

ViewPoint

(March 2008)

There Has to Be a Better Way

For the past five years or so, exporters have struggled with both high interest and exchange rates, especially those selling in US dollars. As far as Government is concerned, the debate over what can be done to control inflation alongside the Official Cash Rate (OCR), now rests with the select committee, which is currently deliberating alternatives. However, while the committee continues its deliberations and the Government its policy of inaction, the combination of the high OCR and the 'global credit crunch' is starting to squeeze our domestic sectors as well, and it is becoming increasingly apparent that the OCR has failed to control inflation and that fundamental changes to the implementation of monetary policy are necessary.

This Association recently put forward the idea of a Variable Rate Compulsory Superannuation scheme (VRCS).¹ The compulsory saving scheme can boost New Zealand's saving rate, however, under a variable rate regime, it can act as the lever of monetary policy to combat domestic inflationary pressure without impacting on exchange rates.

A similar scheme was suggested by Phil Verry in 1999; the Interest Linked Savings Scheme (ILSS).²

Technically, OCR interventions can be seen as an interest surcharge above the free market interest rates, and the ILSS is a saving surcharge that is linked to interest rates, which to a degree, mimics the OCR approach. As a result, the monetary policy will be implemented via the setting of the saving surcharge rate instead of OCR, and interest rates are determined by market.

¹ NZMEA ViewPoint. [A Case for Compulsory Superannuation.](http://www.mea.org.nz/document.aspx?id=342)
<http://www.mea.org.nz/document.aspx?id=342>

² Verry, P A (Phil). [Interest Linked Saving Scheme: A Policy Framework for Economic Growth and Development.](http://www.redstagtimber.co.nz/monpo.asp) *Submission to the Finance and Expenditure Select Committee.*
www.redstagtimber.co.nz/monpo.asp

The RBNZ can choose different levels of stringency for the application of a savings based approach. At the lowest level, the surcharges are directly credited to the KiwiSaver account of the payers; at a higher level, the credit process will be deferred until the sought anti-inflation response is attained. The most stringent instrument is similar to a non-governmental tax that credits the surcharges to a taxpayer-owned fund.

Equity is a key feature of this approach, in that it allows for better targeting, and the collateral damage to non-culpable sectors and parties is minimised as the exchange rate is disengaged from the interest rate, enabling the NZD exchange rate to return to trade based levels.

The funds saved can be dedicated to promote economic growth, which further counters inflation through supply-side stimulus.

Both the ILSS and VCSS are savings based control mechanisms for the money supply. Both seek to control inflation without collateral damage to the exchange rate, but they differ in some important ways. ILSS is targeted at borrowers, while VRCS is targeted at all income earners.

In 2007, 2.1291 million people in paid employment, including both self-employed and wage and salary earners, received an average weekly of NZ\$820³, which implies a total annual earning of NZ\$90.78 billion; for the year ended 30 June 2007 according to the Household Economic Survey (HES), private households spent NZ\$6.072 billion⁴ on interest payments, which include interest on mortgages, personal loans, etc, and businesses spent approximately NZ\$46.752 billion⁵ on interest and donations for the 2006 financial year, according to the Annual Enterprise Survey. Potentially, the VRCS is more effective as it has a broad base compared to the ILSS.

What is truly disappointing about this issue is that the ILSS was proposed back in 1999, yet the question is where would New Zealand be today economically had the ILSS been implemented almost a decade ago?

³ Statistics New Zealand, Table Builder, <http://wdmzpub01.stats.govt.nz/wds/TableViewer/tableView.aspx?ReportName=Incomes/Earnings%20by%20region,%20sex%20and%20age%20groups>

⁴ Statistics New Zealand, Household Economic Survey- Expenditure on goods and services; <http://www.stats.govt.nz/people/work-income/household-economic-survey/more-hes-data.htm>

⁵ Statistics New Zealand, Annual Enterprise Survey; <http://www.stats.govt.nz/products-and-services/hot-off-the-press/annual-enterprise-survey/annual-enterprise-survey-2006-financial-year-provisional-hotp.htm?page=para002Master>

With a savings based inflation control approach, the economy would not have been sucked into the 'sub prime' crisis now sweeping world markets. The loose money that has been running throughout the world financial systems would not have found its way into New Zealand quite so readily because interest rates would have been maintained much closer to OECD average. Productive investment would have been encouraged as the cost of capital in New Zealand would have been closer to world averages and the economy as a whole would have benefited from a trade driven exchange rate. It is unlikely that we would not have seen the development of the 'two economies', a huge housing bubble and the accelerating loss of productive jobs and capability offshore.

We are in the hole, how deep and how dark is just becoming apparent. Digging our way out will not be possible unless we learn from the experience of the last few years.

If New Zealand is to generate future growth in the economy that is sustainable over the long term, then the monetary policy mechanism must control inflation without impacting on the exchange rates. The OCR approach has failed exporters and can now be seen to have failed New Zealand. The OCR approach helped created a bubble in the domestic economy and has decimated the productive sector.

The VRCS and ILSS are two options open to the Government. A savings-based inflation control approach should be welcomed by New Zealanders. After all, the surcharge is going to apply if monetary policy is to be used, and that surcharge will either be a savings based spending delay; interest-based which is a cost to the individual and a clear wealth transfer, or tax based which is a partial wealth transfer.

Given that choice, the outcome seems pretty obvious, but the question is this - are our policy makers willing to acknowledge the failure of the OCR, and more importantly, are they willing to really change before the damage to the New Zealand economy is irrevocable?