Improving New Zealand’s Economic Growth

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Improving New Zealand's Economic Growth

I'm conscious of George Bernard Shaw's comment that 'if all the economists were laid end to end, they would never reach a conclusion'. So I'll try and be more of a one-handed economist in offering some thoughts on New Zealand's economic performance, ways in which it might be improved, and our role in the Reserve Bank.

New Zealand's Economic Performance

Like other small, commodity-producing economies, our economic prospects depend greatly on the growth in world trade and output. IMF data suggests that the global economy is expanding at an annual rate of around three and a quarter percent - or just below its average rate for the past three decades. But it doesn't feel like business as usual.

Over the past two decades, the global economy has changed dramatically. Asia is now the world's largest economic region. Its GDP at market exchange rates is about 15 percent higher than that of North America and 60 percent more than the euro area. China and East Asia are the main growth poles in the global economy and emerging and developing countries accounted for 80 percent of global growth last year. Among the advanced economies, growth prospects in the US are improving (despite December quarter GDP) but the recovery is the slowest for 70 years. Japan is going through another weak patch, and the euro area is likely to be in a difficult recession until 2014, and then recover slowly. This, in spite of US$15 trillion of additional spending by the world's governments in response to the global financial crisis and over US$5 trillion of quantitative easing by the major central banks.

With official interest rates close to zero in the major advanced economies, investors continue to search for higher yields in countries with stronger growth rates, favourable commodity price outlooks, sound macroeconomic policies, and higher interest rates. As with Australia, Canada, Sweden, Norway and some Asian and Latin American countries, the ensuing exchange rate appreciation affects the growth of our import substitution and export sectors. I'll return to this issue in greater depth when addressing the New Zealand Manufacturers and Exporters Association later this month.

How have we fared relative to other advanced countries over the past two decades?
Since 1990 we’ve outperformed many OECD countries on inflation and unemployment. Our inflation rate has been one and a quarter percent below the OECD median and our unemployment rate half a percent lower. But our per capita income has lagged behind and we’ve run large current account deficits. Real per capita GDP growth has been one and a quarter percent, about half a percent below the median and our current account deficit has averaged five percent of GDP – about the 6th largest relative to GDP in the OECD region.

There are two main ways in which our prosperity can improve over the longer run. The first is if the world is willing to pay more for what we produce. The second is by raising our labour productivity – that is by increasing the level of output per working hour. In the short term, we can generate higher income if we increase labour force participation or work longer hours. But we already have a higher proportion of our population in the labour force than nearly all other OECD economies and we work longer hours than most people in the OECD.

The good news is that there’s strong international demand for our commodity exports. Despite falling over the past 15 months, our terms of trade, or the ratio of export prices to import prices, remain 20 percent higher than the average for the 1990s. This improvement partly reflects the expansion of the global middle income class over the past two decades, led by China, and the rising demand for protein.

Chart 1: New Zealand’s terms of trade
(Index June 2002 = 1000)

Source: Statistics New Zealand
Our labour productivity story is much less impressive. Since 1990, our labour productivity has grown at an annual rate of one percent, about one and three quarters percent below the seven largest OECD economies. This is the main reason why our real per capita GDP is now 25 percent below the OECD median.

This is striking given the high international rankings for the quality of our institutions, control of corruption, ease of doing business, and according to the World Bank, the highest per capita endowment of renewable resources in the world.

Chart 2: Labour productivity growth in selected OECD economies, 1990-2011
(Average annual rate)

Source: OECD

So why is our per capita income so far below the OECD median? Partly it’s due to our geographic location and small economic size. Distance and economic size matter a lot even in a more globalised world of trade, capital and knowledge flows, and increasing interdependence. This also partly explains why our export range is concentrated over relatively few products – with food and beverages accounting for almost half our exports. The OECD and IMF believe size and distance, which limit economies of scale and market opportunities, account for around three quarters of the gap in our per capita income compared to the OECD average.

But this is not the whole story. Despite our high international rankings in key areas, the latest World Economic Forum’s Global Competitiveness Report ranks New Zealand’s overall
competitiveness at 25th out of 142 countries. Besides market size, we perform poorly on our macroeconomic environment, and especially on our budget deficit and low national savings. But regulatory and performance-related factors also diminish our growth potential. Many of the remedies to substantially improve our ranking lie in our own hands, and groups such as the 2025 task force, the Savings Working Group, and the Productivity Commission, emphasised reforms that can raise our living standards.

