
Speeches

The Building Blocks of Economic Growth

An address by Donald T Brash, Governor of the Reserve Bank of New Zealand to the Canterbury Employers' Chamber of Commerce, Christchurch on the 28 January 2000.

Introduction and retrospective

Over the past few years, as this speech has become an established part of my diary, I have used the occasion to address various issues of the day, such as developments with the exchange rate, the balance of payments and the Reserve Bank's inflation target.

Since this is my first public speech of the new millennium, the temptation is to step back much further than usual and attempt to place current economic and monetary policy matters into the context of the past thousand years.

Instead I want to speak on a subject that is of rather more immediate interest, economic growth. What drives it, what will help us do better, and where does monetary policy fit into the scheme of things? To get ahead of myself for just a minute, there won't be too much about monetary policy. Good monetary policy is important, but even the best monetary policy in the world will not of itself generate growth.

But as topical as growth is, history matters when we think about growth. So let me indulge just briefly in a piece of millennium contextualising. In an excellent survey a few weeks ago, *The Economist* magazine¹ reviewed humanity's experience of economic growth over the past 1000 years. That survey observed that the steady rise in living standards that we in the Western world now take for granted is, in fact, a fairly recent phenomenon. Had I lived at the turn of the last millennium, for example, my life would almost certainly have been – in the famous words of Thomas Hobbes – “poor, nasty, brutish and short.” My lifestyle would have been essentially unchanged from that of my ancient grandparents and great grandparents. Prior to about the middle of the 18th century, economic growth was so slow that it was often imperceptible within the span of a lifetime.

The staggering growth of the last two or three centuries has supported a huge increase in population. And, in the West, ours is the first age in which affluence has been enjoyed by more than just a tiny fraction of the population. Even the less well-off can have access to things that were scarcely dreamed of by even the wealthiest at the beginning of the twentieth century – things like an electric washing machine, a television, a stereo, a computer, vaccination against disease, contact lenses, air travel and so on.

So what happened to launch us into an age in which rising living standards and increasing wealth have become the norm rather than the exception? To understand that is to give ourselves a much better chance of understanding the way ahead.

Knowledge helped: the fruits of formal scientific endeavours, and of the applied curiosity of so many remarkable men and women. But, as *The Economist* essay notes, much of the knowledge that proved so important in sparking the extraordinary growth in Britain, and subsequently elsewhere, was not new. Some of the key technologies were available in Rome and China hundreds of years earlier. So knowledge alone was not sufficient. It did not give rise to sustained economic growth in China. Indeed, in many cases the technologies that proved so valuable in Western Europe centuries later had, by then, been completely lost to the Chinese.

So if knowledge alone is not sufficient to promote growth, what are the other factors or attributes required?

There is no simple formula. Indeed, that is one of the things that make economics so interesting. As we look to history to identify the successful economies, and then try to analyse what made them so, we find ourselves wading into the uncertain fields of social values, politics and institutions. We have to grapple with such things as property rights, law and order, the ability to contract into the future with confidence,

¹ 25-31 December 1999 issue.

culture and values, an openness to innovation, social cohesion, public infrastructure, fair and efficient taxes, and sound money.

Before anyone objects, let me volunteer immediately that that list is neither comprehensive nor ranked in order of importance. But whatever the full story, we quickly find two themes emerging: sustained growth and prosperity required an openness to change, and both vigorous markets and good government had important roles to play. In short, markets and governments needed each other.

What about the future?

Well, all that is interesting history, but what does it mean for 21st century New Zealand?

Clearly, New Zealanders want rising standards of living. Rising living standards have a number of dimensions – each of us places value on a variety of different things, some traded in the market-place, others not. But there is a widely-shared consensus that strong economic growth is a key foundation on which broadly-based increases in living standards can be built.

Equally clearly, there is a degree of public dissatisfaction with both the pace and the nature of the economic growth achieved in recent decades. And the facts are quite stark. Our standard of living has improved over the years. But the improvements in New Zealand have not matched those enjoyed by Australians or others in Europe and North America.

