

National Party Kapiti Electorate Committee

A Rattle of Teacups?

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A RATTLE OF TEACUPS?

I recently read a story about Albert Einstein queueing to enter heaven. He meets three men and asks them about their IQs. The first replies 190. "Wonderful," exclaims Einstein. "We can discuss my theory of relativity." The second answers 150. "Good," said Einstein. "We can discuss the prospects for world peace." The third mumbles 50. After a pause, Einstein inquires: "So what is your forecast for growth in GDP next year?"

The story probably sums up most people's view of economic forecasters. As someone once said, forecasting is always difficult, especially about the future. For reasons that I will try to explain, I think there is reason to be suitably cautious in predicting New Zealand's economic outlook over the next few years. There are grounds for both optimism and pessimism.

The grounds for optimism are that New Zealand has been engaged in a programme of economic reform since the mid-1980s which, if persisted with, will greatly improve our economic and social position. Few people today dispute the fact that New Zealand had to change course. Since the early 1970s virtually all the indicators of economic performance - productivity, growth in output, inflation, internal and external debt, unemployment and others - were poor and/or deteriorating. With the institution of the wage-price freeze, nearly all the signalling mechanisms of a market economy were suspended. We were becoming the economic equivalent of a Polish shipyard.

New Zealand has attracted attention around the world for the thoroughness and the quality of its economic reform programme. It features repeatedly in the business and financial press. Recent examples include the *Australian Financial Review* which reported on the switch from "an old East European-style economy to a radically deregulated, market driven one". An article in the London *Financial Times* praised the transformation "from a heavily protected, over-regulated, high inflation economy to one of the most open in the world". There is some exaggeration in these judgments, as I shall suggest later. Nevertheless, they highlight the fact that New Zealand is in the international mainstream in its pursuit of an open, internationally competitive economy capable of much greater economic and social success.

The transition has inevitably been a difficult one. As an *Australian Financial Review* editorial put it, "there was never any chance that New Zealand could change course without painful disruption". The task has been made harder by the fact that until recently the policy framework lacked consistency and we stopped for an extended teabreak along the way. Yet the difficulties of transforming a highly distorted, debt-ridden economy living beyond its means need to be put in perspective.

Our experience has been of an economy in which output has been static over the last five years and where unemployment has grown from 5 percent to nearly 11 percent of the labour force. We could have done a lot better if we had not suffered from the disastrous 1985 wage blow-out and the excesses that followed financial market deregulation, and if the previous government had not neglected the vital areas of labour and social policy reform and had reversed the upward trend in government spending. Even so, a static level of output means that, while production fell in some industries due to recession and restructuring, there was at least an equal and

offsetting growth in production in new and expanding industries. Now there is overall growth.

Compare this experience with that of the former Soviet Union. Last year the Russian gross domestic product declined by 17 percent. Over three years the GDP of the former Soviet Union will have declined by almost half. Inflation is running at 600 percent, and some observers believe as much as a third of the workforce will probably end up unemployed - in a country which traditionally denied the existence of unemployment and therefore has no safety net. The policy reforms being implemented are far from adequate and the outlook can only be viewed with deep pessimism. Russia will be lucky to avoid a full scale economic and political crisis over the next couple of years.

The OECD, which has a major role in advising governments in the ex-communist bloc, last reported on the New Zealand economy at the time that the present government assumed office. By no stretch of the imagination can its views be regarded as radical or extreme. It reflects the collective experience of its member governments, the advanced industrial countries. The OECD's advice was fully in line with the views of our organisation.

The report stressed the need to attend to the major weaknesses in the labour, social policy and government spending areas. It concluded:

"To build on the reforms of recent years and to underpin the much-needed improvements in the country's medium-term growth prospects, it is essential for New Zealand to consolidate and extend the policy orientation pursued since the mid-1980s."

This reflection of the consensus of international thinking is worth considering against the background of allegations that economic policy in New Zealand has been hijacked by radical elements within and without the political system, and of pressures to change voting arrangements in the belief that better policies would result. To its credit the government has followed this mainstream body of advice and addressed the weak areas of policy. They were neglected precisely because they were difficult and politically sensitive. It is no surprise that many of the decisions have been unpopular, particularly when the handling of some of them left something to be desired and when the benefits of reforms take time to materialise. People may reasonably suspend judgment but they ought, if they are fair-minded, to be responsive to evidence and logical argument. And the evidence is that over the last 12 months we have seen the beginning of a solid and soundly-based recovery.

