

Waitakere Business Club

The Challenges of Success

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THE CHALLENGES OF SUCCESS

I take it as my starting point that I do not need to convince most in this audience that New Zealand's economic outlook is now a good deal brighter. We are seeing today the benefits of several tough years of economic reforms. The politicians have not been slow to point to the evidence of economic recovery that is around us. This evidence is genuine, and governments, business and the community deserve credit for what has been achieved.

The upturn which began in the export sector in the middle of 1991 has now spread to the domestic economy, and is continuing to gather pace. More importantly, it is soundly based, it is not posing a threat to inflation, and it promises to be sustainable provided - and this is a major proviso - the policy momentum to strengthen our still vulnerable economic situation is maintained.

Rather than spend time detailing the improved economic indicators and signs of growing confidence, it seemed to me more interesting to reflect on what has brought about our improved outlook, how it fits into global trends and what challenges lie ahead. For there is still much to be done to achieve the economic security that most people want, and to see that the gains are fairly spread. We have stopped going backwards relative to the rest of the world but the successful countries are not standing still. In the global economic competition, we are engaged in a race that has no end.

The OECD economic survey of New Zealand which came out last week confirmed that the competitive gains that have been achieved "provide New Zealand with the best opportunity it has had for many years to embark on a period of sustained non-inflationary growth." The OECD is not, as some have suggested, merely a stool pigeon for its member governments or their ministries of finance. Reading between the lines of its bureaucratise, it is pretty obvious when the OECD takes a dim view of a country's economic management. Its reports on New Zealand in the early 1980s or its recent reports on Sweden are cases in point. So it is reassuring that this reflection of official intergovernmental thinking is positive about New Zealand.

It is also useful to have the OECD's confirmation that New Zealand has not been following some extreme 'New Right', monetarist economic programme as some of our populist politicians and superficial media commentators would have it. The programme is fully in line with the approach which the organisation has recommended to its member governments since the late 1970s.

At that time, following the two oil shocks and the stagflationary experience of that decade, there was a growing consensus that economic performance had been undermined in many countries by expansionary monetary and fiscal policies and a build-up of structural rigidities.

Policy thinking shifted in favour of the adoption of a consistent medium term framework which emphasised, in OECD-speak, macro stability and micro flexibility. In essence this meant, on the macro side, a monetary policy stance geared to suppressing inflation, supported by budgetary policies which avoided borrowing

pressure on financial markets and the accumulation of debt. On the micro side, it meant as many efforts as possible to free up markets, improve incentives and make the economy more flexible. This is the prescription which, in broad terms, New Zealand has endeavoured to follow since 1984.

Many OECD countries bit the bullet at the time of the second oil shock and went for policies of disinflation and structural reform. After difficult recessions in the early 1980s, their economies picked up, investment grew strongly and unemployment rates came down. New Zealand only belatedly bit the bullet, by which time its position was much more serious, but the pattern of its experience is turning out to be similar. Some countries lost their grip following the 1987 sharemarket crash, with the result that inflation and budget deficits became a problem again, and they have had to experience another period of recession to bring them under control.

Some of our populist politicians have claimed that policy thinking has moved away from this OECD consensus. It is true that there have been exceptions, such as the so-called 'kinder, gentler' strategies which President Bush and Prime Minister Major pledged to follow. But it soon became apparent that there was nothing kinder and gentler about their resort to more interventionist and inflationary policies. They turned out to be a recipe for economic muddlement, involving a protracted recession in the case of the United States and a return to an unemployment level of over 3 million in the case of the United Kingdom. In general, however, there has been no backsliding in mainstream thinking. As Michael Prowse, writing in the *Financial Times* earlier this year, put it:

"The 1980s appear to have changed attitudes, perhaps for good, in many countries. Asked to cite a viable alternative to free-market capitalism, democratic socialists used to shout "Sweden", which for decades had grown rapidly despite the claims on resources of a large and intrusive state. But Sweden is now trying to move into the European mainstream by curbing welfare spending, cutting tax rates and subjecting the government sector to market disciplines, and if you look beyond the industrialised world, there seems no question that free-market doctrines are gaining ground."

The collapse of state communism is, of course, the most dramatic manifestation of this trend, which has undermined confidence in large government and bureaucracies everywhere. Examples with closer parallels to New Zealand can be found in Latin America, where, in the words of British journalist Anatole Kaletsky:

"The 1980s saw a flowering of democracy, an opening up to the outside world, and a revival of competitive capitalism of a kind not seen since World War II."

The two star performers in Latin America have been Mexico and Chile. Both have implemented successful economic reform programmes on similar lines to New Zealand. The adjustments they undertook were in many ways more difficult and painful than New Zealand's, but they too are now reaping major benefits.

