

**Mr. Brash addresses the concern about New Zealand's balance-of-payments deficit** Address by the Governor of the Reserve Bank of New Zealand, Dr. Donald T. Brash, to the Canterbury Employers' Chamber of Commerce in Christchurch on 30/1/98.

### Introduction

I am delighted to be addressing you once again, on the last Friday of January. If my memory is correct, this is the fifth year in which I have done this, and I appreciate your tolerance in inviting me back each year. On previous occasions, I have addressed a range of issues, often relating to the exchange rate and to the question of whether monetary policy was too tight or too loose.

Today, I want to focus on one particular subject. Over the last few weeks, there has been heightened public concern about New Zealand's balance-of-payments deficit, triggered at least in part by media reports of comments made by the International Monetary Fund in the context of their recent review of the New Zealand economy. And this public concern is hardly surprising: at 6.4 per cent of GDP in the year to September 1997, New Zealand's current account deficit is already one of the highest in the world. The Reserve Bank's latest projections have that deficit increasing further to nearly 8 per cent of GDP in the year to March 1998, a level comparable with that in the crisis year of 1984, and closely similar to the deficit in Thailand's balance of payments before its mid-1997 difficulties. Moreover, our current account deficit is adding to a net stock of external liabilities which, at some 80 per cent of GDP, is already probably the highest of any developed country.

So the questions I want to address today are, first, do large current account deficits matter? And secondly, if they do matter, what should policy-makers seek to do about them?

### Do large current account deficits really matter?

There are a number of well-respected economists who argue that large balance-of-payments deficits are not something for policy-makers to be concerned about. They argue that a current account deficit is simply an indication that investment being undertaken in New Zealand exceeds the savings of New Zealanders and that, since the public sector is running a surplus, this excess of investment over savings simply reflects the decisions of countless individual New Zealanders in the private sector to borrow (or raise equity capital) to finance investment. In the longer term, this process will be self-correcting as either New Zealanders decide not to take on additional debt or foreigners decide not to extend additional credit. This view, in which the balance of payments is expected to adjust relatively smoothly, without the involvement of governments or central banks, is taken by such eminent economists as Max Corden and John Pitchford in Australia and Milton Friedman in the United States.

Even economists who do not take quite such a sanguine view of current account deficits as that concede that deficits are of much less concern today, with a floating exchange rate and the virtually complete abolition of the distortions which previously affected the allocation of investment, than was the case, say, prior to 1984. At that time, deficits were often the result of substantial fiscal deficits and had to be covered by government borrowing overseas in foreign currency. Today, of course, the government's accounts are in surplus. So what causes the sort of current account deficits that have recently provoked so much comment?

It is probably fair to say that today's deficit is in part the result of the enthusiasm which foreigners have had for investing in New Zealand. Not, I should stress, because foreign investment creates a current account deficit over the full life of the investment. On the contrary, I believe it can be shown that, after taking all the direct and indirect effects into account, most foreign investment in New Zealand actually tends to have a beneficial effect on the balance of payments.

Rather what I am saying is that, as foreign capital flows into New Zealand, it is matched by a current account deficit.

In other words, if there is a net inflow of capital, there must of necessity be a current account deficit. Because that is what a current account deficit actually means - it means there is a net inflow of capital. If the current account were in balance, there would be no net capital inflow. If the current account was in surplus, it would mean that there would be a net capital outflow. (Those who say, and many do, that New Zealand needs an inflow of capital to finance its future development are in effect saying that New Zealand must continue to have a current account deficit.) So in that sense, part of the reason for our current account deficit is simply a reflection of the enthusiasm which foreign institutions, companies, and indeed individuals have had for investing in New Zealand in recent years.

Some of this foreign investment has been in the form of so-called direct investment, involving a foreign company establishing a controlling interest in a New Zealand operation. As you know, there has been a very large amount of investment of this kind going back over many years - in banks, insurance companies, and manufacturing - while in recent years the rate of foreign direct investment has, if anything, increased - in telecommunications, food processing, hotels, forestry, commercial property, and transport.