Does that slide in relative living standards mean that the reforms of the past 15 years were misdirected or wrong? Again, my view is clear. The reforms were necessary, they were generally well-directed and, on the whole, they were well-executed. They helped deliver us both increased actual growth during the 1990s – we've broadly kept pace with the world in the 1990s – and they've increased our potential for growth in the years ahead. But the challenge now is to sustain the growth, and begin to close the gap between average incomes in New Zealand and incomes in other developed countries.

We did very well for a long time because there weren't many of us, and climate meant we were very efficient producers

of agricultural products that were prized by rapidly growing urban populations abroad. But as Denmark can't today prosper on fine bacon, or Italy on the very best olive oil, so the best Canterbury lamb and good Akaroa wine won't be enough to keep us at the leading edge of the nations of the world. The pressures we have been responding to in the last 20 years are largely beyond the control of any government – a continuation of a two-centuries-long slide in the real price of commodities and basic manufactures, falling transportation and information costs, and new technologies that increasingly both require and reward skills. Add to that a legacy of change postponed.

As I travel the country talking with groups like this, it is very clear that New Zealanders are anxious about the way forward and are groping for answers about what will restore our relative position in the world. And there seems to me to be no good reason why New Zealanders should not aspire to living standards within, say, the top 10 of OECD nations. We were there in the 1950s, and indeed probably for much of the early part of the twentieth century as well. We now stand at about 20th, near the bottom of the OECD league, with average incomes 20 percent adrift of even middle-ranking countries like Australia, Sweden, and Ireland.

We are capable of reversing the trend but there are few certainties, no quick fixes, and no guarantees. Governments cannot simply push a button labelled "high growth", and no one will gift growth to us. Some things we know work; others we suspect might. But in other areas, we simply have no idea whether we are hurting or helping (or neither) the cause of growth.

Often it seems that the pre-conditions for growth are laid down across decades, perhaps centuries. If so, they are hard to lose, but also hard to gain. In many respects, government policies and private sector practices are very different in, say, the United States and Germany – and yet both are wealthy, growing, economies. And no matter what the policy regime, the countries of West Africa, for example, are likely to be desperately poor for decades to come. Probably a few things matter a lot, and a lot of things matter a little. Unfortunately, it is often easiest to do something about things that won't do very much to boost long-term prospects.

Some things we simply can't change. Geography matters, and drawing a circle centred on Christchurch with a radius of 2100 kilometres will always encompass only a few million New Zealanders and a lot of seagulls. Similar circles centred on Dublin, Helsinki, or Singapore encompass hundreds of millions of people. That harsh fact makes it all the more important that we get right what we can influence.

What else matters? First, and to go back to the history I started with, we can say confidently that knowledge matters. That has rarely been more obvious than over the past few years in the United States. As we speak, the US economy is on the verge of breaking all previous records for uninterrupted growth – by next month, a record 107 months. During the 1990s, many think that the sustainable medium-term growth rate of the US economy has risen from around 2.5 percent in the early 1990s, to around 3 or even 3.5 percent today. In large part, that increase reflects the extraordinary developments in information technology in recent decades that are now coming to fruition. Record-high share prices year after year do raise questions about how much is sustainable, but the change in the underlying technology is real and will not be lost – it is transforming the US, and indeed the entire developed world.

So knowledge matters, and it will matter increasingly. We need people with ideas and innovations, and entrepreneurs to help convert those innovations into successful businesses. But we also need social attitudes that encourage both ideas and enterprise, and financial markets that support and sustain that enterprise.

New Zealand will lift itself back to the top tier of OECD economies only with firms and workers that are equipped with the skills and energy to participate fully in a knowledge-based economy. And not simply to participate, but to be at the leading edge of developing and applying new technologies, and finding markets for them.

A number of firms here in Christchurch – including Aoraki Corporation, run by our own director, Sir Gilbert Simpson – are already a part of that drive, but we still have a considerable way to go. This is certainly not a technology-averse society. We lead the world in the take-up of new banking technologies (such as EFT-POS); leading-edge New Zealand technology played a big part in winning – and, we all hope,

retaining – the America's Cup. And yet it is sobering to turn from the impressive anecdotes to the hard data, where we find that New Zealand's ratio of exports of high-tech products to our imports of such products is among the very lowest in the developed world – ahead only of OECD laggards Greece and Turkey.