Mexico, it will be recalled, went bust just over 10 years ago, triggering the Latin American debt crisis. Like New Zealand, it was characterised by an inward-looking

development strategy, widespread state intervention in markets and increasing government spending and borrowing. Since the 1982 debt crisis the turnaround has been extraordinary. The fiscal balance has gone from a massive deficit of 17 percent of GDP in 1982 to a surplus in 1992. Public sector debt is now lower than New Zealand's, at 39 percent of GDP. Mexico broadened its value added tax and lowered marginal rates of income tax. It shifted from a trade regime with quantitative controls on practically everything in 1982 to a situation where the maximum tariff is now 20 percent, and it is moving to full free trade with the United States. There has been a large scale programme of privatisation, which is now being extended to toll roads, airports, ports, water, sewage and electricity generation.

It took more than 6 years of stabilisation and restructuring before the first signs of success appeared, even though Mexico's programme was in many ways more exemplary and more consistently adhered to than New Zealand's. Inflation is now down to single figures, capital inflows have grown, investment and jobs have followed and economic growth has resumed.

Two features of Mexico's experience contrast with New Zealand's. First, the cornerstone of Mexico's economic policy has been fiscal rectitude. Its debt problem has been resolved whereas it still casts a long shadow over New Zealand's outlook. Secondly, Mexico was fortunate in having an extremely flexible labour market. Real wages fell by 31 percent during the recession, greatly cushioning the increase in unemployment. They have now returned to former levels and unemployment is below 3 percent despite significant growth in the labour force.

A similar story has unfolded in Chile. Since the mid-1970s Chile has undergone a transformation from an inward-looking socialist economy to one which is now open, export-orientated and a strong competitor of New Zealand on world markets. Mistakes were made in the process and the transformation was more wrenching than anything New Zealand has experienced: GDP fell by no less than 14 percent, for example, in the recession of the early 1980s. Nothing good can be said about the political regime that initiated the changes, but it stuck with its free market programme despite the setbacks. From the mid-1980s the economy began to grow strongly and the centre left government elected in 1989 has not changed course. Output grew by almost 10 percent in 1992, and following labour reforms along New Zealand lines in the late 1970s unemployment has dropped from 20 percent of the labour force to the current level of 5 percent. Chile's credit rating has recently been upgraded by Standard and Poor's.

The worldwide shift to greater reliance on markets and less reliance on governments is ongoing. Chile is currently privatising public hospitals. Argentina, which is shaping up as Latin America's latest success story, has embarked on a similar path under a populist president. Its privatisation plans include telecommunications, electricity, railways, water and postal services. In Asia, where state enterprises accounted for only 3 percent of GDP in the early 1980s compared with 12 percent in Latin America and New Zealand, governments are selling many of their remaining businesses.

Even in the former bastions of state welfare the same trends can be seen. Sweden is introducing a system of vouchers to break the state monopoly on education and allow parents the choice of sending their children to private schools. Italy is going in for large scale privatisation in response to its economic crisis. Germany has announced

plans to privatise its motorways. Labour reforms along New Zealand lines are underway in Australia and will be accelerated if the Coalition parties are successful in next week's election.

Plainly New Zealand has been a laggard not a forerunner in reforming its economy in a market direction. The OECD report reminded us that there is still a great deal to be done. Items in a lengthy list included trans-Tasman shipping, reform of producer boards, further tariff reductions and faster progress with privatisation. The OECD commented unfavourably about an education culture which is not geared to the needs of a competitive economy, and argued for greater private sector competition in education and less subsidisation at the tertiary level.

The major areas of policy weakness, however, for which no early solutions are in sight, are the government's finances and unemployment.

The OECD highlighted the problem of the continuing high level of government borrowing and debt as the main threat to a sustainable recovery. It would be reckless to allow this problem to persist. A more robust position needs to be achieved before the next cyclical downturn.

The credibility of all political parties will be tested this year against their plans to remove this threat. Reliance on economic growth will not be a credible stance given the structural nature of the problem, nor will tax increases since these would only harm the economy. An economy in which well over 40 percent of national income is directed by governments will continue to perform poorly relative to economies with much lower taxing and spending burdens. The problem must be addressed by reductions in low quality or poorly directed spending. Firm action now would also avert risks of an undue growth in consumption spending, strengthen New Zealand's competitive position and help prevent a deterioration in the balance of payments.

As for unemployment, the outlook has been improved immeasurably by the Employment Contracts Act, and employment is now growing for the first time since 1984/85. However, community attitudes and other institutional arrangements are still not conducive to achieving rapid reductions in unemployment. To moralise and nothing more about the problem, as *The Economist* said last week, is worse than useless.

There is no reason why New Zealand could not return in the space of a few years to a position of full employment. However, high unemployment will remain endemic so long as the view is taken that paying people according to their economic value is exploitation. The reality is that internationally mobile industry can now tap into highly competitive and increasingly skilled labour in Asia and other regions. Such firms will not use New Zealand labour at wage rates which underwrite higher standards of living unless its productivity is commensurately higher. Determining that such wage rates are exploitative and unacceptable would be to condemn many of our unskilled to unemployment and welfare dependency, and lead some New Zealand firms to join the international migration to more attractive locations.

