

## **The importance of raising New Zealanders' savings**

**Dr David Skilling**

**As published in the New Zealand Herald on Monday, May 8, 2006**

Over the past 15 years New Zealand has pursued a hands-off policy approach to personal savings, based on the twin beliefs that people make systematically rational savings decisions and that the government has no interest in the aggregate outcomes that are generated such as the current account deficit or the strength of capital markets.

New Zealand has been more or less alone among developed countries in holding to these beliefs. And it has become increasingly clear that this pursuit of purity has come at a very real cost. New Zealand's household savings rates are the lowest in the OECD at -7% of household income, and as a consequence New Zealand is heavily reliant on importing capital from foreign savers.

This reliance on foreign capital is reflected in New Zealand's current account deficit of 9% of GDP, one of the largest in the OECD, and in one of the largest stocks of net external liabilities in the developed world. The current account deficit is driven largely by the investment income deficit in New Zealand, currently 7% of GDP, reflecting the lack of domestic New Zealand savings.

New Zealand is in uncharted territory in running a current account deficit of this size. The rule of thumb has been to treat a current account deficit of more than 5% of GDP as dangerous. There are many costs and risks associated with a deficit as large as New Zealand's, such as a high cost of capital and vulnerability to changes in investor sentiment about the attractiveness of New Zealand.

Indeed, there has been much recent comment in publications like the Economist and the Financial Times about the risks associated with the high current account deficits in small countries like Iceland and New Zealand. Currencies like the New Zealand dollar have been supported by 'carry trades' in which capital is attracted into countries like New Zealand because of the high interest rates that are offered. When this process unwinds, there is the potential for a substantial depreciation in the currency and slower rates of economic growth.

Mitigating these risks is sufficient motivation in itself to take action to raise household savings. Indeed, concern about Australia's current account deficit, captured in Paul Keating's famous 'banana republic' comment, was a key driver in the establishment of Australia's compulsory savings scheme.

But the case for action does not rest simply on demonstrating that serious risks exist. The more important reason for taking meaningful action to raise savings is to strengthen the New Zealand economy. Even if a crisis is not thought likely, configuring policy to increase household savings should be a key economic policy priority because of the economic upside this will generate.

First, an increased pool of domestic capital means that New Zealanders will have a larger ownership stake and will obtain a greater portion of the returns generated in the New Zealand economy (and elsewhere). Because New Zealand has been heavily dependent on foreign capital to finance our spending and investment, the New Zealand economy has a high level of foreign ownership. As a consequence, New Zealand exported about \$13 billion, or 8% of GDP, to foreign investors in 2005.

For New Zealand to benefit from the success of New Zealand companies as they grow and expand into international markets, a greater ownership stake is vital. It may be that many New Zealand companies are able to obtain capital on global capital markets, but the returns flow offshore to reward the investors who have put up the capital. Ultimately, it is ownership that drives wealth. New Zealand cannot spend its way to prosperity on the back of foreign credit.

Second, for a small, remote economy like New Zealand, a deliberate focus on raising savings is needed to make New Zealand a more attractive place for companies to locate. There will always be pressure for companies to move from New Zealand to larger markets, but having deep, liquid capital markets will help to counter this agglomeration pressure. Generating a domestic pool of capital will grow and strengthen New Zealand's capital markets, lead to more aggressive pricing of companies, and provide expansion capital for large and small New Zealand companies. These factors will help to anchor companies in New Zealand as they expand their operations internationally.

Without a greatly increased level of savings, New Zealand is likely to become an increasingly peripheral economy. New Zealand will continue to struggle to hold onto New Zealand companies as they grow. Becoming a 'branch office economy' may not be catastrophic, but neither is it conducive to creating a New Zealand economy that can generate high rates of income growth into the future that will enable New Zealand to converge to the income levels of Australia and other developed countries. New Zealand's economic future will be much brighter if we increase savings.

Given New Zealand's current savings performance, and the importance of increasing savings, it is time to rethink our current policy approach to savings. It is instructive that Australia's outcomes look very different after 15 years of a very different approach to savings policy. The Australian compulsory superannuation scheme is widely credited as having been the major factor driving the growth in Australian capital markets, and has assisted Australian firms to aggressively expand internationally as well as supporting robust economic growth.

Australia's private pension funds under management are currently about NZ\$840 billion, compared to NZ\$30 billion in New Zealand, are growing at over NZ\$100 billion a year, and are projected to approach NZ\$3 trillion within the next decade. The debate in Australia is about the difficulties of having too much capital to fund domestic investment opportunities, not a conversation heard frequently in New Zealand.

