

Submission to the New Zealand Savings Group

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Summary

This submission focuses on national savings. These are the savings that affect the current account deficit.

It considers the experience of the author in managing the balance of payments in the micro economy of Tonga. It goes on to reveal how that experience can explain the current account deficit in countries as diverse as the Philippines, the United States of America, Australia and New Zealand.

To conclude, it presents an approach for raising savings in New Zealand that involves relatively minor changes to banking guidelines. Yet these changes can raise national savings, increase employment and stabilize inflation.

Introduction

“Saving” has a different meaning depending how the term is used:

- To an individual person, it may mean private saving such as money in the bank;
- For sectors within an economy, it may mean the domestic savings of the household sector that are invested in industry or used to finance government expenditure; and
- For a nation, it can mean the difference between income from foreign sources (predominantly exports) and expenditure on foreign imports and foreign services.

There may be links between these forms of savings. But that is not necessary. For example, an exporter in China may earn additional export income and immediately spend that money paying employees and buying additional materials. That exporter may not consider that they are saving. Yet while the additional income earned from exports is spent in China, it is contributing to China’s national savings.

If the exporter decided to set aside some of that additional income to invest in new plant and machinery, then that would be contributing to domestic saving and those spending those savings would be classified as investment. If the investment in plant and machinery were directed at domestic suppliers, then “national” savings would remain unaffected.

In this submission I wish to concentrate on national savings. These are the savings that relate to the balance of payments and the current account balance. These savings are not related to private and domestic savings. It does not matter how much people within the economy save and lend to each other, that saving and lending will not have a material effect on the balance of payments or the current account balance. Whoever spends that money and how it is spent is irrelevant in determining the external balance in the medium and long term.

The reason for this is that the money we earn represents our production or contribution to the economy. When we, or someone else to whom we lent that money, spend that money, the value of the products purchased can not exceed the value to the products produced.

Balance of payments problems and current account deficits exist when a country buys more than it has produced.

Tongan Experience

In 1980, I joined the Ministry of Finance of the Kingdom of Tonga as the economist. At that time, Tonga had a relatively simple monetary system. It was only in 1974 that Tonga established its first bank.

Early in 1981, the Ministry noted that Tonga's foreign reserves were declining significantly. The Ministry eventually traced this back to a growth in bank lending. We found evidence to show that when bank lending increased, foreign reserves decreased. When bank lending declined, foreign reserves increased.

The Ministry realised that if Tonga was to maintain its foreign reserves and the security of its currency, it must manage the growth of bank credit. Consequently, the Secretary for Finance wrote to the Bank of Tonga advising it that if foreign reserves were greater than the equivalent of six months imports, there would not be any restriction on its lending. If foreign reserves were to fall below that level, it was to start restricting its lending. If foreign reserves were to fall to 3 months imports, it could maintain existing lending levels (lend what was repaid). If foreign reserves were to fall to 2 months imports, it was to cease lending.

In March 1982, Hurricane Isaac devastated Tonga's export industries. Even so, Tonga did not experience any balance of payments problems. The Bank of Tonga managed its lending according to the level of available foreign funds.

Tonga joined the IMF in 1985. In its first report, the IMF commended the government for the success of its lending policies in managing the balance of payments.

The point here is that Tonga successfully managed its lending according to its available level of savings. It continues to do this and its foreign reserves are currently in excess of the equivalent of six months imports.

US Experience

Yet other economies were taking a different approach. In the USA, bank lending was being deregulated in the early 1970's. This led to a massive growth in bank credit which in March 1973 reached an annual growth rate of 16 per cent as shown in Figure 1 below.

