Department of Internal Affairs maintains a National Dog Database of information supplied and maintained by local councils, including registration details, microchip numbers where applicable, breed, and year of birth. However, the database does not have a mandatory data field indicating whether a greyhound was, or is, used for racing. There is also no specific registration requirement under the Dog Control Act or the Racing Act for greyhounds that race, nor is there any tracking of greyhounds at the end of their racing careers. The petitioner says that more than 10,000 ex-racing dogs are unaccounted for. We are concerned about these apparent anomalies, and consider that better tracking of greyhounds involved in the racing industry is needed. The New Zealand Greyhound Racing Association has recently amended its rules of racing to require litters to be registered with the association, dogs to be registered with the local council, and detailed information to be provided when greyhounds are de-registered from the association. The organisation has also undertaken to share its registration data with local authorities, the Department of Internal Affairs, and animal welfare groups. We are encouraged by these developments.

Recommendation

We recommend to the Government that it ask the Department of Internal Affairs to establish and maintain a database of greyhounds, tracking their identity and their location from registration until death.

Welfare of greyhounds

Mr Cross’s petition focuses on injuries to and outcomes for greyhounds in the New Zealand racing industry. The Animal Welfare Act 1999 establishes a duty of care for owners and people in charge of animals, requiring them to meet the animal's physical, health, and behavioural needs. Failure to do this is an offence under the Act, carrying substantial penalties, as is ill treatment of an animal, and failure to alleviate pain or distress.

The petitioner also considers that there is prolific breeding of greyhounds for the racing industry and that this situation needs to be controlled.
Codes of welfare under the Act set detailed minimum standards and recommend best practice for people caring for animals. The Animal Welfare (Dogs) Code of Welfare 2010, and the Animal Welfare (Transport within New Zealand) Code of Welfare 2011, include the welfare of greyhounds. The dogs’ code applies to people using dogs for sport, and it includes requirements concerning ill health and injury, training, and euthanasia. Although the code does not refer specifically to racing greyhounds, the National Animal Welfare Advisory Committee is considering the development of standards for the use of animals in entertainment, and this may result in some generic standards to cover the use of animals in racing.

The transport code is also relevant for racing greyhounds, in setting minimum standards of care and management when transporting animals. Failure to meet a minimum standard in a code can be the basis for a prosecution for an offence under the Animal Welfare Act. The petitioner is critical of the transportation of greyhounds over long distances, particularly when they are injured.

The Ministry for Primary Industries encourages people to report any animal welfare issues or complaints to their local branch of the SPCA, or to the Ministry’s animal welfare hotline. The Ministry has previously responded to concerns raised by Aaron Cross about the welfare of greyhounds through its ministerial process, but told us that it has received no complaints about racing greyhounds constituting breaches under the Animal Welfare Act, and has not carried out any monitoring of the industry. All reported complaints involving non-compliance with the Act and codes of welfare are investigated. The SPCA has not had any recent prosecutions in relation to greyhounds, although they have investigated complaints, at least one of which the industry was helpful in resolving.

The National Animal Welfare Advisory Committee considers there are two welfare issues relevant to this petition: euthanasia of animals considered to be of limited usefulness to racing, and the risk of injury to animals incurred in racing. It says these issues are of worldwide concern for horse and greyhound racing industries, and there is evidence that the ethical position of some societies is becoming opposed to racing animals. However, it also points out that greyhound racing has a long and legitimate history as a widely accepted use of animals, and the industry appears to be taking serious steps to reduce the welfare costs of its activities.

NZGRA’s objective is to have no healthy dogs euthanased; they consider that the solution lies in reducing injuries and providing more options for dogs retired from racing.

**Recommendations**

We recommend to the Government that it ask the National Animal Welfare Advisory Committee to

- consider developing standards for the use of animals, in particular greyhounds, in racing
- consider developing guidelines on the breeding of greyhounds
- consider reviewing the Animal Welfare (Dogs) Code of Welfare 2010, with a view to specifying the circumstances in which animals can be euthanased.
Animal Welfare Amendment Bill

This bill proposes changes to the Animal Welfare Act to improve its enforceability, clarity, and transparency. Currently the codes of welfare are not directly enforceable, although a breach of a code can be used as evidence to support a prosecution under the Act. The bill would provide enforceable regulations alongside the codes of welfare. Failure to comply with a regulation would be an offence punishable by prosecution or instant fine. The regulations are likely to be developed using existing standards in the codes of welfare, possibly converting some minimum standards in the dogs’ code of welfare into enforceable regulations.

The bill would allow animal welfare inspectors to issue compliance orders, requiring a person to take action to comply with the animal welfare law. This and other new enforcement tools, like infringement offences, would give inspectors more ways of dealing with offending that was not serious enough to warrant a prosecution. The public and affected parties will be consulted as the regulations are developed.

We wrote to the Primary Production Committee asking that it consider recommending amendments to the Animal Welfare Act to include provisions on the welfare of racing greyhounds. We understand that the committee is considering our request.

NZGRA Welfare Review

In July 2013 NZGRA provided us with the findings of a review it commissioned into the greyhound racing industry. The accountancy firm WHK (now Crowe Horwath) undertook the review, examining the welfare of racing greyhounds, the lifecycle of racing greyhounds, the tracking of greyhounds, and the responsibilities of owners, trainers and clubs. It developed detailed recommendations for:

- research on track safety, and better injury reporting
- breeding education programmes
- improving the welfare of greyhounds by formalising, enforcing and monitoring NZGRA’s welfare standards, employing a welfare officer, establishing formal agreements between NZGRA and the SPCA and the National Animal Welfare Advisory Committee, and communicating with other greyhound racing jurisdictions
- better enforcement of the rules regarding retirement of greyhounds, and a review of these rules and the funding needed to achieve better retirement outcomes
- better tracking of greyhounds
- a review of the service agreement between the NZGRA and the Racing Integrity Unit, and alternative racing programs to accommodate more dogs.

The review’s report notes that a number of welfare actions have been initiated by NZGRA, but says that the board has not been as proactive as it should. A lack of monitoring and enforcement of welfare rules has led to non-compliance. It suggests that the NZGRA, as the industry body, should lead a cultural change within the industry so that welfare considerations outweigh competitive or commercial consequences.

