How fast can the New Zealand economy grow?

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An address to the Auckland Rotary Club, Auckland, 6 October 1997

Introduction: economic growth is important

Ladies and gentlemen, I am delighted to be addressing the Auckland Rotary Club today. Just 15 years ago I was a member of this Club, and I look back to that time with very warm memories.

When I was invited to speak to you, I was given a clean slate: I was essentially allowed to choose my own subject. And I want to use that freedom to go beyond my usual territory of monetary policy, interest rates, exchanges rates, MCIs and all the rest, to talk about a broader issue, namely New Zealand's future economic growth - what it may be, what is constraining it, and how it can be enhanced.

And I want to do that for two reasons. First, because economic growth is the ultimate objective of much public policy, and that in turn because it is economic growth which gives us choices - the ability to enjoy better quality housing, the ability to have better health care, the option of choosing more leisure, the ability to invest in environmentally-friendly production techniques, the freedom to choose between an array of options denied to those where economic growth is low or non-existent.

And secondly, I want to talk about economic growth because there is still a great deal of public misunderstanding about the role of the Reserve Bank and monetary policy in encouraging or discouraging economic growth. There is still quite a widespread view that the Reserve Bank's exclusive focus on delivering predictably low inflation involves a cost in economic growth, and that if only the Bank were not so obsessive about its inflation objective the New Zealand economy could grow much more quickly. People look back to the 5, 6 and 7 percent growth rates achieved just a few years ago, and wonder why we can't return to those growth rates. They look at our Asian neighbours expanding with breathtaking speed, and wonder why we can't emulate them. They reflect on the painful restructuring that the New Zealand economy underwent from 1984, and ask if it was all worthwhile. Some people suspect that perhaps the Reserve Bank has denied us the benefits which *should* have been available.

So today I want to discuss the issue of economic growth in the broadest terms. My aim is to provide a framework for thinking about what is a reasonable expectation for New Zealand's growth, to identify some of the factors that will determine whether we are able to achieve that potential, and to discuss the linkage between growth and the Reserve Bank's interest, namely inflation.

Running the economy is like running a marathon

Let me start by reminding you of the challenge facing a marathon runner. The objective is to go as fast as possible over the *full distance*. It makes no sense to sprint, 'hit the wall', and simply not finish the race, or spend much of the time on hands and knees recovering from that initial bout of excessive enthusiasm. Nor does it make any sense to walk most of the way, finishing the race with unused reserves of energy. Neither approach is likely to lead to running the race in a personal best time. And that is why experienced athletes constantly check their pace, making sure it is neither too fast nor too slow.

In terms of an economy, going too fast also leads to 'hitting the wall', with symptoms typically being a burst of inflation, a deterioration in the balance of payments position, perhaps an asset price boom, signs of difficulty in finding skilled employees, and very often a sense of euphoria ('look how fast I'm going and I still feel good!'). The results of hitting the wall are typically a sharp recession - sharper still if overcooked asset prices are collapsing.

To complete the analogy, in any long distance race you will find several runners who have paced themselves correctly, but who complete the race in very different times. Each may have done a personal best time, but those personal bests will be very different.

So it is with economies. Some economies will be able to sustain a much faster pace than others without running into the too-fast danger territory; some will naturally grow more slowly than others, without leaving large amounts of unused energy or potential. And it is not necessarily a question of one economy being better than another; it's just a question of being different. If that thought surprises, I'd simply note that the 'best', most highly productive, economy in the world - the United States - is also one of the slower growing economies, and has been now for some decades.

What is it that determines why some economies can achieve *sustainably* faster growth than others? Potential growth ultimately depends on two things: quantity and quality. The quantity of people and capital, in the form of factories, forests, trucks, roads, and all the rest. And the quality of those same things. Countries that have faster potential growth rates have faster trend growth in the quantity of people and capital at work in the economy, and/or faster trend growth in the quality or productivity of those things.

