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# Investment, Savings and Growth

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## **Acknowledgement**

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**This essay discusses why increasing New Zealand's household savings matters for improving investment, productivity and economic growth.**

### Savings in New Zealand

First, some facts. New Zealand's household savings performance is amongst the worst in the OECD, as shown in Figure 1. Despite strong economic growth over the past decade, New Zealand's household savings rates have consistently declined and compare poorly with Australia, the UK, the US and Canada (and even more so with most European countries).

And the Reserve Bank report that household financial asset holdings have been roughly constant over the past decade as a share of household disposable income, while household borrowing has grown strongly as people borrow for mortgages and for personal credit.

At the same time, private consumption growth has been growing strongly – retail spending growth, for example, has been growing at about 7% a year over the past few years, far outstripping income growth.

In aggregate, this is reflected in New Zealand being one of the most externally indebted countries in the world. New Zealand's net external liabilities – foreign investment in New Zealand less New Zealand's investments overseas – are about 80% of GDP. This has created a net investment deficit of about 6% of GDP, meaning that foreign savers receive about 6% of every \$1 of GDP produced in New Zealand.

And were it not for the high rates of public saving (fiscal surpluses) New Zealand's external debt position would be even worse. As Don Brash has noted, New Zealand is an 'indebted people'.

### Savings & Investment

This savings record has significant consequences for investment in New Zealand.

For one thing, investors charge New Zealand borrowers a risk premium because of the high external indebtedness. The benchmark estimate is that an extra 10 percentage points of external debt leads to about a 25 basis points increase in the real interest rate. This deters investment.

Low domestic savings are also likely to constrain the development of New Zealand's capital markets, in terms of their depth and liquidity. In turn, the evidence shows that this will reduce investment and growth in the New Zealand economy.

Further, low domestic savings constrain investment in the economy more directly. One of the best documented results in economics is the persistent correlation between domestic savings and domestic investment. Recent international estimates suggest a correlation of about 0.6 for OECD countries over the 1990s – and similar estimates have been made for New Zealand. Although the correlation has reduced over the past few decades, the reduction has been slow and the correlation remains substantial.

Now of course correlation is not the same as causation. But there is evidence that suggests that causality does run from domestic savings to domestic investment. For example, there is a powerful 'home bias' tendency in investment decisions where investors disproportionately invest in local markets, despite the gains available from international portfolio diversification.

And these arguments have particular relevance to New Zealand. The international

evidence shows that small, distant countries are much less likely to receive international flows of capital than are larger, more proximate countries. The implication is that New Zealand is not well placed to receive ongoing flows of FDI and equity investment in the productive economy.

This is due to a combination of limited market access and limited information. Investors invest in markets, companies and products they understand and know, and these are disproportionately local. As a result, many types of productive investment continue to be heavily local despite the effects of globalisation.

This home bias is particularly acute for New Zealand investments that require specific knowledge e.g. for small firms or those that have a high risk profile. For such investments, much of the financing is likely to be domestic in origin – to paraphrase, home is where the money is. Conversely, debt financing (e.g. for residential mortgages) is less informationally demanding, and New

Zealand may be able to continue to access these funds.

So despite New Zealand's openness to international capital markets, domestic savings and foreign savings are far from perfect substitutes. Because of this, New Zealand's low household savings are likely to constrain investment in the productive base of the New Zealand economy. And the reliance on foreign capital is also likely to bias the type of investment made in New Zealand.

Indeed, the OECD report that New Zealand's business investment rates are consistently in the bottom quartile of the OECD – and are considerably lower than in Australia.

In terms of the destination of foreign capital, New Zealand received substantial FDI into the economy in the early and mid 1990s – largely into parts of the economy focused on the domestic market. However, net FDI

FIGURE 1: Household savings as a percentage of disposable income

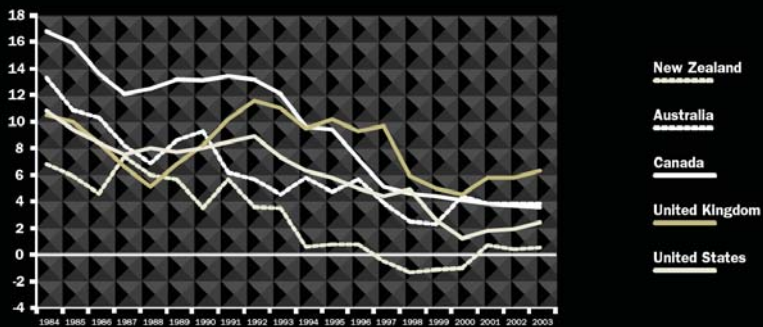
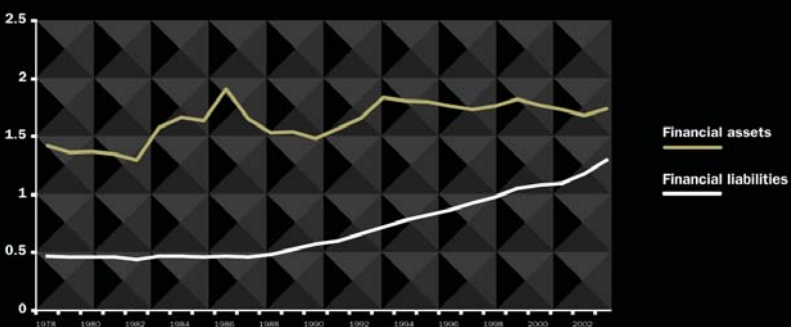