The NZGRA has informed us that it has accepted all of the review’s recommendations, and the rule changes were passed at the industry’s annual general meeting in October. The Association has also advised that it will soon be appointing an animal welfare officer.
Recommendation

We recommend to the Government that it ask the New Zealand Racing Board to review the New Zealand Greyhound Racing Association’s implementation of the recommendations arising from the welfare review of the greyhound racing industry by August 2014.
3 Conclusion

We have carefully considered the issues raised by the petitioner, and have heard and received evidence from a number of organisations. As racing greyhounds is legal in this country, we have chosen not to enter into the moral debate about the merits of greyhound racing in itself. However, we have been made aware that there are some welfare concerns within the greyhound racing industry that need addressing, and we have made a number of recommendations for improvement. In particular, possible amendments to the Animal Welfare Act present an opportunity to consider provisions for racing greyhounds, and we have written to the Primary Production Committee in this regard. Meanwhile the New Zealand Greyhound Racing Association has informed us that it is implementing the recommendations of the NZGRA welfare review. We encourage the New Zealand Racing Board to review this work by August 2014. We will also review this situation within 12 months.
Appendix

Committee procedure
The petition was referred to us on 21 February 2013. We received submissions from the petitioner, the New Zealand Greyhound Racing Association, the Department of Internal Affairs, the Ministry for Primary Industries, and the National Animal Welfare Advisory Committee. We heard evidence from the petitioner, and the New Zealand Greyhound Racing Association.

Committee members
Hon Ruth Dyson (Chairperson)
Chris Auchinvole
Kanwaljit Singh Bakshi
Hon Trevor Mallard
Mojo Mathers
Eric Roy
Inquiry into the accessibility of services to Parliament

Report of the Government Administration Committee

Fiftieth Parliament
(Hon Ruth Dyson, Chairperson)
May 2014

Presented to the House of Representatives
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Inquiry into the accessibility of services to Parliament

Summary of recommendations

The Government Administration Committee makes the following recommendations to the House:

- That it ask the Parliamentary Service and the Office of the Clerk to develop policies for accessibility, in accordance with the United Nations Convention on the Rights of Persons with Disabilities. (p. 9)

- That it ask the Parliamentary Service and the Office of the Clerk to devise and implement a plan to address disability access concerns regarding Parliament, including those raised in this report and others that may be raised in subsequent consultation, and to report back to us on progress in twelve months (p. 9)

- That it ask the Parliamentary Service and the Office of the Clerk to consult with disabled people regarding all accessibility issues and upgrades. (p. 9)

- That members ensure that their offices outside Parliament are fully accessible, and that the Parliamentary Service help members to do so. (p. 22)

- That it ask the Office of the Clerk and the Parliamentary Service to ensure that all venues used outside Parliament are fully accessible for disabled people. (p. 22)

The Government Administration Committee makes the following recommendations to the Government:

- That it appropriate funding dedicated to making the parliamentary precincts and processes accessible for disabled people by
  - providing mobility car parks close to the main public entrance
  - providing appropriate signage, accessible walkways, and rest benches in the precincts
  - ensuring that information on security processes is readily available at security checkpoints and on the Parliament website
  - providing disability awareness training for security staff
  - upgrading the reception counters to ensure full accessibility
  - urgently upgrading the stairway between the Executive Wing and Parliament House to ensure full and equal access for disabled people
  - upgrading all the lifts to talking lifts
  - installing tactile indicators where necessary
  - clearing the hallways and walkways of obstacles
  - ensuring that the necessary contrast is on all glass windows, doors and walls
- providing toileting facilities for assistance dogs
- providing NZSL interpreters and live transcription services for parliamentary tours, select committee hearings, parliamentary functions, and meetings with members of Parliament. (p. 15)

- That it provide funding for upgrading the Parliament website to make more information available, to publish educational videos, and to ensure that information and videos are available in additional languages and accessible formats such as easy-read and large print. (p. 20)

- That it provide funding for Parliament Television to provide live audio descriptions and simultaneous New Zealand Sign Language interpretations of coverage of the House. (p. 20)

- That it ensure that sufficient funding and support is provided to enable disabled members of Parliament to carry out their roles as elected representatives fully. (p. 22)
1 Introduction

We initiated this inquiry to investigate bringing the accessibility of the services provided to Parliament into line with the principles and provisions of the United Nations Convention on the Rights of Persons with Disabilities. The services provided in the parliamentary precincts by the Parliamentary Service and the Office of the Clerk of the House of Representatives are fundamental to the ability of members of Parliament and staff to carry out their roles, and also to the ease with which the public can access parliamentary information and processes. These services include maintaining the precincts, supporting the House and select committees, and managing the Parliament website and Parliament Television (PTV). The convention was ratified by New Zealand in 2008, and government agencies are obliged to ensure that their policies are consistent with the convention.

We have analysed the services provided by the Parliamentary Service and Office of the Clerk against the principles of the United Nations Convention on the Rights of Persons with Disabilities (Appendix C). Key principles in the convention are that signatories promote actively an environment in which persons with disabilities can effectively and fully participate in the conduct of public affairs, without discrimination and on an equal basis with others, and encourage their participation in public affairs and take appropriate measures to ensure to persons with disabilities access, on an equal basis with others, to the physical environment, to transportation, to information and communications, including information and communications technologies and systems, and to other facilities and services open or provided to the public…

The Parliamentary Service declares that one of its objectives is creating an accessible Parliament so that the public can learn about and experience the parliamentary process, access parliamentary information, and access the Parliament buildings. One of the stated objectives of the Office of the Clerk is to enhance the effectiveness of Parliament by ensuring that “public respect for the institution of Parliament grows because the public is informed about what Parliament is doing and able to participate.”

Parliament is at the heart of democracy in New Zealand and should be accessible to everyone. Our recommendations seek to ensure that it is, and that people have equitable access to the democratic processes. In our view ensuring equal access for disabled people will have a spill-over effect on access for other groups such as young and elderly people.

We are concerned that, on the available evidence, Parliament is not regarded as accessible by disabled people. If disabled people feel that they are an inconvenience and unwelcome at Parliament, they will stay away.

A disability survey is held every five years in conjunction with the census. The 2006 Disability Survey found that approximately 17 percent of New Zealanders or 660,300 people reported having a disability. The survey defined disability as “any self-perceived

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limitation in activity resulting from a long-term condition or health problem; lasting or expected to last six months or more and not completely eliminated by an assistive device.” A disability may affect a person’s mobility, senses, or mental capacity for certain activities. Disease, illness, accidents, and injuries are the most common causes of a disability in an adult.