There has been considerable debate in recent years about the role that government support for research and development can, or should, play in helping foster this sort of orientation in our firms. In its recent briefing papers, the Ministry of Research, Science, and Technology has highlighted that New Zealand stands out as providing less support than most other countries. I am no expert in this field, and the potential costs and benefits of such policies need to be weighed carefully. There can be considerable costs to getting policy wrong. But that cuts two ways: there are costs in adopting measures that later prove to be lemons, but there are also costs in not adopting initiatives that should in fact be pursued. New Zealand's history is, of course, littered with examples of the former sort. I suspect we should be wary of dogmatism about things that are likely to be of secondary importance, especially when we still know relatively little about the longer-term impact of the general tax and spending policies that affect incentives throughout the economy and society.

Turning from firms to their workers, there are signs that the quality of the labour force is improving. The number of students enrolled in tertiary education has increased markedly throughout the 1990s, and whereas only 5.5 percent of the adult population had a university degree in 1986, by 1996 that number had risen to 8.5 percent. The performance of the education sector remains critical to the future of New Zealanders. But schools and universities can't do it alone. They can only work with the raw material they are given – children who are already shaped by the attitudes and practices of their parents, peers and communities.

Many young New Zealanders are still leaving school less well-educated than their international counterparts. And a disproportionate number of Maori and Pacific Islanders are leaving school without qualifications and, as a result, are working in low-skilled jobs. Over the coming decades, this group will form an increasingly large part of the working

age population. Raising Maori and Pacific Islander educational performance provides a significant opportunity for improving New Zealand's growth prospects. And the threat to social cohesion – and, hence, to the capacity of the country to adapt and grow – is equally real if, as a nation, we fail on this count.

A key aspect of any successful growth strategy will be openness to international trade and a thorough-going integration into the global economy. When so much about growth is uncertain, this is one area in which economists find relatively little to dispute, particularly for a small country such as New Zealand. Studies show a clear link between the openness of an economy – openness, that is, to international trade, investment, and ideas – and economic growth. Openness enables us to specialise, to find global and not just local markets (and rewards) for innovative products, and it provides the constant discipline and challenge of the fresh ideas, perspectives and products the wider world is making available.

For much of the last half century New Zealand was not an open economy. Indeed, although we now have quite an open economy, we opened up only relatively recently. And that is reflected in our ratio of trade to GDP, which – contrary to much popular mythology – is much lower than would be expected for a country our size. The length of time an economy has been open also matters. Attitudes and values, skills and markets, can only rarely be transformed overnight, no matter what happens to the direct financial incentives firms and individuals face. By its nature, culture, whether business or otherwise, changes relatively slowly.

In a sense, none of this should be a surprise to a New Zealand audience. From the early European sealers and whalers, to those exchanging flax for muskets, through our agricultural age, to the dawn of the 21st century today, so much of our economic activity has depended on two-way foreign trade. Even for the small settler communities at the end of the earth 150 years ago, it never made sense to attempt to self-sufficiently meet all their own material needs. Self-sufficiency makes so much less sense today, if we value prosperity and opportunity at all. With all due respect to the Christchurch technology sector, and I have a great deal of respect for it, think of the inefficiency and waste involved if we'd had to

develop and maintain our own Microsoft, meeting only New Zealand needs, our own Boeing, our own Vodafone. And equally, the prospects for our own innovators – Tait Electronics or Aoraki Corporation, say – would have been bleak had they been limited to New Zealand sales alone.

As a nation, we turned inwards in the late 1930s, taking the protectionist route to development. The advocates of that change were unquestionably well-motivated. They too recognised that in the long-run agriculture was unlikely to sustain first-world living standards and strong growth. But equally clearly it was a wrong turning that delayed our adjustment, our shift to a high-tech globally-integrated economy, by several decades. We pay the price for that now, in at least two ways. First, our economy and people are less able to take advantage of the opportunities that beckon this decade than we might have been if we'd avoided the by-ways of protection. But, second, we face the very real human and social costs of adjusting away from the industry structures which the protective policies of the 1930s onwards bequeathed us.

