Growth, productivity and monetary policy: longer-term perspectives

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Introduction: competitiveness and productivity

I have been asked to discuss the New Zealand economy in a medium term context, with particular reference to the place of forestry. I am conscious also of the overall theme of this conference – the competition gap. I applaud the Association for choosing to focus on that theme, because while that is clearly a very relevant issue for the forestry sector to be debating, it is equally relevant to the broader economy.

We all wish to raise living standards in New Zealand. The reform effort of the past 13 years has been focused on precisely that goal. To achieve it, we require a sustained lift in productivity, across the New Zealand economy. Improved productivity and 'meeting the competition gap' are one and the same thing.

It is not my intention to provide a substantive projection of New Zealand's economic prospects over the growth cycle of a GF17 pine tree. Nor do I intend to discuss the likely prospects of the forestry sector. Rather, I will try to lay out a few of the very broad factors that will shape the development of the New Zealand economy over the medium term, and to reflect a little on the factors that influence interest rates and exchange rates over longer time horizons.

The determinants of economic growth

Last month, Governor Don Brash delivered a speech to the Auckland Rotary Club under the topic 'How fast can the New Zealand economy grow?' The key theme of that speech was that our growth potential is determined ultimately by quantities and quality. The quantity of people and the quantity of capital – in the form of factories, forests, trucks, roads, computers and all the tools of a modern economy. And the quality of those same inputs – how well they work and how efficiently they are deployed.

As Dr Brash went on to say, the Reserve Bank believes that New Zealand's longer-term growth potential is probably of the order of 3 percent annually at present – a result of a trend growth in the working age population of around 1.5 percent and trend growth in output per person, or productivity, also of around 1.5 percent.

Lifting that growth potential requires bigger quantities or better qualities – of people, attitudes and equipment.

On the quantities side, we can't do a great deal in the short term about the size of the working age population. After centuries of diligent practice, it still takes around nine months to produce a new Kiwi and, only a little quicker than Pinus Radiata – around 20 years – to get that new Kiwi into the work force. Of course, we can import new workers 'ready built-up'. But even then, as we have discovered in recent years, there are limitations on how quickly new immigrants can be absorbed.

In any event, while increasing the size of the labour force may enable us to boost overall economic growth, what really matters for living standards is *per capita* growth. And that means we need to focus on output per person, or the productivity of our work force, not just its raw quantity.

In the longer term, and at the risk of doing some violence to the wealth of economic research on the subject, productivity is heavily dependent on one key factor – the quality of our human resources. Living standards rise on the back of overall educational attainment and attitudes. That implies a continuing need to raise the quality of our general educational effort. It means raising the numbers participating in higher education. It means improved on-the-job training. It means better trained managers able to make smarter decisions and provide improved management of our work force – in the forest, on the factory floor, in the research laboratories, within both the public and private sectors. And it means smarter governance from within the nation's board rooms.

The role of capital investment

Intertwined with the quality of our work force and how well it is managed is the issue of the quality and quantity of physical capital available to each person. By teaming better trained people with better technology and working with more and better physical capital we can provide a recipe for making serious progress in raising productivity. And through that, we can make serious advances in our living standards.

New Zealand's history provides some useful insights into the role of capital investment. During our slow growth phase – through the seventies and eighties – our investment levels were quite respectable by the standards of other developed economies – somewhere around 25 percent of GDP per annum. What was impeding growth was not so much an inadequate quantity of investment, but poor quality investment – a persistent tendency to direct capital into low-yielding activities.

The sources of that misdirection of capital are not hard to find. They lie with government-led investment decisions – for example, 'Think Big' projects – and with investment encouraged into sectors or activities sheltered by protections of various kinds. It is those protections – the import quotas, licensing arrangements, or tax incentives – that produce situations in which the returns to private investors become disconnected from the underlying market realities. The individual investor may be profiting as a consequence of those protections, but only at the cost of overall national efficiency and income.

Raising productivity means allowing change

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, to increased market flexibility – in order to encourage available resources of labour and capital to move into those areas where private financial returns and national economic returns are similarly high.

Of course, encouraging the flow of resources into higher-yielding activities also implies that those same resources, labour and capital, are permitted to move *away* from activities in which returns are low. So when we see sheep and beef farms being converted into either dairy units, on the one hand, or pine forests on the other, we need to check if there are particular regulatory or taxation reasons encouraging that shift. If there are none, we are entitled to conclude that rational investors are making a judgement that the future returns on investment in dairying or forestry are likely to be superior to the future returns on sheep and beef farming. Moreover, we are entitled to presume that, as a result of that changed land use, our national growth potential will be higher. The efficiency of our capital stock will have increased.