According to the 2006 Disability Survey the most common types of disability among adults are physical and sensory; 12 percent of adults over 15 years old reported having a physical disability, 8 percent a sensory disability, and 7 percent other types of disabilities. In New Zealand approximately 12,000 people are blind, and a further 125,000 adults aged over 40 have disabling vision loss. Around 11,000 people in New Zealand are deaf and one in six people suffer from hearing loss. People may have more than one type of disability.

Disabled people come to Parliament for many different reasons: as members of the public, as submitters, as parliamentary staff members, as advisors or other official visitors, or as members of Parliament. People can visit Parliament to observe Question Time, take a tour, attend a select committee meeting, or visit a member of Parliament, among other reasons.

We heard that disabled people often have decisions made for them; we would like disabled people to be involved in making any decisions to be taken regarding the accessibility of Parliament. We would like to see the necessary changes proposed in consultation with disabled people and their representative organisations.

We are grateful to the submitters who contributed to this inquiry, who are motivated to improve the accessibility of services to Parliament.

Terms of reference

We established the following terms of reference for our inquiry:

1. Parliament buildings, Parliament processes and members of Parliament are accessible to disabled people:
   a. accessibility of parliament buildings (for example, access to buildings, moving around buildings, signage in Braille and easy-read, provisions for guide dogs)
   b. accessibility of MPs in their out of Parliament offices (for example, offices accessible, NZSL interpreters provided for meetings with MPs)
   c. accessibility of Parliament’s public processes, such as Question Time, select committee hearings, etc. (NZSL interpreters made available on request), and
   d. accessibility of out-of-Parliament events that Parliament hosts.

2. Disabled people can access Parliament information and communications:
   a. accessibility of Parliament public information, such as notices of calls for submissions, Parliament website, pamphlets, etc. (website accessible, in plain language and easy to navigate, easy to read information provided, information in NZSL video clips, other alternative formats provided where appropriate)
b. accessibility of Parliament communications technologies such as sound system and Parliament TV (captioning) etc, and including facilitating the use of assistive and new technologies where appropriate

3. Disabled people can stand for elections and effectively hold office in Parliament—
   a. whether Parliament’s appropriations support existing disabled MPs to carry out their functions without discrimination, providing full and equal participation and equality of opportunity (eg: NZSL interpreter services, electronic note-takers)
   b. Parliament appropriations promote the participation of disabled people in political parties.

Structure of the report

We have structured this report so as to take the reader through the journey that a disabled person has to make to access Parliament. We would like the reader to understand the lived experiences of disabled people who visit Parliament. We will analyse the barriers that exist for disabled people on this journey, and canvass some practical ways to address them.

Recommendations

1. We recommend to the House of Representatives that it ask the Parliamentary Service and the Office of the Clerk to
   • develop policies for accessibility, in accordance with the United Nations Convention on the Rights of Persons with Disabilities
   • devise and implement a plan to address disability access concerns regarding Parliament, including those raised in this report and others that may be raised in subsequent consultation, and to report back to us on progress in twelve months
   • consult with disabled people regarding all accessibility issues and upgrades.
2 Physical access

Access to the parliamentary precincts

Parliament is central to democracy in New Zealand. At Parliament the general public can visit a member of Parliament, watch proceedings in the House, attend an event, or make a submission to a select committee. If it is difficult for a person to access a place they are likely to stay away. Every submitter who commented on physical access to Parliament expressed concern about how difficult Parliament was to navigate for disabled people.

Article 9 of the United Nations Convention on the Rights of Persons with Disabilities guarantees equal access for disabled people to facilities and services provided to the public. This section of our inquiry looks at physical access, and specifically where reasonably equal access for disabled people is not being provided.

For the purposes of this inquiry, by the parliamentary precincts we mean Parliament House, the Executive Wing (the Beehive), the Parliamentary Library, Bowen House, and the parliamentary grounds.

Parliament House and the Parliamentary Library are registered as Historic Place Category 1 buildings, and modifying them therefore presents particular challenges. The New Zealand Historic Places Trust manages permits for making changes to historic places. The Parliamentary Service told us that this status creates some restrictions, but architectural and structural design also make some changes difficult. We understand that most of the internal layout of Parliament House, for example, does not have a high heritage protection and some floors have undergone extensive refurbishment. The Parliamentary Service said that the previous refurbishment of these floors complied with the Building Code at the time of the work.

The current Building Code seeks to ensure that buildings can be accessed by disabled people. However, the Building Code is the minimum standard for accessibility, and we consider that buildings of such public importance as those in the parliamentary precincts need to be more accessible and compliant with the United Nations Convention on the Rights of Persons with Disabilities. Older buildings and renovations often do not meet current building standards; when standards are changed, they do not apply retrospectively.

We were made aware of a Disability Access review which is being undertaken jointly by the Ministry of Business, Innovation and Employment and the Office for Disability Issues. It will determine whether the current building regulatory system meets the needs of disabled people. We look forward to learning the results of the review, which are expected later this year, and their possible implications for the parliamentary precincts.

Various physical barriers at Parliament inhibit the mobility of disabled people when they are visiting or working at Parliament. The challenges vary with the many different types of impairments. We look at specific access issues below.

Approaching the buildings

Parking is an issue for disabled people wanting to visit Parliament. Disabled visitors may park in the “mobility car park” in the external car park, or the executive parking building if
they secure permission from security officers first. From these parking spaces accessible entrances to Parliament are readily available, but they require entry through secured doors. None of this information is currently available on the Parliament website.

As there is no public parking at Parliament, members of the public who wish to visit must make their own way from the street. A person arriving on the street outside the front of Parliament House may have been dropped off, parked on the street, or arrived by public transport. People may also be dropped off on the forecourt.

The Australian Parliament has public car parking, with accessible car parks close to the public lifts. We consider that the New Zealand Parliament should provide accessible car parks close to the main public entrance.

We heard from submitters that getting to Parliament can be difficult for many people. Some cannot drive and rely on other people or public transport; others have specially adapted vehicles.

We heard that people in general find the signage around Parliament insufficient to direct them from the front gates to the main public entrance. The most accessible route from the back of Parliament is via the path between Parliament House and the Parliamentary Library, but this route also does not have signage.

We heard that for some mobility-impaired visitors the walkways from the main gates to the main entrance are too steep for them to use and do not contain sufficient rest areas. We consider that better signage, accessible walkways and rest benches in the parliamentary precincts would address these concerns.

We are aware of the Wellington City Council’s project to develop a grand staircase to link Cenotaph Square with the Parliament forecourt. Submitters were concerned that this would not be accessible, and we share this concern.

