'THE VIEW FROM THE COUNTING HOUSE'

This article is taken from an address by the Governor, Mr Spencer Russell, to the Christchurch Rotary Club on 7 May 1985.

"This year, 1985, brings a moment of decision as far as our progress and prosperity are concerned. We are always on the stage of history and the decisions we make day by day affect not only the present but also the future.

The present is of particular importance because we now face a special challenge, that of making fundamental changes in our economic policies, and the consequences of the decisions we make will dictate our future for many years to come.

It is generally accepted that New Zealand is no longer a 'special case' entitled to some sort of special treatment by the world and that we cannot become a fortress where we can live in self-contained isolation until the world becomes more to our liking. For that reason, any examination of our position must begin with the conditions in the rest of the world.

The strongest and most sustained world recovery for a decade is now almost two years old. The initial expansion in the United States has spread in varying degrees to most industrial and developing countries. As this long-anticipated expansion has gathered momentum, it has sparked a number of optimistic predictions.

The OECD noted in 1984 that overall prospects for output and inflation looked as good as, or better than, at any time since the watershed years of the early seventies. To an extent, those predictions have been borne out.

The industrial countries are estimated to have grown as a group by nearly five per cent over 1984, an expansion which, most significantly, has been achieved without a resurgence in inflation.

It is important to note that this outcome has not been reached merely through good fortune. It was obtained principally because most western countries adopted policies several years ago to rein in inflation, correct major imbalances and increase the flexibility of their economies. The countries which laid this groundwork and implemented the appropriate policies for a sustained recovery are now able to expand, in response to, and as part of, the improvement in the international environment.

There has therefore been a considerable improvement in the world economy. But it would be unwise, and over-optimistic, to ignore the fact that a number of substantial problems remain.

The OECD expects the forces which have been fuelling the recovery of the industrial countries to continue, exerting a positive influence over the next year and a half. However, growth in those countries is expected to weaken slightly over this period.

Current indications tend to confirm predictions of a slow down in the United States economic recovery. There is some suggestion that other major countries, such as Japan, Germany and Britain, should take over the role which has been performed by the United States in sustaining world demand, but they are unwilling to sacrifice domestic policies aimed at containing inflation in order to be the locomotive for further world expansion. In those circumstances the projected slow down in growth over 1985 and into 1986 may be more pronounced.

The developing countries have also benefited from the upturn. The recovery in world trade has provided many heavily indebted countries with breathing space which allows them to install and pursue programmes for economic stabilisation and adjustment. These efforts, which have been assisted by the positive and flexible response of the creditor financial institutions and the co-operation of central banks and international agencies — in particular the International Monetary Fund — have been reflected in an improved situation for some of the larger sovereign debtors, for example, Mexico and Poland.

This degree of consultation and co-operation between financial institutions is a hopeful sign but it would be too optimistic to believe that the problems of refinancing the massive debts of many countries and the implementation of sustainable policies to achieve economic viability in those countries have been solved. While the crises of three to four years ago have been averted, there are still no grounds for complacency and indeed the difficulties of some countries appear almost beyond solution.

New Zealand cannot expect much assistance from the international economy over the coming year. In fact, the impact of the world recovery on New Zealand so far has been quite limited and almost disappointing. Certainly we cannot look overseas for a solution of our problems.

To some extent, this is due to factors beyond our control. Protectionist sentiment, leading to the erection of barriers against our agricultural products, has subsided very little with the world recovery. Indeed, in some respects it may have strengthened. We still have problems of access to many countries. Indeed, by means of massive subsidies to their domestic agriculture, the same countries have managed to accumulate large surpluses of some agricultural commodities, significantly depressing world prices in the process and denying New Zealand access to potential new markets.

In fact, our terms of trade — the imports that a given amount of exports will buy — actually fell by 1.4 per cent over the year to December. We did experience an improvement in average export prices but this was more than offset by strong rises in the cost of imports.

Overseas trade factors were not the only causes of our economic difficulties. The problems of access and oversupply did not arise overnight. If nothing else, the oil shocks of the mid-1970s should have provoked a recognition of the need to make fundamental changes and we have certainly had the time to do so.

As a country we have never really faced up to these issues or to the fact that the world had changed and would not return to the old familiar pattern. As a result, our economy has performed quite poorly in terms of growth in output and employment and in price stability. It has fallen behind economies which were even more exposed than we were to the international environment, including some much less well endowed with natural resources. And in the process, we have accumulated a considerable overseas debt.

More recently the New Zealand economy has enjoyed a relatively buoyant period. Real GDP is estimated by the Department of Statistics to have grown by 8.5 per cent during 1984. This has been accompanied by a substantial decline in unemployment. However, this was not part of a pattern that can be expected to continue. It came in part from some of the benefits of earlier restructuring and devaluation, and in part from fiscal and monetary policies designed to lift the economy out of its 1982/83 trough. It came at the cost of our balance of payments and it is doubtful if there will be much growth in the current financial year.

Only basic changes will provide the sustained growth on which recovery and improvement in our standard of living depend. This was, of course, recognised at the Economic Summit Conference. It was accepted then that, if New Zealand were to permanently reverse its relatively poor and intermittently deteriorating economic performance, a primary requirement would be a consistent and balanced economic approach.

