RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Geopolitics, New Zealand and the Winds of Change

A speech delivered to the* ‘Shaping Futures National Conference’ Financial Services Council *in Auckland

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Kia orana tātou kātoatoa
Tēnā koutou katoa
Welcome all

Thanks for the opportunity to speak today on such a far reaching topic. It is a pleasure and a privilege, especially in front of such a large and important audience who impact the lives and financial security of so many New Zealanders. It is also timely to chat about financial issues given it is 'Money Week', the annual awareness week championed by the Commission for Financial Capability.

I know many people will be thinking, 'what has the Reserve Bank Governor got to say about anything long-term? Doesn't the Bank just sit and watch for outbreaks of inflation – shifting the official interest rate on a needs-be basis? Some will even comment publicly, 'How dare the Governor speak outside of their 1 to 3 percent inflation mandate!'

I hope to convince you we have a strong vested interest in, and influence on, the long-term economic wellbeing of New Zealand. The long-term issues are critical to our task of maintaining low and stable consumer price inflation, promoting a sound and dynamic financial system, and meeting the currency needs of the public.

First, what do I see as the long-term challenges facing the globe?

I summarise the key plague on economic society as 'short-termism'. This is the overt focus on the next day, week, or reporting cycle. In contrast, by long-term, I mean anything that ranges from 'outcomes' over the next few years, through to an 'idealised vision' that could last inter-generationally.

A short-term focus can be driven by the need to survive from day-to-day. However, it is too often driven by the desire to consume at an unsustainable rate. The desire for instant gratification or reward can often leave behind a trail of unintended consequences. Some of these consequences may impact on us personally, but we too often assume we won't be the one affected. An often-posted analogy of short-termism is the seasonal over-imbibing at the staff Christmas party, and all of the personal and societal consequences that follow.

Let's get more tangible.

We strive in business every day to achieve economic growth – or economic security and wealth. We also aspire to use this wealth in a pleasant, sustainable, natural environment that we can call home. We also aspire to live and bring our families up in a safe place, of social cohesion, being accepted and appreciated. And, we want to live in a place where everyone can participate despite our differences, a 'diversification dividend' not cost.

Wow, what a cool place that would be. Where do I buy the ticket? A virtuous, **wealthy**, and **rich** society.

Too often, however, due to short-termism, we view economic growth as something that comes at the expense of a sustainable environment, or social cohesion and cultural acceptance. How does this 'vicious' circle manifest itself so often around the world and through time?

The financial system plays a significant role. A financial system works best – is sound and efficient – when all relevant risks are adequately identified, priced, and allocated to those who can best manage them. These are the risks, in large part, that may lead you to consume/spend today, rather than save/invest for the future. You are either unconvinced you will be compensated sufficiently for the risks that could arise through time, or you haven't thought that far ahead or that well. The problem is that focusing on the short-term means that many risks are neither identified or priced, and often allocated to those who are least aware of them and unable to manage them. Our financial systems are struggling globally to identify, price, and allocate risk.

What have we witnessed over the last couple-of-hundred years or so? Incredible per-capita economic growth. Millions of people have been lifted out of poverty, and there has been a rapid increase in the human population and our longevity. This period represents an unprecedented rise in many positive economic welfare measures. The growth in productivity – output per person – is amazing.

But is all well, or at least as good as it could be? What are our big challenges – globally and at home in New Zealand?

There has been a rapid rise for many out of subsistence and into emerging or First-World income status. But we continue to experience massive challenges that are, too often, resolved through financial crises, wars or civil unrest; or at the cost of someone else or something, such as the environment.

At present we experience challenges such as:

Environmental degradation, with climate change now well accepted as a significant impact on economies worldwide. The impacts are physical through nature, and financial through changes in consumer and investor preferences, and regulation.

Mass urbanisation and all of the challenges this brings is accelerating globally, quite the opposite to what I was taught would happen when I was in school. Computers would mean we all lived on lifestyle blocks in a paperless world. Yeah right.

I have seen global estimates from the World Economic Forum that some 60 percent of the world population, within the next couple of decades, will live in cities with populations greater than 10 million people, many of these in current Emerging Market nations. The challenges this brings to resources, infrastructure, and social cohesion are immense – unprecedented. And we complain about Auckland traffic.

Ageing populations are also dominating the outlook for the next 30-plus years, with Japan being the canary for us all to watch. Their population is on the decline due to their demographic profile weighted so much to the elderly. Savings and consumption patterns are changing simply due to this population swing. The older have the savings and are demanding less in goods, but more in services, especially human contact. Loneliness is a significant and growing disease. Yet the owners of capital are struggling to create careers out of caring for the elderly, at least at incomes that attract and retain the people needed. The same could be said for tourism in New Zealand.

