

## **FROM BASKET CASE TO CASE STUDY NEW ZEALAND 1984 - 96**

It is a great pleasure to be opening a conference which will feature contributions by so many of the people who have helped transform the New Zealand economy and give our country a future. Since 1984 New Zealand has seen a remarkable period of economic change. It has been a transformation which has not gone unnoticed in the rest of the world. But while the reforms have won much international acclaim, some people in New Zealand have short memories. They have forgotten that for 25 years or more prior to 1984, New Zealand's economic performance was a disaster.

New Zealand once had the third or fourth highest average living standard of any country in the world. By 1984 we were 23rd in the OECD, and continuing to lose ground relative to both the developed and the newly industrialised economies. Our productivity growth had for decades been the worst of any OECD country, as had our per capita economic growth. Unprocessed pastoral products still accounted for the bulk of our exports, and our manufacturing sector was grossly inefficient. Since the first oil shock economic growth had slumped, and unemployment had begun trending upwards. At the same time we were failing to live within our means as a country and were seeing a rapid build-up in both foreign and domestic debt.

This outcome was due to economic policies that were arguably the most interventionist outside of the third world and the Iron Curtain countries. We were a highly protectionist economy: high tariffs and import licensing were articles of faith. Domestic competition was severely restricted, if it was allowed at all. Almost every significant sector was extensively regulated. Thanks to the political clout of our dairy industry, you needed a doctor's prescription to buy margarine. When shops were finally allowed to open on Saturday morning - after bitter opposition - this was considered a major liberalising move. Tourists joked that they came to New Zealand and found it shut. To cap it off, we had one of the most inefficient and inflexible industrial relations systems in the developed world - craft-based trade unions and a national award system that applied to all workplaces regardless of their individual circumstances.

Almost every economic policy was shaped by the specific interests of a pressure group. Indeed our economy was one huge interlocking grid of special interests, walking around with their hands in each other's pockets. Manufacturers were vigilant at clinging on to their protected status. The resulting cost structure meant

that exporters were often struggling. However, rather than reform the domestic economy, the government's response was to subsidise exporters. The unions guarded their own privileges jealously, and often used their monopoly power to obstruct more productive work arrangements. Management tended to acquiesce in this industrial vandalism; it was much simpler to fly to Wellington and lobby the government for special favours than to make their own workplaces more productive.

Naturally we all learnt to play the lobbying game - even those who realised the rules were absurd. I well remember when Morrison Industries - a company with which I was associated - obtained the right to manufacture bicycles. We put our case before the Tariff and Development Board - the words 'tariff' and 'development' went together in those days - and won. Bicycle imports were reduced to a token level. The officials became quite enthused about this great new manufacturing 'winner' they were picking. It was not hard to pick the loser in this deal - the consumer. The consumer lost out every time.

New Zealand's state sector fitted this environment of special interest politics like a glove. Most government services were monopolies. Almost all were inefficient and overstaffed; they had no incentive not to be. The poor quality of their services constituted a burden on the private sector. For instance, a new business starting up had an average wait of six weeks just to have a telephone installed. But there was no question under our old economic regime of making government trading organisations more efficient. We had to protect the 'jobs' of people 'working' in these departments. They constituted a powerful special interest of their own.

The late Sir Robert Muldoon - whose tenure as prime minister can tactfully be described as idiosyncratic - raised the policies of government intervention almost to an art form. Finding something in the economy still moving in 1982, he slapped a comprehensive freeze on all wages, prices and interest rates. His tenure was abruptly cut short by a snap election which he lost.

Such was the state of the economy inherited by the man who will be speaking next - Sir Roger Douglas. The day after winning the general election in 1984, the Labour government was informed that it faced a foreign exchange crisis. Within days the situation had escalated into a constitutional crisis. Decisive corrective action was required, and was boldly taken.

The currency was devalued and interest rate controls were removed in order to allow monetary policy to defend the new exchange rate. Price controls were quickly removed.

Two enormous tasks followed. The spiral of fiscal deficits, public debt and credit downgrades had to be reversed, and markets had to be freed up to allow the private sector to generate sustainable economic growth. These twin tasks of stabilisation and liberalisation took most of the next decade. The programme constitutes what a former OECD senior official, David Henderson, has called "one of the most notable episodes of liberalisation that history has to offer".