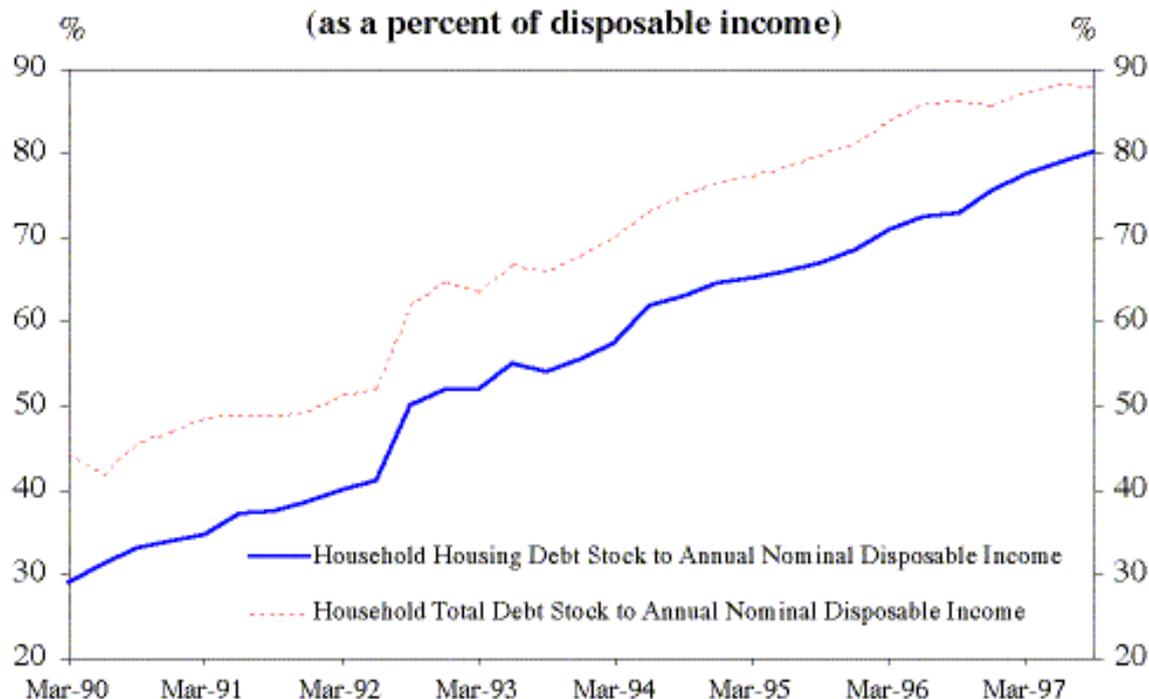
In addition, there has been an increasing flow of so-called portfolio investment from overseas - non-controlling investment in New Zealand equities, a huge investment in New Zealand dollar government securities, and most recently a very large investment in New Zealand dollar securities issued by overseas corporations and governments, the Eurokiwi and Samurai bond issues. These Eurokiwi and Samurai issues have, through the swap market, provided New Zealand banks with attractively priced fixed-term funding, keeping longer-term interest rates lower than they would otherwise have been and making possible the recent rapid growth in the fixed interest rate home mortgage market.

#### New Zealanders' enthusiasm for borrowing

But if this desire to invest in New Zealand on the part of foreigners had been the whole story, we might have expected to see interest rates in New Zealand at levels equal to or even below interest rates abroad, and asset prices - share prices in particular - at high levels by world standards as the impact of the abundant overseas capital swamped our small economy and readily met New Zealanders' demand for funds. Instead, while New Zealand interest rates have been very much lower in recent years than would have been the case had there been no capital inflow, they have tended to be higher than those in major capital markets, whether measured in nominal terms or in inflation-adjusted terms. The prices of shares and commercial property have tended to increase more slowly than those in many overseas countries. This suggests that, while foreign investors have been happy to provide capital, many have done so because New Zealand has offered unusually attractive yields. What is striking is the willingness of New Zealanders to pay those yields. At least part of the reason must lie in a strong demand for additional funds within New Zealand.

To some extent this demand has reflected strong investment activity in the corporate sector, as recent reforms have opened up profitable investment opportunities or have obliged companies to invest in cost-reducing facilities to improve their competitiveness. There has also been a strong cyclical recovery in investment spending after the 1991 recession. Strong investment spending widens the current account deficit in the short-term, but as long as that investment turns out to be profitable, any foreign capital tapped to finance it - whether in the form of debt, new equity, or retained earnings - will create no problems. In fact, corporate balance sheets in New Zealand have generally remained healthy after the stresses of the late 1980s and early 1990s.