The examples of Mexico and the Asian economies that have typically avoided unemployment problems highlight the importance of flexible labour markets, particularly wages that are sensitive to levels of unemployment and the state of the economy in general. Trade unions resist this idea, because their concerns are for their

employed members, not those without a job. But paying stevedoring labour \$50-70,000 a year when people are prepared to work for much less merely inflates costs in our ports, reduces the profitability of our export industries and means fewer people are employed in them. If we are serious about unemployment, governments must address things like statutory and court-imposed barriers to job creation and work disincentives such as open-ended welfare benefits, and public and private sector employers must make supply and demand the main criteria in setting wages.

Besides needing to recognise that some major problems remain to be tackled, we also need to recognise that it is in the nature of things that the path of economic recovery will be bumpy rather than smooth. In the space of the last 18 months we have seen a series of setbacks, some of them partly self-inflicted such as the disasters in the wool and kiwifruit industries, and others outside our control such as the electricity shortage, the South Island snowfalls and toxic algal bloom in the shellfish industry. We are overdue for a summer drought, the GATT talks may fail, and world interest rates may be more likely to rise than fall. I am not sure that we are prepared to face these situations with the steadiness of nerve that they require, or to recognise that the best protection against them is continuing reform rather than a risky strategy of timid gradualism.

For example, neither the Reserve Bank nor the private sector covered itself with glory over monetary policy developments earlier in the year. The Reserve Bank reverted to its bad habits of talking about an exchange rate target rather than just keeping its eye on the inflation ball. For its part, the private sector seemed to forget that from time to time short-term interest rates will rise as well as fall as part of the price of securing low inflation as well as low long-term interest rates. As one financial analyst noted, the Manufacturers Federation was quickest off the mark to demonstrate that not a lot has been learned in recent years in calling for a softer, 'no tears' approach to monetary policy.

Similarly, some major energy users are currently lobbying against the current phase of electricity sector reforms on the grounds that they will lead to increased prices. They seem to have forgotten that only a few years ago, and with an equal lack of credibility, they argued that the earlier reforms would push prices up by 40 percent. Instead, wholesale prices have come down by around 14 percent in real terms, and the rebalancing of retail electricity tariffs is providing additional benefits to the business sector.

It is nevertheless true that in general there is now a higher level of economic understanding in the New Zealand business community and business organisations. Former critics like Bruce Hancox, Michael Robson and Sir Robertson Stewart have come out in support of current policies. Among business organisations, only the Auckland Chamber of Commerce is the exception in sending out mixed messages on privatisation and calling for 'incentives' - that is to say handouts - for business. It was interesting that in the recent Western Australian election campaign their counterpart organisation, the Chamber of Commerce and Industry in that state, strongly opposed attempted election bribes by the Labour government - a so-called Adding Value package - with an advertising campaign "Don't Give us Carrots, Give us Change." As *The Economist* put it recently:

"The best industrial policy is ... one which provides a sound macroeconomic climate, opens the economy to competition, and equips

people with the education and skills for tomorrow's knowledge-based businesses."

Yet ignorance is a renewable resource. The Alliance Party economic manifesto reminded us that there are vast reserves of it in the community. It was as if the madness that was Muldoonism had never happened. The contrast between this phenomenon and the way people with international experience view New Zealand is striking. Heinz chairman Tony O'Reilly recently described New Zealand's economic reforms as "little short of miraculous." He added:

"What has been achieved by governments of both parties over the past 10 years ... is a miracle of modern democracy. The systems and processes in Australia will be sorely tested to achieve the same results."

And in a similar vein, the governor of the Bank of Scotland, Bruce Pattullo, recently told *The National Business Review* that New Zealand was admired overseas for its discipline in restructuring the economy. He added, however, that moves to a proportional representation political system might undermine that achievement and deter international investment:

"If you give up the first past the post system there is a question whether MMP will allow the government to be as resolute if and when tough action needs to be taken."

The answer from the experience of countries like Italy, Germany and Sweden is very clear - it won't. All of them now face immense economic problems - including in Sweden's case a budget deficit of 14 percent of GDP - and in none of them is there a political constituency capable of effectively responding.

New Zealand's weakness for many years has been a lack of public awareness of our growing economic predicament, an unwillingness to face up to the disciplines which would bring us greater success, and a susceptibility to the soft options of populist politicians. Having achieved so much in recent years, will we be tough-minded enough to persevere, or will we opt for more teabreaks or another Muldoonist era of timid gradualism? The answer to that question will basically determine whether we will cope with the challenges of success.

The question cannot be answered as confidently for New Zealand as it can for, say, Mexico, Chile, or the Asian economic success stories. At a national beauty contest in Mexico the newly crowned Miss Mexico was asked the traditional question following her coronation: "What is your greatest wish?" The answer was as swift as it was unusual. "To see the free trade agreement signed with the United States," she replied.

Mexico's current government is regarded as one of the world's most economically literate and this story tells us something about the economic literacy of the community. I shall be more confident about New Zealand's outlook when the same question here brings the response: "To halve the national debt."