Before summarising for you some of the principles driving the reforms, I want to take this occasion to comment on how this remarkable episode occurred.

In my view it resulted from an extraordinary constellation of events, ideas, courage, vision, leadership, and ability to execute. The critical trigger was the external debt crisis. As Mancur Olson has noted, successful domestic reforms often appear to follow from severe external threats and shocks. New Zealand's experience appears to fit this mould.

There is more to it, however. For example, New Zealand's 1938 foreign exchange crisis moved policy in an inward-looking, defensive direction. This was exemplified by the adoption of import licensing as a 'temporary measure'. Why did New Zealand move in the opposite direction in 1984?

The need for fundamental change had long been obvious to many politicians, including many in Muldoon's cabinet, many business leaders, the government's key policy advisers and many practising economists. Roger Douglas published a book in 1980. Its title adequately captures its spirit. It was *There's Got to Be a Better Way*.

These politicians provided the leadership, vision and courage for what was to follow. Key figures in the 1984-87 period were the prime minister, David Lange, the minister of finance, Roger Douglas, and those assisting with the finance portfolio, Richard Prebble and David Caygill.

Treasury, which had been unsuccessful in the battle against Muldoon's disastrous 'Think Big' government investment projects and the two-year wage and price freeze, had clear views on what needed to be done. They were pulled together in

the few weeks following the announcement of the snap election in mid-June 1984, as a post-election briefing for the incoming government.

Published some months later under the title of *Economic Management*, this briefing provided the intellectual basis, the strategy and the blueprint for the subsequent reform programme. Graham Scott in the Treasury oversaw the preparation of this briefing and Roger Kerr was his right hand man.

The story was much the same at the Reserve Bank, except that its views were better known through its research publications and the prominence of Roderick Deane. The three public servants I have just mentioned made outstanding contributions to what was to follow.

Meanwhile, and entirely independently, some leaders in the business community had decided that they had had enough of the old ways. I am proud to be associated with those who set up the New Zealand Business Roundtable, an organisation of chief executives of New Zealand's larger companies. It is unusual amongst business groups in that it has been dedicated from the outset to the proposition that the interests of the business community are likely to be best served by policies which are in the long-run interests of consumers and the economy overall. This means open and competitive markets and smaller rather than larger government.

The organisation's role is to commission, publish and disseminate the best possible research and analytical contributions to public debate. It is not a lobby group but relies instead on the power of ideas. Roger Kerr was appointed as our executive director in 1986. He has conceived and executed a large work programme including many contributions by international scholars. His influence has been immense. The importance of basing reforms on a strong and consistent intellectual framework that is articulated in a way that can be widely understood cannot be over-emphasised.

However, it would be wrong to give the impression that other organisations were not also moving with the times. Under the leadership of Ian Douglas, manufacturers were moving to support free trade with Australia. That was the start of an enormous shift in thinking for the Manufacturers' Federation. Today this formerly most protectionist of the business organisations stands with the Business Roundtable and Federated Farmers in supporting the elimination of all tariffs.

One of the most notable stories is that of Federated Farmers. This organisation had to cope with the prospect of widespread bankruptcies amongst farmers early in the

reform programme. The problems arose because the elimination of farm subsidies coincided with high real interest rates and a sharp increase in the real exchange rate. The last of these arose from increases in government charges and the large and unfortunate surge in wage rates which followed the ending of the wage and price freeze.

Under Peter Elworthy's leadership, Federated Farmers resisted pressures from its members to call for a reversal of these policies and a return to subsidies, lower interest rates and an artificially lower dollar. Instead it called for an extension of the reform programme.

It is a reflection of those times that the Labour government responded in a manner which would previously have been unthinkable. In December 1985 it issued a statement of policies to support farmers - by lowering tariffs and phasing out import licensing.

Interestingly, one group which had little to do with the reform programme and in general remained wedded to outdated economic thinking was the academic community. As David Henderson has noted:

... academic economists in New Zealand appear to have been not only more divided about reforms ... but actually on balance hostile, possibly to a greater degree than in any other OECD country.

It is difficult to communicate today the enthusiasm generated in the mid-1980s between the public and private sectors by the government's evident commitment to policies likely to serve New Zealand's best long-term interests.