After 15 years of these different policy approaches, the evidence is increasingly clear that New Zealand's current approach to savings is not delivering good outcomes. New Zealand's approach of policy neglect with respect to personal savings has made us unique in the OECD, and it is unlikely to be a coincidence that New Zealand has both the most hands off approach to savings in the OECD and also amongst the worst outcomes.

If New Zealand continues with its current approach, we will remain exposed to serious risks and more importantly the New Zealand economy will not be strong enough to hit its full growth potential.

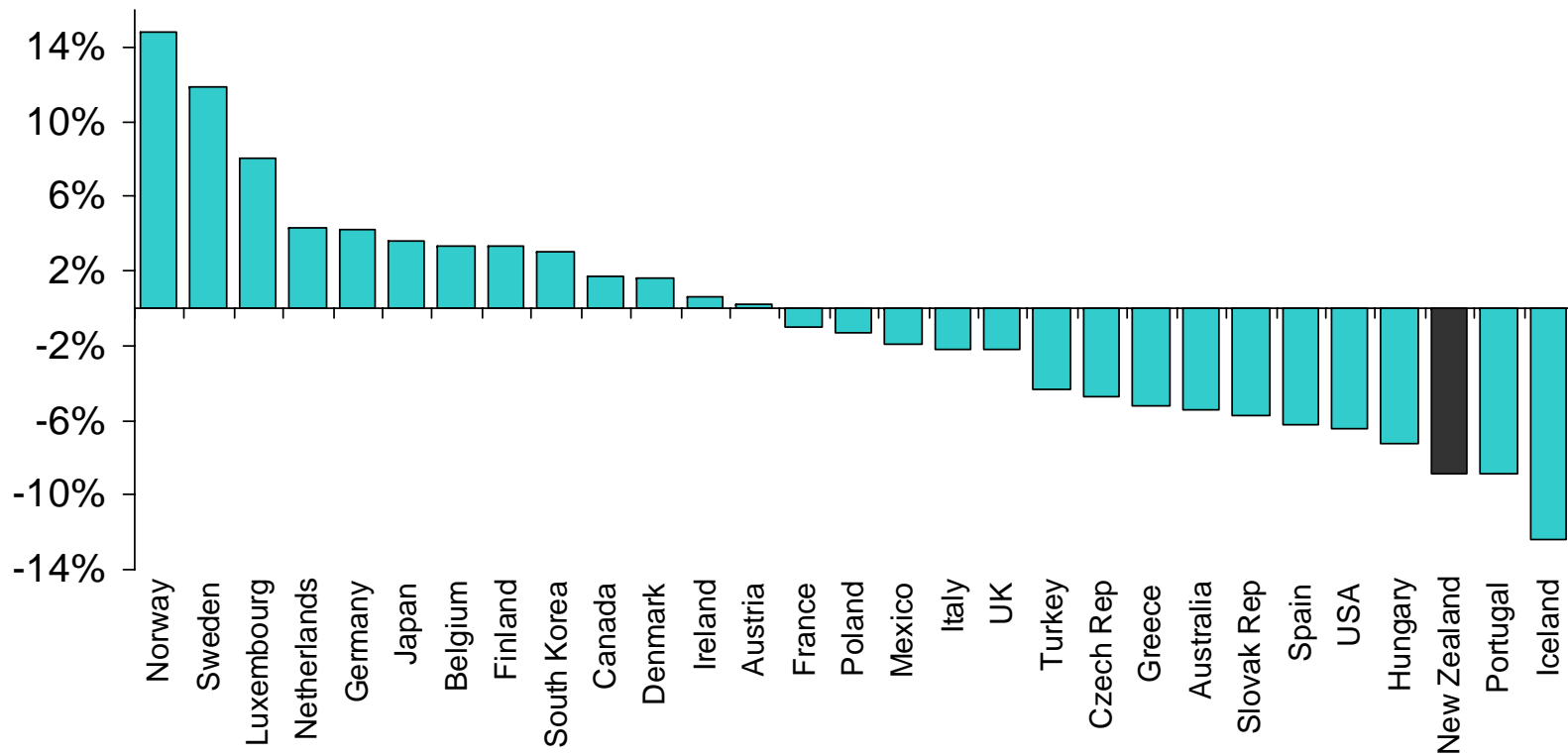
New Zealand should learn from countries like Australia and Singapore and others, who have benefited enormously from a much more deliberate approach to savings. In this context, the government deserves credit for introducing the KiwiSaver scheme. However, although welcome, KiwiSaver is likely to have only a modest effect on savings. Something much bolder is required in order to respond to the challenges and opportunities described above.

The KiwiSaver scheme does, however, provide a platform on which to build a much more ambitious savings scheme. There is growing awareness of the need for action, and there is a window of opportunity to respond with a strong fiscal position, corporate profitability, low unemployment, and strong wage growth. But to convert this concern into action, political

leadership is required. We need to seize this opportunity with both hands and not squander this opportunity as we have in the past.

