

Savings Working Group Submission: What caused the collapse of saving in 2002?

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1. Introduction

The Treasury discussion document *Saving in New Zealand – Issues and Options* is an excellent overview of the issues. It is by now painfully clear that a lack of saving and overreliance on debt accumulation is not only impoverishing but also extremely risky. Figure 11 highlights the key policy issue, namely that the tax system rewards speculation in housing over savings in cash and bonds. It would have been helpful, however, to highlight the incentives for negative gearing, which has made borrowing to speculate in property particularly fruitful.

This paper has two aims:

- To place NZ's dissaving in the context of the international economy since 2000;
- To draw some policy conclusions therefrom.

The subject matter is complicated. For the sake of brevity, only a high level sketch of the issues is presented here.

Table 1: outline of the argument

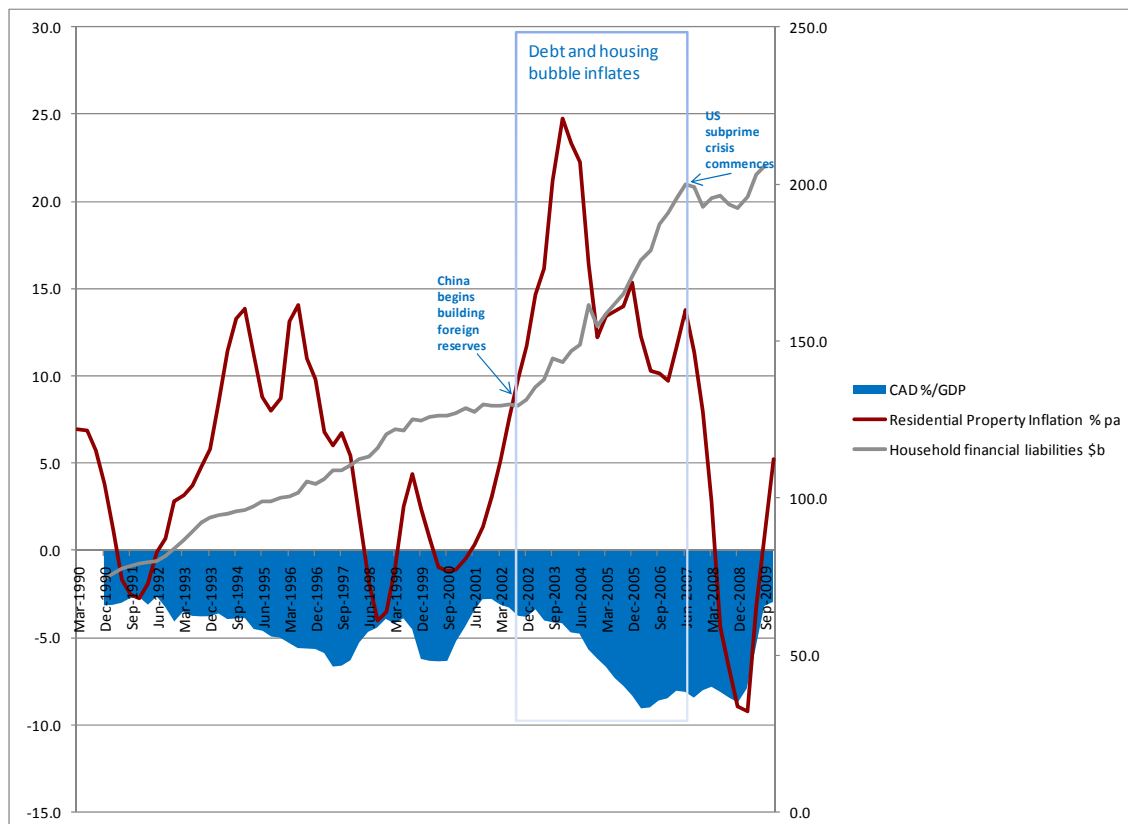
Argument	Support
The collapse in NZ saving from 2002-07 was exceptional	Change in trend in debt accumulation
Underlying driver was changes in Chinese economic policy	Chinese economic aggregates
This necessitated debt run-up by free-market economies	International comparison
Policy options others than compulsory saving and tax reform are available	Discussion of policy regimes in Australia, Germany, Japan and Korea
German policy regime is worth examining from the point of view of New Zealand	Discussion of German regime with respect to credit creation
Import certificates offer a possible failsafe switch where other policy options may be insufficient	Paper by Warren Buffet
Discussion with respect to Australia	RBA policy