Richard Prebble reported in his recent book, *I've Been Thinking*, that when he was minister of state-owned enterprises he approached 200 top business people to serve on their boards. Their potential legal liabilities would be enormous, and the annual remuneration he could offer represented about one day's pay in terms of their opportunity cost. Yet only three of these 200 turned him down.

Following the 1987 election and the collapse of the Lange-Douglas administration, we must give credit to David Caygill and Ruth Richardson as key supporters of the path-breaking Reserve Bank Act and continued tariff reductions. After the change of government in 1990, other vital reforms were the Employment Contracts Act,

introduced by Bill Birch, and the Fiscal Responsibility Act which was the work of Ruth Richardson.

The reform programme has been sustained during the terms of four prime ministers and four ministers of finance. It now faces the test of the first MMP parliament. This parliament has no mandate to alter the basic policy framework.

How is it that a reform programme can be so robust?

The two dominant figures in those respective governments, Roger Douglas and Ruth Richardson, will shortly be giving you their own analyses of the situation. I will content myself with stressing some of the broad principles which drove the reforms. It was the consistency with which these principles were implemented - across a wide range of areas - which distinguish the New Zealand liberalisation programme.

First, our reforms were from the start focused on the medium term. *Ad hoc* responses to short-term problems - which had bedevilled economic policy-making in New Zealand - were largely rejected. The attitude adopted was that if a policy was not good for the medium term it was not good - period. The new focus was especially apparent in macroeconomic policy. In the past, monetary policy had often been subordinated to the short-run goals of boosting economic activity and jobs - usually in an election year. The result was predictable: high inflation, big fluctuations in output, but hardly any growth. After 1984, monetary policy settled into its proper medium-term role of ensuring price stability. Fiscal policy had likewise been aimed at propping up economic activity in the very short run, with serious consequences for debt and interest rates. Under the reforms, fiscal policy took on an increasingly medium-term orientation, aimed at controlling, reducing and eliminating the fiscal deficit.

A second principle of the New Zealand reforms was that special interests should no longer be allowed to dominate over the wider interests of the community. Every New Zealander is, ultimately, a consumer, and will benefit in a policy setting where resources are used in the most efficient manner. In the end, enough sector groups realised that everyone would benefit if we had an economy in which no one's special interest held the legitimate interests of others to ransom.

A third principle that drove the reforms was the recognition of the central role of competitive markets in creating wealth. The incentives in markets far surpass those

that operate within a centrally planned system. And the ability of markets to harness and coordinate widely-dispersed information, through the mechanism of the price system, vastly exceeds the capacity of central planners. Mainstream economics has long known these truths, and they have been repeatedly demonstrated in recent history by the success of market economies. But in New Zealand prior to the reforms, even many business people had an instinctive distrust of market forces and believed that markets needed to be heavily regulated.

A fourth principle behind our reforms was the conviction that New Zealand needed to open itself up to international competition and to international influences generally. The insular assumption that New Zealand industries could not compete, and had to be protected, was progressively abandoned. We discovered we could compete on world markets if the government addressed the inefficiencies elsewhere in the economy which had raised costs and compromised productivity. The last few years have seen a rapid growth of high value-added manufactured exports, and defeatist attitudes are now a thing of the past. New Zealand has become more integrated with the rest of the world in many other ways. Foreign investment has flowed into the country, and immigration is bringing people with important skills and links to overseas markets.

A fifth principle of the reforms was that there is no economic logic in viewing the labour market fundamentally differently from the way we view any other market. There is nothing in this crucial market which stops the laws of supply and demand from operating. On the contrary, labour markets work best for both workers and employers where employment contracts can be freely negotiated and where policy makers resist the temptation to 'help the worker' by imposing statutory monopolies or privileges on unions. That is the lesson from countries with relatively flexible labour markets such as the United States, Switzerland, Japan and the Asian 'tigers'. With the passing of the Employment Contracts Act 1991, New Zealand joined this group.