**Graph 1**  
**Household Debt Levels**  
 (as a percent of disposable income)



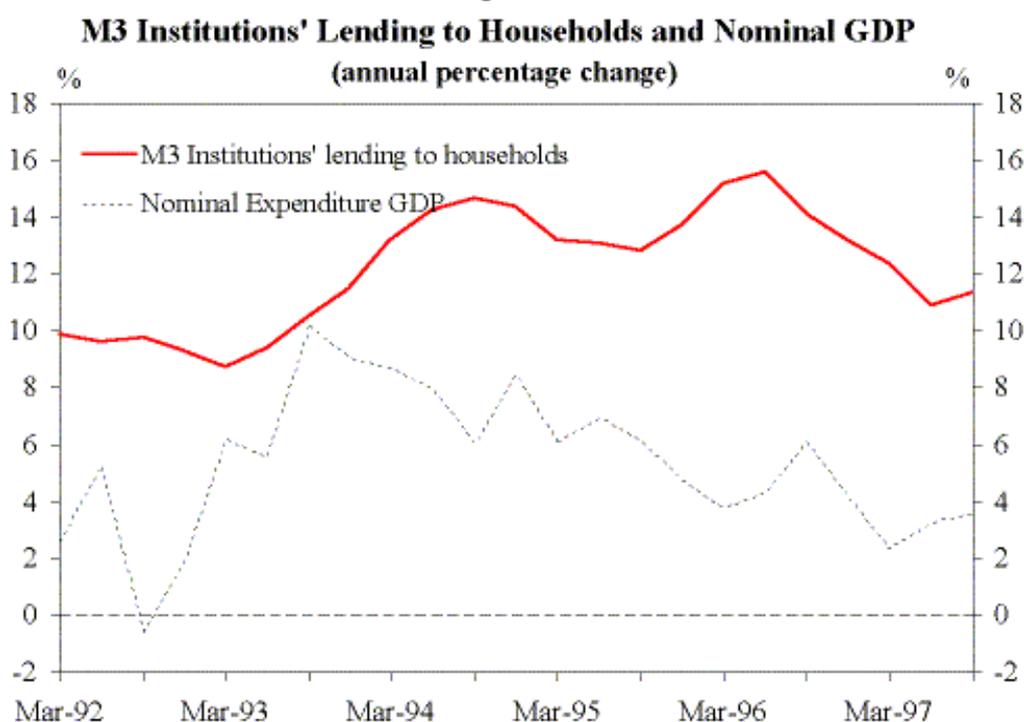
Note: The household total debt stock includes household debt (other) and household debt (housing). The household debt (housing) component captures loans made by MI institutions against the security of residential property for housing purposes. The household (other) component captures lending to households not secured against houses and lending secured against a home but which is known not to be for housing purposes.

But much of the demand for borrowed funds in recent years has come from the household sector, and has been secured by that favourite New Zealand financial instrument, the house mortgage. This borrowing has taken the ratio of household debt to household disposable income from a relatively low 42 per cent as recently as mid-1990 to almost 90 per cent currently (Graph 1) - from a level which was relatively low by international standards to around the levels of indebtedness seen in places like the United States. It has also taken the share of loans extended to the household sector from 31 per cent of total bank loans to 52 per cent of the total over the same period, an increase in the dollar amount from \$16 billion to \$50 billion in just seven years. As Graph 2 illustrates, lending by major financial institutions to the household sector has been growing markedly more quickly than nominal GDP throughout most of this decade.

Some of the borrowing by the household sector has been undertaken as a relatively cheap and efficient way of funding small businesses owned by the household sector, and to that degree is 'mislabeled' as household sector borrowing. But for the most part, the rapid growth in household indebtedness appears to have helped make possible the rapid rise in house prices seen in much of the country in recent years and, as employment, incomes, and wealth have risen, strong consumption growth.

Obviously, this sort of strong growth in lending to households cannot continue indefinitely, but while it does there is likely to be pressure on our external accounts. Credit, after all, is designed to allow us to increase our investment without sacrificing current consumption, or alternatively to increase consumption now in the expectation of higher income in the future. Both of these mean enjoying now a level of consumption beyond what is produced locally: and in simplified terms, that is what a current account deficit is.

**Graph 2**



Other things being equal, a strong demand to borrow tends to push up interest rates. It is those pressures which then draw in foreign capital. The capital inflow in turn tends to check the extent to which interest rates rise in response to the strong borrowing demand.

The willingness of foreign investors to provide capital allows us, as a nation, much greater flexibility in making our own spending and investment decisions. But of course, the foreign investors expect to earn a return on the funds that they invest in New Zealand, and by using those foreign funds we are taking on an obligation to pay interest or dividends on the capital used, just as we do when we use funds from a domestic source. If we use the capital unwisely, then we compromise our future prospects, and that is no different when talking about four million people as a group than it is when we talk about people individually.