Security at the entrances

At the public entrances of Parliament House and Bowen House all public visitors must go through security checks. We heard from submitters who were concerned that there is very little information displayed at security areas to explain the entry and security processes, which can feel invasive and make people uncomfortable. We recommend having this information displayed prominently, in a way accessible to disabled people, at checkpoints and on the Parliament website to help prepare and reassure people.

Maintaining adequate security procedures is important and we acknowledge that parliamentary security officers are well trained. We would like the training to include disability awareness, including sensitivity when dealing with disabled people, to ensure that their dignity is respected, in line with Article 4 section 1(i) (see Appendix C) of the United Nations Convention on the Rights of Persons with Disabilities.

Reception counters

Once past security, all public visitors must check in and register at one of the reception counters in Bowen House or the Executive Wing, where they are directed to their destinations. We were concerned to hear that for people in wheelchairs these counters are too high for engagement with the receptionist.

The main counters in both the Executive Wing and Bowen House are 1470mm high. The Building Code requires that where counters are provided for public use at least one must
be accessible. Guidelines provided by the Ministry of Business, Innovation and Employment specify that counters should be at least 250mm deep to provide knee space and that 700mm is the preferred height. Each of the counters at Parliament has a lowered section, which we heard the Parliamentary Service intended for use by people in wheelchairs, but because they are well to the side of the receptionist’s work-station, they do not in practice work as intended. The specifications of the lowered sections comply with the guidelines; however the Building Code also specifies that disabled people should be able to carry out “normal activities and processes” in a building. As these counters do not in practice achieve this, we consider that they are not complying and work should be undertaken to ensure that they are practical to use and fully compliant.

**Access throughout the parliamentary buildings**

We heard that physically moving around Parliament is very difficult for many disabled people. A number of issues and obstacles have been brought to our attention, and we will make a number of recommendations addressing them.

**The staircase between the Beehive and Parliament House**

If a mobility-impaired person is unable to access stairs and needs to go to Parliament House, they must take a route that is quite different from that used by able-bodied members of the public. There are eight steps between the Beehive, where the public enter the complex, and Parliament House, and no ramp or other accessible internal access. To attend a select committee meeting in Parliament House, for example, they would have to take the Beehive lifts to level one, take the walkway to Parliament House, then take the Parliament House lift back down to the ground floor.

We understand that the Parliamentary Service considered providing an alternative to the stairs, but concluded that it was “impossible” in architectural terms, and argued that the alternative route was acceptable.3 We heard that portable lifts are used in Australia, and recommend that the possibility of providing such a lift alongside the staircase be explored. Portable lifts are not permanent fixtures, and can be custom-built to meet specific requirements. A portable lift would allow mobility-impaired people to access Parliament House directly from the Executive Wing public entrance. We are not convinced that all the options have been explored in relation to this issue and consider that urgent action should be taken to address this issue.

**Bridge access on level one**

The bridge that connects Parliament House to the Executive Wing is sloped and around 12 metres long. We understand that this is not ideal: according to Design for Access and Mobility – Buildings and Associated Facilities NZS 4121:2001, rest areas should be provided at intervals not exceeding 9 metres. The Parliamentary Service considers that the bridge is suitable and complied with the Building Code when it was built. We emphasise that the Building Code is the minimum standard and often does not guarantee full access.

**Accessibility of members’ offices at Parliament**

We heard that some members’ offices in Parliament are not accessible to mobility-impaired people. Some member’s offices on level 3 of Parliament House are not accessible by wheelchair; and three member’s offices on level 2 of Parliament House can be reached only via stairs.

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Doors

Many of the doors around the parliamentary complex are hard to open and pass through. Some doors are fully automated and require the user to press a button or swipe an access card. Some, such as the doors leading to the Bowen House select committee rooms, are very heavy and almost impossible for some disabled people to open on their own. The Parliamentary Service submitted that many of the heavy doors are difficult to modify because of their historic status and architectural limitations. From the evidence we have received we are not convinced that this is so in every instance; for example the doors leading to the Bowen House select committee rooms, which are often used by the public, could be replaced with automatic doors.

Wheelchair users at Parliament

There are no dedicated wheelchair spaces in the parliamentary public gallery. We heard that this was of particular concern at the final reading of the Disability (United Nations Convention on the Rights of Persons with Disabilities) Bill in 2008. The Parliamentary Service argued people in such spaces would stand out unduly in the public gallery, but we consider that unwelcome conspicuousness is outweighed by access considerations. We consider that providing dedicated fully accessible wheelchair spaces in the parliamentary public gallery is important.

We were made aware that at a recent meeting of another committee, a member of the public had to park their wheelchair in the aisle of the meeting room, which is contrary to health and safety requirements to keep aisles clear. The appropriate response would have been for staff to remove some of the chairs to make space for wheelchair users. This situation highlights the need for more disability awareness on the part of parliamentary staff during select committee proceedings.

We are aware that the members’ seating area in the debating chamber cannot be accessed by wheelchair; the Parliamentary Service said that it would consider rectifying this if the need arose. We consider that the Parliamentary Service should be prepared for a member of Parliament in a wheelchair, and should address this in the disability access plan. Staff should also be trained to assist disabled members of Parliament.

Audio quality in the Chamber

The sound quality in the Chamber is poor and often it is difficult for both members in the Chamber and the public seated in the gallery to hear what is being said. We recommend that this system be upgraded to improve the sound quality.

Information on access

We heard that there is a lack of information on the Parliament website about the parliamentary precincts. It was also suggested that the website provide videos on getting to and around Parliament; maps would also help people to determine their exact destination and plan their route in advance.

A map of the complex is available on the Parliament website but it is not helpful for getting to the Parliament buildings. The Australian Parliament website has multiple maps showing different ways to get to the Australian Parliament in vehicles and on foot. Its website also provides detailed floor plans, highlighting toilets, accessible toilets, information desks, and lifts, and provides useful information such as walking distances from public transport.
Tours
The Parliamentary Service is flexible in accommodating disabled people who want to take public tours of Parliament. The normal tour route is almost fully accessible, with the exception of the base isolator exhibit in the basement of Parliament House, which is accessible only via stairs. With prior notice New Zealand Sign Language (NZSL) interpreters can be contracted to assist groups that include hearing-impaired people. The route taken is somewhat flexible, and the Parliamentary Service works with groups to accommodate their specific access needs.

The Parliamentary Service submitted that they have provided a virtual tour of Parliament buildings on the website. The virtual tour contains selected highlights of Parliament and consists of images described only in English text. For full accessibility such features should be available in other languages including NZSL. We do not consider the virtual tour as an adequate alternative to a physical tour of Parliament.

