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Removing the upwards bias on interest rates is the only way to bring equilibrium to the balance of payments.

The elephant in our economic lounge we too readily pretend is not there is a current account deficit that annually increases our external debt relative to GDP, and is not in the foreseeable future going to get small enough to reduce New Zealand's debt-to-GDP ratio.

While the precise significance of the external debt as an economic performance indicator is a moot point, there is a widespread feeling some part of the New Zealand economy smells bad; it might just be that elephant.

Few, if any, of our economic policymakers really seem to understand why our external debt is as high and as intransigent as it is. The best most policymakers and journalists seem to be able to come up with is we are, increasingly, a nation of spendthrifts.

The core problem we face is the percentage of our GDP that must be spent on debt service keeps increasing. That percentage is the difference between GDP and GNI (gross national income), and, in the year to June 2007, was 7.1%.

More than 7% of New Zealand's GDP is claimed by foreigners. While interest rates and exchange rates have a direct impact on that figure, essentially it represents the cost of our external debt. (As well as working to pay the taxman, every fulltime worker works three hours per week to simply service the external debt.)

Indeed, that cost keeps rising, because our external debt as a percentage of GDP, keeps rising.

The main reason our indebtedness to the rest of the world keeps rising is we borrow all of the funds required to service that debt, plus an additional amount that enables us to import more goods and services than we export.

GNE (gross national expenditure) is 101.4% of GDP. More importantly, GNE is 109.2% of GNI. In the year to June, New Zealanders spent 9.2% more than New Zealanders earned. While existing debt will have fallen as a share of our rising national income, this additional 9.2% represents a significant increase in our future annual debt-servicing liability to foreign investors.

Why do we spend so much? Are we genetically programmed to overspend? Did we suddenly become much more spendthrift from 2004, when the excess of GNE over GNI really started to take off?

The answers to the latter two questions are "no" and "no". We react (rationally) to the price signals we are presented with, just as people of any other nationalities or ethnicities would.

The balance of payments represents a mathematical identity; something that is always true by definition.

The identity is as follows:

Annual Current Account (CA) + Annual Capital/Financial Accounts (KA) = change in Official Reserves (AR), where the current, capital and financial accounts taken together represent the Balance of Payments (BOP), and the capital/financial accounts represent net foreign investment.

Under a fixed exchange rate regime (New Zealand before March 1985), official reserves are the balancing item. (Official reserves represent a part of a country's monetary base, but that is incidental to our purpose of understanding what causes what in the balance of payments.)

Thus an inflow of either export receipts or foreign investment causes official reserves to increase.

Under fixed exchange rates, a balance of payments deficit would cause official reserves to decrease, possibly to unacceptably low levels. In this situation, a government would have to restore the balance by borrowing from financial markets abroad (as the Rowling and Muldoon governments often did), or devalue the currency (as they also did on a number of occasions).

A devaluation would restore the balance of payments by increasing the current account, through increased exports and decreased imports.

Under floating exchange rates, everything changed except the basic mathematics of the balance of payments identity. The idea was official reserves should no longer be the balancing item.

Under a "clean float", essentially what New Zealand had from March 1985 to June 2007, official reserves would not change.

Rather, a balance of payments surplus would create an excess demand for the New Zealand dollar, which would then appreciate. A balance of payments deficit would create an excess supply of New Zealand currency, which would then depreciate.

Then, much as in the case of a devaluation, final adjustment would take place through the current account (through changes in export receipts and import payments).

Under floating exchange rates, the balance of payments identity becomes: Annual Current Account (CA) + Annual Capital/Financial Accounts (KA) = 0, with final adjustment taking place through the current account.

The assumed (though rarely stated) wisdom is New Zealand's balance of payments problem (an unsustainably large current account deficit) is caused by New Zealanders being spendthrift by nature and suddenly (that is, autonomously) becoming more spendthrift (for instance, sometime around 2003 or 2004).

If that were true, we would in 2004, have seen the CA fall (that is, become even more negative), followed by a fall in the exchange rate, followed by a restoration of the CA to what it had previously been.

It is because of the simplicity of this adjustment method that we chose to float the dollar in 1985.

However, the principal story of New Zealand's balance of payments since 1985 relates to two other things that also happened in 1985.

The first was the deregulation of New Zealand's banking sector and financial markets. The second was the introduction of a monetary policy regime that explicitly focused on inflation reduction as its major objective, and was willing to raise interest rates to hitherto unknown heights as a means of achieving that objective.

Both events caused autonomous increases in the capital/financial accounts.

Because of the laws of mathematics, a rise in the capital account had to be met with a fall in the current account. The appreciating currency was the mechanism by which this adjustment took place.

In other words, an autonomous inflow of net foreign investment necessarily induced an increase in the current account deficit.

The banking sector eventually settled down, but monetary policy practices entrenched in the 1989 Reserve Bank Act retained their bias in favour of high interest rates. It is that historic (since 1985) upward bias in interest rates that has generated net inflows in foreign investment in most years; hence the bias in favour of appreciating exchange rates and increased current account deficits.

We have to stop blaming New Zealand households for a major economic problem that is not their fault. Indeed, had New Zealanders spent less and saved more (as we have been exhorted many times to do), the exchange rate would have had to rise to higher levels to restore balance to the balance of payments. (Remember that payments balance when $CA+KA = 0$; if an already-positive KA increases then an already-negative CA must decrease further.)

The only way that New Zealand can restore some semblance of sustainability to its balance of payments current account is to remove the upwards bias on interest rates. The ball is firmly in the court of the Reserve Bank and its doubles partner, the government, which writes the Policy Targets Agreement which the Reserve Bank must implement.

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CAPTION:

Blind spot: It's a jumbo problem. As well as working to pay the taxman, every fulltime worker works three hours per week to simply service the external debt.

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