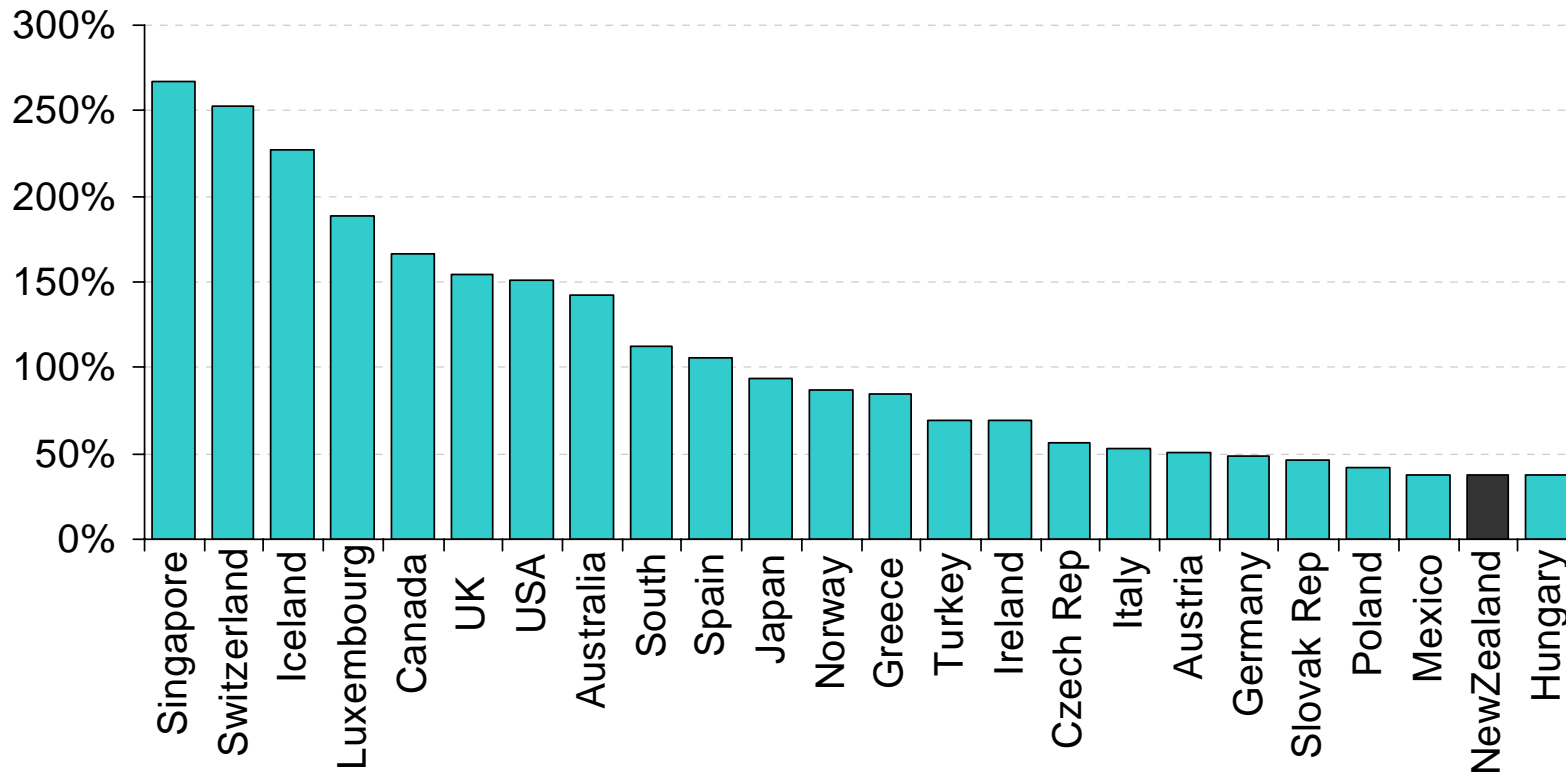
***Dr David Skilling is the chief executive of the New Zealand Institute, a policy think tank comprising business, community and education leaders. The Institute's reports are available at [www.nzinstitute.org](http://www.nzinstitute.org)***

## CURRENT ACCOUNT AS A % OF GDP, 2005



Source: OECD; Statistics New Zealand.

## MARKET CAPITALISATION AS A % OF GDP, 2006



Note: In instances where countries have access to regional or major nearby exchanges only the national exchange was considered. In instances of multiple national exchanges only major, distinct exchanges were included. In all cases we have made conservative assumptions that likely understate market value, particularly for European countries.

Source: IMF; Deutsche Bank; relevant national exchange for Iceland, Canada, Slovak Rep, and Czech Rep.