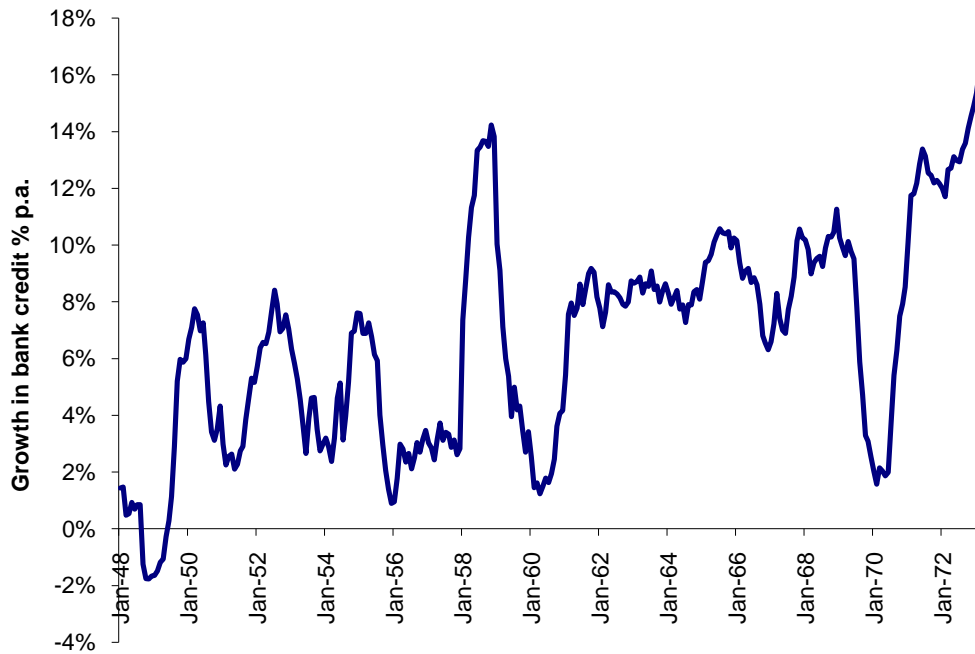


Figure1. The rate of growth of US bank credit to March 1973

As in Tonga, bank lending depleted foreign reserves. President Richard Nixon had responded by closing the “gold window” in 1971. However, this had not curtailed the loss of foreign reserves.

The US Federal Reserve system consists of twelve districts, each with its own board. Frequently, the members of these boards are chief executives of banks from the district. This continues to be the case. These board members are unlikely to impose policies that restrict the lending of their own banks. That would restrict their profits. However, the foreign reserves of the Federal Reserve were being depleted and that problem needed to be addressed.

Rather than constrain bank lending, it appears that the Federal Reserve persuaded the President Nixon to float the US dollar. This policy preserved the Federal Reserve’s foreign reserves yet allowed the banks to continue to lend.

Rather than constrain lending, it was now necessary for banks to lend. The floating exchange rate system prevents money from being created through national savings. That was money created by raising foreign receipts above foreign payments. Under the floating exchange rate system, the only source of new money was bank credit and the economy needed additional money to facilitate economic growth.

Yet bank credit continued to cause people to buy more than they produced leading to current account deficits. Instead of depleting the foreign reserves of the Federal Reserve, the current account deficits now raised the foreign debt of the private sector. Figure 2 charts the growth of bank credit in the USA, the accumulated current account deficit and the fiscal deficit (which some economists claim is the source of the US current account deficit.)