Three areas seem particularly important. The first, is to raise our level of saving and investment, and improve the quality and productivity of our investment.

In 2007, the World Bank analysed the stylised characteristics of the 13 economies that had grown at an average rate of seven percent per annum or more for a 25 year period since the 1950s. Eight of the countries were in Asia. ¹

We share many of the characteristics of these countries in terms of openness of the economy, macroeconomic stability, and market based resource allocation. One key difference however, is that all these countries had savings and investment ratios in excess of 25 percent of GDP and often over 30 percent.

Over the past three decades our net national savings rate averaged only three percent of GDP – almost five percentage points below the OECD median. For the past 25 years, our net household savings as a percentage of household disposable income averaged minus two and a quarter percent - the lowest in the OECD (where data are available), and 10 percentage points below the OECD median.

Our desire for such high levels of consumption was met by borrowing the savings of foreigners. As a consequence, our net foreign liability position is 73 percent of GDP, one of the highest ratios in the OECD, and not much different from some countries that have been at the centre of the financial crisis in the euro area. The build-up in external debt increases our vulnerability to economic shocks and the high propensity of New Zealanders to borrow means that higher interest rates than elsewhere are required to achieve similar inflation outcomes.

¹  The Growth Report, Strategies for sustained growth and inclusive development.
Although, our national savings ratio is low, our investment rate over the past three decades has been around the OECD average, and this is also true of business investment. But our capital to labour ratio, or the amount of capital that labour works with, is low by OECD standards. Second, much of our investment goes into housing rather than more productivity-promoting investment, and in 2011, 70 percent of households' net wealth was in the form of net equity in housing.

We need more investment, including foreign investment, that can bring benefits of job creation, technology transfer and market opening. Today, about 75 percent of global trade is undertaken by multinational corporations and about a third of trade is intra-firm trade. However, instead of welcoming foreign investment, we have one of the more restrictive frameworks among OECD countries. We should re-examine the factors, including tax and regulation, that diminish and distort the incentives to both save and invest.
Chart 4: Real business investment
(Share of GDP)

Source: OCED

A second priority should be to return to fiscal surpluses and lower public sector indebtedness. This will strengthen the economy’s resilience and create more fiscal room for responding to future economic shocks. The expansion in government spending has historically been one of our main growth industries and our budget deficit relative to GDP, after adjusting for the impact of the economic cycle on spending and revenue, was one of the largest in the OECD in 2011. This is the main reason why the 2012 Global Competitiveness Report ranked us 112th for our budget deficit. Important steps are being taken to reduce government spending and this will be an on-going challenge as demographic change will greatly expand government outlays unless there’s significant policy change. For example, the ratio of the over 65 age group to those of working age is projected to change from 1:5 to almost half that in 25 years’ time.

Increasing fiscal deficits mean that monetary policy has to be tighter and interest rates higher than otherwise, and this adds to the exchange rate pressures on the export and import substitution industries. This constrains output and employment in sectors facing international competition - sectors where productivity growth potential is usually higher. Instead, resources often find more attractive returns in the non-traded or sheltered sectors
where, although measured productivity is lower, producers face less international competition and can raise prices more readily. This is one reason why it’s critical to cut back ineffective government spending, and ensure that our welfare spending is targeted better at those in need.

Modern growth theory stresses the importance of the role of human capital, and the knowledge and skills of the population. The quality of education is critical in creating opportunities for growth and increasing real income. We need to improve the evenness of our education outcomes. Globalisation and technology have widened the distribution of income within most advanced economies, including New Zealand, over the past three decades. In the mid 2000s we had greater income inequality than most OECD economies, and this is unlikely to have changed. The bottom income deciles are populated by those with lesser skills, and those who experience prolonged and recurrent spells of unemployment. Addressing these groups would both promote productivity and reduce inequality.

Our education system is well regarded internationally. We rank 7th among 65 countries in the OECD’s Programme for International Student Assessment that tests high schoolers’ performance across reading, mathematics, and science. But, we have the greatest difference in reading performance between students from different socio-economic backgrounds out of all OECD countries, and the PISA scores for Maori and Pacific Island students are much lower than the average for students of European descent. Over the past 15 years, unemployment rates for Maori and Pacific Islanders have been three times that for the European population.