New Zealand's sustainable growth now about 3 percent annually

So how fast can New Zealand grow in a sustainable, or 'long-term average', sense? Looking forward, we estimate New Zealand's potential growth rate currently to be around 3 percent annually - a result of trend growth in the working age population of 1.5 percent and trend growth in output per person also of about 1.5 percent. That growth in real output per person comes from a combination of growth in the *quantity* of capital, and growth in the *quality* of that capital and the way we use it. In other words, we should expect our growth rate to *average* about 3 percent annually over the course of our usual economic cycles, with outcomes for any given year ranging from about 1 percent at the trough to, perhaps, 4 or 5 percent at the peak.

If a 3 percent average growth rate does not sound very exciting, let's put that into a broader context. Sustained growth of 3 percent is clearly well ahead of our experience in the seventies and eighties. Indeed, between 1975 and 1990, growth averaged less than 1 percent annually. Of course, occasionally we grew more quickly than that, but those periods of faster growth were typically short-lived, and associated with unsustainably large fiscal and balance of payments deficits and rapidly increasing inflationary pressures.

And the difference between a 1 percent average growth rate and a 3 percent average growth rate adds up to an enormous difference in the volume of goods and services available to New Zealanders if the difference is sustained for, say, 10 years. Today, our economy is producing goods and services totalling about $100 billion each year. If that total grows by only 1 percent a year for a decade, in 10 years' time we will be producing goods and services of $110 billion. If the total grows at an average of 3 percent a year, in 10 years' time we will be producing goods and services of $134 billion. The difference of $24 billion annually is a lot of additional hospital operations, or tertiary education, or restaurant meals, or overseas holidays.

But what about the much more rapid growth of the 1993 to 1995 period, during which at one point growth exceeded 7 percent? Surely that shows that we are capable of much faster growth than 3 percent? Clearly we can grow faster than 3 percent at times, and we are likely to do so, just as the marathon runner can occasionally sprint. Equally clearly, however, growing at 5, 6, or 7 percent for a brief period tells us nothing about how fast we can grow *on average* over a longer period of time.

The rapid growth which we experienced for a brief time in the 1993 to 1995 period was the result in part of adding more capital and of improving productivity, but was fundamentally the result of being able to bring back into employment the large number of people who had become unemployed during the recession of the late eighties and early nineties. You will recall that unemployment reached 11 percent of the labour force in the early nineties, and fell to 6 percent by the mid-nineties.

Everybody hopes that unemployment falls below its present level, of almost 7 percent of the labour force. Growth rates aside, lower unemployment implies a huge improvement in well-being, both for the individuals concerned and for society as a whole. It is conceivable, although unlikely during the next two or three years, that we could reduce unemployment by 5 percent of the labour force again. But it is clearly inconceivable that we can do that repeatedly, since that would quickly imply negative unemployment. To the extent that the very rapid growth of the mid-nineties was a result of being able to 'mine' the unemployment rolls for additional workers, it is not something which can be repeated indefinitely.

3 percent growth looks good by the standards of other developed countries

If we look at other countries, we find that, by the standards of the developed world, our 3 percent looks reasonably attractive. For example, the United States is generally estimated to have a growth potential of a little over 2 percent, being 1 percent labour force growth, and 1 percent annual productivity gain.

Over recent months, some US commentators have wondered whether the US productivity trend has lifted - largely as a consequence of the impact of new computer technology - but the jury is still out on this question. Certainly the fact that US unemployment has recently been falling markedly, and now stands at 4.9 percent, its lowest level in nearly a quarter of a century, strongly suggests that recent US growth has also been dependent on 'mining' the unemployment rolls for additional workers, and is likely to slow as finding additional workers becomes increasingly difficult.

It is also interesting to recall that, while some people have questioned why New Zealand can not achieve US growth rates, over the six years to March 1997 New Zealand grew at an average rate of 3.1 percent annually, slightly faster than the US economy grew over the same period (2.7 percent).

Mr Ian Macfarlane, Governor of the Reserve Bank of Australia, noted in a recent speech that, between June 1991 and December 1996, both New Zealand and Australia had enjoyed economic growth of 3.6 percent, and that that growth had been faster than growth in *any* of the other 16 developed countries against which he compared us with the exception of Norway and Ireland. (Speech to the Australia-Israel Chamber of Commerce in Melbourne on 15 May 1997.)

