

## **ILSS Politicians update December 2007 - December 18th, 2007**

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1. First, may I convey to each of your best wishes for the Christmas festive season and for a 2008 that brings success to all New Zealanders.

2. The big issue facing New Zealand is the wedge that has opened between our economic performance and the economic performance of once comparable nations, especially Australia, which is set to widen next year. This wedge exists because of New Zealand's relatively low incomes. Solve that problem and just about every other problem facing our society – and there are plenty of them, including environmental – either disappears or is more easily addressed.

3. The solution exists, awaiting the requisite political leadership. It is timely, before this year closes, to issue a progress report on developments since we made and widely distributed our submission to the Finance and Expenditure Committee, in July. The submission made a comprehensive case for the introduction of the 'Interest Linked Savings Scheme (ILSS), as a suite of new instruments designed to:

a. Provide more effective and non-destructive instruments for the conduct of Reserve Bank monetary policy;

b. Equip the New Zealand economy with the powerful engine for economic growth that it currently lacks, capable of increasing sustainable GNI growth, from the present 1-3% pa constraint, to 3-5% pa, based upon: first, capture of present economic leakage (free gain); and, second, investment to create ongoing productivity gains, to return average NZ incomes to the top half of the OECD and then to the top quarter, where with our resources they should be.

### **ILSS Support, Solution Not Credibly Faulted by Anyone**

4. It is pleasing to report that since the ILSS solution was released and widely distributed, it has not been credibly faulted by anyone. On the contrary, it has won considerable authoritative support, from a group with combined credentials that we think are unsurpassed. We consider that this support lays a sound foundation for political endorsement of ILSS in keeping with the recommendation we left with the Select Committee.

### **OCR Alternative to ILSS Is Not Tenable**

5. The recently released Ministry of Economic Development report, titled 'Economic Development Indicators 2007' in effect, endorses key parts of our analysis in the ILSS submission to the Select Committee. It incorporates a chart titled 'Real GDP per capita as a proportion of the OECD average', which we copy below;

6. Note New Zealand's relative failure. This chart is sobering enough, but the real decline in relative incomes is, in fact, significantly worse than even the chart discloses, due to:

a. The chart expresses GDP. This is a misleading indicator because a high proportion of New Zealand's GDP now accrues to foreigners (their interest dividends and profits from their investments in NZ, in excess of such international

earnings by New Zealand investors). This net deficit on international investment incomes is now transferring 8% of New Zealand's GDP to foreigners, (which means Kiwis are now working one month of each year to service foreigners' investment, which is set to get worse):

b. To be truly representative of New Zealand's real performance, all such charts should be expressed in GNI terms. If the chart was expressed in GNI terms it would show an even worse deterioration of both position and trends. It would show that New Zealanders' incomes kept in touch with Australia (and the OECD average) up to 1984 and the ever widening wedge opened up since then. In GNI terms, it continues to widen;

c. The slight GDP improvement against the OECD average since 2000 still lags the growth rate of Australia, so the magnet for skilled emigration to Australia continues to increase – even more seriously in GNI terms – as, consequently, does the risk to New Zealand's economic and social future;

d. The slight GDP improvement since 2000 has been mainly driven by increased consumption, fuelled by burgeoning borrowing of debt from foreigners, not by productivity gains. Foreign debt – already NZ has the highest debt per capita in the world – is compounding at a faster rate than is New Zealand's economic growth, so foreigners' share of future GDP will escalate (unless NZ has massive gains from terms of trade, which hope has failed in the past). Therefore, the 'growth' since 2000 was not derived from investment for increased productivity, so its sustainability is uncertain.

7. The foregoing scenario is exacerbated by:

a. Chronic current account deficits – at \$13 billion pa, or 8-9% of GDP, the worst per capita in the developed world – which are remorselessly adding to national foreign debt and to servicing (interest) costs;

b. High foreign ownership of our productive assets, resources and businesses. This is a barrier to Kiwis' ability to regain lost ground relative to once comparable nations (which benefit from our income transfers);

c. Present OCR-based monetary policy, which is the principal reason for: the disconnection of the NZ economy from the global economy, (refer ILSS submission and the MED report), the foregoing loss of economic relativity since 1989; and the entrenchment of the general economic decline noted above.

8. It is now compellingly evident, for the reasons given in the ILSS submission, that continuation of the OCR-based methodology for the operation of monetary policy is not tenable. To argue, against the evidence, that the OCR-based methodology can work, let alone to claim it is superior to the ILSS solution, is to invite derision and the conclusion that those who would so contend simply do not understand the subject. The ILSS submission analyses why the OCR-based methodology can never be effective and can only cause even more needless economic destruction. Notably, this analysis has not been credibly faulted. Neither has the ILSS solution.

Is the Reserve Bank hopelessly compromised?