FIGURE 2: Household financial assets and liabilities as a percentage of disposable income



inflows are now very low. And many of New Zealand's listed companies already have very significant foreign shareholdings. Much of the capital inflows into New Zealand now are due to residential mortgage borrowing. Going forward, it does not seem likely that New Zealand can rely significantly on foreign savings to finance domestic investment into the productive economy.

Of course, low household savings is not the only constraint on domestic investment. The small size of the New Zealand market is likely to reduce the number of profitable investment opportunities, given that many New Zealand companies do not operate in export markets. Indeed, many New Zealand companies have a high dividend payout ratio – a signal of an absence of profitable investment opportunities. Expanding the effective size of the New Zealand economy e.g. through exporting is also important to increase investment – but domestic savings need to be available to finance this increased investment.

### Investment & Growth

Raising productive investment in the New Zealand economy is of critical importance in raising New Zealand's productivity and output growth. Simply put, for the New Zealand economy to grow at above average rates, above average rates of investment in the New Zealand economy will be required.

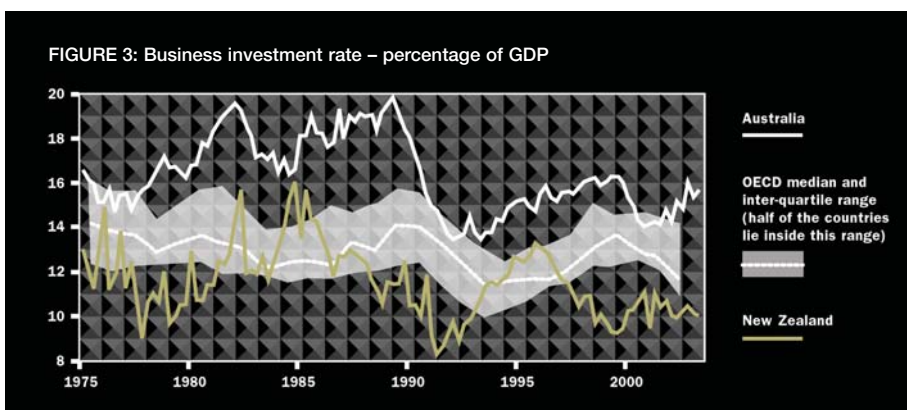
The low level of investment in the New Zealand economy is a key factor that


distinguishes the New Zealand economy from the Australian economy and also from other OECD economies. The IMF estimates that 75% of the difference in labour productivity between Australia and New Zealand is due to a lower level of investment in New Zealand.

Investment raises income by making workers more productive, and is also a vehicle for transforming the New Zealand economy by changing the mix of goods that are produced. Increasing investment is not simply about accumulating more capital to produce the same set of things.

Indeed, a common element of the experience of many small countries that have grown rapidly over the past few decades – like Singapore, Ireland, Finland, Australia – has been very high, sustained rates of investment. Investment has been used to transform their economies and to enhance their overall economic competitiveness. This contrasts with the New Zealand situation, with low investment and an economy that has not fundamentally changed over the past few decades in terms of the structure of economic activity, export mix, technological intensity and so on.

At the moment, much of New Zealand's strong economic growth is supported by consumption growth, the housing market, and commodity prices. The challenge is to transform the New Zealand economy into an economy driven by productivity growth, which can sustain high rates of





growth. A higher level of productive investment is an important part of making this transition.

Some of the capital required to finance this investment can be imported from foreign savers – but a good portion of it will need to be domestic capital raised through higher rates of household saving. It is very unlikely that investment can be substantially increased in New Zealand simply by relying on FDI or other forms of foreign investment.

### Concluding remarks

Increasing New Zealand's savings and investment rates is critical to transforming the New Zealand economy, and moving New Zealand from a consumption-led economy to a productivity driven economy. Just as few people or companies spend their way to prosperity, but rather get ahead through investing and hard work, so too national economies do not spend their way to economic transformation – it requires investment. And financing this investment will require increased household saving.

## ABOUT THE AUTHOR

### David Skilling

David is the Chief Executive of the New Zealand Institute. David was previously a Principal Advisor at the New Zealand Treasury where he worked primarily on economic growth issues. David has a Ph.D. in Public Policy, and a Master in Public Policy degree, from Harvard University, as well as Master of Commerce (Hons) degree in Economics and a Bachelor of Commerce degree in Accounting & Finance from the University of Auckland. He was a Teaching Fellow at Harvard University for three years, and has also worked at the OECD, McKinsey & Company, and Deloitte.

