

EMBARGOED UNTIL 8.00 P.M. MONDAY 12 JUNE 1995

New Lynn Rotary Club

**Is New Zealand Now in the Same League As the
Asian Tigers?**

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IS NEW ZEALAND NOW IN THE SAME LEAGUE AS THE ASIAN TIGERS?

I am grateful for the opportunity you have given me to speak to you today.

The topic I have chosen: "Is New Zealand now in the same league as the Asian tigers?" is meant to be a question about how good New Zealand's growth prospects really are following the policy reforms we have been through over the last decade or so. Are our economic prospects now strong enough to match those Asian economies that have been consistently the most rapidly growing economies in the world over several decades?

I apologise if you thought for a moment that I was going to talk to you about whether New Zealand should be part of some new football league which might or might not include Asian teams. Recent developments in team sports are a fascinating reflection of how close international linkages are becoming in many spheres of activity - but I have other things to talk about.

The topic I have chosen will be of some interest to you because the living standards of all New Zealanders depend ultimately on the growth prospects of the New Zealand economy. I think it is important that we should all have realistic expectations about the magnitude of the rewards that can be expected from the policy reforms in New Zealand.

There are likely to be adverse consequences both if we are too pessimistic and if we are too optimistic.

If we are too pessimistic we might not recognise the magnitude of the rewards that are possible by maintaining the impetus of the reform strategy. Like members of sports teams who do not recognise their own potential, we may not see the merits of making further efforts to improve our performance.

If we are too optimistic, we may underestimate the extent to which future incomes would be affected if some of the old interventions, which shielded particular groups, were restored and fiscal disciplines relaxed. We may act

like members of sports teams who are so confident of winning that they forget to train, and spend the prize money before they have earned it.

The main point I want to make is that the policy reforms of the last decade or so provide New Zealanders with the potential to go a fair way toward catching up to the countries which have the highest per capita incomes. How fast we can close the gap and how close we can stay to the performance standards of the leading bunch will continue to depend very much on the policies we adopt.

If you think this sounds as though I see a lot of similarities between economic performance and sport you are correct. Like all analogies, however, this one breaks down in some important respects.

First, everyone engaged in economic activities contributes to the enlargement of economic output, the 'prize pool' which is shared among the players. Economic activity is a 'positive sum game' in which a country or a team can usually get higher rewards by just playing better - 'winner take all' situations are rare.

Second, if New Zealand were to fall into bad habits and again become unable to compete effectively in economic terms, I expect our athletes would still perform creditably in high performance sport as they did in the past. They would have a stronger incentive to use their sporting ability to escape from an economy which offered poor alternative opportunities to earn an income.

Before moving on to consider just how much growth potential the policy reforms provide, I think it would be useful to make some general observations about how policies affect growth rates.

What is the relationship between policies, incomes and growth rates?

A question which people sometime ask is: "If policies are so important, why is it that after the policy reforms New Zealand does not grow as fast as China - a communist country with much less secure property rights and more limited freedom of contract than New Zealand?"

There are two reasons why China is growing more rapidly than New Zealand:

- (i) China is starting this growth phase from a much lower base than New Zealand, providing more scope for rapid growth by drawing resources into the market economy;
- (ii) Rapid growth is more likely to reflect the extent of policy improvements than the superiority of policies over those followed in other countries. Policies generally have a more durable impact on income levels than on growth rates. When policies improve there is a boost in growth in the adjustment period, which can take several decades, while average income levels are rising to a new equilibrium.

China's policies have improved a lot relative to the policies it had in place a decade ago. We can safely predict, however, that if both China and New Zealand were to maintain the same policies in place in the future - with the same degree of uncertainty about the future direction of policy - the growth rate in China would fall below that in New Zealand, well before average income levels in China had risen to New Zealand levels.

When I discussed this point recently with an Australian economist, he responded that he would be prepared to stake one of his two most valued possessions on that prediction being accurate. He stressed, however, that to avoid confusion I should emphasize that I was talking about a situation with unchanged policies in both countries. He said it was important not to underestimate the capacity of the Chinese to further improve their policies - and equally important not to under-estimate the capacity of New Zealanders to 'fumble the ball'.

I think I detect in that latter remark some envy of New Zealand's recently found ability to maintain a coherent economic strategy.

There has been a huge amount of research undertaken by economists over the past few decades on the question of what are the factors that matter most in determining why some countries, for example Asian tigers, have much more successful growth records than others.

The World Bank drew a lot of this work together recently in a report entitled *The East Asia Miracle*. I think this report is an important one even though some

conclusions in it are ambiguous in some respects and have been interpreted in different ways.

The report is important because it reflects the fundamental change in recent years in the worldwide debate between those advocating increases and those advocating reductions in government intervention. This long debate has moved on to new ground. It is no longer about central planning versus markets. Even those now favouring intervention recognise that it will be damaging unless it occurs in 'market friendly' ways.

There is now a consensus that certain policy fundamentals have been of critical importance in providing an economic environment to encourage the high levels of private investment and rapid skill development which have been an important feature of growth in East Asia.

The policy fundamentals I am talking about here include macroeconomic stability, low international trade barriers, low taxes and efficient public administration, and strong security of people and property.

In some of these areas the policies of some of the Asian tigers may not yet compare favourably with high income countries, but the important point is that over all of these areas the policies of the Asian tigers have generally been superior to those of other developing countries which have failed to grow as rapidly.

When you look at why these policy fundamentals are so important, it is obvious that they improve incentives by reducing unnecessary costs and risks associated with investment of all kinds. I am using the term investment here to include the investment of individuals in developing their own skills and 'intangible' investments by firms in developing new business strategies, as well as physical investment in capital equipment and buildings.

The relationship between physical investment and the potential for higher output is so obvious that many people have been misled into claiming that this investment is the engine of growth. This 'capital fundamentalism' was fashionable among development economists in the 1950s and led to experiments in government intervention in many countries to raise investment rates. The results of these experiments in centrally planned economies show

that high investment rates of physical investment do not necessarily result in high rates of economic growth.

It was possible for central planners to ensure that funds were taken out of households' budgets and invested, but they did not have a good way to ensure that investment would be highly productive.

A slightly different version of capital fundamentalism has come into popularity in some quarters in recent years, with research results showing high correlations between investment and economic growth being used by some people to argue for special subsidies for equipment investment. Other research (for example an article published recently by Robert King and Ross Levine) has confirmed earlier path-breaking work (research by Solow and Denison) which showed that growth in capital stock per person typically accounts for only about 4 percent of the growth of output per person.

Capital fundamentalists make two errors:

- they overstate the importance of physical investment relative to less tangible forms of investment; and
- by focusing on the level of investment itself and on government policies to increase investment, they run the risk of distorting the allocation of resources and reducing the output attainable.

A focus on the policy fundamentals does not presuppose that any particular level of distribution of any type of investment is desirable. What such a focus does do is create an environment in which complex transactions - involving many different people in different locations, doing different things at different times for mutual benefit - can occur at low cost. These complex transactions enable gains from specialisation and trade which are central to the growth process.