### The lessons of Asia

The key issue at the moment is whether a current account deficit approaching 8 per cent of GDP, well above the 5 percent of GDP sometimes regarded as being dangerous, should be of concern. And the answer appears to be 'not necessarily'. Singapore ran a current account deficit averaging 10 per cent of GDP for 20 years from 1965 to 1985, while Canada ran a deficit which exceeded 5 per cent of GDP for most of the 43 years from 1870 to 1913.

But what about the recent lessons of Asia? What about the risk that foreign capital might suddenly flow out again, with disastrous consequences for New Zealand banks, New Zealand corporates, and the New Zealand dollar? Indeed, hasn't the New Zealand dollar already been dragged down because of foreign concerns about our links with Asia?

Let me correct one misapprehension at once. Yes, as of the middle of this week, the New Zealand dollar had declined by some 17 per cent against the US dollar since 1 January 1997, but this is closely similar to the extent to which the Australian dollar had declined against the US dollar over the same period (15 per cent), and was from levels at which the New Zealand dollar was widely

regarded as being significantly over-valued. In fact, virtually all currencies have depreciated against the US dollar over the last year or so. This is simply another way of saying that the US dollar has itself appreciated against virtually all currencies. By comparison to the 10 to 20 per cent depreciation of most currencies, including the New Zealand dollar, against the US dollar, the currencies of many East Asian countries have fallen very much more sharply - by 44 per cent in the case of Malaysia, by 50 per cent in the case of South Korea, by 52 per cent in the case of Thailand, and by 84 per cent in the case of Indonesia. Neither New Zealand nor Australia has had an experience even remotely similar.

It is worth looking briefly at some of the factors which have provoked recent problems in Asia because understanding these factors helps in understanding why the sorts of vicious corrections we have witnessed in Asia are not likely to happen here.

There appear to have been three factors in particular which caused what seemed initially like a localised currency crisis in Thailand to spread so quickly to embrace many parts of Asia:

- \* First, a serious lack of transparency in many Asian countries and markets, which made it difficult for investors to assess and understand the risks they were assuming, and which contributed to the speed at which confidence collapsed as soon as bad news began to appear.
- \* Second, fairly widespread evidence of poor credit evaluation by banks and other intermediaries, perhaps in part a result of the often-close connections between governments, banks, and big business, and in part a result of over-confidence and carelessness borne of decades of strong economic growth. (Paul Krugman has suggested that the willingness of banks to take on high credit risks was in large part the result of the perception that the liabilities of banks were effectively government-guaranteed, and that the moral hazard created by this perception was itself the cause of grossly inadequate credit evaluation.)
- \* Third, the widespread maintenance of pegged exchange rates, which compromised the ability of the countries concerned to maintain adequate monetary control when faced with very large capital inflows, and which seriously complicated financial management when problems began to emerge.

#### New Zealand different from Asia in several crucial respects

Of course, capital could flow out of New Zealand, and it would be a brave (or foolhardy) central banker these days who would claim 'it can't happen here'. Foreign investors could decide to sell-up and leave New Zealand, and indeed New Zealand investors could do likewise, in the absence of any controls preventing them from doing so. But I don't think we are afflicted by any of the particular Asian problems I have just mentioned.

To begin with, a rapid outflow of capital is very unlikely if the policy framework remains sound and transparent and if those who are the recipients of the foreign capital inflow remain creditworthy.

In that regard, there is no sign of the policy framework here being changed. Almost all political parties are committed to the retention of the current transparent and independent monetary policy framework, established without dissentient vote in Parliament in 1989. Almost all political parties recognise the importance of continuing to run fiscal surpluses at this stage of the demographic cycle, and the high level of fiscal transparency is simply not a political issue at all. Almost all political parties are committed to an internationally open and competitive economy.

And as far as creditworthiness is concerned, one of the major 'borrowers' - to the extent that foreign investors have bought New Zealand dollar government securities on the New Zealand market - is the government itself. The government has become markedly more creditworthy in recent years, as the ratio of net public sector debt has declined from around 52 per cent of GDP in the early 1990s to some 27 per cent currently. In the private sector, banks have on average strengthened their total capital position since the beginning of the decade, and all registered banks comfortably exceeded both the tier 1 and total capital ratios prescribed by international agreement as at the last date for which we have complete data (30 September 1997). All but two of the banks are rated by one or more of the international credit rating agencies, with the four largest banks all enjoying an S&P rating of AA- or better. In addition, of course, almost all the banks operating in New Zealand have the backing of financially strong overseas parent banks. Among corporates, balance sheets are probably as strong as they have been at any time in the last two decades. It is in the household sector that balance sheets are probably becoming most extended, after seven or eight years of strong borrowing, but international creditors are protected from potential bad debt problems in that sector by the fact that the foreign capital which has, in effect, been lent to ordinary household borrowers has been channelled through the banking system, and, as indicated, our banks are in robust condition.

