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### **Correcting New Zealand's External Imbalance**

In his early budgets, former finance minister Michael Cullen worried a lot about the deficit in the current account of the balance of payments.

In the five years before he came into office the annual deficit averaged just over 5% of GDP. He left office with deficits at record 8-9% levels.

The current account balance is the difference between what the country exports and what it imports and pays on net overseas borrowing. Statistically, it is also equal to the difference between investment and savings – if national investment is higher than national savings, the deficit is funded from external borrowing.

The pattern of surpluses and deficits of other countries influences New Zealand's external balance.

Dr Cullen saw the current account deficit largely as a deficiency of savings. This predisposed him to running large government surpluses (a component of national savings) and to interventions such as the Cullen superannuation fund and KiwiSaver.

However, savings is only one influence. A balance of payments deficit might also reflect high investment, low exports relative to imports (because of a loss of international competitiveness), or low national income relative to spending, perhaps because of excessive government spending.

How can we adjudicate between such views? We have some diagnostic tools.

For example, if there is a competitiveness problem we would expect to see a cost-price squeeze on internationally competing industries via increasing relative unit labour costs, a higher real exchange rate or faster inflation in non-traded goods than in traded goods. This would lead to slow growth in

exporting and import-competing activities relative to growth in sheltered sectors (such as housing).

We would also expect international agencies to be reducing New Zealand's ratings for international competitiveness.

Similarly, if the problem is due to government policies that favour spending over economic growth, we might expect to see the share of government spending on goods and services in the economy growing.

All these things happened on Dr Cullen's watch. There was a marked decline in the statistical measures of competitiveness. The export sector of the economy has been in recession for the last five years while imports surged. The share of government spending in the economy grew from 2001, and the current account deficit increased sharply from around the same time.

None of these developments is necessarily due to a 'savings deficiency'. Statistics New Zealand data show no trend decline in the national savings rate in the last 30 years. It has been roughly on a par with the rates of the United Kingdom and the United States. Although it declined somewhat after 2004, the loss of competitiveness and the widening of the current account deficits commenced earlier.

Moreover, there is no 'right' level of saving, and how people split their income between consumption and saving is not the government's business.

In short, Dr Cullen appears to have misdiagnosed the problem and consequently failed to solve it. The new government is on sound ground in scrapping contributions to the Cullen fund and winding back KiwiSaver subsidies (which Treasury estimated would reduce national savings).

Concerns about saving would be better focused on the incentives arising from policies such as free or heavily subsidised health and education and tax-funded superannuation and welfare. Why save if the government is doing the job for you?

The Cullen legacy of large current account deficits put our credit rating at risk and left the country exposed to external funding constraints with the international financial crisis.

Fundamentally, reducing the current account deficit requires increasing exports and import-competing production relative to production for the domestic market.

The rest of the world has been marking down our exchange rate, signalling the need for such a rebalancing of the economy.

Policy actions to date are facilitating this rebalancing. The government is seeking to reverse the trends in government spending and cost-increasing regulation that did so much to reduce international competitiveness.

Central and local government account for a significant share of the non-traded goods sector of the economy. Reining in government spending is an important means of releasing resources for employment in traded goods production.

Arguably, faster adjustment to cope with the precarious state of the external accounts is called for.

In the current environment, anything that reduces economic flexibility and impedes rebalancing increases external risks and makes the task of reversing the slump in productivity growth harder.

Policies relating to labour and capital market regulation, competition law, resource management, infrastructure, the responsiveness of the education system and welfare policies, as well as government spending, should all be up for review.

We need to see our exposed industries expanding, not stagnating, while the government reduces its claims on resources and increases productivity in the sheltered sectors that it dominates.

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