1 December 2005

Hon Dr Michael Cullen
Minister of Finance
Parliament Buildings
WELLINGTON

cc: Alan Bollard, Governor, Reserve Bank of NZ
John Whitehead, Secretary to the Treasury

Dear Minister

BUSINESS CONCERN OVER INTEREST RATES

I am taking the unusual step of writing to you because of serious concerns among Business NZ members, first, about interest rate levels and second, about the possibility of direct intervention by the Reserve Bank.

A number of leading indicators show that the economy is slowing, perhaps faster than many had considered likely. Business NZ's Performance of Manufacturing Index and the NZIER's Quarterly Survey of Business Opinion (both October 2005) show firms are increasingly pessimistic, with activity softening and costs rising. Our members' view is that increases in the OCR in this environment will further harm business confidence and investment.

At the same time, there is also disquiet at proposals for a Supplementary Stabilisation Instrument Project, with an initial report expected by the end of January 2006. Direct intervention by the Reserve Bank, as envisaged by this project, could harm business confidence and investment still further. As with any intervention, investors will likely build into their decision making the risk of further interventions, which will create uncertainty, impacting on the credibility of New Zealand's major institutions including the Reserve Bank.

Rather than investigating potentially onerous interventions in the housing market – which could well fail given innovative behaviour on the part of individuals, and if successful, could adversely affect the ability of small businesses to expand by borrowing against their homes - Business NZ wishes to advance a number of suggestions to help reduce inflation, without directly intervening in the credit market or similar. None of them provides a complete 'quick fix' but all of them together could help reduce inflationary pressures.

While acutely aware of inflationary pressures arising from strong growth in the housing sector, Business NZ considers that relying solely on the lever of interest rates to dampen demand could harm the private sector, especially exporters.

Strong growth in recent years has been on the back of greater use of existing labour resources and running down of ‘spare’ capacity of resources such as roading and electricity. We are now into a period where resources will be in short supply, with the need to focus on productivity improvements.

Effective policies revolve around ensuring that markets are competitive (i.e. removing monopoly status from the provision of goods and services), reducing regulatory burdens that place unnecessary costs on businesses and individuals, and reducing fiscal stimulus of the economy by maintaining a tight control on Government expenditure.

Raise labour productivity

Business NZ firmly supports the Government’s focus on productivity and welcomes its consistent messages in support of productivity improvement. It is widely accepted that the only way to improve real income is by increasing productivity. The OECD *Economic Survey of New Zealand* (July 2005) said:

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

The goal of increased productivity can be realised through actions by individual businesses and also by adjustment of Government policies that affect businesses’ ability to do so.

An example of an area with potential for policy adjustment is the recent decision that the minimum wage should be increased to $12 hour if economic conditions permit. This could feed through into relativity claims across the board, further fuelling inflationary pressures and diminishing the likelihood of productivity improvements.

The business community would welcome moves by the Government to consider all such regulations bearing in mind their potential impact on productivity.

Target central and local government spending

Most Government spending is on domestic goods and services, and increased demand puts pressure on prices and costs. Poor quality expenditure will further undermine competitiveness, while the OECD, for example, has been critical of some aspects of the ‘working for families’ package.

Increasing real Government expenditure at a time when the economy is operating at close to full capacity will bring further inflationary pressures. Local government rating increases have also generally been well in the excess of movements in the

Consumers Price Index. As well, many services provided by Government and local government are non-contestable and hence not subject to normal market pressures or disciplines.

Reduce taxes

The Government's planned review of company tax has been warmly received by business. A reduction in company tax would increase investment and would be unlikely to have the same inflationary pressures as targeted expenditure at lower income groups. A decision not to implement carbon taxes would be similarly welcomed by business.

Remove monopoly provisions/increase competition

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

Reverse increasing state regulation

Businesses are facing higher compliance costs while intervention in industries such as telecommunications, electricity and transport is adding to costs and discouraging investment and innovation. Unwanted regulation can cause inefficient outcomes for the business community as the latest Business NZ-KPMG Compliance Cost Survey confirms. Business NZ recommends a Regulatory Responsibility Act to support the Fiscal Responsibility Act (now part of the Public Finance Act) and the Reserve Bank Act.

Of the above actions, none offers a short-term solution. However, an announcement of firm Government intentions to move in these areas would immediately assist in increasing business confidence.

I would be happy to discuss any of the issues raised above.

Yours sincerely

Phil O'Reilly
CHIEF EXECUTIVE