2. Collapse in NZ national saving from 2002-07 was exceptional by historic norms

As identified in Figure 8 of *Saving in New Zealand*, insufficiency of saving in NZ can be measured by the current account deficit (CAD), which measures the excess of investment over savings. One can go further and infer that if the CAD is a measure of how much additional saving is needed to fund our *present* rate of investment, then the additional saving required to fund a *higher* level of investment would be greater than the present-day CAD. Given the government's objective of closing the income and labour productivity gap with Australia, the rate of investment required (and hence the increase in saving) must be sharply higher than the recent range of 18%-25%. Given the size of New Zealand's structural CAD and notably poor labour productivity, it would not be difficult to construct an argument that a gradual increase in saving of $\geq 10\%$ of GDP is optimal.

Saving in New Zealand created a picture of national with a large structural CAD caused by internal policy settings, viz, unfunded universal superannuation and large tax breaks for negative gearing into property. However, the stunning collapse in saving around 2002 suggested external forces were at play.

Figure 2: collapse in NZ saving around 2002



Data: RBNZ Financial System Stability Report. Chart: author's own.

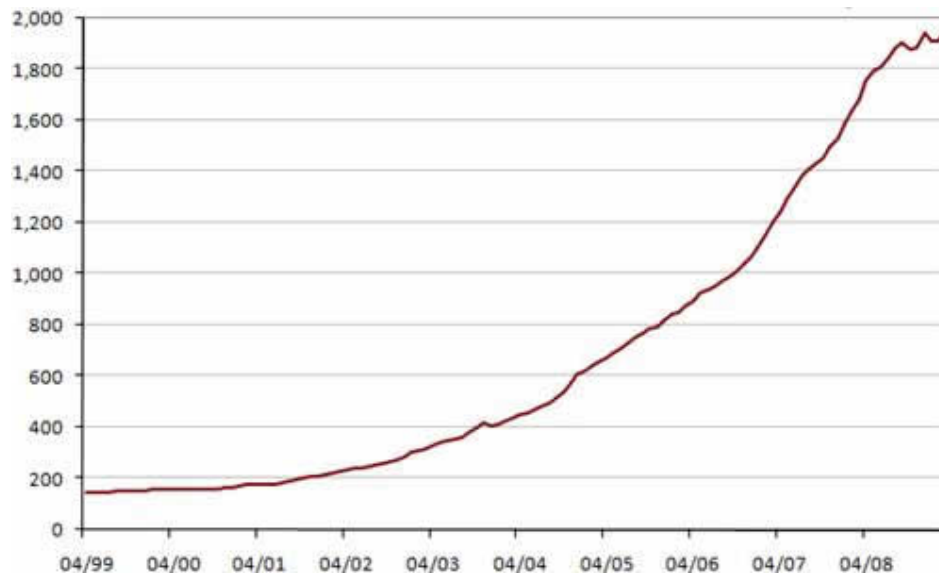
Figure 2 strongly suggests:

- 2002 ushered in a period of accelerated household borrowing, largely mortgages, which caused our savings rate to fall as reflected in the CAD; and
- This had the effect of turning a normal cyclical rebound in the property market into a super cycle or bubble. For simplicity, only residential property prices are presented here but commercial and rural data are consistent.