Access for vision-impaired people
We heard from submitters that for people with sight loss the accessibility of the parliamentary complex is inconsistent. Some areas are easily accessible, others hard for vision-impaired people to navigate.

Lifts
Most of the lifts in the parliamentary complex do not have Braille numbering on the control panel. The control buttons for some of the lifts are not directly beside the lifts, which again presents a problem. Talking lifts are easier for vision-impaired people to use, and increasingly common. We consider that all the lifts at Parliament should be upgraded to talking lifts.

Mobility
Moving around Parliament can be hard for those who are vision-impaired. We heard that a route may seem technically accessible, but still present obstacles. Objects, displays and design features may prevent vision-impaired people from walking close to the walls to assist safe navigation.

We heard that some of the glass windows, doors, and walls in Parliament lack sufficient visual contrast. Unassisted vision-impaired people may walk into the doors, windows, or walls or find it hard to navigate around them.

We heard that Parliament also lacks sufficient tactile indicators of direction or upcoming obstacles such as stairways. Parliament should be safe for everyone to walk around.

Assistance dogs
Assistance dogs are welcome in the parliamentary precincts, but obstacles still remain for them. One is the lack of toileting areas for the dogs, which limits the length of time they can stay in the complex. Also, many of the automated doors and lifts in Parliament close too fast to allow a person and their dog to pass through.

Access for hearing-impaired people
At Parliament hearing loops are available in the House, the committee rooms, and most of the meeting and function rooms. A hearing loop sends an amplified signal, which is picked up by either a provided receiver and headset or special hearing aids. Users can adjust the
volume to suit their needs. However, there is little signage around the complex or information on the website to make people aware of the hearing loops. We encourage the Parliamentary Service to make this information easily accessible for people who might want to use it.

We heard that people who use NZSL as their primary form of communication feel that they cannot engage in many of the parliamentary processes, because they believe that services for hearing-impaired people, such as NZSL interpreters or captioning, are not available at Parliament. We have been told by the Parliamentary Service and the Office of the Clerk that on request NZSL interpreters can be made available for people taking parliamentary tours or making a submission to a select committee. We are disappointed that there is no funding to provide NZSL interpreters for people meeting with a member of Parliament; this must be funded out of the member’s office budget. We consider that these services should be funded and that information on this should be readily available on the Parliament website.

**Recommendations**

2. We recommend to the Government that it appropriate funding dedicated to making the parliamentary precincts and processes accessible for disabled people by

- providing mobility car parks close to the main public entrance
- providing appropriate signage, accessible walkways and rest benches in the precincts
- ensuring that information on the security processes is readily available at security checkpoints and on the Parliament website
- providing disability awareness training for security staff
- upgrading the reception counters to ensure full accessibility
- urgently upgrading the stairway between the Executive Wing and Parliament House to ensure full and equal access for disabled people
- upgrading all the lifts to talking lifts
- installing tactile indicators where necessary
- clearing the hallways and walkways of obstacles
- ensuring that the necessary contrast is on all glass windows, doors and walls
- providing toileting facilities for assistance dogs
- providing NZSL interpreters and live transcription services for parliamentary tours, select committee hearings, parliamentary functions, and meetings with members of Parliament.
3 Public information

The United Nations Convention on the Rights of Persons with Disabilities states that signatories should provide

information intended for the general public to persons with disabilities in accessible formats and technologies appropriate to different kinds of disabilities in a timely manner and without additional cost.

The Office of the Clerk and the Parliamentary Service both publish information on the Parliament website and some is provided in hard copy for visitors to Parliament. This information is mostly about parliamentary proceedings, but also includes material of historical and general interest. Information for visitors is displayed around the precincts in various forms.

Parliament also has a Facebook page and Twitter accounts, but we heard from submitters that they are not being utilised extensively. Submitters suggested that the Facebook page and Twitter accounts would communicate with the public more effectively if they were updated regularly.

The information on the website and at Parliament is in various formats including print, audio, webcast, television, and video. However, the format and presentation of information often limit access to it by disabled people. Like physical accessibility, problems with information are often specific to particular impairments.

Printed information

The Parliament website is the main source of public information about Parliament. It is important that disabled people can access such information in a form that they can understand and engage with. Almost all the information on the Parliament website at present is available only in English text. We were told that the Parliament website falls well below recognised standards for website accessibility; we understand that the Parliamentary Service and the Office of the Clerk are working to make it compliant with the New Zealand Government Web Standards. We recommend that completion of this work be given a high priority.

Online information

We heard that suitably formatted and sized print information displayed on screen is generally accessible to most disabled people. However vision-impaired people may have particular needs, which are discussed separately below.

Content may also present problems for some people. Technical or otherwise complex information may be too difficult for some readers to decipher or follow. We heard that producing documents in “Easy-read” can make information accessible to people with learning disabilities. Easy-read is a standardised way of expressing information so that it easy to read and understand. It involves using brief jargon-free sentences, clear formatting structures, and pictures and symbols to help convey the meaning of the text. We were pleased to learn that there is an Easy-read guide to making a submission, but disappointed that it is not available on the Parliament website. We consider Easy-read versions of all
information on Parliament and its processes should be made available on the Parliament website and in hard copy at Parliament.

Accessible information for vision-impaired people

Several submitters told us that for vision-impaired people, the formatting of online print information is often an obstacle. Specific issues affecting the readability of text by people with limited vision are alignment, colour contrast, font choice and size, block letters, italics, and text over images. The Royal New Zealand Foundation of the Blind reviewed a selection of Parliament’s printed public information and in general considered the accessibility of the documents good, although the occasional use of block capitals and italics was not ideal. We heard that making documents also available in large print would improve access to the information.

It is also important to ensure that all online documents are produced in a format compatible with magnification software and screen readers. Screen readers communicate text as synthesized speech or Braille displays, and are often used to access on-screen information. However, these programmes and devices cannot read or reproduce some kinds of text formatting. The New Zealand Government Web Standards contain useful information on making documents accessible for vision-impaired people.

Information and displays

Information on displays and signs around Parliament is only available in English text. We would like to see information at Parliament available in different languages and formats, such as Māori, NZSL, Braille, and in audio versions. We note that in the United Nations Convention on the Rights of Persons with Disabilities Article 9 section 2(d) (see Appendix C) there is a requirement to provide public signage in Braille and Easy-read formats.