Of course, rational investors may be wrong in their judgements. Only time will tell. But so long as those investors are risking their own money, in an efficient regulatory and tax environment, we stand the best possible chance of maximising the performance of the economy overall.

One message should be very clear. We cannot lift our economic performance by locking land, labour or capital into low-yielding activities. Lifting our growth performance will inevitably mean continuing change, including the decline of some sectors, in order to free resources for movement to expanding, higher-yielding activities. And in a world of ever faster innovation, the high performance economies are likely to be the more flexible ones – the ones most able to quickly take up emerging technologies and production processes and to encourage the shift of resources from one industry or production technique to another.

Monetary policy has a background role in facilitating faster growth

You will note that so far I have managed to avoid any mention of monetary policy or the role of the Reserve Bank in all of this. Interest rates and exchange rates haven't entered the equation. That's because monetary policy and the Reserve Bank have an important, but essentially 'background', role in allowing the economy to achieve its longer-term growth potential.

A couple of points are relevant here.

What I have discussed so far are the 'real' contributors to economic growth – the quantity and quality of inputs. These are the 'supply side' factors.

Monetary policy and the Reserve Bank operate on the demand side. The task of monetary policy is to maintain price stability. That involves ensuring that demand in the economy grows roughly in line with the capacity of the economy to meet that demand. The Reserve Bank's *Policy Targets Agreement* (PTA), signed by the Minister of Finance and the Governor, sets a 0 to 3 percent inflation target as the Governor's *sole* objective. The PTA establishes that single objective of price stability "...so that monetary policy can make its maximum contribution to sustainable economic growth, employment and development opportunities within the New Zealand economy."

The rationale for that position is quite straightforward, and is particularly relevant to a sector such as forestry which involves such long investment horizons. 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.

Simply adopting an easy monetary policy does nothing to increase the supply of labour or its skill level. It does nothing to improve the availability of better technologies. But most importantly, an easy monetary policy that gives rise to a risk of future inflation is likely to divert investment and the flow of resources *away* from sectors with longer-term investment horizons – such as forestry – towards quick return real estate and similar investments that exploit the tax and other distortions which emerge in an inflationary environment.

Once price stability has been achieved, monetary policy is essentially an exercise in smoothing economic cycles – slowing the economy when it looks likely to overheat, stimulating it as activity slows.

That is not a straightforward exercise. Even if we get it right, (and we won't always) there will still be economic cycles. But we should be able to avoid the boom/bust cycles of old. If our longer-term growth potential is around 3 percent, it is probably the case that growth outturns in the 1 percent to 5 percent range will be the norm. Occasional external shocks and surprises – climate, international events, and so on – may take us outside that range. But surprises of that sort should be rare.

However, a sustained growth performance within a range of that sort would represent a substantial step up from our experience through the sixties and seventies, and would place us somewhere near the top end of the OECD growth league.

Interest rates are determined by international conditions and local risk factors

So what does that mean for interest rates and exchange rates in New Zealand over the longer term?

Essentially, in our world of open capital markets, interest rates in New Zealand will tend to settle at some margin above or below a benchmark set in US financial markets. How large that margin is (and whether it is positive or negative) will depend on the risks and returns that savers, both domestic and foreign, associate with New Zealand.

There are, of course, many different risks that enter that assessment. But a key one is the risk of future inflation. A firm commitment to the maintenance of price stability is already resulting in substantially lower interest rates in New Zealand. The rate paid by the New Zealand Government on its New Zealand dollar 10 year bonds has fallen from around 10 percentage points above that paid by the US Government on 10 year US dollar bonds in the mid 1980s, to little more than half of one percent above the US rate.

Our shorter-term interest rates have also fallen sharply relative to those in other countries over the past decade or so, but they remain high by OECD standards, and high in real terms. That will remain the case so long as the strong demand for borrowing that we have seen over the past several years continues.

On that note, it is worth reminding ourselves that the route to consistently lower interest rates lies in allowing both savers and borrowers to become confident that the risk of future inflation is slight.

We can't look to the exchange rate to boost international competitiveness

A conference examining competitiveness may find it tempting to look to the exchange rate for salvation at some point. Don't bother.

The forestry industry, like every other export industry in New Zealand, is going to have to live with an exchange rate that varies. There is nothing you can do about that, and there is nothing the government or the Reserve Bank can do about that. We live in a world of floating exchange rates.