In other words, although it is too early to be dogmatic - given the influence of cyclical factors on growth rates measured over relatively short periods - New Zealand does appear to have made a significant gain in its growth potential in recent years, and to have lifted its performance from near the bottom of the class to somewhere rather closer to the top of the class of developed countries.

Why do the Asian Tigers seem so much more successful?

So where do the Asian Tigers fit in - countries that have been routinely achieving growth rates of 8 to 10 percent per annum - and why can't New Zealand be more like them? That's a question that has challenged economists around the world for some time. It would be misleading to claim that any sort of consensus has been arrived at - indeed, the debate on the sources of these extraordinary growth rates still rages.

But it seems likely that the very rapid growth achieved by the Asian Tiger economies, and by China, can be explained very readily in conventional terms, by looking at growth in the inputs of labour and capital, and at productivity improvements.

Thus demographics and migration trends are obviously important in determining how fast a labour force will grow. And Asian economies have experienced very rapid increases in their effective labour forces in recent years. Singapore, for example, almost doubled the proportion of its population engaged in the formal labour force between 1960 and 1990. That increase accounts for close to one-third of Singapore's remarkable average growth rate of 8.5 percent over that period.

Similarly, a few decades ago many Asian economies operated with little in the way of modern tools and machinery. In recent years, the growth in the quantity of capital has been huge. Annual investment in Singapore has consistently exceeded 30 percent of GDP, and rose to almost 50 percent at times during the seventies.

Those very high rates of investment, and the ability of traditionally poor, often agricultural, economies to pick up, off the shelf, very much more productive technologies from other countries have in turn made it possible to achieve extremely rapid improvements in labour productivity. Thus for example, taking a peasant farmer employing a water buffalo and a wooden plough and giving him either a modern tractor and a plough, or a modern computerised lathe, is likely to see an extremely large increase in output per person.

It seems clear that if a country has available some underutilised labour, large amounts of capital and an ability to adopt the latest technology, perhaps through being open to foreign direct investment, it is possible to grow very quickly indeed during a 'catch-up' phase. But once a country reaches the developed country norms in terms of labour force participation rates, standards of education, and available technology, growth rates will also tend to slow to match the developed country norms.

Japan seems to have undergone that transformation in recent years. After growing at a very rapid pace that enabled it to transform itself over the post-war period from a rather poor and war-devastated country to one having per capita incomes amongst the highest in the world, Japan's growth rate over the past few years has been much closer to that of the 'more established' developed economies.

Lessons for New Zealand: immigration policy, benefit policies, and education policy all important

What can we learn from this survey of growth in other countries that is relevant to New Zealand today? The most important lesson is that if we wish to lift our long term growth rate - our *sustainable* average growth rate - we have to look to those factors that are important *determinants* of long term growth, namely the quantity and quality of the labour force, the quantity and quality of investment, and the other factors which determine the productivity with which labour and capital are combined.

The supply of labour is largely determined by population growth and the proportion of the population which is engaged in employment.

We can influence population growth to some extent, by our policy on immigration. The experience of Australia, Canada and the United States - indeed of New Zealand -

suggests that a well-considered immigration policy can have a significantly beneficial effect on an economy's long-term growth rate not only by increasing the labour force but by bringing skills, market knowledge and capital.

The proportion of the population engaged in formal employment (the participation rate) can be influenced by policy even more substantively. For example, pension and entitlement rules which impose very high effective tax rates on low income people contemplating staying in, or re-entering, the work force tend to reduce participation rates. This makes the current discussion about reforming the benefit system of direct relevance to potential growth.

With an ageing population and sensible policies on retirement income, we can expect a greater proportion of the population to remain in work beyond the current retirement age and, with some evidence that people remain healthier, both physically and mentally, when they are employed, that is almost certainly something to be welcomed for reasons going well beyond potential growth rates. Moreover, we can probably expect the trend towards higher participation rates for women to continue, and this too will mean that the labour force is likely to grow rather more quickly in the years ahead than does the population generally.