So there seems little reason for any sudden loss of confidence leading to capital flight.

Secondly, even if there were to be a sudden flight, leading to a sharp depreciation in the New Zealand dollar, the result would be very different in one important respect from what we have seen in some Asian countries in recent months. In those Asian countries currency weakness led to very serious problems because, previously, as I have noted, currencies had been actually or virtually pegged to the US dollar. This led borrowers to take on large unhedged US dollar liabilities - these looked very cheap at the time and, with the explicit or implicit guarantee that there would be no currency depreciation, devoid of currency risk. When as so often happens the countries concerned were forced to abandon their peg to the US dollar and the currencies fell sharply as a consequence, the losses which both banks and corporates sustained were often huge, threatening many of them with insolvency and collapse. (Indeed, the losses were magnified because, with sharply increased liabilities expressed in local currencies, borrowers rushed to sell assets, which tended to push down asset prices sharply as well.) These large losses in turn tended to further reduce investor confidence, and accelerate the capital outflow.

By contrast, much of the foreign capital inflow into New Zealand has been either in the form of equity investments, with no currency risk borne by the company receiving the capital, or in the form of New Zealand dollar borrowings, by government and banks. The quarterly disclosure statements published by New Zealand banks show that they have little in the way of unhedged foreign exchange positions and, although I do not have detailed information on which to make a dogmatic assertion, I would be fairly confident that the unhedged foreign exchange liabilities of New Zealand corporates are very small. They have been operating for too long in a freely floating exchange rate environment to be unaware of the risks, and indeed some still recall the losses they sustained by borrowing in low interest foreign currencies in the 1970s and 1980s when the New Zealand dollar itself was pegged.

A third point to note is that, if a capital outflow did occur, interest rates would rise sharply as a result and it is very likely that the combination of sharply lower exchange rate and markedly higher interest rates would quite quickly reduce the current account deficit. The Reserve Bank might well be blamed for the sharp rise in interest rates, and to be sure we would not be at all opposed to such an increase since if the exchange rate fell sharply a marked increase in interest rates would be needed to keep inflation under control. But it is also true that, unless the Bank moved to pump money into the economy aggressively, any sharp outflow of capital, whether owned by foreigners or owned by New Zealanders, would necessarily result in a sharp increase in interest rates,

since those selling New Zealand securities and other assets would be forced to increase the yields offered on those assets in order to encourage others to buy them.

In other words, with a floating exchange rate, investors (whether foreign or local) wishing to sell out of New Zealand assets or the New Zealand dollar need to find private sector buyers to sell to. The central bank is not going to be supporting the price of the New Zealand dollar, or of New Zealand bonds, or of New Zealand shares.

And of course, although capital outflow can alter the price of assets, foreign corporate owners can not take the land and buildings which they own with them. Those assets would remain in New Zealand, with their ownership changing from foreign to local.

Whether or not an outflow of capital was 'painful' and disruptive would depend very much on the magnitude and speed of the outflow. If, as seems quite unlikely, it happened on a large scale and over a short period, the adjustment could involve markedly higher interest rates. Companies exposed to interest rates and not benefiting from the fall in the exchange rate would be put under pressure, and some might well collapse, notwithstanding their currently-strong balance sheets. This would be part of the process of reducing the current account deficit, as resources were displaced from domestic or non-tradeable parts of the economy and enticed back into exporting and import-replacement industries. Household borrowers, especially those with variable rate mortgages, could also face some very sharp adjustments to their spending patterns.

So the deficit is not a matter for alarm, but we should not be complacent.

So in answer to my first question, namely, whether our large current account deficit matters, my answer is that it isn't a matter for great alarm at present. The deficit in part reflects international enthusiasm for investing in New Zealand, and in part a judgement by many thousands of New Zealanders that there are attractive investment opportunities in New Zealand which are worth pursuing with borrowed funds (especially in the housing sector) and perhaps a judgement that future incomes will rise sufficiently rapidly to support a higher level of consumption spending now. There are market mechanisms which generally succeed in reconciling the intentions of individual households and firms with the interests of the nation as a whole. Some other countries have experienced similarly large deficits for years on end without ill effect, although it is not common to sustain for too many years a large current account deficit, in a floating exchange rate regime, without particularly high GDP growth rates.