I do not propose to list all the indicators of improving trends as I am sure they are familiar to you. The important point is that having achieved low inflation, a stronger competitive position, and much higher levels of productivity and efficiency in many industries, the economy is poised to grow. Those - like Brian Easton, Len Bayliss, Bryan Philpott, BERL, the Auckland University economics department, Manfred and the producer boards - who argued that the economy would not recover under present policies are being proved wrong. The government's forecasts are for 3 percent growth this year and for 2-3 percent growth in the following two years. Several forecasting groups have higher numbers.

A move to a growth rate of 2-3 percent a year on a sustainable basis may not look exciting but it is worth underlining its genuine significance. It would represent a doubling of our recent growth performance. Over the course of a decade, a growth rate of 3 percent would compound to an increase of more than 30 percent in the size of the economy. While the priority must be to get the unemployed back into work and to repay debt, that increase in output and hence incomes would leave something over for improvements in general living standards. Contrary to some conventional wisdom, a 3 percent growth rate would also be perfectly consistent with steady reductions in unemployment. It is not the case that still higher growth rates would be necessary to cut the rate of unemployment, though of course they would help. There is no necessary relationship over the long run between a country's growth rate and its employment performance.

I believe New Zealand could do better than achieve a 2-3 percent trend rate of growth, particularly since we have so much catching up to do. But if we want Asian-style growth rates, we need to do a lot more to evolve an Asian-style economy. The secret of the success of the Asian economies is no different from the OECD consensus on economic policies that I mentioned earlier. For all their differences, they have prospered from open, export-oriented trade policies, low inflation, low government spending and tax burdens, flexible labour markets and competitive education systems. They have not prospered because of extensive government planning, especially after they grew beyond the early stages of development. Some government interventions in their economies continue to hold them back.

Contrary to some of the commentaries that I referred to earlier, New Zealand is still far from looking like an economic tiger. This is where my more pessimistic scenario for the future comes in. The government is still encountering immense difficulties, for example, in modernising bureaucratic and unresponsive education and health systems. The recent *World Competitiveness Report* gave New Zealand pole position - up from 8th last year - for the "government policy most conducive to competitiveness" category, but only a middling 13th ranking on how well our education system meets the needs of a competitive economy. The Gibbs and Carr task forces concluded that hundreds of millions of dollars of extra value could be derived from resources used in the health sector, yet the government's reforms in this area remain fiercely contested.

While the rest of the world is pressing on with privatisation, the process in New Zealand virtually ground to a halt last year. In Argentina, a country which looks like a rising star in Latin America after many years of decline, the government under a populist president is privatising the state airline, railways, telecommunications, gas, oil exploration rights, water supply, road maintenance and construction, electricity and the postal system. In New Zealand privatisation of industries such as electricity - which is largely in private hands around the world - and postal services seems to have been put in the 'too hard' basket.

Many other obstacles to a better growth performance - ranging from reform of the regulations governing agricultural marketing boards to trans-Tasman shipping to restrictive practices in the legal profession to the absurd rules governing pharmacy ownership - remain unaddressed. In each of those cases vested interests continue to successfully resist threats of competition. But by far the greatest threat to a period of sustainable growth is the government's fiscal position and the debt burden overhanging the economy. The implications of the recent budget must be regarded as somewhat ominous.

On the positive side, it is encouraging that the government is controlling its expenditure more tightly, and its apparent commitment to reducing the government's share of the economy could mark a real turning point. For this the minister of finance, in particular, deserves great credit. Nevertheless, government spending is projected to grow again in real terms after a cut last year.

It is also encouraging that the government did not come up with a raft of tax incentives and other expedients that could only distort and harm the economy. The response of some lobby groups was that the budget did nothing to encourage business. As one commentator put it: "That suggests that the hand-out mentality has not yet been eradicated by years of subsidies and consequent indebtedness."

What has to be of major concern in the budget, however, is the outlook for government borrowing and debt. On the budget figures, we are continuing to run financial deficits totalling over \$8 billion in the next 3 years. This amounts to around an extra \$8,000 of indebtedness for every household - on top of the \$45,000 of gross public debt which each household already owes. The ratio of gross public debt to GDP is still rising. Public sector net worth, already a negative \$14 billion, is still declining. The increase in debt servicing is the largest item of increased expenditure in the budget. It will be up by 21 percent or \$900 million in the next 3 years. We are still running up massive debts and sending the bills to our children. As the minister of finance has said on many occasions, this is fiscal child abuse on a grand scale.

It is not as if most of the additional borrowing is going to fund new investment. Around \$4.5 billion will be used just to finance current consumption - the shortfall between current revenue and current expenditure. No household or business would prudently borrow to pay for the groceries, and nor should the government.