Use of CAPTCHA

We heard that CAPTCHA—the Completely Automated Public Turing Test To Tell Computers and Humans Apart—, used on the Parliament website, is exceptionally difficult for blind and some other disabled people to use. It involves deciphering distorted letters and numbers, and is designed to stop a computer programme from accessing certain functions in order to prevent spam. CAPTCHA is used on the Parliament website by those making a submission, signing up for alerts, and contacting a member of Parliament.

Some submitters reported not being able to use CAPTCHA independently on the Parliament website. Making a submission and contacting a member of Parliament are crucial aspects of engaging with democracy and Parliament. Submitters requested that CAPTCHA be removed as soon as possible. We are pleased to hear that the Office of the Clerk and the Parliament Service have recognised this as a problem, and are working with disabled people towards a solution. We think that it is critical that this is resolved urgently.

New Zealand Sign Language

New Zealand Sign Language (NZSL) is an official language of New Zealand, and the primary language of many of the approximately 11,000 Deaf people in the country. Interpreters can translate speech into NZSL directly in person, or provide translation or commentary on screen. State Parties are required to provide sign language interpreters in the United Nations Convention on the Rights of Persons with Disabilities Article 9 section 2(e):
State Parties shall also take appropriate measures to provide forms of live assistance and intermediaries, including guides, readers and professional sign language interpreters, to facilitate accessibility to buildings and other facilities open to the public.

**Select committees and submissions**

We were concerned to hear that some submitters were not aware that a submission in NZSL would be accepted by a select committee. This is a significant issue given NZSL’s status as an official language of New Zealand, and because making a submission is fundamental to participatory democracy in New Zealand. We note that the guide *Making a Submission to a Parliamentary Select Committee* states that a submission in NZSL is acceptable. Nevertheless, this information clearly needs to be disseminated more widely and accessibly.

Accessibility could also be improved by making more information available in video clips, which can convey information via still and moving images, audio, and text. Video clips in NZSL would greatly increase access for Deaf people, and the audio would increase access for visually impaired people. Videos of physical access routes would be useful for disabled people. We consider that it is vital to make use of video to share information effectively.

We were made aware of a useful example of accessible videos on the Parliament of Canada’s website. Information videos on the Canadian system of Government are also available with a translator translating into American Sign Language as well as subtitles in English, showing next to the video.

**New Zealand Legislation website**

We looked at the possibility of making NZSL video translations available on the New Zealand Legislation website. The Parliamentary Council Office (PCO), which is responsible for the website, told us that it would be difficult to decide exactly what to put into NZSL videos.

PCO did not consider that translating entire pieces of legislation would be useful or practical, and even making NZSL videos of the bills digests had problems. Bills digests are technical and use legal terminology extensively, and PCO argued that NZSL translations would not be of much use to the general public. There would also be timing issues, as bills digests are often not available until close to the debate time, leaving too little time for providing and using a translation.

PCO suggest that explanatory notes, Hansard of a minister’s first reading speech, disclosure statements, and regulatory impact statements might be better suited to translation into NZSL on video.

We consider that this matter needs to be investigated further.

**Parliament Television**

Parliament Television (PTV) is run by contractors on behalf of the Office of the Clerk. The Office of the Clerk remains the owner of all its content, while the hardware used for PTV broadcasting is owned by the Parliamentary Service. It is likely that any changes to PTV would need to be a joint venture between the Office of the Clerk and the Parliamentary Service.
Development of the channel

We heard a suggestion that the PTV channel should be utilised to show more content for the public’s benefit at the many times when the channel was not being used to broadcast the House. We heard a suggestion that shows such as *Back Benches* and election debates could be broadcast on PTV.

Live captioning

Submitters were keen to see live captioning of proceedings broadcast live on PTV. Captioning involves adding a text description of the audio component in the video footage being shown. We are aware that it is provided a number of parliaments, including those of Canada and the United Kingdom. Live captioning would offer significant benefits for hearing-impaired people.

In 2012, the Office of the Clerk ran a trial of live captioning, which encountered timeliness problems; but the Office is confident they can be overcome with properly trained staff. This project is continuing, and it is hoped that live captioning will begin early in the next Parliament.

We are pleased with this initiative and think it will be very beneficial to people with hearing loss. We hope that live captioning will begin early in the next Parliament, and will progress to live captioning of all proceedings on PTV by the end of the parliamentary term.

Audio descriptions

Submitters also suggested the use of audio descriptions of proceedings on PTV for the benefit of vision-impaired people.

We heard from the Royal New Zealand Foundation of the Blind that visually impaired people find it hard to follow proceedings in the House, especially during Question Time, when interjectors speak over the top of the main speaker. Visually impaired people have difficulty following the flow of interjections as they cannot see the speakers. Although we acknowledge that interjections are now as McGee describes them a “well-established custom of the House”, we consider that audio descriptions would help to mitigate the problem.

We heard that a possible solution would be to use more sophisticated microphones and audio equipment, to pick up sound only from the current speaker. However, this would not improve access to the same extent as audio descriptions, which we believe are the best solution.

NZSL

We are aware that PTV has used NZSL interpreters, for example for maiden speeches in February 2012 and during the passage of the New Zealand Sign Language Act 2006. We heard that making NZSL interpretation available full time would be very useful for people who use NZSL to communicate. Interpretation on PTV would involve a secondary screen inset in the main PTV broadcast, to display the interpreter translating live what is being said in the House.

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We note that for Sign Language Week 2014, Question Time and tours were covered by NZSL interpreters, and that this was a successful project that we consider should be provided permanently.

**Recommendations**

3. We recommend to the Government that it provide funding for upgrading the Parliament website to make more information available, to publish educational videos, and to ensure that information and videos are available in additional languages and accessible formats such as easy-read and large print.

4. We recommend to the Government that it provide funding for Parliament Television to provide live audio descriptions and simultaneous New Zealand Sign Language interpretations of coverage of the House.
4 Other accessibility issues

Engaging with Parliament

Youth Parliament and the possibility of a Disabled People’s Parliament

Youth Parliament, held once every three years, is a two-day event where young people engage in various parliamentary processes as an actual member of Parliament would, for example attending a select committee meeting and question time in the House. We heard that Youth Parliament 2013 had two Deaf members, and every Youth Parliament since 1994 has had a Deaf member. Sign language interpreters assisted them for the duration of the event, and particular effort was made to ensure the event was fully accessible for them.

