

**Submission to the Savings Working Group**  
**from Len Bayliss 16/11/2010**



.The establishment of the Savings Working Group reflects concerns over high levels of overseas and household debt , unsustainable current account deficits and a low household savings . It is important that the underlying reasons for these situations be closely analysed particularly before developing a medium term savings strategy.

Large scale overseas borrowing is not a problem as long as the borrowed funds are predominantly invested in the tradeable and related sectors . This has not occurred in New Zealand over recent decades because overseas funding have been largely invested in property where profits have been higher and risk much lower than investing in exporting and other tradeables . In other words investment misallocation reflecting distorted price and tax signals has been a major problem -arguably New Zealands most serious economic problem .

A major, if not the major cause of this investment misallocation has occurred because a generally overvalued forex rate has eroded tradeable sector profits and savings ie retained profits and depreciation allowances.. This has seriously weakened tradeable sector vitality,investment, research ,innovation and hence international competitiveness..As a consequence the tradeable sector has been unable to perform its prime function ,in a commodity based economy , of being the driving force for GDP growth and rising levels of employment .High levels of tradeable investment,much higher than has recently been achieved ,are necessary to rebalance the economy and avoid high unemployment .

In the absence of consistently high rates of investment in the tradeable sectors the only economic policy capable of raising GDP and employment , a political imperative , was a rapid expansion of household debt leading to a falling savings ratio . This debt increase was the main cause of a fall in the household savings ratio . .In other words an overvalued forex rate has necessitated a rise in overseas and household debt to maintain growth and rising employment . Such policies were also very popular with the great majority of voters who benefited greatly from rising house prices .On the other hand the minority who suffered ,as house ownership became less affordable, had little political clout. Large budget deficits, as a means of stimulating activity and employment were both less effective and politically unacceptable .

### **Officials support**

\  
Apart from being a political necessity the main thrust of macro economic policies has generally had strong support from both the Treasury and the Reserve Bank .This particularly applies to monetary policy as determined by the Reserve Bank Act 1989.

- Officials for many years strongly argued that the forex rate arising from a clean float is the correct rate and hence cannot be either undervalued or overvalued .

- Officials maintained ,as did Minister of Finance Bill Birch in private discussion ,that private overseas borrowing will always be beneficial as overseas lenders will insist on their efficient allocation.By contrast Government overseas borrowing was generally misallocated .

-Officials agreed that a policy induced rise in interest rates had an adverse impact on the forex rate but this was usually short term ,was usually relatively minor and was part of the price of having a clean forex float with all its attendant advantages..The ideal policy was to have high interest rates to fight inflation and a low forex rate to encourage export led growth but this was not possible under any policy mix .

Officials were proud that New Zealand's economic policies received much favourable international comment and could see no valid grounds for change except to enhance competition , diminish protection, increase privatisation and toughen fiscal policies .For my part I wrote to the Governor RBNZ in 1993 and to the Minister of Finance 2003 drawing attention to the adverse impact of forex overvaluation ,and recommending a flexible fiscal policy to supplement interest rate policy , so relieving some of the forex pressure . In addition I urged that the RBNZ direct the banks to tighten their house lending criteria .These recommendations were politely disregarded .Officials were convinced that the main thrust of policy was correct .

### **Household debt increase**

Apart from poor macro economic policies there is a need to explain the rapid rise in household debt and the related decline in the household saving ratio. The reasons are very clear

Financial sector liberalisation led to increased competition and to much greater stress on profits, share market performance and market shares ..This particularly applied to banks where competitive pressures in the past had been fairly subdued .The banks response was to put much more emphasis on expanding low risk/ high profit household credit together with a willing acceptance of increased risk as demonstrated by softer lending criteria. This was not a matter of concern to bank boards and management particularly as their share prices were rising strongly .The Reserve bank was not concerned, or was not aware , at deteriorating credit quality and welcomed the apparent benefits from increased competition. Broadly similar attitudes prevailed in other English speaking countries .

Household investors responded rationally and intelligently to easy credit and rising property prices by substantially increasing their investment in housing. which was very willingly financed by banks .. Nevertheless the much increased popularity of housing

investment by small investors was quite extraordinary . . It was obvious to most household investors that housing was, on a risk adjusted basis, much the best retirement investment asset . .In addition most persons were well aware that making ends meet on NZ Superannuation was only just possible with home ownership . This was demonstrated by the large number of superannuitants receiving rent subsidies . As noted above the increase in household credit was the main factor in maintaining economic and employment growth.- and hence a political necessity .There was no criticism of this trend from any government but latterly there was much exhortation to increase retirement saving and much sermonising over New Zealanders increasing profligacy.- but no effective action to restrain house price increases !

How did a large increase in housing investment by households ,in the circumstances the optimum retirement investment asset, become associated with a dearth of retirement saving ? In part this reflected focusing on the wrong statistics ie“national accounts” saving rather than “net asset” saving with the latter revealing much higher rates of saving. ie increasing net asset values. Moreover “national accounts” saving by households is substantially diminished by the exclusion of black economy incomes and the inclusion of black economy expenditure - the black economy is usually estimated at around 7% of GDP. In addition there was no mention that the decline in household saving was offset by a rise in government saving .In fact “ government” and “business” saving was never mentioned in public debate -as far as the general public was concerned “household” saving was“ total” saving .