The *quality* of our labour force can also be influenced through public policy choices, but only slowly. It is abundantly clear that the process of economic development and growth goes hand in hand with enhanced educational standards. We in New Zealand once routinely listed 'a well-educated labour force' as one of the clearly identifiable strengths of our economy. We can no longer be so confident on that front. The capacity of today's high school graduates to write grammatical English seems to be disappointing to a great many employers, while international studies comparing the ability of New Zealand students in mathematics and science with that of students in other countries suggest that we no longer have anything of which to be terribly proud. In the Third International Maths and Science study, New Zealand ranked 22nd out of 41 countries in science and 24th in maths. By contrast, the top four countries in maths were Singapore, South Korea, Japan, and Hong Kong, with Singapore, South Korea and Japan also occupying three of the top four positions in science.

As a general proposition, those economies which have been out-performing us in terms of per capita growth have typically also been out-performing us in educational effort. Whether that is because those countries have better educational structures, or just have people who are more convinced of the crucial importance of a good education, I do not know. But the result is that the quality of their labour force is rapidly improving, whereas ours is improving rather more slowly. For the longer term, it may well be that the most important policy area relevant to improving our sustainable growth rate is education policy.

The quality of management also matters, and in this regard I have no doubt that the opening up of the New Zealand economy during the last decade or so has been a catalyst for improved business management in New Zealand. Certainly poor management is no longer sheltered by regulations and tariffs which keep competitors at bay.

Similarly, economies that grow strongly typically have good industrial relations. Here too we have made progress in recent years. The less centralised structures we now have for negotiating pay and conditions have been beneficial from the standpoint of encouraging both employers and employees to focus on their mutual stake in staying up with, if not ahead of, the competition. At the very least, nobody seems to want to go back to the very highly centralised industrial relations structures we had in the seventies and eighties. And the number of 'days lost' as the result of strikes is well down on what used to be regarded as normal. These things are all helping our growth performance.

Lessons for New Zealand: policies which distort investment decisions damage our growth prospects

Additional investment, so that each person employed is teamed with a greater amount of physical capital, is also crucial to our growth performance. But in some ways the *quality* of additional investment is even more important than its quantity. When we look at New Zealand's slow growth period - through the seventies and eighties - we find that the ratio of investment to GDP was quite respectable by comparison with other developed countries. What was impeding growth was not so much an inadequate *level* of investment as a persistent tendency to direct capital into low-yielding activities.

Perhaps the best-known examples of low-yielding investment were the 'Think Big' projects of the late seventies and early eighties, but a great many could also be found in the private sector. Partly because of the distortions caused by inflation, much investment was channelled into real estate investment, sometimes well ahead of demand. Partly because of subsidies, capital was invested in the production of sheep meat for which there was no market. Largely because of quantitative import restrictions and high tariffs, a great deal of capital was invested in activities which, while profitable to the investors, added little or nothing to output valued at international prices. Worse, in some highly protected industries, when measured at international prices the value of output was actually negative. In other words, the cost of inputs, at world prices, exceeded the value of outputs at world prices.

It is with those considerations in mind that countries seeking to boost their growth performance look to micro-economic reforms - to reduced protection, to deregulation, to flatter and broader tax structures, and to increased market flexibility - to encourage available resources of labour and capital to move into those activities where private financial returns and national economic returns are similarly high.

With that, of course, goes the requirement that those same resources are permitted to move *away* from activities in which the returns are low. Allowing industries which depend for their continued existence on protection from imports to continue operating indefinitely may be doing a favour to the subsidised few, but it certainly does not help our growth potential.

(It surprises me that we still hear, occasionally, a manufacturer argue that we should not reduce tariffs in New Zealand because other countries use tariffs to protect the internationally uncompetitive parts of their economies. Since tariffs are essentially a tax on exports, and our export industries are almost by definition those which are the most efficient in international terms, why we should tax such industries just because other countries tax *their* export industries is frankly beyond me.)