3. Underlying driver was Chinese economic policy

China acceded to the WTO in December 2001, markedly reducing the barriers to Chinese imports in most OECD countries. Chinese goods were extremely price competitive at the prevailing exchange rate, meaning there was the potential for a sharp increase in the value of the renminbi. The Chinese authorities by running a managed currency regime that varied between a fixed rate and an extremely slowly crawling peg in relation to a basket of currencies, overwhelmingly the US dollar. Stabilising the RMB required vast purchases of foreign currency assets, mainly US Treasuries and agency debt, evidenced by a massive increase in China's reserves.

Figure 3: Chinese foreign exchange reserves¹



This was accompanied by an astounding collapse in Chinese private consumption as a share of GDP from above 50% to around 35% presently. The exact mechanisms by which Chinese policymakers achieve such high savings rates are complex and beyond the scope of this document².

It is legitimate to ask why one should look to Chinese policy as the source of economic imbalances, when the US and European economies are so much larger. The answer is that this decision represented an active policy intervention that put in train a chain of events. Once China, now the

¹ http://www.aph.gov.au/senate/Committee/economics_ctte/firb_09/report/c04.htm

² For a discussion see Professor Michael Pettis, <http://mpettis.com/2010/04/chinese-savings-and-the-wealth-effect/>. Contrary to popular belief it is China's SOEs, not households, that account for the surge in saving in the past decade. China's households save no more than those in India.

world's second largest economy, had decided to run a massive current account surplus, the rest of the world by definition had to run a massive current account deficit (simply as an accounting identity).

The burden of adjustment fell on economies with the fewest constraints on credit creation, such as the US, UK, Australia and NZ. The US, as owner of the reserve currency and global borrower of last resort, wore the brunt of the adjustment. However all these countries experienced large increases in their CADs, increases in private debt and property prices. The transmission mechanism was the lower-than-expected interest rates and higher exchange rates that each of these countries experienced (relative to what the case would have been without policy intervention).

While it is interesting to debate the culpability of the US Federal Reserves in the mid-2000s financial bubble, the more important point is that aggressive policy intervention by Chinese authorities to create large current account surpluses made it inevitable that loosely regulated economies would begin dissaving.³

4. Effect of Chinese policy stance was neutralised outside Anglo-Saxon policy zone

It is interesting to note a few policy regimes that were not adversely affected by the change in Chinese policy.

- In Germany, an internal price-wage devaluation and strict controls on both mortgage finance and consumer credit led to a surge in manufacturing and a high current account surplus.
- In Japan, ongoing deflation of the 1980s asset price bubble left an ageing population with little incentive to borrow.
- In Korea, elements of the traditional Asian development model were moderated by a freeing up of consumer credit. The result was a current account broadly in balance.

It is the example of Germany that is most interesting. With a floating exchange rate and an electoral system resembling MMP, it is also culturally less removed from New Zealand than say Korea.

Germany's internal devaluation (the wage and price reductions in response to the post-unification malaise) is well known. What is less known is the internal constraints on leverage at the household level. Credit cards are far less prevalent than in Anglo-Saxon countries, facing a range of additional charges and less widespread recognition. More significantly, banks are generally reluctant to lend greater than 60%-70% of the value of a house purchase.

5. Policy implications

Saving in New Zealand provides a useful overview of the options facing policymakers. However, it is worth placing on the table some additional tools for policymakers to consider.

³ In purely logical terms it would have been possible for the Anglo-Saxon countries to aggressively react by promoting savings, leading to a rise in unemployment in those countries and in China, but this response was never likely given these countries' political cultures.

Limiting negative gearing. Losses from residential property investment should not be able to be deducted against other income.

Implement LVR restrictions on mortgages. Over time, the RBNZ could increase the minimum deposit, or conversely specify a minimum LVR to which mortgage lenders must adhere. This change should be introduced gradually in order to limit the chance of triggering a Fisher debt deflation. For example, the RBNZ could announce the minimum LVR quarterly in advance, with a commitment given not to alter the rate by greater than 2.5% per quarter.