Moreover, we are well placed to weather any capital outflow which might eventuate. While a current account deficit of about the present size was associated with a foreign exchange crisis in 1984, that situation was one where the Government was trying to maintain a fixed exchange rate against a widespread belief that the exchange rate was over-valued. Today, with the exchange rate freely floating and able to adjust, month to month and hour to hour, to reflect changes in demand and supply, the situation is fundamentally different.

But we should not be complacent. The size of our accumulated external liabilities does, as the IMF has suggested, make us somewhat vulnerable to unpredictable external shocks, or to a sudden loss of confidence for whatever reason. It puts a premium on maintaining the confidence of markets that New Zealand remains a safe place in which to invest, and means that the quality and transparency of economic and financial sector policies are crucial. In a situation where much of the capital inflow has, in effect, found its way into financing consumption, higher house prices, and residential investment, rather than into much higher investment in directly growth-enhancing sectors, we would be unwise to assume that we can sustain a deficit at around current levels indefinitely. Much will depend on the rates of economic growth we are able to sustain: the results in recent years have been encouraging, but to adopt a cricketing analogy, the innings is really just getting underway.

If we want to reduce the deficit, what needs to be done?

If as a country we want to reduce our vulnerability to external shocks by reducing first our current account deficit and then, over time, our high ratio of net external liabilities to GDP, how could this be done?

The first point to reiterate perhaps is the one which the Corden/Pitchford/Friedman school would probably make, and that is that, because the public sector is in surplus, our current account deficit reflects decisions being made in the private sector to take on more liabilities. This will not continue indefinitely, since at some point we are likely to find either borrowers deciding that they have taken on enough debt or lenders making that decision for them! New Zealand has already seen a very strong increase in the ratio of household debt to household disposable income, as already noted. This has seemed prudent to thousands of New Zealanders, partly because house prices have increased strongly in recent years. And while to some extent it does make sense to anticipate future income growth, the ratio of house prices to incomes is currently at historically high levels - the sort of levels reached in the mid-1970s, just before the very sharp fall in real house prices in the second half of that decade, or in the United Kingdom before the savage correction in the late 1980s and early 1990s. If New Zealand house prices were to falter, even more if they were to fall back somewhat over the next year or two, as several commentators are now suggesting is very likely, we could quite quickly see a rapid slow-down in the growth of household sector borrowing followed by a down-turn in investment in housing and a rather broader slowdown in consumer spending. This would in turn quite quickly produce a reasonably rapid reduction in the current account deficit, both as the demand for imports fell away and as the profitability of foreign companies operating in New Zealand dropped. Any policy issue would disappear.

But supposing this does not happen in the near future. Are there measures which policy-makers should be considering to reduce the deficit?

We know from long and bitter past experience that imposing direct controls on imports is no solution. Unless matched by measures to reduce domestic spending power, consumers initially spend on items other than controlled imports in such a way that exports tend to be reduced and other imports increased. The balance of payments is not helped. Moreover, in time New Zealand producers invest in the production of the items subject to import controls, and since these items are almost by the nature of the case expensive to make in New Zealand, productivity suffers and efficient exporters are severely hindered. There is no solution in trying to license or control imports.

#### The key challenge: how to increase national savings

Since at root a balance-of-payments deficit is an excess of investment over saving, any attempt to reduce the deficit must either look to reduce investment or to increase saving. I will assume that reducing investment is hardly an attractive policy option given the constant pressure for a higher standard of living and more jobs, which leaves us with the question of how to increase savings in New Zealand. And I can't stress too strongly that, fundamentally, reducing the current account deficit is ultimately about how we might increase total national savings relative to national investment.

For a great many years, the public sector was a net dis-saver in New Zealand, as indeed it still is in most countries in the world. This was reflected in a considerable build-up in net public sector debt, to a peak of some 52 per cent of GDP in the early 1990s, as I have already mentioned. Partly as a result of the sale of government assets but mainly, since 1993/94, as a result of running budget surpluses, debt has been roughly halved in relation to GDP and at the present time the public sector is making a contribution of some 1.5 per cent of GDP to our total national saving effort. This is a very much better performance than that of virtually any other developed country (the

exception, as to so much else, is Singapore), but it is a markedly smaller contribution to national saving than the public sector was making in, say, 1995/96. In that year public sector saving amounted to 3.7 per cent of GDP. So in the last couple of years the trend in public sector saving has been unhelpful in terms of the balance-of-payments deficit, a reflection of a strong increase in public sector spending over the last two years and a reduction in tax rates. One way of reducing the balance-of-payments deficit might be to increase the public sector surplus again, although nobody should under-estimate the difficulties of doing that in a country where pressure to increase government expenditure is relentless.