Lessons for New Zealand: growth affected by high taxation?

Attention is also increasingly focusing on the role which the total size of government plays in influencing an economy's growth rate. In recent months, a series of studies commissioned by the Inland Revenue Department has reached the conclusion that when a government's total tax revenue exceeds about 20 percent of GDP the impact on growth is negative. Another study commissioned by the Treasury has cast some doubt on the methodology used in the studies commissioned by the IRD, but suggests that the optimum level of taxation, relative to GDP and from a growth point of view, is probably *below* 20 percent. Why? Presumably because with low tax rates fewer resources are squandered in trying to minimise tax obligations, and the disincentive effects of taxation on effort and risk-taking are reduced.

I myself do not know why countries with relatively low tax burdens appear to grow more quickly than those with relatively high tax burdens, or indeed whether there is any causal relationship between low tax levels and high growth. But it does seem clear that the East Asian countries where economic growth has recently been most rapid are also countries where the ratio of tax revenue to GDP is very much lower than it is in New Zealand or other developed economies.

Lessons for New Zealand: growth remains heavily dependent on foreign savings

One other issue deserves mention. Before a country can invest it must have access to savings - either its own domestically-generated savings, or the savings of other countries. New Zealand has a long record of relying on the savings of others. That was hardly surprising when, as a colonial outpost, we drew on the capital of Britain to fund our development. We also relied on a flow of migrants to boost the available labour force. Together, those imported resources were combined to generate growth and wealth at a rate that was probably similar to that achieved by the Asian Tigers in the last decade or so.

While the flow of migrants is generally rather smaller in modern New Zealand than was the case during the late nineteenth century, we've never fully weaned ourselves from a relatively heavy dependence on the savings of others. We appear to see nothing unusual, let alone undesirable, in continuing to do so indefinitely.

It is not at all obvious that we would invest more, or would invest more efficiently, if we generated more savings domestically. But it seems to me, as someone who believes that our being open to international capital markets has been hugely beneficial to our economy and to our society, that we would probably face a more stable and perhaps more secure future if our dependence on the savings of others were reduced. At the very least, we need to recognise that there is little point in decrying the degree of foreign ownership of New Zealand businesses and assets if we are not also ready to decry the paucity of New Zealand savings.

Growth and monetary policy

So where does monetary policy fit into this growth story? It may surprise you to hear me contend that, as a determinant of long term growth potential, monetary policy has a relatively modest and indirect influence.

I say that because, as I have explained, long term growth is a product of labour and capital, and how productively those two factors work together. The things which I have described as being crucial here are essentially 'supplyside' matters - the rate of growth of the labour force, the quality of the education system, the extent to which government policies distort the allocation of investment, and all the rest. These are the crucial determinants of our sustainable growth rate.

But monetary policy can help in two ways. First, by keeping inflation stable it can, as a by-product, assist in moderating economic cycles - restraining demand when it threatens to exceed the economy's capacity to supply and encouraging demand to increase when it threatens to fall short of capacity. In other words, successful monetary policy aimed at keeping inflation stable also keeps the economy's pace as close to the optimum as possible. In the marathon analogy, successful monetary policy avoids the economy 'hitting the wall', but also avoids it 'running too slowly', with unused reserves of labour and capital.

Secondly, there is now strong evidence that high inflation positively damages sustainable growth, and growing evidence that there is some damage caused even by quite low rates of inflation.

Nobody argues that price stability will create a major improvement in an economy's sustainable growth rate - that growth rate depends primarily, as indicated, on all the real factors I have already discussed. But it now seems beyond reasonable doubt that keeping the general price level stable is the best contribution which monetary policy can make to the way in which the economy operates, and therefore the best contribution to the economy's sustainable growth rate. In an inflation-free environment, investors and the public generally get their best shot at reading accurately the signals that markets are delivering - which goods and services represent best value, where the best returns on investment may be found, how much to consume and how much to save.

Price stability is not a sufficient condition for strong growth. It is not even a necessary condition for strong growth. It is just the best contribution which *monetary* policy can make.