Further increases in the Core Funding Ratio. In this writer's view, the introduction of the RBNZ Core Funding Ratio was an outstanding policy initiative: subtle, politically unobtrusive and yet effective in reducing financial risk. It should be increased to circa 100% at the fastest speed the environment will permit.

Restrictions on credit cards. While personal credit is small relative to mortgage borrowing in New Zealand, they are extremely expensive and discourage the holding of basic precautionary bank balances. The RBNZ could discourage their use and abuse through a combination of charges, usage restrictions (e.g. restricting their issuance to high credit score borrowers) and red tape.

Import Certificates. In a prescient article for *Fortune* magazine on 10 November, 2003⁴, investor Warren Buffet made the argument that America's extreme trade deficits would one day be a problem. He proposed a solution. *"We would achieve this balance by issuing what I will call Import Certificates (ICs) to all U.S. exporters in an amount equal to the dollar value of their exports. Each exporter would, in turn, sell the ICs to parties—either exporters abroad or importers here—wanting to get goods into the U.S. To import \$1 million of goods, for example, an importer would need ICs that were the byproduct of \$1 million of exports. The inevitable result: trade balance."* Such a policy would act as a fail-safe, introducing a variable and market-determined tariff in the event other policies were not successful in balancing trade. The limitation of this policy with respect to New Zealand, however, is that we have been running trade deficits for so long that there is now a large and permanent deficit on investment income in the national accounts. That is, the country can still run a significant CAD even when trade in goods and services is in balance.

Consider "illogical" policies. The Treasury appears nervous of the apparent internal contradiction between introducing compulsory saving and the pre-existence of a generous universal state superannuation scheme. It should consider that New Zealand's financial and economic environment is buffeted constantly by distortions originated by the great powers. In order to navigate through these shoals, it may be necessary to adopt policies that fly in the face of pure efficiency or paper models. National saving is a case in point. It is too important to be left to an unreliable market.

6. Comment with respect to New Zealand's relationship with Australia

New Zealand is in an enviable position with respect to its relationship with Australia. The Deputy Governor of the Reserve Bank of Australia, Ric Battellino, gave a speech in June 2010 wherein he concluded in effect that Australia's high rates of borrowing and private debt were indefinitely

⁴ Reproduced here in PDF format:

sustainable.⁵ The point of view is widely held in Australia. Therefore, it is likely that Australia will continue to experience a high exchange rate, high rates of personal consumption and high imports for some time to come.

The implication for New Zealand is clear. New Zealand has significant latitude to reduce borrowing and consumption, and move to a permanently lower yield curve than Australia. This should see the NZD fall towards the low end of its historic range relative to the AUD, making New Zealand businesses and exporters more cost competitive with Australia.

The risk of any set of policies designed to delever an economy is that there will be a shortfall of aggregate demand leading to mass unemployment. With Australia as New Zealand's closest trading partner, an increase in net exports should be able to counterbalance any shortfall in domestic demand.

7. Concluding comment on welfare issues

It should be clear from the preceding discussions that the author favours a New Zealand where consumption, leverage, interest rates and the exchange rate are all lower, businesses face a lower cost of capital, and investment in productive capital becomes the highest and best use of savings. However, many people in New Zealand are living hand to mouth and hence unable to endure a large reduction in consumption without considerable hardship. Similarly, asset markets in New Zealand are overleveraged and cannot be deleveraged overnight without a dangerous collapse in asset prices, triggering massive bankruptcies.

For these reasons, policymakers should progress cautiously on a number of fronts, with a view to holding consumption more or less steady in real terms, especially for the less affluent members of society, while the adjustment is made to a higher saving society. The author asserts that higher saving is in itself a contributor to social welfare, reducing financial stress and distress on young people, families and retirees. A future in which even lower wage earners owned meaningful private savings buffers, and were able to bestow lump sums of capital on their children and extended family members at crucial life milestones, would be a safer and happier one for all New Zealanders.

⁵ <http://www.rba.gov.au/speeches/2010/sp-dg-150610.html>