There are no easy answers to the practical questions of just how fast we should move away from that protectionist route. Much of the work has already been done, even though the current government and its predecessor have answered slightly differently the questions about the protective barriers that remain. Trade matters – it is simply vital to our future – but I believe there is also a strong recognition of the need to bring people along. Speaking only a couple of weeks ago of the changes new technology is bringing about in the US, Alan Greenspan – himself an enthusiastic advocate of the market economy – noted:

But as we seek to manage what is now this increasingly palpable historic change in the way businesses and workers create value, our nation needs to address the associated dislocations that emerge, especially among workers who see the security of their jobs and their lives threatened. Societies cannot thrive when significant segments perceive its functioning as unjust².

If an innovative and competitive private sector is important, so too is an innovative and efficient public sector. In my

² "Technology and the economy", remarks to the Economic Club of New York, 13 January 2000.

many years of observing political processes, I find it difficult to recall a period when the calls for increased public spending were more intense – health, education, superannuation, defence, conservation, R & D and industry support can all present strong cases as to why more public spending in those areas is desirable. Yet we know that our public spending is now not particularly low by the standards of other countries – and health, education, and welfare spending (as a share of GDP) is higher today than it was 15 years ago. We know also that much of our workforce is mobile, and that tax rates are one – though of course only one – part of the equation that skilled young New Zealanders face as they make their judgements about whether to stay or go. Likewise our companies are increasingly mobile. They don't have to be based in New Zealand, especially as they grow and find bigger and easier markets elsewhere. Our public infrastructure, business environment and tax regime will increasingly figure in the decisions about where companies choose to reside.

I am not here arguing that small government is necessarily better government. The evidence of successful economies internationally is quite mixed on that front. Across quite a range, the size of government seems to matter less than does the quality of government policy. But it seems axiomatic that, when government represents the biggest single sector of the economy, its own efficiency and effectiveness will be an important influence on overall economic performance.

This takes me to another important component in successful growth strategies – macroeconomic stability. By that I mean the overall balance of government taxes and spending – the fiscal balance – and the thrust of monetary policy.

The goal of fiscal policy in recent years has been to maintain surpluses and reduce public sector indebtedness. Progress on that front has been impressive. A string of fiscal surpluses since 1993/94 and a sharply-reduced government debt to GDP ratio may seem of little relevance in the face of pressing social needs. But there can be little doubt that this improved fiscal performance has contributed to improving overall economic performance in New Zealand. And of course improving economic performance – and in particular faster growth – also makes us able to more readily fund additional public spending over the medium-term.

In principle and other things being equal, an improvement in the fiscal position tends in the short term to ease the pressures on monetary policy, and hence on interest rates and the exchange rate. The opposite is also true. But these are transitional effects only.

Perhaps more important are the medium-term effects. First, the much-reduced public debt achieved in recent years provides the government with greater breathing space to cope with adverse shocks to our economy in future – and, of course, adverse shocks will happen again. The lower debt levels will also help the government cope with the marked increase in the pension burden after 2010 as the post-war “baby-boomers” move into retirement years, without major increases in tax rates.

Secondly, and more directly relevant to our growth prospects for the next decade or two, the lower the level of public debt, the lower our interest rates are likely to be on average over the course of the business cycle. In fact, of course, our long-term real interest rates have been – and remain – consistently higher than those of countries such as the US, Australia, and the UK, despite the improved fiscal position. We have paid – and continue to pay – a premium price for access to world capital markets. That acts as a drag on our growth prospects – projects that would otherwise be done simply don't get done because the cost of capital is too high. So what is going on here?

We pay that premium price for capital because we save insufficient ourselves. Part of the price of growth is deferring gratification – and as a nation we don't rate terribly well on that score. In fact, we now have one of the lowest savings rates (as a share of income) in the developed world, and that is reflected in the disconcertingly large current account deficit and our huge dependence on external debt and equity capital. By running operating surpluses, the government has reduced its call on the pool of domestic savings, and so helped to avoid putting upward pressure on interest rates. But the government cannot sensibly offset without limit the low savings of the private sector.

The other part of macroeconomic stability is my own territory, monetary policy. Next week marks a decade since the Reserve Bank was formally made independent, and since 1988 we've been required to target, and deliver, price stability. The

Reserve Bank's mandate is to ensure that CPI inflation stays within the 0 to 3 percent range set by agreement with the Government. Price stability isn't the most important objective a society can aspire to – far from it. The real objectives lie elsewhere – growth, employment, equity, justice and so forth. But monetary policy is targeted on price stability for two reasons: first, because inflation is damaging, even at quite low levels, and secondly, because over time monetary policy cannot durably affect anything other than inflation. By maintaining long-term price stability – and in particular by building public confidence that price stability will be a permanent feature of our economy – we ensure that monetary policy doesn't act as a drag on our growth prospects.