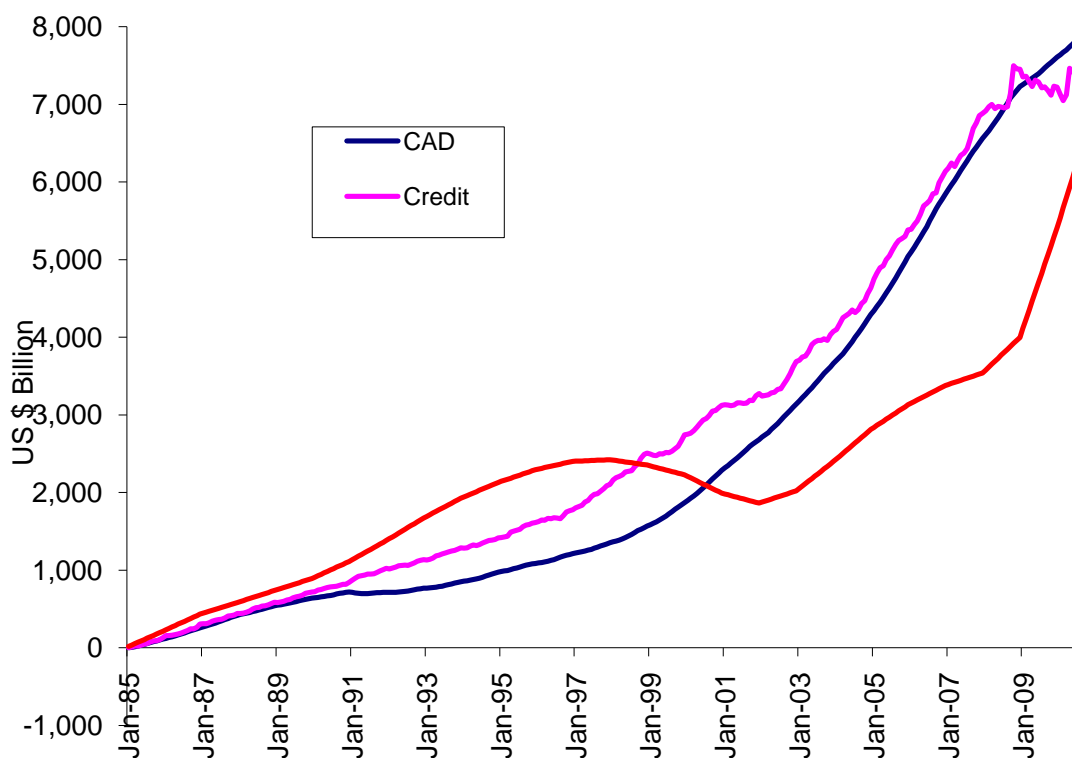


Figure 2: USA growth in bank credit, accumulated current account deficit and fiscal deficit

As mentioned above, floating the dollar prevented money being created through national savings. Instead, that money inflated the value of the US dollar, reducing the income of exporters and raising imports. To achieve that increase in imports, Americans were required to shift their spending from domestic products to the now cheaper imported products. American manufacturing and other import competing industries were devastated by the outcome. What were the centres of US industry are now called the rust belt.

Figure 3 shows US exports and imports as a percentage of GDP. Before 1973, US imports and exports were below 6 per cent of GDP. During that time, any increase in exports would stimulate the economy so that GDP increased with export growth. After 1973, any increase in exports stimulated growth in imports. They did not stimulate the economic growth. Hence exports and imports became a larger share of GDP. This became known as globalisation.

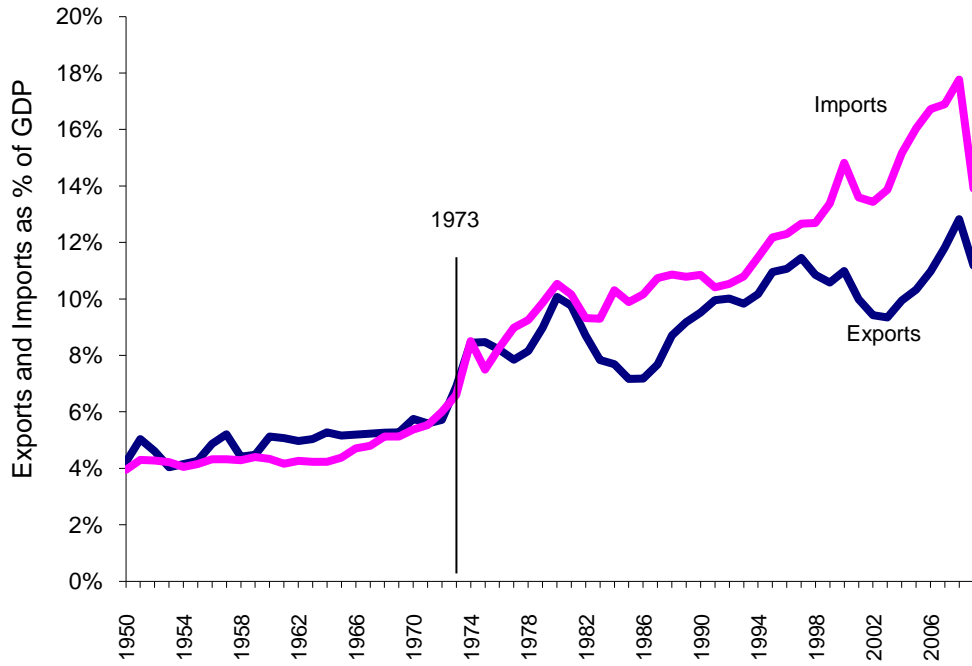


Figure 3: US exports and imports as a percentage of GDP

The floating exchange rate system slowed the rate of economic growth and reduced real wages. Figure 4 shows real average wages for private non-farm workers in the US. Their incomes have not returned to the level they were in 1973.