A sixth principle of the New Zealand reforms was a recognition that, while market failure sometimes occurs, government failure is also a very real feature of the world, and cannot be ignored when designing policy. Government failure can occur when the political process is captured by interest groups, or when governments substitute short-term political goals for sound medium-term policies. Implicit in virtually all of the New Zealand reforms was a realistic appreciation of the potential for this type of failure. In our new monetary and fiscal policy framework the recognition of the potential for government failure probably went furthest. Thus we have a Reserve

Bank Act which entrenches in law the explicit goal of price stability. We also have a Fiscal Responsibility Act that sets down criteria for fiscal disclosure and principles of responsible fiscal management - such as running a balanced budget and achieving a prudent level of debt - which a government must follow over the medium term.

A final principle of the reforms was a recognition that, if a government wants to redistribute income, it should take the direct and obvious route of using the tax and social welfare system for that purpose. Prior to our reforms, many features of our economy involved implicit redistribution between one group and another. Partly through confused notions of what was 'equitable', our whole economy had become a network of cross-subsidies. For instance, many goods and services produced in the state sector were underpriced, with obvious consequences for resource misallocation. The reformers realised that in the end such an economy made everyone poorer.

These, then, were some of the key principles behind our reforms. Their benefits are now undeniable. After a difficult five years following the 1987 sharemarket crash, the New Zealand economy has performed well since real GDP bottomed in June 1991. Growth has averaged around 4 percent per annum. More importantly, New Zealand has demonstrated the capacity to grow in a sustainable fashion. Inflation has been controlled within or near its 0-2 percent target range. In place of running large fiscal deficits, we are now producing sustained fiscal surpluses - a development which has enabled the government to repay all of its net foreign currency debt while simultaneously cutting personal income tax. New Zealand's international credit rating has overtaken Australia's. Unemployment has fallen from its peak of 10.9 percent to 6.3 percent today - one of the lowest rates in the OECD.

It would be wrong, of course, to imply that all worthwhile reforms have been implemented, and that policymakers can now put their feet up and enjoy the gains. Life is not like that. The world does not stand still. While New Zealand pauses to negotiate a coalition government - with the prospects of more spending here and greater compulsion there - many other countries are moving ahead. New Zealand is still a highly taxed country relative to its Asian trading partners, and others are moving more quickly to restrict the scope of government activity so as to allow more scope for private enterprise.

We continue to wallow in mediocrity in our systems for the delivery of health and education. Community dissatisfaction now focuses on these sectors which, almost

alone in the economy, are characterised by dominant state providers and a lack of competition.

An even bigger issue for western nations like New Zealand is the future scope of the welfare state. Far too many able-bodied people live on welfare, and the talk is of adding to this by raising, rather than abolishing, the minimum wage. The welfare system subsidises those who have more children than they can afford to bring up and rewards men who abandon their responsibilities. The breakdown of the family unit is one of the most distressing statistics of our times.

Our system of accident compensation is a debt-ridden and divisive national disgrace. And because a few throw themselves on the mercies of others when it comes to retirement savings, it is seriously being contemplated that the savings of all of us must be regulated because big brother knows best. A compulsory savings scheme, if implemented, would be another enormously costly regulatory monster.

As in many industrialised countries, there has been an orgy of over-ambitious regulations of a social engineering nature in recent years. The Employment Court, the Bill of Rights Act, the Human Rights Act, the Fair Trading Act, the Securities Amendment Act on insider trading, the Health and Safety in Employment Act, the Privacy Act, the Treaty of Waitangi legislation, the Resource Management Act, the BioSecurity Act, the Commerce Act, innumerable tax rulings and countless other pieces of legislation are frustrating and bewildering commerce in innumerable ways. Meanwhile government expenditure has resumed its menacing upward creep. Add to these problems wage pressures in the non-traded goods sector and the danger signals for New Zealand's external competitiveness are obvious.

While New Zealanders can take real pride in the quality of the past reforms, we cannot eat last year's bread. The baker must return anew to the ovens each day, and so must any country that wants to raise its living standards. We have with us in this conference some who have excelled as reformers in the recent past. We can learn from their wisdom, but the task of moving ahead is a fresh responsibility and a shared one. New Zealand is still operating well below its potential and can do far better yet, given political leadership and informed public opinion. The same goes for most other countries.

I look forward to learning your ideas on how all of our countries can deal with the challenges and opportunities open to us as we approach the twenty-first century.