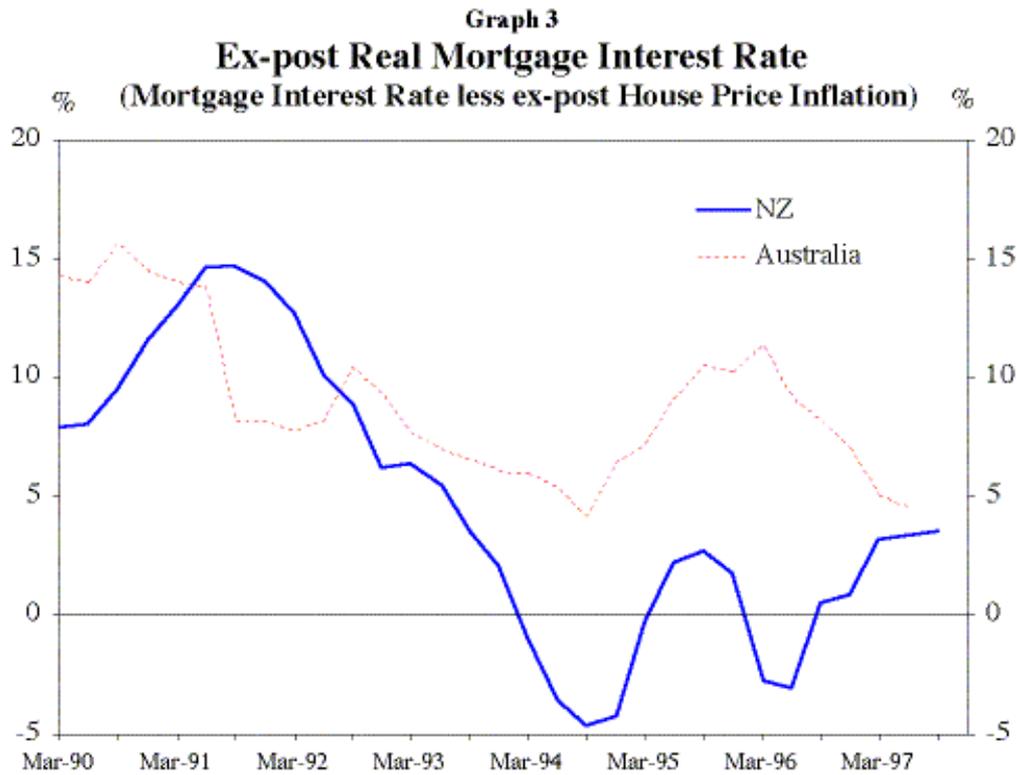
New Zealand's record of household sector savings seems to have been relatively poor for many years. There have doubtless been many reasons for this. In the high inflation 1970s and early 1980s, when many interest rates were controlled at artificially low levels, the after-tax real return on savings invested in fixed interest securities was strongly negative, creating a strong disincentive to save. This situation changed markedly in the mid-1980s, with positive after-tax real interest rates, but at about the same time financial sector liberalisation greatly increased the ability of many households to borrow; this too almost certainly discouraged net saving. And of course for most of the last half century New Zealanders have been encouraged to believe that the things for which people save up in many other countries - education, medical care, and retirement - would largely be taken care of by government. We were effectively told: you don't need to save and, by the way, if you do, you're a fool, because government-sourced inflation will steal a large chunk of what you save anyway.

I'm frankly not sure how this culture of low household-sector saving can be changed. Clearly there is a significant section of the community that has no surplus income at all. To suggest that a solo parent living on benefit has scope for increased saving is absurd, and would be presumptuous in the extreme coming from me. But it is also true that too many New Zealanders on higher incomes still have attitudes to their personal finances that only made sense in the high inflation 1970s and early-1980s. The mind-set was that only a fool had personal savings, and the quick and the clever were in debt up to their eyeballs. Indeed, those attitudes were sensible from an individual's point of view, with negative real interest rates and rising asset prices. Those attitudes no longer make sense.

Part of the problem in recent years may have been the less-than-ideal mix of monetary conditions, with interest rates too low to encourage saving or discourage borrowing and with the exchange rate too high to allow the export and import-competing sectors to grow. This mix of monetary conditions was particularly unhelpful when most of the inflation pressures were in the domestic parts of the economy, especially the housing sector, and not in the export and import-competing sectors. The Reserve Bank began to tighten monetary policy early in 1994 to head off the inflationary pressures which we projected at that time. By the end of that year, 90 day interest rates had risen from around 4.5 per cent in January to close to 10 per cent, while the exchange rate had increased from 57 on the trade-weighted index (TWI) to 60. Through the next nine quarters, to the end of March 1997, interest rates never went much above 10 per cent, but the exchange rate continued to increase until the TWI reached 69. As a consequence, lending by major financial institutions to the private sector continued growing at rates more than double that of nominal GDP growth. In other words, although the exchange rate was putting great pressure on the exposed parts of the economy, interest rates were not nearly high enough to restrain a huge surge in private sector borrowing.