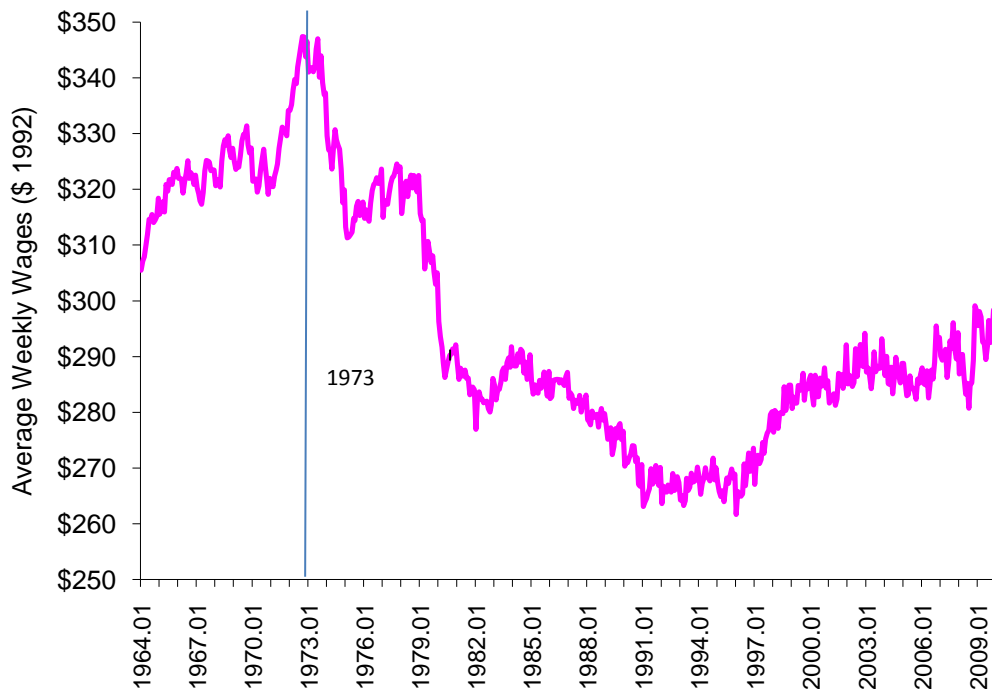


Figure 4. Average real wages for non-farm workers in the USA

As noted above, in the environment of a floating exchange rate system, it was necessary for US banks to increase credit to provide the additional money necessary for the economy to grow. US economists acknowledged and promoted the benefits to of financial deregulation. Other countries moved to deregulate their financial systems. However, for countries with fixed exchange rates, financial deregulation created international financial instability. It depleted their foreign reserves and stimulated speculation in their currencies.

Philippines Experience

Faced with this international financial instability, many countries floated their exchange rates. Consequently, these countries started to suffer the same consequences as the USA. Figure 5 compares the growth of bank credit and the current account deficit for the Philippines in the 1980 to early 1990s.

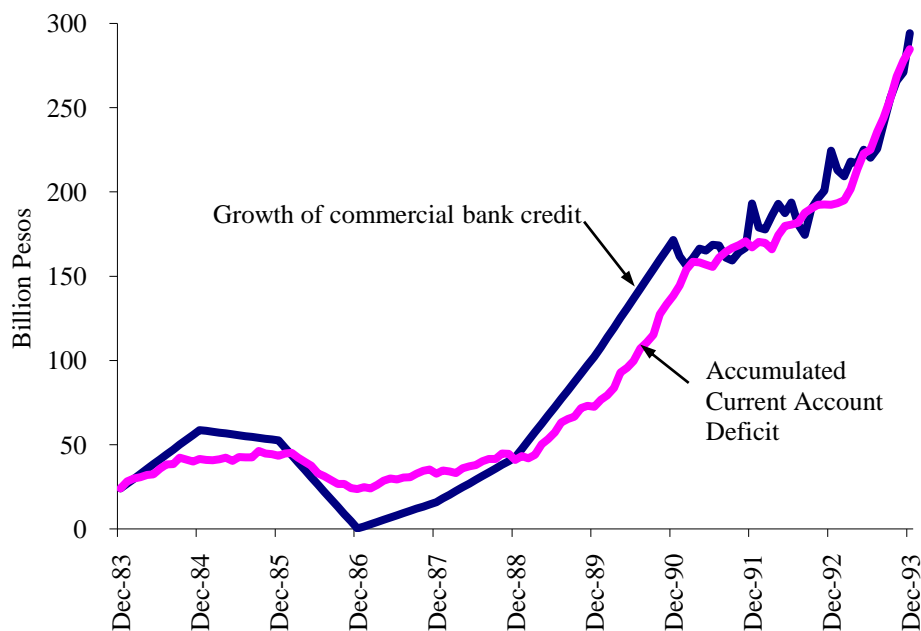


Figure 5. Commercial bank credit and the current account deficit in the Philippines

The Philippines has now moved away from a strict observance of the floating exchange rate system. Since 2003, it has experienced current account surpluses and its rate of economic growth has increased.

