

## **PULLING THE ECONOMY OUT OF THE 'DEATH SPIRAL'**

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, because the Reserve Bank is a far greater handicap to New Zealand exporters than are the trade barriers of any other country. In effect, by persistent over-valuation of the NZ dollar, the Reserve Bank taxes NZ exporters and subsidises imports. This irrational situation has to be changed.

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.

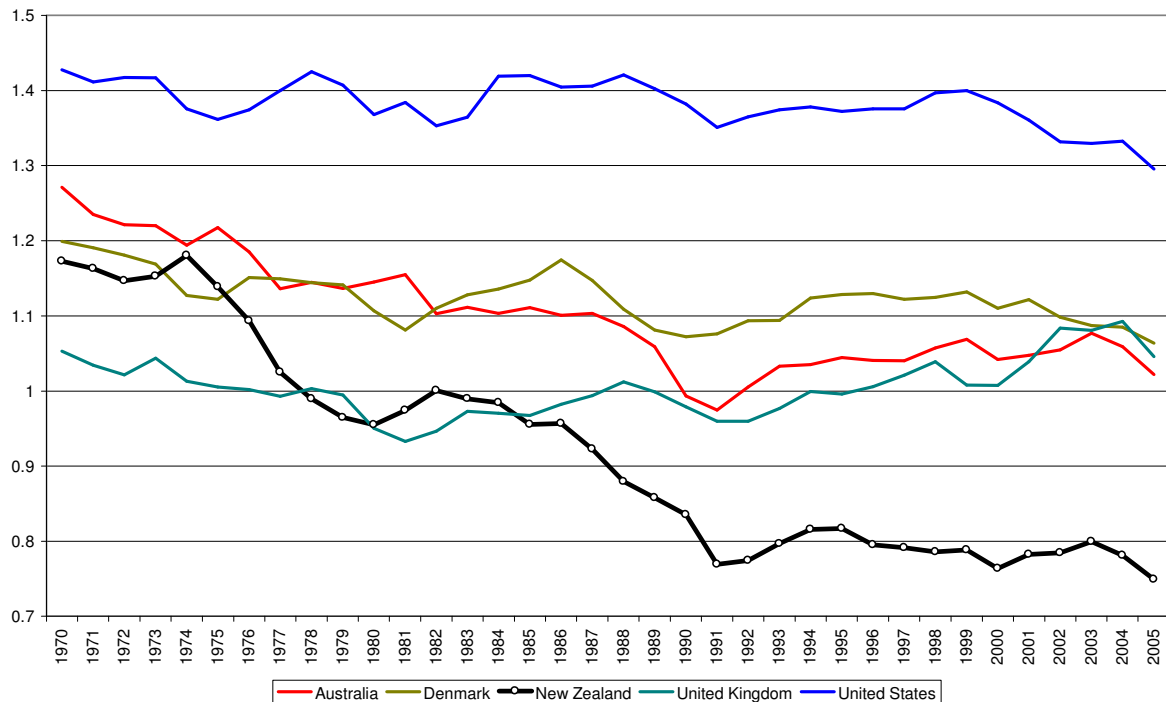
Many exporting companies have shifted offshore to reduce their exposure to the costs and risks for their businesses of the Reserve Bank's dogged persistence with its high interest and exchange rates policy. What was once a trickle, has become a steady and increasingly threatening stream. Large chunks 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*". The chantings of one or two of these local economists who persist in 'talking their books' – are they our economic Judas sheep? – would make great Tui billboards, such is the cynicism they deserve.

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. Neither have I been, since when the policies that in 1984 started this, the most serious, phase of our relative economic decline, because that decline was always inevitable from that point-in-time onwards, unless more sensible economic policies were introduced. They are still awaited.

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.

Many kiwis have resorted to increased borrowing to supplement their declining relative spending power, (over)-spending on average up to 117% of their incomes. This, too, has added to the mirage of economic progress. With the highest levels of debt per capita in the world and the highest debt relative to GDP in the developed world, we are already deep in the mire of debt junkies.

These short-term economic performance enhancing 'drugs' have masked the true extent of our failure. We are the Ben Johnson of world economies: shooting up on our own myths to self-delude that we are better than in fact even the dismal statistics say we are.

In reality, New Zealand has by far the developed world's worst basket of economic performance indicators, as the list in the accompanying panel records. It is understandable that Prof Steve Hanke recognised that the New Zealand economy is "*in a death spiral*". As matters stand, it can only get worse. Already, the economic chickens are coming home to roost, faster than is being acknowledged by officials. These circumstances argue that fair value for the NZ dollar is only 50-55 US cents, if real economic recovery is to start.