While it is conceivable that we could fix our exchange rate to the US dollar, or the Australian dollar, or even the TWI (as we once did) we can't fix to all simultaneously. Inevitably we have to learn to cope with exchange rate variability.

In fact, on measures of shorter-term exchange rate volatility, the New Zealand dollar is a surprisingly good performer**.** Day-to-day volatility of our currency is modest when measured alongside the experience of other developed countries – even those much larger than New Zealand.

To assess the impact of longer-term exchange rate trends, we need to look to measures of the 'real' or inflation-adjusted exchange rate – because that is what matters for exporters. On that basis, we find that the New Zealand dollar moves through the inevitable cycles, but will typically be found within about 15 percent to 20 percent of its longer-term average. Our recent experience has been consistent with that. The real TWI was around 10 percent below its long-term average at its last trough in 1992. At its recent peak, in April of this year, it was around 17 percent above that same longer-term average.

While cycles in the real exchange rate of that amplitude can certainly create discomfort for exporters, it is clear that they are well within the range experienced by other currencies. In essence, exporters should be factoring cycles of that sort into their business planning. It is clearly relevant to the variability of their future earnings stream, and therefore, to the value of their assets and to the nature of the capital structure they require to stay in business. Of course, it is also relevant to their balance sheet management and to risk hedging strategies they may need to adopt.

The best contribution that governments and central banks can make to moderating real exchange rate cycles is to embrace policy consistency and transparency – in monetary policy, fiscal policy, and in tax and regulatory policies. The decline in exchange rate volatility in recent years provides some evidence to support that.

One point we should all be clear on. There is no future in thinking we can pursue competitiveness, in forestry or any other sector, through attempts to use monetary policy to engineer a weaker exchange rate. I say that for several reasons:

- Competitiveness and the productivity improvements that ensure competitiveness are products of 'real' advances in efficiency, technology and management. Lowering the exchange rate makes no one more efficient.

- The focus of monetary policy on the single objective of price stability is key to convincing savers and investors that, in taking their decisions, they do not need to factor in a large inflation risk. It is only in that way that we can get sustainably lower interest rates.

- As our own history well demonstrates, any short-term gains that may be available to exporters as a result of a one-off depreciation of the exchange rate are quickly eroded as future inflation increases. As a fix for competitiveness problems, exchange rate depreciations are both addictive and ultimately destructive.

- Central banks do not determine real exchange rates in the long term. Markets and relative economic efficiency/productivity trends determine real exchange rates.

What of the balance of payments deficit?

Let me touch on one other issue that is relevant to the longer-term behaviour of the New Zealand dollar and New Zealand interest rates – the balance of payments.

We are currently running a current account deficit of the order of 6 percent of GDP. That makes ours amongst the largest external deficits in the OECD. Note also that New Zealand's net foreign debt currently amounts to around 80 percent of GDP – which puts us at the top end of international experience. To prevent that external debt ratio from increasing further, it is necessary for the current account deficit to decrease to less than the annual growth of GDP - ie to something less than about 3 percent.

The key issue here is domestic savings behaviour. To the extent that domestic savings are insufficient to fund the nation's investment needs, we must rely on foreign savings. And if we are reliant on foreign savings, we must, by definition, continue to run a current account deficit. That is a simple accounting identity.

I note with interest the estimates of some commentators who suggest that the forestry industry alone will require substantial volumes of foreign investment over the next few years. They may be correct in their estimates of investment needs. But if those needs are met from foreign investment, we must accept that that is equivalent to saying that New Zealand must continue to run a current account deficit.

Will New Zealand generally, and the forestry sector in particular, have difficulty attracting the investment capital it requires?

Probably not. So long as investors have confidence in the quality of our industries, the reliability of future earning streams, and the quality of our future macro and micro economic policies, it is unlikely that we will have difficulty in attracting the necessary investment.

We compete in a global market to sell our products. Equally, we compete in a global market to attract savings for investment. The pool of savings available globally is enormous, and New Zealand's needs represent just a minute fraction of that available. New Zealand need not, therefore, regard itself as investment constrained.

But to the extent that our domestic savings fall short of the levels required to fund our investment needs, our external debt ratios continue to rise, then the risks perceived by potential investors will also rise. With higher risks come increased interest rate margins. It is probably also the case that those high external debt ratios leave New Zealand a little more vulnerable to shifts in international market sentiment, which may reveal themselves in sharp and sometimes disruptive movements in interest rates and exchange rates.

For those reasons, it is our belief that New Zealand would face a more secure future if our dependence on the savings of others were reduced.