Australian Experience

Australia floated its currency in 1983 and, as shown in Figure 6, it has created a similar outcome. The Australian example clearly shows that the fiscal deficit is irrelevant in determining the current account deficit. The growth of bank credit is more significant. Since 2002, statistics for the growth of bank credit in Australia have been tainted with other forms of lending that are not strictly bank

credit. This has meant that in recent years, the chart has not reflected the true relationship between the growth of bank credit and the current account deficit.

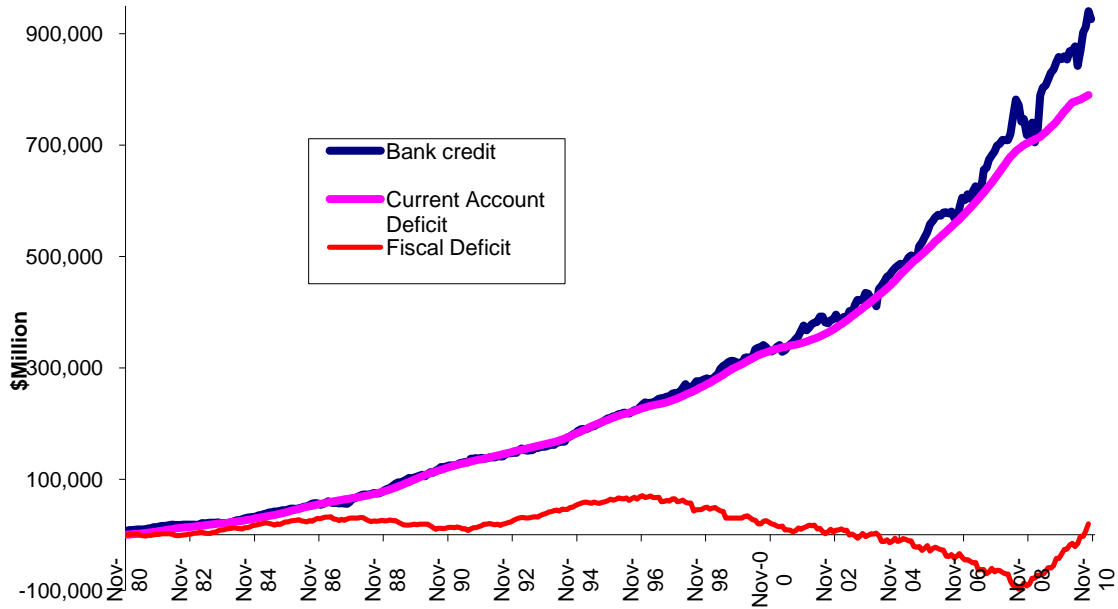


Figure 6. The growth of bank credit, the current account deficit and the fiscal deficit in Australia

New Zealand Experience

However, the Reserve Bank of New Zealand publishes statistics specifically on the monetary growth from bank credit. This is called the M3R series. Figure 7 compares the growth of bank credit in New Zealand with the current account deficit for New Zealand.