Mass migration (in addition to urbanisation) pressures are also growing globally, driven by the factors mentioned above. Climate change means people must leave and find new homes, witness the Sahara-African peoples virtually swimming to Europe. Social cohesion is being challenged as national boundaries and beliefs are being threatened with change.

Which brings me to the **income and wealth inequalities** that come and go through economic history – with the global economy currently testing fresh cyclical boundaries.

What do I mean by inequality? Well, even if the economic 'pie' has grown in total, the rewards are always skewed one way or another. Over recent decades, the rewards to the owners of capital (profits) have outstripped the owners of labour (wages) more than throughout economic history. In addition, wage growth both within, and more so between, firms has become more dispersed. Supposed low-skilled jobs have been far out-paced by high skilled jobs.

Now we also have the rise of ‘superstar companies’ that are in the ‘winner take all (or most)’ of an entire industry. These superstar firms generally have lower ‘wages-to-profit’ ratios than their competitors, accentuating the income divergence. How do they manage this? Through superior economies of scale driven by technology and brand advantages that are not easily replicable. Witness Facebook, Amazon, Google, Alibaba and so on. This is also true within the financial sector, where big banks gain significant economies of scale, leaving smaller banks struggling to compete. This would be fine if it didn’t lead to other problems such as ‘too big to fail’ and excessive risk taking incentives.

We are not immune to these issues locally, not by any sense of the word. But, we do have opportunities to lead the globe in positive change if we can become more long-term in our economic activity.

In New Zealand, we are being challenged on the environmental consequences of our efforts. We also have significant ongoing migration and urbanisation, as people want to be part of our place and together. We have creaking infrastructure and suffer from over-exuberant asset (house) prices. We also have persistent and stubborn unemployment and low-income challenges. This is especially so amongst Pasifika and Māori, despite their significant contribution to our economic and cultural wellbeing, and despite the current labour shortages. And, we have a rapidly ageing, and too often lonely, population.

Underlying these challenges is New Zealand’s persistently low productivity growth – or economic output-per-person. The reasoning behind the low productivity is well understood but, apparently, difficult to combat in a coordinated, persistent, manner.

An excellent paper by our own Productivity Commission,[1] outlines succinctly the problem of low productivity and the causes in New Zealand. In large part, our low output-per-person is due to the ‘capital-shallowness’ of much our economic activity. This refers both to physical and human (knowledge) capital. New Zealanders have low savings rates (personal capital), meaning they don’t tend to draw advantage from profits (the returns to capital). Likewise, many of our larger companies are driven to pay dividends (often offshore due to their ownership) rather than re-invest in their own company, or New Zealand more broadly. These challenges are compounded by the relatively small scale of New Zealand firms, and by a low level of technology and knowledge dispersion between firms.

Paul Conway challenges us all, including policymakers: assist small, remote, firms into the global economy; improve the matching of jobs and skills; use immigration wisely to lift human capital; make investment easier and more effective; moderate the pace of population growth to encourage capital-deepening; improve competition in the services sector; and strengthen the economic returns from science and innovation.

So with problem identification and solutions outlined, wouldn’t we just move on to resolution? Short-termism challenges us always and everywhere.

[1] Paul Conway, (2018), ‘Can the Kiwi Fly? Achieving productivity lift-off in New Zealand’, *International Productivity Monitor*, No. 34, Spring 2018.

Why do we run into roadblocks to long-termism?

Capitalism is necessary, and a marvel, driving human welfare in a strongly positive direction for a few centuries now. But we all know – even Adam Smith, the godfather of free markets knew – that capitalism is not perfect. Markets can, and do, fail for a variety of well researched and understood reasons. Otherwise, why would we need government, regulators, and a central bank?

A significant challenge is human myopia, the inability and/or unwillingness to think about the long-term. After all, 'she'll be right'.

Myopia is actually incentivised in many of our contracts – the drive to shorter deadlines and frequent reporting for rapid personal gratification. This shorter horizon is a perverse outcome. Annual bonuses for example can lead to excessive risk taking, lack of concern for unintended consequences, and a desire for short-term cost cutting and lack of reinvestment. However, the bonus was implemented with the intent of 'buying the employee in' to the business for long-term gain.

The myopia challenge is further enforced by what is known as the 'principal-agent problem'. The advent of the remarkable limited-liability company structure has liberated economic activity. These legal structures allow people to take risks with their and others capital, but with more limited personal financial consequences.