This particular misrepresentation was only part of the barrage of highly misleading information disseminated by self interested organisations- political parties , the finance industry,managed funds ,trade unions etc- for the most part seeking incentives /subsidies for household saving and other advantages.. This misrepresentation has dominated public debate ..The concept that a managed retirement fund was the optimum retirement saving asset in spite of all the evidence to the contrary .was actively propagated . The long term problems of financing NZ Superannuation were greatly exaggerated .The realistic policies propounded in the 1997 OECD report “Maintaining prosperity in a Ageing Society”.ie “Ageing policies” to encourage longer working lives thus maintaining the “employed /dependent” ratio were totally ignored. There was much advocacy for compulsory saving in spite of the fact that NZ Superannuation is a compulsory saving scheme without individual accounts .All pay via tax contributions and all receive .No one pointed out that compulsion based on individual accounts as in Australia was strongly biased against women, would lead to a substantial increase in poverty and showed little impact on household saving.

## **A medium term savings strategy**

The main economic objective is to rebalance the economy so that growth is primarily determined by exports, and not by debt financed housing and household consumption, and also that investment allocation is substantially improved. Hence the two main priorities in a medium term savings strategy are to focus on achieving high rates of business saving particularly in the tradeable and related sectors and restoring government saving to a significant level.

### **Business saving**

The major savings priority is to substantially increase business, particularly tradeable sector, savings. This requires major changes in monetary policy placing much greater emphasis on both the forex rate and asset prices. The present "clean" forex float should be replaced by short term measures which attempt to keep the forex rate at a competitive level, i.e. a level which in conjunction with the terms of trade maintains a high level of savings (retained profits) and investment in the tradeable sectors. Flexible short term interest rates should be supplemented by controls on short term capital movements and by flexible fiscal instruments thus giving somewhat greater ability to influence the forex rate.

Controls on short term overseas capital were recommended for New Zealand by Charles Goodhart the speaker at this year's RBNZ monetary policy lectures. Goodhart an Ex Bank of England senior official is a highly regarded international authority on monetary policy. Since then the IMF was reported as supporting controls on short term capital in certain circumstances and has already endorsed such controls for a number of countries. More flexible fiscal policies have also attracted increasing international support and have been recommended in New Zealand i.e. changes in fuel taxes as recommended by Dr Brash or a flexible GST with the former being preferred because of greater administrative simplicity.

The RBNZ should, as have other central banks, also take steps to ensure that bank lending standards are maintained and, if necessary, request that mortgage terms be raised or lowered. In addition the Government should try to ensure, in conjunction with local government, that shortages in the supply of sections particularly in the major urban centres should not develop. The large increase in house prices mainly reflected a large increase in land prices in part caused by supply shortages and planning delays. These policies may need to be supplemented by influencing short term rates of immigration.

It must be stressed that many difficulties would remain even with the adoption of these policies. A small country's ability to influence its forex rate, particularly in a highly unstable international environment, requires good judgement, great skill, basically sound economic policies and good luck. But the attempt must be made as we cannot stand by, as

has occurred over recent years ,and allow our export industries competitiveness be undermined by an overvalued forex rate .

### **Government saving**

Current government dissaving requires firm fiscal action, as quickly as circumstances permit , to restore a significant level of positive saving ..The main emphasis should be on restraining expenditure growth .Tax reductions to encourage saving should be viewed with considerable scepticism - most of the gains if any would have already resulted from reducing the top rate of income tax from 66% at a relatively low income levels. income.It should also be noted that the very substantial deterioration in New Zealands Gini Coefficient ,ie much greater income inequality ,appeared to have been strongly influenced by the introduction of GST and the offsetting major reduction in high tax rates.

Specific measures to assist government saving would be to wind down the NZ Fund as recommended by Michael Littlewood (NZ Economic Papers 2009) ---whilst all government and business subsidies to Kiwi Saver should be terminated .Both these measures ,were based on spurious economic reasoning to overcome a non existent household savings problem . The increase in household savings via Kiwi saver subsidies was largely achieved by reducing government savings and are probably the most wasteful and inequitable government expenditure at the present time -and are the most popular amongst electors for its generous handouts .

### **Household savings**

There is no household savings problem in fact there is convincing evidence, as above , that there has never been one .A rise in the household saving ratio on a national accounts basis is already occurring, whilst net asset saving has declined with both acting as a welcome brake on activity . .Hence there is no need to introduce policies to increase household saving . .In any case many economists specialising in this field doubt such policies even exist . .Ian Mcfarlane, the recently retired Governor of the Reserve Bank of Australia, spoke for many economists( including myself} that any person who proposed workable policies which would raise household savings would be awarded the Nobel prize for economics .!!

However some measures are required to improve the allocation of household savings Efficient allocation is severely handicapped by extensive advertising of gross returns and other misleading information, , Accurate information on net real returns ie net of tax and costs over 1, 5, 10 and 25 year periods since the 1985(after the forex float) would at least provide an accurate historic basis for decision making by small investors These statistics should cover managed funds ,term deposits,government bonds,company debentures ,commercial property ,houses etc .This information is readily available overseas-for instance in Australia managed funds have to publish their total cost ratios which when subtracted from gross returns reveal the true return to investors .The

Retirement Commission is taking action over this matter and the SWG should give the Commissions important and welcome initiative strong support .

It should be recognised that high risk volatile equities are not a suitable savings vehicle for many household investors . A bank term deposit option should be made available to Kiwisavers .Another suitable option would be to offer inflation proof bonds with a 3% real return.

Len Bayliss,