We consider that a Disabled People’s Parliament along similar lines could help increase the accessibility of Parliament for disabled people. Such a Parliament could help the providers of services at Parliament understand the needs of disabled people. It could probably be run in a very similar way to the Youth Parliament, and the issues to be debated could be decided in consultation with disabled people. We would support such an initiative, and see it as a potentially effective way to address accessibility concerns.

Disabled members of Parliament holding office effectively

The recent Members of Parliament (Remuneration and Services) Bill included a clause seeking to establish members’ entitlement to services that take into account the particular needs of those with physical or sensory impairments. Submitters expressed concern that elected members of Parliament with impairments do not in their view receive enough support to carry out their roles fully.

This issue was highlighted in 2012 when the Speaker, Dr the Rt Honourable Sir Lockwood Smith, needed to authorise the Parliamentary Service to provide note-takers for Mojo Mathers MP, who is deaf. The enactment of the Members of Parliament (Remuneration and Services) Bill has brought some clarity to this issue. The Parliamentary Service submitted that it does its best to assist members of Parliament with an impairment and respond to their needs. Disabled members of Parliament must be supported so that they can carry out their roles as members fully, and we are not satisfied that this is always done as well as it might be.

Access outside of Parliament

Members’ offices outside Parliament

We were concerned to hear that the out-of-Parliament offices of some members of Parliament were not accessible, meaning meetings with some constituents had to be organised elsewhere. We consider that, in line with Article 9 of the Convention, members’ offices outside Parliament should be accessible to all their constituents.

The Parliamentary Service provides guidelines to members regarding their out-of-Parliament offices, including information on the needs of disabled people. In 2008 and 2010 the Parliamentary Service received a number of queries about the accessibility of members’ offices.
Events outside Parliament

Submitters were also concerned that events held outside Parliament were not always accessible. The most common such events held outside Parliament are select committee hearings of evidence, which are held at various venues around New Zealand. Some of these venues are not accessible. Proximity of the venues to public transport was another issue. Such events are intended to engage with the public; and, besides being inequitable, any limitations on access to them tend to limit their effectiveness.

Recommendations

5  We recommend to the Government that it ensure that sufficient funding and support is provided to enable disabled members of Parliament to carry out their roles as elected representatives fully.

6  We recommend to the House of Representatives that members ensure that their offices outside Parliament are fully accessible, and that the Parliamentary Service help members to do so.

7  We recommend to the House of Representatives that it ask the Office of the Clerk and the Parliamentary Service to ensure that all venues used outside Parliament are fully accessible for disabled people.
5 Conclusion

We initiated this inquiry because we are concerned about barriers to the accessibility of services provided to Parliament. In our inquiry we wanted specifically to engage with disabled people to hear what they considered to be the major issues and their opinions on them. The submitters we heard from were passionate about making Parliament more readily accessible for disabled people, and we are grateful for their input.

The United Nations Convention on the Rights of Persons with Disabilities seeks to ensure, as far as is realistically possible, the full participation in society of disabled people. Our inquiry has demonstrated that while many useful initiatives have already been undertaken, there is still more work needed to give disabled people the opportunity for full access to and participation in Parliament. We are confident that this can be done, and are encouraged that the Office of the Clerk and the Parliamentary Service are taking steps to do so.

Some of our recommendations, such as providing more accessibility information on the Parliament website, accessible car parks, renovating the reception counters, and ensuring the precincts are suitable for vision-impaired people, may not prove to be expensive to implement, and we think they should be considered promptly.

We are aware that Parliament House and the Parliamentary Library are historic places. On the evidence we have heard, we are confident that architectural upgrades to the buildings can be made to greatly improve access, with appropriate sensitivity to the buildings’ heritage value.

The accessibility of information is shifting territory because of rapid technological change. The main source of public information about Parliament is its website, and we would like to see it developed to make it comprehensively accessible. We also consider that the website should be modernised, which should increase its accessibility. Information videos in English, Māori, and NZSL would be very useful, making Parliament and parliamentary processes much more accessible.

Several submitters commented on noteworthy issues that were not within the scope of our inquiry. For example, we were very concerned to hear that blind people in New Zealand do not have means of making an independent and secret vote. Others raised the accessibility of political parties, particularly their websites and other public information. We have written to the Justice and Electoral Committee and the Electoral Commission expressing our concerns.

We consider that all of the people of New Zealand should have access to this country’s Parliament. We recommend that the Parliamentary Service and the Office of the Clerk be more proactive in making essential services to Parliament accessible for all. We would like to see all the necessary changes made in consultation with disabled people and their representatives, and we have asked that these agencies report back to us on progress in twelve months’ time. We would like to be part of a New Zealand Parliament that is a world leader in accessibility, and accessible to all New Zealanders.
Appendix A

Committee procedure
The committee called for public submission on the inquiry. The closing date for submissions was 12 July 2013. The committee received 29 submissions from the organisations and individuals listed in Appendix B and the committee heard 18 of the submissions orally. We heard evidence in Wellington and Auckland.

We received advice from the Ministry of Social Development.

Committee members
Hon Ruth Dyson (Chairperson)
Chris Auchinvole
Kanwaljit Singh Bakshi
Mojo Mathers (from 28 August 2013)
Hon Trevor Mallard
Eric Roy
Holly Walker (until 28 August 2013)
Appendix B

List of submitters

ACHIEVE
Alexia Pickering JP QSO CNZM
Association of Blind Citizens of New Zealand
Auckland Disability Law Incorporated
Barrier Free New Zealand Trust Community Justice Project
CSS Disability Action
Canterbury District Health Board
Deaf Aotearoa New Zealand
Deafradio
Disabled Persons Assembly
Dr Hilary Stace
IHC
InternetNZ
Kim Robinson
Martine Abel-Williamson
Mary Schnackenberg
New Zealand Disability Support Network
New Zealand Public Service Association
Nicholas Ruane
Office of the Clerk of the House of Representatives
Parliamentary Counsel Office
Parliamentary Service
Paul Brown
People First New Zealand
Peter Ray and Rosemary McDonald
Reza Reyhan
Richard Cullingworth
Royal New Zealand Foundation of the Blind
The National Foundation for the Deaf
Appendix C

United Nations Convention on the Rights of Persons with Disabilities
Articles 3, 4, 9, 21, and 29

Article 3
General principles

The principles of the present Convention shall be:

(a) Respect for inherent dignity, individual autonomy including the freedom to make one’s own choices, and independence of persons;

(b) Non-discrimination;

(c) Full and effective participation and inclusion in society;

(d) Respect for difference and acceptance of persons with disabilities as part of human diversity and humanity;

(e) Equality of opportunity;

(f) Accessibility;

(g) Equality between men and women;

(h) Respect for the evolving capacities of children with disabilities and respect for the right of children with disabilities to preserve their identities.