But hold on, you may be saying. Don't we have some of the highest inflation-adjusted interest rates in the developed world? And so we do, if one compares interest rates with inflation in the CPI. But of course few of us borrow to buy the goods and services in the CPI basket. Rather, most of us borrow to buy assets, and particularly real estate. And when our interest rates are compared with changes in an index of house prices, as shown in Graph 3, it can be seen that our

mortgage interest rates adjusted by house price inflation have been very low in recent years, and well below those in Australia. For whatever reason, our real interest rates have not been seen as particularly high by New Zealanders - despite all the protests to the contrary. If they had seemed high, we would not have been increasing our borrowings by 10 to 15 per cent per annum, and we would have been increasing our saving. As noted earlier, the ratio of household debt to household disposable income has more than doubled over the last seven years, and most of this increase has had nothing to do with buying food and other necessities.



However, central banks have very limited ability to influence the mix of monetary conditions. This is ultimately determined by the decisions of countless thousands of individual investors here and abroad, and by the actions and expected actions of other central banks.

As I have acknowledged previously, we gave some consideration when the exchange rate was at its peak in early 1997 to undertaking some form of so-called sterilised intervention in an attempt to reduce the exchange rate and increase interest rates - without risk to the inflation objective - since most of the inflationary pressures were coming from sectors relatively immune from exchange rate pressure but more susceptible, we believed, to interest rate pressure. But most of the international evidence suggests that such sterilised intervention has little lasting effect unless it is simply a precursor to an easing of overall monetary policy.

I believe that the introduction of the Monetary Conditions Index in December 1996 may have helped to change the mix of monetary conditions to some extent by eliminating the impression which had grown up that we had an exchange rate target as well as an inflation target, but even this is by no means certain.

If the central bank can not do much to improve our national saving performance, could the Government do more? I have already mentioned the importance of the Government itself continuing to run fiscal surpluses. There are almost certainly other policies which would have an effect on private sector saving performance.

For example, there may be some scope to further reduce our relatively heavy dependence on raising government revenue from the taxation of income, in favour of relatively greater reliance on taxes on expenditure, thus increasing the incentive to produce and save. Unfortunately, there is very little evidence that specific tax incentives for saving would increase overall private sector saving (as distinct from changing its form), and some evidence that national saving would actually be diminished by such incentives, because of the cost to public sector savings of providing the tax incentives.

There is probably an on-going need to encourage New Zealanders to take more responsibility for their own future, though how this can be done after so many decades of encouraging them to believe that doing so is entirely unnecessary is a political challenge of mammoth proportions. At very least there is a pressing need for a multi-party consensus both to reassure New Zealanders that future governments will be able to provide a basic safety net for all in retirement, and to make it clear that those wanting a more comfortable lifestyle in retirement need to start saving now.

There is also the superficially attractive option of attempting to widen the gap between New Zealand interest rates and those overseas through some direct policy measures. If this could be achieved, the argument runs, New Zealand interest rates could be driven up to the point where New Zealanders were encouraged to kick the borrowing habit without provoking a huge inflow of foreign capital and the related increase in the current account deficit. This is a route which Chile, for example, has followed, requiring a part of all monies borrowed overseas to be deposited for one year in a non-interest-bearing account with the central bank. Others have noted the possibility of reintroducing a withholding tax on interest payments to foreigners. Such proposals should be treated very cautiously. Not only would there be significant administrative problems in ensuring compliance with such measures but the longer-term costs of undermining investor confidence in New Zealand's commitment to free and open capital markets would weigh heavily against any possible shorter-term adjustment gains.

Alas, none of the possible policy changes to encourage private sector saving - or reduce private sector borrowing - is politically easy. But then living beyond our means carries risks as well. I myself do not think that these risks are terribly large at present, but the longer we continue living beyond our means, the greater those risks become.

New Zealand is relatively prosperous, is well-endowed with educated people, and has natural resources which many others would give their eye teeth for. It is not obvious to me that we should be content to be a heavy user of the savings of others indefinitely, especially when a significant part of those foreign savings is being used not to generate faster economic growth but simply to buy ourselves larger houses.