

PULLING THE ECONOMY OUT OF THE 'DEATH SPIRAL'

(An Overview)

Now that a Free Trade Agreement (FTA) with China looks to be in the bag – although the details are not yet known – the next priority FTA the New Zealand government needs to negotiate is with the Reserve Bank of New Zealand.

The Reserve Bank is a far greater handicap to New Zealand exporters than are the trade barriers of any other country. In effect, by its persistent over-valuation of the NZ dollar, it taxes NZ exporters and subsidises imports, to create massive current account deficits that are funded by borrowing from foreigners, to add to New Zealand's mountain of foreign debt. This irrational situation has to be changed.

There is a perverse irony. The signing of the FTA is likely to coincide with the closure of the NZ Wood Innovation Centre, based in Shanghai, a further victim of the prolonged period of over-valuation of the NZ dollar due to Reserve Bank monetary policy, which has decimated exporters' incomes. In the wood processing sector plants and shifts have also been closed.

Only a few New Zealand exporters, such as dairying, are investing in new plant for exporting. The rest have made the completely rational decision that it would be an unduly futile, even disastrous, thing to do. Our company, a significant exporter but for prudence focussed mainly on the domestic market, has reached exactly that conclusion.

Many exporting companies have shifted offshore to reduce their exposure to the costs and risks for their businesses of the Reserve Bank's dogged persistence with its high interest and exchange rates policy. What was once a trickle, has become a steady and increasingly threatening stream. Large chunks of the industrial base are simply disappearing. New Zealand's skill base is rapidly diluting, too, by emigration.

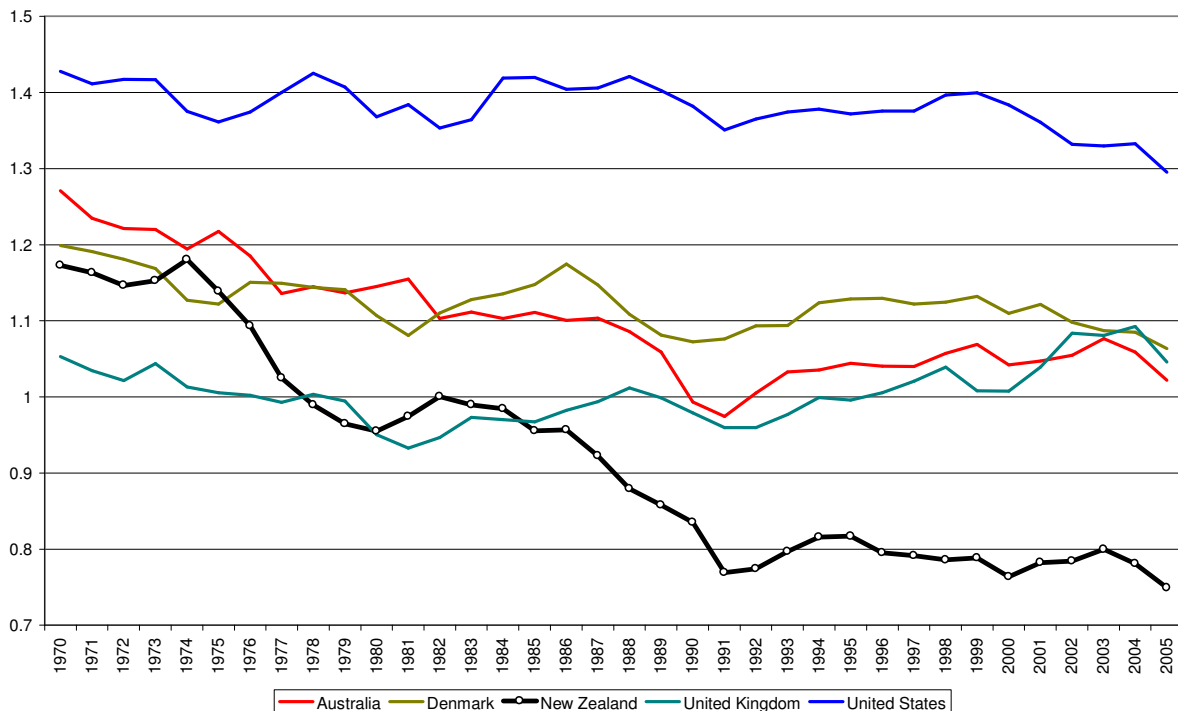
The Reserve Bank in effect attacks business incomes to ineffectually pretend it is controlling inflation much of which, in fact, it is itself causing. It draws some of its persistence from the urgings a small coterie of financial sector economists whose employers are the only real winners, for the time being, in what the eminent USA economist, Prof Steve Hanke, when referring to the New Zealand economy late last year, described as being "*in a death spiral*".