The limited liability structures do, however, mean that responsibility for all of the outcomes of business activity can be compromised. Hence the list of rules, regulations, and company directorship codes that exist. The line between the owner of the capital (the principal) and the manager of the capital (the agent) is lengthened. 'Who owns a company?' is a tough question.[2]

This principal-agent separation gets even harder now that we have investment portfolios as our way of investing in 'growth assets' ie, in business. The link is now the saver (owner of the capital), the investment manager (who may even outsource parts of this), and then the company agent. Principal-agent-agent. This represents in large part the industry structure that most of the people in this audience operate in.

What does it mean? How responsible is each of the agents for the long-term preservation of the principal's capital – and how can the principal insist on this responsibility to the level that matters to them – financially, ethically and otherwise? The asymmetry of information that exists in favour of each of the agents in this chain dwarfs the principal's knowledge. Hence the drive for transparency and burden of proof in business.

Fortunately – in some ways – the growth of portfolio diversification means that a principal is not overly exposed to any one 'rogue agent' or unfortunate event. A Kiwisaver investor, for example, owns several hundred, if not thousands, of companies in small proportions. For every idiot company (or idiosyncratic risk) in a portfolio, there is likely to be an offsetting genius.

Unfortunately, in other ways, the portfolio diversification even further reduces the drive, willingness, and ability of the investor to demand disciplines on the companies they are

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[2] Andrew G. Haldane, (2015), 'Who owns a company?', speech by Mr Andrew G Haldane, Executive Director and Chief Economist of the Bank of England, at the University of Edinburgh Corporate Finance Conference, Edinburgh, 22 May 2015.

invested in. You have to cluster the investment managers to demand excellence from some of the firms in these portfolios – to care about the long-term.

I won't labour a significant additional challenge too much, but let's not forget that investment managers are likewise incentivised to behave in a short-term manner too often also. The outcome of their behaviour leads to the pro-cyclical nature of investing, including institutional 'herding' and locking in losses, rather than benefiting from bargain price opportunities. Such institutional (and business confidence) herding destroys wealth, increases financial volatility, and kills long-term strategies.[3] As Frankie Howerd, the British comedian, said: 'there's nowt so queer as folk'.

Another challenge is that of 'externalities' – the tragedy of the commons (and also the horizon). Too many risks are not priced (or managed) by any individual, and hence under-invested in, or not owned or managed. Why would I, for example, spend all my money cleaning a river that everyone else can benefit from and/or continue to pollute? I can't capture all of the reward I am owed.

I am reminded of the first economics text book I was given at school (Samuelson) – posing the question on page one to entice my mind into the cut and thrust of economics (yawn, stare out the window).

'Why are diamonds expensive and water is free?' After all, you can live without the first (perhaps as a bachelor), but not without the latter.

The answer was meant to be 'scarcity'. Diamonds are rare and water is everywhere. Oh how quick things change. The answer now is that diamonds are sold in part under a cartel and marketed well, while water has never been properly priced – and hence too often misused and polluted, with drastic current consequences globally.

What are we left with from short-termism? Misallocated capital, under invested labour, pollution, and challenged societies. This is not the fault of capitalism. It is the reality of human nature.

By the way, these thoughts are not the rantings of a single Governor of a central bank. The issues are well understood. They in fact dominated the recent Kansas Federal Reserve Bank Economic Symposium I attended in Jackson Hole, Wyoming, only a couple of weeks ago. This is a prestigious annual gathering of wise economists, and me this time.

What were the Jackson Hole topics? Awareness of technology disruption and the rise of the 'superstar firms' – winner takes all/most. Rising industry concentration of firms, in the US especially. Economies of scale and 'intangible' capital that is excludable and hard to replicate assisting this concentration. Rising inequality as people move to low wage/profit firms away from high wage/profit firms. There was even a discussion of apparent monopsony wage-setting behaviour by some firms, especially amongst franchise chains.

Can we get better at this capitalism thing? Yes we can.

Deliberate strategies exist to force savers/investors to behave more long-term. I refer you to the New Zealand Superannuation Fund's website, where simple instructive examples (and speeches) exist on how to be 'long-term' in behaviour. Understand your purpose, your

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[3] Jukka Pelhman and Han van der Hoorn, (2010), 'Procyclicality in Central Bank Reserve Management', IMF *Working Paper* 10/150, June.

endowments (your relative natural advantages), your investment beliefs, and then stick to the strategies that best exploit all of the above. They've got it down to one page of instruction – say it simple, stupid.[4]

Also instructive, and critical, are the rapidly growing clusters of global capital concerned with better managing the failures that can arise from 'short-termism'. Trillions of dollars of capital are now joining efforts under various umbrellas. One cluster is the United Nations efforts around: Principles of Responsible Investing; Carbon Disclosure Projects; Sustainable Development Goals; and the Global Compact for Work practices. There are also private sector and 'NGO' groupings. For example: Focusing Capital on the Long-Term; Inclusive Capitalism; and One Planet, a spinoff from the CoPP22 global climate change agreement signed in Paris in 2016 (to which New Zealand committed). And, the International Forum of Sovereign Wealth Funds led the way in developing guiding principles ("the Santiago Principles") for the long-term management of sovereign funds.