Since mid-1984 there has been a succession of policy moves and with it, a recognition of the immediacy of the problem. There has been action on a number of fronts, in deregulation of the financial sector, in industry support mechanisms and the exchange rate area. Moreover, the Government has tackled the task of reducing the government deficit and has implemented a very firm monetary policy to restrain the growth of money and credit to manageable levels and thereby reduce inflation in the medium term. These represent progressive steps toward producing a more flexible and efficient economy designed to compete in the harsh realities of the world's markets.

The Summit Conference recognised that the process of adjustment would not be painless; nor would it have immediate results. Given the time that our present difficulties have persisted this would have been, to say the least, unreasonable. We are now passing through that interim period when the costs of the adjustment, particularly in price levels and interest rates, have become apparent.

1985 is the crucial year, the test of our confidence in ourselves and our willingness to accept short term discomfort for long term gains. A key problem in the past has been difficulty in maintaining a commitment to the adjustment process and a natural unwillingness to accept unpleasant economic measures. This is not to suggest that we have not made some progress. We have, but less than we might and later than we should. And at the end of the day we have found that we have endured a great deal in terms of low growth and high unemployment for very little.

While there may be some argument over the effects, I believe that there is now wide recognition that we really have no alternative but to adopt policies along the lines that have recently been introduced. With a legacy of persistent inflation, balance of payments problems, low growth and an accumulation of overseas debt, and against the background of the predicted international environment, we seem to have exhausted the other possibilities.

Certainly, we cannot afford the luxury of gradual change. We have already exhausted the time for that. Nor can we adopt an isolationist mentality based on the hope that everything will come right if we merely wait until the world comes to its senses and needs us again. An economy as open as New Zealand cannot expect to isolate itself from the realities of the world's marketplace. We must take account of the overseas climate in our domestic production, investment and pricing decisions. In effect, we must adopt a full market philosophy.

Recent increases in the Consumers' Price Index and in interest rates were predicted by the Reserve Bank and by private sector forecasters, most of whom agree with the view that the pressures on interest rates and prices should subside later in 1985. Interest levels have contributed to financial pressure on all borrowers and more particularly on the farming and personal sectors. In the latter case the burden of the higher cost of home finance is very great. But the answer to high interest rates lies in cutting back the deficit between government revenue and expenditure, thus reducing the Government's need to compete with the private sector for loan finance.

Perhaps the greatest test of the resolve to accept short term discomfort for long term stability will come with the 1985/86 wage negotiations. Despite recent cost pressures there is still a crucial need for wage restraint. One of the more positive aspects of the current upturn has been the substantial reduction in unemployment which has declined from 83,000 in early 1984 to just over 50,000 in March 1985.

The linkages between labour demand and wages are complex but it is a reasonable assumption that, providing there is a tight monetary policy — and this is a key to controlling inflation —higher wages result in some cases in higher prices but in others in reduced opportunities for employment.

One achievement of the Summit Conference was its recognition that, unless increases in labour costs were better matched to productivity growth, it would be difficult to expand employment to any significant extent. It is apparent that few groups — and in particular wage and salary earners — would gain from a return to the sort of wage-price spiral that has occurred in the past.

Equally, there is a need for restraint on the part of the corporate sector and for competitive forces to limit price increases. A profitable corporate sector is in the national interest but in a more market-based economy profit must be earned through efficiency and cost control and not guaranteed by a permissive cost-plus philosophy.

Moreover, the business sector may have been slow to recognise the clear signals given by the Government that fiscal, and more particularly, monetary policy will not accommodate either unreasonably higher prices or excessive across the board wage or salary increases. Companies which ignore those signals may well find difficulty surviving in a more open and competitive economy, to the disadvantage of their shareholders, their management and their staff.

It is rather disappointing that the public debate on another important issue, that of tax reform, has tended to generate rather more heat than light. The case for taxation reform is quite clear and is supported by most in the community.

There can be little doubt that the present system has faults. It does not sufficiently encourage innovation, effort or productive investment. The heavy reliance on direct, or income tax, means that the overall burden falls unfairly on low to middle income wage and salary earners. It inhibits incentive and encourages evasion at higher income levels.

If we seriously wish to correct this distortion and introduce a greater degree of equity into distributing the cost of conducting our Government, a substantial shift to a system based on indirect and expenditure-based taxation seems essential.

Such a shift would certainly have an effect on prices but should not have any sustained impact on inflation. Although such a system as GST may not be without its flaws, we have overseas experience on which we can draw to reduce its complexity and therefore its administrative requirements.

New Zealand has now reached a time of decision. Many of the events that caused a decline in our fortunes took place more than a decade ago.

We are now left with no alternative but to restructure our economy so that we can compete in a world that does not believe that it owes us a living. If we can do this successfully we will restore the growth that alone will provide the standard of living and the level of social services that we all want.

There will be some pain in this. But it should not be long-lasting and hopefully it will be evenly spread. We have already come a good part of the way and provided we understand the reason, we will complete the journey successfully.

The decline in our fortunes began more than a decade ago. In human terms, a child could have begun school then in a climate of economic uncertainty and now be looking for work in a situation which has not greatly changed. A new generation began school this year. We owe it to them to see that they leave school with the same confidence in their country and its future that we inherited."