By their chantings, one or two local finance sector economists persist in 'talking their books', to the detriment of the real economy. But Prof Steve Hanke is not influenced by the home-town irrational exuberance or private agendas, here, that have masked the reality of New Zealand's declining relative economic performance.

The chart '*GNI per capita as a proportion of the OECD mean*' provides the statistical evidence of our unique failure amongst OECD nations. Up to 1984 our relative average incomes kept in touch with the OECD average, including the UK and Australia. By 2005, ours had dropped to only 75% of the OECD average. We have declined further since then, so we would now be only around 70%.

That would not be so serious if Australia and the UK had followed us down, to mitigate Kiwi's urge to emigrate. They have not. Their average incomes are now around 105% of the OECD average – 50% above ours. It is no wonder Kiwis are leaving.

Real gross national product (GNI) per capita as a proportion of the OECD mean – courtesy MED



Unfortunately, even these dismal statistics tell only part of the story. Driven by necessity, a higher proportion of our population is engaged in the workforce than in other countries; and they work longer hours, with resulting social cost. Consequently, work that was not traditionally measured as part of GDP – child care, elder care, counselling, lawn mowing, gardening, vegetable growing, sewing, baking, etc – are now included, to disguise the true enormity of the post-1984 policy failure.

Currently, the Finance and Expenditure Committee of parliament (FEC) is considering submissions for changes to the way monetary policy is being operated. It is a review for which I have personally pressed since the mid-1990's.

I have made a cornerstone submission. It analyses how and why present monetary policy has failed; and it advocates the introduction of a suite of new instruments, to supplement the OCR: the "Interest Linked Savings Scheme" (ILSS) solution. It has never been credibly faulted.

There is a need for urgency. In the emerging international credit crunch environment, the high OCR could create the perception that New Zealand is permanently deserving of high interest rates.

The FEC can draw confidence in the ILSS submission from recent comments made by yet another eminent USA economist, Joseph Stiglitz, who won the Nobel prize economics in 2001. During a visit to New Zealand he implicitly criticised NZ monetary policy and endorsed the ILSS analysis of the problem, saying:

"The Reserve Bank's exclusive focus on curbing inflation is a mistake. It's exactly the wrong mandate, especially at this juncture."

"In a small open economy quite often raising interest rates is counter-productive because it induces a flood of capital into the country and doesn't have the dampening effect it would have in a closed economy."

"It is also ineffectual if the inflation is imported, like when it reflects high international prices for oil and food. Raising New Zealand interest rates will have no effect whatsoever on Saudi oil production."

Stiglitz questions the wisdom of having almost all the country's banks foreign-owned, seeing it as a potential risk to stability in the supply of credit if the parent banks get into difficulties.

"I don't think countries should turn over control of the supply of credit to international markets."

He is not advocating a return to an insular economy. "But at least part of the system should be deeply rooted at home". Amen.

The ILSS analysis and solution has won considerable and highly credentialed support from those who have come to understand the issues and the opportunities and who do not have personal baggage or paradigm lock-in. It is more than simply an effective and non-destructive way to combat inflation: it is a powerful engine for economic recovery. It is the key to improving New Zealand's productivity growth and general economic expansion. In my opinion it will define the economic credentials of each political party, too.

The FEC review process should not be distracted or delayed by ill-conceived proposals, such as a variable tax on fuel – fighting inflation with inflation! – which is a fundamentally professionally unsound recent suggestion.

To adequately describe ILSS and its merits would require a further article. The full ILSS submission to the FEC, that outlines how the ILSS solution will work and its benefits, can be accessed on our websites: www.erosgroup.co.nz or www.redstagtimber.co.nz

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