Let me dwell just briefly on some of the shorter-term connections between monetary policy and growth, including some that achieved a certain prominence with the new *Policy Targets Agreement* signed by Dr Michael Cullen and me on 16 December last year.

Monetary policy responds to forecasts of emerging inflation pressures looking one to two years ahead (and not to the most recent actual CPI). The trigger here is not growth itself. Economic growth is good, and we certainly do not, as some have suggested, live in fear of it. What prompts an increase in the OCR is when growth in demand looks like getting out of line with growth in the capacity of the economy to supply goods and services. When that looks like happening, there is a risk that inflation will pick up, and in those circumstances an increase in the OCR, to lean against the growth in demand, is in order. Can I stress that the economy's capacity is determined by the whole variety of things I've talked about today, and hardly at all by anything under the control of the Reserve Bank. As I said right at the start, the best monetary policy in the world will not, of itself, generate growth.

Over the last few years, as inflation expectations have settled down, and markets and the public have come to believe that price stability will endure, monetary policy has been able to think a little more about medium-term prospects and outcomes. The extent of the change shouldn't be overstated – we've always recognised that monetary policy works only with a lag – but we've been able to be a little more relaxed about short-term "wobbles" in the inflation rate, such as

those caused by moves in the exchange rate. We do this because we recognise that to react too much to short-term movements in inflation could induce unnecessary variability in economic activity and output.

In a sense, that is just what the new provision in the *Policy Targets Agreement* recognises. We didn't seek the change, and yet its addition helpfully, and more formally, reminds us that there are, in the short-term, sometimes trade-offs. If that is so, then we need to think seriously about the implications for the short-term variability of output, interest and exchange rates when deciding on the OCR needed to ensure that medium-term price stability is maintained. In some circumstances, accepting a bit more short-term variability in inflation **may** mean a bit less variability in interest and exchange rates, and *vice versa*. I say **may**, because it isn't the case in all circumstances. In many situations, the best way to minimise fluctuations in inflation, output, interest rates, and the exchange rate will be to adjust the OCR firmly and promptly to guard against imbalances emerging in the economy.

None of this – in fact, nothing – will alter the fact that a growing and prosperous New Zealand economy will always live in an uncertain world subject to shocks and surprises. Monetary policy can assist in responding to shocks – moving to stimulatory mode as Asia struck, moving back towards neutral now, heading for restraining mode as and when growth begins to put strain on capacity and threatens to reignite inflationary pressures. But we won't – indeed can't – remove the economic cycle, or the bulk of the big cycles in interest and exchange rates.

In all this, I hope I don't appear defensive when I remind you – as I must often remind myself – that in a world of huge uncertainty a very considerable element of art is involved in reaching monetary policy decisions. That means it will often only be with the benefit of very considerable hindsight that the final verdict can be delivered on whether or not the best decisions were made at the time.

Conclusion

Improving our economic growth performance is a big part of what the public look to governments and their officials to

provide. But while sustained strong growth inevitably involves governments, there are severe limitations on what governments alone can do. Firms, individuals and markets generate growth. And yet firms and individuals are affected in so many ways by what governments do that without a cohesive society and good government it is almost impossible to have sustained and broadly-based economic growth. Much has been done in New Zealand in recent decades as governments, firms and individuals have begun to awaken to the implications of the world economy for New Zealand's future economic prospects.

Change takes time, and recent economic performance suggests New Zealand will probably not close the gap that

has developed between our incomes and those of our fellow OECD countries in the near future. There are no guarantees, and nothing can be taken for granted, but there are a number of causes for greater optimism in the longer term. New Zealanders are increasingly better educated, firms and workers are more experienced in managing the open economy, macroeconomic credibility has been established; and over time, exposure to the competitive pressures and opportunities of an increasingly high-tech world should help transform the nature of New Zealand business. Monetary policy will continue to do what it can, providing a stable backdrop against which firms and households can plan for a better New Zealand in the new millennium.