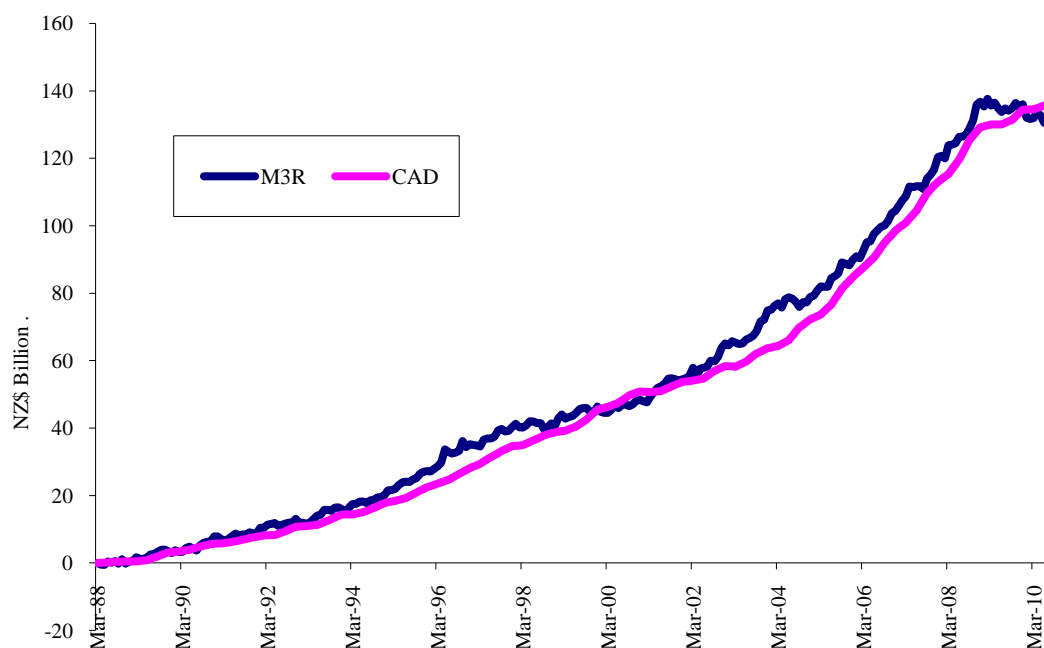


Figure 7. The growth of bank credit (M3R) and the current account deficit in New Zealand

The reason that the current account deficit is equal to the growth of bank credit is that the floating exchange rate system prevents national saving. Some countries, such as Japan, have been able to generate current account surpluses. This appears to be attributable to the high levels of private and domestic savings have been invested overseas. But this has not been the case in New Zealand.

New Zealand has suffered similar problems to the USA and other countries that have floated their exchange rates. These include slow rates of economic growth, high rates of unemployment, low real wages growth and rising foreign debt.

Once a country has diagnosed the problem, it is relatively easy to rectify that problem.

Raising savings in New Zealand

A conservative response would be to return to the fixed exchange rate and manage the growth of bank credit. However, in three steps it is possible to modify the banking guidelines to achieve a better outcome that retains a market determined exchange rate.

The first step is to link bank lending to national savings. For example, bank lending could rise by, say, \$12,000 for every 1 ounce of gold or foreign exchange equivalent that banks save with the Reserve Bank of New Zealand. This immediately removes the requirement of the floating exchange rate system that international receipts and payments should be equal. It allows New Zealand exports to stimulate economic growth.

Banks would buy up foreign exchange to increase their lending. However, bank lending increases imports which depletes their foreign reserves and curtails their lending. Therefore, lending would grow only as national savings increased.

The second step is to provide guidance to the foreign exchange market on the exchange rate. If the amount of bank lending were reduced by \$1,000 for every 1 per cent of unemployment, then to maximize their lending and profits, banks would drive the exchange rate to a level that would maximise employment. For example, if unemployment were 5 per cent, banks would be allowed to lend only \$7,000 for each additional ounce of gold or foreign exchange equivalent that they held. In response, banks would drive the exchange rate lower and increase lending so as to achieve full employment.

The third step is to manage the growth of bank credit to control inflation. If the amount that banks were allowed to lend were reduced by \$1,000 for every 1 per cent of inflation, banks would manage their lending to minimise inflation. Thus if unemployment were 5 per cent and inflation were 3 per cent, banks would be allowed to lend an additional \$4,000 for each additional ounce of gold, or foreign exchange equivalent, that they held. Given these requirements, banks would manage the exchange rate and their lending to maximise employment and minimise inflation.

In such an environment, New Zealand would be increasing its national savings in the form of increased foreign reserves or reduced net foreign debt. Also, it would enjoy a stable exchange rate that provided employment and monetary growth that would minimise inflation.

Data Sources

The Microsoft Excel spreadsheets showing these charts and the associated data are available for:

US charts at: <http://www.buoyanteconomies.com/USACAD.xls>

Australian charts at: <http://www.buoyanteconomies.com/UnendowedMoney.xls>

New Zealand charts at: <http://www.buoyanteconomies.com/NZM3RMoney.xls>