**Chart 5: Unemployment rates**

![Chart 5: Unemployment rates](chart5.png)

Sources: Statistics New Zealand
How can the Reserve Bank best contribute to New Zealand’s economic prospects?

There are two main ways.

The first is by delivering price stability and reducing the risk of inflation surprises. Price stability, and expectations that future inflation will be both low and stable, contribute to economic growth in several ways. They reduce uncertainty as to future inflation outcomes and assist planning and long term contracting. They enable producers and consumers to identify relative price shifts and allocate resources in response to shifts in demand. They avoid the distortions created by the interaction of high rates of inflation and the tax system that lead to higher effective rates of taxation. And they reduce the incentive for investors to acquire non-productive assets, such as investment properties, as hedges against inflation. Research by the IMF suggests that in industrialised countries the threshold level of inflation above which inflation significantly slows economic growth is estimated at 1-3 percent.  

In considering inflation pressures the Reserve Bank closely examines recent developments in the economy, and the outlook for competitiveness, demand, and output growth and employment. In setting the official cash rate we aim to avoid excessive volatility in output growth, interest rates and the exchange rate. We seek to respond to changing conditions but avoid rushing into decisions that might need to be quickly reversed and in doing so create uncertainty as to the Reserve Bank’s objectives.

Four times a year we prepare two year ahead economic forecasts. But forecasting is far from an exact science. Instead, there are conditional probabilities around each element in the forecasts and our published numbers are our central expectations: that is, what we believe is the most likely path of these variables. There are always many uncertainties, an important one right now being the economic impact of reconstruction here in Christchurch. For example, how much investment will take place and how quickly, how will insurance pay-outs be used, how much employment is likely to be generated and where does it come from, and what cost pressures and bottlenecks are associated with reconstruction and how is the impact being reflected more broadly across the country?

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The second area where we contribute to New Zealand’s growth is by strengthening prudential regulation and supervision to help create a more stable and efficient financial system. A well-functioning financial system helps an economy grow by pooling and mobilising savings, allocating funds to investment, providing liquidity, and redistributing risk. The financial system needs regulation because in a limited liability framework the interests of banks and bankers can differ widely from those of society at large. Bankers face incentives to increase leverage and risk in the expectation of achieving higher returns. In doing so they tend to under-price tail risk and often seek to build competitive advantage through complex financial products and customised services. Their financial accounts can be opaque and shareholders and creditors often lack the means to monitor bank balance sheets, or the incentive to do so if they believe that the government will provide financial support to a failing institution. As the global financial crisis demonstrated, interconnections among financial institutions, and their sheer size, mean the failure of a financial institution can have massive destructive effects on the economy and the welfare of citizens.

The Reserve Bank has several important initiatives underway to enhance the stability of our financial system. Last month we increased the capital requirements for our banks and are currently registering over 100 insurance companies and around 60 non-bank deposit takers. We’re working with banks to introduce an open bank resolution system by 30 June this year, which will enable a distressed bank to continue operating, while placing the cost of the bank’s failure on the bank’s shareholders and creditors, rather than taxpayers. And, later next month, we will consult with financial institutions on a framework for the potential use of macro-prudential instruments. These instruments, which include the counter cyclical capital buffer, sectoral capital requirements, the core funding ratio, and quantitative restrictions on high loan-to-value ratio lending, are designed to increase the resilience of the financial system to shocks, and dampen the financial cycle when concerns increase about systemic risk.

**Conclusion**

To a considerable extent our destiny largely lies in our own hands. We don’t have the luxury that many developing countries enjoy of relying on catch up technology to propel growth. We operate much closer to the technological frontier, and if we are to attract new capital, entrepreneurship and investment in innovation, our policies have to stand out internationally.

There’s no simple generic formula for raising growth rates, but the more prosperous countries and the economies that are growing rapidly all built strong linkages with the global
economy, and created an environment that fostered strong productivity growth, and high rates of investment from domestic and foreign sources.

We’ve much to do in continuing to build our global linkages and addressing government spending and regulatory issues that diminish productivity and competitiveness. But addressing these will create valuable payoffs for our future given our major resource endowments, our impressive agricultural and primary production engine, and the potential in our education, tourism and other sectors.

In most situations the comments made almost a century ago by William Bryan, the 41st US Secretary of State remain relevant: “Destiny is not a matter of chance; it is a matter of choice”.