By far the worst policy legacies of the disastrous 1980's is the Reserve Bank Act. It is entirely unsuited to the structural characteristics of this small, remote, export-

dependent economy. It is the reliance upon the single OCR instrument for the operation of monetary policy that is the core problem, combined with the extraordinarily myopic obsession that characterises the Reserve Bank. Monetary policy devastates the real economy with enormously high interest and exchange rates – to futilely try to combat the inflation that, in fact, the high OCR causes – to thereby produce disastrous economic consequences that are the exact opposite of those that these market interventions are supposed to achieve: giving relative economic decline, not prosperity. The Reserve Bank lightly passes over such economic destruction as 'collateral damage', to deflect focus from its responsibility. This is not good enough.

It is this failed monetary policy methodology that has locked New Zealand into the bottom end of the OECD, by almost every measure. Unless changed, it will ensure our further relative decline. It wrecked "Export Year", last year. It will make liabilities out of Free Trade Agreements, not assets.

How has this disaster come about? Why is the policy so insane, so indefensible? Why have I been publicly forewarning of its inevitability since the mid-1990's? Why has the eminent Prof Steve Hanke recently condemned our economy with the apt epithet "*in a death spiral*"?

The answers are obvious, when Reserve Bank monetary policy is demystified and dissected. It works this way.

Everyone knows New Zealand has accumulated massive foreign debt, (due to policy failure). Remember that.

To supposedly combat inflation, the Reserve Bank increases short-term interest rates, by increasing the OCR. The OCR was once 4% pa: it is now 8.25% pa. The high OCR has lifted interest rates charged to Kiwi borrowers. This has several bizarre counter-productive effects:

- The Reserve Bank, in effect, intervenes in the market to increase NZ interest rates, above the levels at which the market would be happy to lend all the funds we need, by imposing a monetary policy surcharge above market interest rates. The effect is to force Kiwi borrowers to gift their wealth to foreign lenders, by 'voluntarily' paying the developed world's highest interest rates on our already massive foreign debt-per-capita;
- Of course, the foreign lenders don't mind us gifting our wealth to them. All the world loves a sucker and, in the form of our Reserve Bank, they gleefully realise when they have found one. So, the inflow of foreign debt becomes a financial tsunami, of 'carry trade' funds: Eurobonds and Uridashi bonds, funded from countries with low interest rates;
- With practically unlimited funds consequently available to them, the only challenge for the NZ-based financial intermediaries was to find borrowers, so debt marketing became the name of the game, targeted at loans 'secured' against house, farm and seaside properties, even risky 100% loans;
- The inevitable consequence (of the Reserve Bank's high OCR policy) has been rapid inflation of property prices, fuelled by the easy credit, as we have experienced: the exact opposite of what the Reserve Bank was supposedly trying to achieve;
- In consequence, property owners have felt more wealthy as their paper equity increased, so they have borrowed and binge-ed on consumer spending, to cause secondary inflation: again, the exact opposite of what the Reserve Bank was

supposed to achieve. The Reserve Bank is causing the inflation it thinks it is combating.

Since I first forewarned of these unintended consequences of flawed monetary policy methodology in the mid-1990's, this analysis has never been credibly faulted. But, even today, the OCR remains at the developed world's high of 8.25% pa and the Reserve Bank appears to be perpetually spooked by concerns about inflationary pressures that are of its own making. It still is and, short of recession, it always will be unless there is policy change. For example, as its policies cause skilled Kiwis to emigrate, it frets about inflation pressures from labour and skills shortages: a self-perpetuating nonsensical cycle. Freezing in front of the headlights is never a sound policy position.

Meanwhile, the damage to the real economy piles up. The evidence is everywhere:

- The OCR single instrument means the response to inflation is lop-sided: it can only suppress economic activity. There is no instrument to combat inflation by supply-side stimulus to growth of production and/or productivity. Consequently, our GNI economic and productivity growth rates are about the worst in the developed world;
- GNI per capita (incomes across-the-board) would now have to increase by 50% to regain parity with Australia and the OECD average. That is how far behind we have fallen;
- For that to happen exports-per-capita in real terms would need to double. That would first need an export-friendly economic environment and policies to give exporters confidence that such conditions would be maintained. Under present monetary policy, that is impossible. The inflow of more foreign debt, attracted by the high OCR, vastly over-values the NZ\$ exchange rates, to render most exporting uneconomic. (Dairying will be only a temporary exception, when its commodity price bubble bursts, as it will);
- New Zealand's consequential chronic annual external current account deficits – around \$13-14 billion, or 8-9% of GDP – are also amongst the worst in the developed world, due to the toxic confluence of the effects of monetary policy: shrinkage by 50% of the export sector; imports in effect subsidised by exporters' incomes; the gifting of Kiwis' wealth to foreign lenders by OCR surcharges; and resulting general economic under-performance;
- In consequence, the level of foreign debt continues to escalate, alarmingly. The future servicing burden (interest) on this foreign debt compounds remorselessly – driven by both increases to quantum of debt and increases to interest rates – to become a millstone around the nation's future economic prospects that can only become relentlessly heavier. Just to service the *additional* foreign debt needed to fund two year's current account deficits will absorb the entire increased export revenues from the temporary dairying price bubble. The debt servicing millstone will be structurally permanent long after the dairy bubble bursts;
- Now, house and farm prices are unaffordable to most would-be new entrants. Combined with low relative incomes, especially compared to Australia, Kiwis are responding by emigrating in droves, including the 100,000 Maori now living in Australia who, by survey, also relish their escape from the negative stereotyping caused by Maoridom's dearth of genuine leadership. In Aussie, they show they can compete as equals. This emigration is stripping the skill base needed to fuel economic recovery; added to by businesses shifting offshore, or staying but consuming their capital by not re-investing;

- The Reserve Bank's single OCR instrument has gone from being impotent to being destructive, as in the mid-1990's I forewarned Don Brash, as governor, would be its fate. Its continued use is indefensible.

The government deserves to be congratulated if it has negotiated a truly favourable Fair Trade Agreement with China. But no FTA will be of value until the monetary policy nonsense is also effectively addressed.

Is there a light at the end of this dismal tunnel? Well, their just might be.

For a long period of time I was a lone voice calling for new instruments for the operation of monetary policy. Now there is a chorus. When my forewarnings fell on deaf ears, or worse, I decided to park the issue to allow time for the mounting evidence of policy failure to become indisputable, as it now is. On 14 October 2005, I decided to use an invitation to deliver a public address as an opportunity to put the issue back on the political agenda. To cut a long story short, the government has responded by instigating a review of monetary policy by the Finance and Expenditure Committee of parliament (FEC). The review is ongoing.

I have made what I believe deserves to be recognised as the 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 ILSS 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, which I will write and offer for publication. Meanwhile, the full 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](http://www.erosgroup.co.nz) or [www.redstagtimber.co.nz](http://www.redstagtimber.co.nz)

**ENDS**

*(Please find attached on next page 'New Zealand's Real Economic Scorecard')*

## **New Zealand's Real Economic Scorecard**

The developed world's worst or near worst by every measure:

- highest foreign debt per capita and as a percentage of GDP;
- highest real interest rates;
- highest international operating loss per capita and as a percentage of GDP, as represented by our chronic and high current account deficits, which are not sustainable;
- the small country economy that is the most disconnected from the global economy, with relatively stagnant export revenues now only 50% of the level New Zealand needs them to be;
- the economy that has most lost its economic sovereignty, by its exposure to and dependence upon the whims of foreign financiers;
- worst plunge in average incomes per capita (in purchasing power terms) over the past twenty-odd years;
- the most rapid penetration of foreign ownership of assets, businesses and resources;
- most average hours worked per capita, with almost one month a year now being worked to service foreign investment;
- lowest national savings per capita;
- the most dis-saving economy in the world (spending up to \$117 for every \$100 earned);
- consequently, the economy suffering the greatest rate of skills flight in the world;
- the worst rate of closures of export plants, or their transfer to more supportive overseas monetary policy environments;
- consequently, the economy that is the most stressed by under-funding services for education, health, welfare, superannuation, defence, policing and social services;
- worst suicide rate in the world, (especially when Reserve Bank monetary policy is attacking the vulnerable export sector);
- the world's most artificial and vulnerable economy, with its feeble growth attained only by a borrow/sell assets and binge policy approach;
- the world's worst record for low productivity gains;
- the world's worst record for low investment in export manufacturing;
- the world's worst record for failure to attract Foreign Direct Investment in new industry or expansion of industry;
- relatively, the world's smallest and shallowest capital markets;
- the world's most overpriced housing, relative to average incomes;
- worst household debt servicing as a percentage of household incomes;
- arguably, the world's worst record for businesses consuming their fixed capital, by running plants out to the end of their economic life and then closing and not replacing them.