Article 4
General obligations

1. States Parties undertake to ensure and promote the full realization of all human rights and fundamental freedoms for all persons with disabilities without discrimination of any kind on the basis of disability. To this end, States Parties undertake:

(a) To adopt all appropriate legislative, administrative and other measures for the implementation of the rights recognized in the present Convention;

(b) To take all appropriate measures, including legislation, to modify or abolish existing laws, regulations, customs and practices that constitute discrimination against persons with disabilities;

(c) To take into account the protection and promotion of the human
rights of persons with disabilities in all policies and programmes;

(d) To refrain from engaging in any act or practice that is inconsistent with the present Convention and to ensure that public authorities and institutions act in conformity with the present Convention;

(e) To take all appropriate measures to eliminate discrimination on the basis of disability by any person, organization or private enterprise;

(f) To undertake or promote research and development of universally designed goods, services, equipment and facilities, as defined in article 2 of the present Convention, which should require the minimum possible adaptation and the least cost to meet the specific needs of a person with disabilities, to promote their availability and use, and to promote universal design in the development of standards and guidelines;

(g) To undertake or promote research and development of, and to promote the availability and use of new technologies, including information and communications technologies, mobility aids, devices and assistive technologies, suitable for persons with disabilities, giving priority to technologies at an affordable cost;

(h) To provide accessible information to persons with disabilities about mobility aids, devices and assistive technologies, including new technologies, as well as other forms of assistance, support services and facilities;

(i) To promote the training of professionals and staff working with persons with disabilities in the rights recognized in the present Convention so as to better provide the assistance and services guaranteed by those rights.

2. With regard to economic, social and cultural rights, each State Party undertakes to take measures to the maximum of its available resources and, where needed, within the framework of international cooperation, with a view to achieving progressively the full realization of these rights, without prejudice to those obligations contained in the present Convention that are immediately applicable according to international law.

3. In the development and implementation of legislation and policies to implement the present Convention, and in other decision-making processes concerning issues relating to persons with disabilities, States Parties shall closely consult with and actively involve persons with disabilities, including children with disabilities, through their representative organizations.

4. Nothing in the present Convention shall affect any provisions which are more conducive to the realization of the rights of persons with disabilities and which may be contained in the law of a State Party or international law in force for that State. There shall be no restriction upon or derogation from any of the human rights and fundamental freedoms recognized or existing in any State Party to the present Convention pursuant to law, conventions, regulation or
custom on the pretext that the present Convention does not recognize such rights or freedoms or that it recognizes them to a lesser extent.

5. The provisions of the present Convention shall extend to all parts of federal states without any limitations or exceptions.

**Article 9**

**Accessibility**

1. To enable persons with disabilities to live independently and participate fully in all aspects of life, States Parties shall take appropriate measures to ensure to persons with disabilities access, on an equal basis with others, to the physical environment, to transportation, to information and communications, including information and communications technologies and systems, and to other facilities and services open or provided to the public, both in urban and in rural areas. These measures, which shall include the identification and elimination of obstacles and barriers to accessibility, shall apply to, inter alia:

   (a) Buildings, roads, transportation and other indoor and outdoor facilities, including schools, housing, medical facilities and workplaces;

   (b) Information, communications and other services, including electronic services and emergency services.

2. States Parties shall also take appropriate measures:

   (a) To develop, promulgate and monitor the implementation of minimum standards and guidelines for the accessibility of facilities and services open or provided to the public;

   (b) To ensure that private entities that offer facilities and services which are open or provided to the public take into account all aspects of accessibility for persons with disabilities;

   (c) To provide training for stakeholders on accessibility issues facing persons with disabilities;

   (d) To provide in buildings and other facilities open to the public signage in Braille and in easy to read and understand forms;

   (e) To provide forms of live assistance and intermediaries, including guides, readers and professional sign language interpreters, to facilitate accessibility to buildings and other facilities open to the public;

   (f) To promote other appropriate forms of assistance and support to persons with disabilities to ensure their access to information;

   (g) To promote access for persons with disabilities to new information and communications technologies and systems, including the Internet;
(h) To promote the design, development, production and distribution of accessible information and communications technologies and systems at an early stage, so that these technologies and systems become accessible at minimum cost.

Article 21
Freedom of expression and opinion, and access to information

States Parties shall take all appropriate measures to ensure that persons with disabilities can exercise the right to freedom of expression and opinion, including the freedom to seek, receive and impart information and ideas on an equal basis with others and through all forms of communication of their choice, as defined in article 2 of the present Convention, including by:

(a) Providing information intended for the general public to persons with disabilities in accessible formats and technologies appropriate to different kinds of disabilities in a timely manner and without additional cost;

(b) Accepting and facilitating the use of sign languages, Braille, augmentative and alternative communication, and all other accessible means, modes and formats of communication of their choice by persons with disabilities in official interactions;

(c) Urging private entities that provide services to the general public, including through the Internet, to provide information and services in accessible and usable formats for persons with disabilities;

(d) Encouraging the mass media, including providers of information through the Internet, to make their services accessible to persons with disabilities;

(e) Recognizing and promoting the use of sign languages.

Article 29
Participation in political and public life

States Parties shall guarantee to persons with disabilities political rights and the opportunity to enjoy them on an equal basis with others, and shall undertake:

(a) To ensure that persons with disabilities can effectively and fully participate in political and public life on an equal basis with others, directly or through freely chosen representatives, including the right and opportunity for persons with disabilities to vote and be elected, inter alia, by:

(i) Ensuring that voting procedures, facilities and materials are appropriate, accessible and easy to understand and use;

(ii) Protecting the right of persons with disabilities to vote by secret
ballot in elections and public referendums without intimidation, and to stand for elections, to effectively hold office and perform all public functions at all levels of government, facilitating the use of assistive and new technologies where appropriate;

(iii) Guaranteeing the free expression of the will of persons with disabilities as electors and to this end, where necessary, at their request, allowing assistance in voting by a person of their own choice;

(b) To promote actively an environment in which persons with disabilities can effectively and fully participate in the conduct of public affairs, without discrimination and on an equal basis with others, and encourage their participation in public affairs, including:

(i) Participation in non-governmental organizations and associations concerned with the public and political life of the country, and in the activities and administration of political parties;

(ii) Forming and joining organizations of persons with disabilities to represent persons with disabilities at international, national, regional and local levels.