9. It is equally obvious that the Reserve Bank has painted itself into a hopeless quandary. Everywhere it looks it is spooked by the shadows cast by its own policy failures. It sees every sign of prosperity as a risk, to be avoided at all costs. Examples of irrational Reserve Bank conduct are:

a. If the government gives back taxpayers some of their own money, in the form of tax cuts, the Reserve Bank will either increase or hold up interest rates which are paid mostly to foreign lenders. Effect? The Reserve Bank would gift the tax cuts to foreigners, by OCR surcharges, as windfall gains to them; and, in consequence, will further attack exporters' incomes and businesses. Both effects would increase New Zealand's current account deficits, already the world's worst per capita;

b. When foreigners increased oil prices for their supply to New Zealand consumers, which financially penalises Kiwis, the Reserve Bank increased interest rates, paid mostly to other foreigners, to impose a second penalty on the New Zealand economy. New Zealanders and their current account deficit suffer a double whammy. Foreigners get double gains;

c. The Reserve Bank regards the higher prices received from the export of dairy commodities – Kiwis increasing their prices to foreigners – as a 'shock', so, again, the NZ economy still cannot win. Urged on by foreign-owned vested interests – to whose influence the bank appears to be irrationally susceptible – the Reserve Bank warns it will again either increase or fail to reduce interest rates. Effect? The extra wealth from higher dairy prices will be mostly transferred to foreign lenders. Again, Kiwis lose and foreign investors reap windfall gains at the expense of the New Zealand economy. It seems the Reserve Bank has not worked out that – with the current account loss running at \$13 billion per annum, or \$26 billion loss over two years, which has to be funded by even higher foreign debt – the additional interest payable on the additional foreign debt borrowed for only two years will remove from the NZ economy and transfer to foreigners the entire projected annual benefit from the dairy price bubble. Even worse, the dairy price bubble is likely to be short-lived, while the increased servicing costs of foreign debt will be permanent and will compound remorselessly, probably from three sources: increased foreign borrowings, much of it to fund the chronic current account deficits; consequently increased interest payable to foreigners; and probably increased interest rates, due to the higher country risk premium that will be demanded by foreign lenders and/or higher world interest rates;

d. As skilled Kiwi workers emigrate to other countries, to in effect escape the Reserve Bank's policies – low incomes, high interest rates, high house prices, high debt, low growth – ironically the bank frets over the pressure on the labour markets that its own policies have caused. Its response to the labour shortage it has caused is to tighten monetary policy even more, which drives even more skilled workers to emigrate – 40,000 Kiwis left for Australia last year, alone. Another irrational self-defeating destructive cycle is perpetuated, to combine with the other effects to compound their serious implications for the future. We raise educate and train skilled New Zealanders and then drive them out of the country, without compensation;

e. There are many other irrationalities. The Reserve Bank policies have caused asset price inflation (house, sea-side and farm properties and consequent general inflation) – refer ILSS submission. Investor owners now expect a return on inflated house prices, by way of increased rentals. Rising interest rates – again the Reserve Bank's handiwork – are adding to this pressure. Rental increases of 30% by 2012 are predicted. The Reserve Bank's response, to 'control' its own inflation, is likely to be even higher interest rates, to thereby intensify the existing inflationary pressures, even more;

f. Meanwhile, the Reserve Bank's attack on exporters and manufacturers, by its high interest and exchange rates policy, continues. The present cycle is into its

fourth year, yet in the mind of the Reserve Bank the inflationary pressures are unabated, despite an OCR of 8.25%, compared with 4.25% in both USA and Canada, 5.50% in the UK, 5.00% in the Euro zone; and 6.75% in Australia (which partially shares the irrationality of the RBNZ). This, alone, should tell it that its policies have failed and will never work. The 'collateral damage' mounts by the day, as companies shift offshore, close or reduce their size. Many sectors are mostly unprofitable: forestry, wood processing, wool, meat, wine, apples, fishing, and manufacturing. Their production counts as export revenue, but it is uneconomic, which means there is little current exporting that is truly economic. Who will invest for export in such circumstances? Few are.

10. There are many more irrationalities concerning Reserve Bank monetary policy, (refer ILSS submission) but the foregoing examples should be enough to conclude there must be policy change.

#### Political Risk

11. The nation needs higher productivity. That requires investment. That requires confidence. It is quite irrational for policymakers to expect productivity gains while the Reserve Bank uses the present methodology for the operation of monetary policy. Also, it is quite unrealistic to expect the Reserve Bank to find solutions, let alone support the obvious solution, ILSS. It has lapsed into a siege mentality, it would appear. It is not even replying to letters, to which a truly professional organisation should be eager to reply. It makes no attempt to constructively engage.

12. The Reserve Bank totally undermined 'Export Year'. Going into the New Year, we suggest policymakers need to address this issue of dysfunctional monetary policy, as the issue that is deserving of the highest priority. The fact that the economy is haemorrhaging through current account deficits of more than \$1 billion per month should, alone, be enough to justify urgency.

#### Political Opportunity

13. Every one of the foregoing dysfunctions of present monetary policy can be assertively and effectively addressed by the ILSS solution. (If anyone does not understand that, then please tell us). I am well aware, from personal experience (refer 'Credentials' section of the ILSS submission, for examples), that the 'Not Invented Here Syndrome' that is endemic within many bureaucracies is a millstone that has to be neutralised. The only antidote to that malaise is political leadership that is intolerant of it.

14. Once understood, the opportunities presented by the ILSS solution are truly immense. We have appreciated the move to conduct the current review of monetary policy, as a result of our pressure. We trust that policymakers will not be deflected from the job at hand, nor even dilute the ILSS solution in the slightest. New Zealanders cannot afford to allow the choices of their government and/or their economy to be circumscribed by the millstone of the Reserve Bank failures that are there for anyone to see, if they so choose, nor by policymakers' timidity.

15. Have a good break. There is much to be done. Fortune will favour the brave.

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