In the face of these numbers, it is disturbing that the budget was greeted with a sense of relief and equanimity by many. It is illusory to believe that the possibility of growth in the economy will make the fiscal problem go away. A former minister of finance assured us that growth would pay for increased spending programmes like national superannuation, and we have been living with the consequences ever since. There is still a major structural problem with the government's finances, and the issue is not *if* it needs to be addressed but *when*. As one financial analyst put it:

"...the government has noisily shifted gears on the issue of fiscal adjustment: it claims that the vigorous response to the pressing financial problem emerging in late 1990 was a crucial element in the recovery starting from mid-1991 and in the huge decline in nominal and real interest rates through 1991 and into this year. And it was. The government line now, however, is that the pressing fiscal problem does need to be addressed... but that nothing dramatic must be done now lest it kill off the fragile flower of recovery... If a tough approach was right in an economy moving into recession in 1990, it is most certainly still right for an economy emerging from recession. The logical gears are clanking on this one."

One might add that if they have any integrity, our surviving tribe of Keynesians, who lambasted the government for cutting its spending and the deficit during the recession, should be calling the loudest for such action now that the economy is in an

upswing. If the problem is not addressed now, the government may be forced to make adjustments when economic conditions are less favourable.

There are mixed signals on other fronts as well. The minister of education, deservedly rated a high achiever in yesterday's *Sunday Star*, is pressing on with initiatives to enhance self-management of schools, modernise teacher employment arrangements and upgrade the curriculum to meet the needs of a competitive economy. Yet at the same time the government is increasing the protection granted to some of our least competitive industries. Some of the items concerned have been given astronomical effective rates of assistance amounting to at least two or three dollars of subsidy for every dollar of value added at world prices. These costs will be borne by exporters and other manufacturers whose effective rates of assistance have fallen to around 15 percent on average. They will also hit low income groups hardest, yet the response from welfare groups who also seem to prefer lobbying for government handouts has been a deafening silence. Are we sliding back to the days when the response to any squeaky wheel was an oilcan?

Because it has done many of the right things, the government stands a good chance of achieving four of the six goals that it set itself for its present term - 0-2 percent inflation, single digit interest rates, growth of 3 percent and a reduced government share of the economy. It could still, with a determined effort, make progress towards its goals of a balanced budget and reducing unemployment.

However, there is a risk that we may be re-entering the economic danger zone. All New Zealand governments over the last 20 years have understood that the country was in serious economic difficulties. For a time all of them began to take some of the necessary and unpalatable decisions, including fiscal decisions. But to date all of them lost momentum and the debt burden and our economic and social vulnerability continued to grow. The possible signs of management fatigue after only 21 months are worrying.

It cannot be too strongly emphasised that our economic position is still extremely vulnerable. The *World Competitiveness Report* put us almost at the bottom of the rankings for the strength of our economy. It is a certainty of economic life that the path of the recovery will not be smooth and that we will be hit by shocks along the way. In the space of just 18 months we have had a Gulf war, a collapse in the wool market, and a drought which caused an electricity shortage. It would be foolhardy to presume that even the next 18 months will be plain sailing, still less any longer period.

We are no doubt all for doing nothing if there is nothing to do. But in business as in government, a 'do nothing' strategy is rarely a winning formula. As a country we need to examine the costs of doing nothing. Over the run of years that it will take us on present trends to achieve a balanced budget, still less the financial surplus needed to repay debt, we could be pursuing a very risky strategy indeed.

The concluding point I would like to make, however, is that it is the business of all of us to make our own assessment of these risks, not just the government's. If the electorate wants to keep on running up bills to pass on to the next generation, to avoid disturbing vested interests and to shy away from the other reforms that would make us a dynamic Asian-style economy, that should be its choice. We cannot expect governments to persist with doing things that the electorate does not want. Some people still seem to think they can vote themselves higher incomes. But we should

also have the economic sophistication and the honesty to reckon with the consequences. Particularly for the old, the unskilled and the immobile - those who cannot migrate to Australia or further afield - the consequences would be unpalatable indeed.

Those who understandably enough emphasise the pain of restructuring might contemplate the meaning of a sign I saw the other day: 'Ears pierced while you wait'. The question they might ask themselves is, 'What, really, is the alternative?'

There appears to be a tacit acceptance, even in unlikely quarters, that alternative policies make no sense. It is interesting, for example, that the NewLabour party in successive alternative budgets has brought its top tax rate down from 55 to 48 to 40 percent, and now supports an inflation goal of 2-3 percent. Similarly, I think there is no likelihood that any future government will reverse the Employment Contracts Act, any more than it would now turn the clock back on other reforms of recent years. The real argument is not about what has been done. The real argument today is about whether we are prepared to do more to achieve assured success or whether we are content with a still fairly mediocre and risky outlook, and want another teabreak.

That is something that only the electorate - and that means all of us - can ultimately decide.