Directly in the Reserve Bank's camp, the G20 have established a Financial Stability Taskforce effort focusing on carbon reduction management. Likewise, there is a newly established Central Banks and Supervisors Network for Greening the Financial System, as well as a rapidly growing green-bond market.

Where is all of this leading? Hopefully, these efforts will in part head off the usual manner in which we 'reset the clock', through some kind of crisis or unrest. Significant global firms, investors, regulators and representatives of civil society are banding together to work hard on resolving the perils of short-termism. If company boards and managers have a long-enough horizon, then there are no externalities – all issues are endogenous to their actions (eg, pollution, employment, inclusion, and sustainable profit).

A personally heart-warming recent local example is the group of New Zealand firms that have signed up to a joint effort to reduce their carbon footprint, under the Climate Leaders Coalition. This group has recognised that consumers are increasingly demanding inter-generational justice, investors want to be properly rewarded for all of the risks they are taking, insurers are increasingly concerned about the cost and ability to insure against climate volatility, and regulators are getting very itchy across many activities – building codes, firm behaviours and so on.

Where does New Zealand sit on the global stage for these long-term efforts?

I could argue that we are so small, no matter what we did across most of these issues, it wouldn't impact global outcomes.

But I would prefer to argue that the world often looks to places like New Zealand for leadership (or at least hope and safety). I also note that we are a small island nation, agriculturally dependent, live mostly on the coastline, have significant foreign-country dependency for capital and insurance, and sell a 'clean experience' to tourists. Hence, we rely heavily on our reputation and management of the long-term issues such as climate change, social cohesion, and inclusion of all.

The great news is we are small, young of nation, lightly populated, green, kaitiaki (caretaking) of spirit, not dependent on the export of fossil fuels, and have a strong rule of law and sound moral compass. Significant and bold leadership is in our grasp.

[4] New Zealand Superannuation Fund, 'White Paper' series, www.nzsuperfund.nz

What are the long-term challenges facing the Reserve Bank?

At the Bank we tell the story of Te Pūtea Matua (our Māori name) more often as that of the Tāne Mahuta of New Zealand's financial system.

In Māori mythology, Tāne Mahuta is the god of the forest and birds. Tāne Mahuta's greatest feat was that he separated Papatūānuku (the earth mother) and Ranginui (the skyfather) so that sunlight could shine into his garden and grow independent of his parents. The Reserve Bank rose for a similar purpose back in 1934, to enable New Zealanders to better grow the New Zealand economy independent of foreign banks' and economies' credit cycles – particularly Britain and Australia.

You will hear a lot more of this in coming weeks. Why? First, storytelling is fun and helps people connect to their daily tasks at the Bank. Second, the Bank is an ecosystem of many activities, just as Tāne Mahuta is, especially with the wider garden (financial system). Severing a root, trunk, or branch will have full ecosystem implications. Finally, we are embarking on a Te Ao Māori strategy at the Bank to help us with diversity and inclusion in thought, and to ensure we are operating effectively given the growing significance of Māori economic activity within New Zealand's financial landscape.

Te Pūtea Matua is in good stead for the future, but not without its challenges. These are driven by technology, economic development, global connectedness, and broader government, public, and employee expectations. It is an exciting and challenging time for the team.

Our current priorities outline the scope of change underway for Tāne Mahuta:

- our legislation (our roots) is under review, with the idea of modernising and refreshing our scope and capabilities, including broader decision making committees. Witness our new dual mandate for inflation targeting *and* contributing to maximising sustainable employment;
- the production and movement of our money (our sap) is under review, with new storage and distribution models, and the role of digital currency, being considered;
- our payment and settlement systems and digital capability (our trunk) are being renewed, with a view to ongoing reliability, security from cyber-risks, and a move to the 'cloud';
- our regulated financial institutions (the branches grafted on to Tāne Mahuta) are under review, including our relationship management with them, and our expectations of their business conduct, capital needs, failure management capabilities, and efficiency metrics; and
- our people (the caretakers or kaitiaki) are being reinvigorated, with a focus on developing *A Great Team, Best Central Bank* vision.

Focusing on the long-term is core business for Te Pūtea Matua – the Reserve Bank. The maintenance of low and stable inflation is a necessary condition of sustainable economic growth. We were pioneers in inflation targeting, with the goal decided by society (1-3% annual inflation), and then the Bank being operationally independent to do its work. This operational independence is critical – that is what ensures we do not suffer from short-termism. New Zealand, and much of the developed world, has a history of high and rising inflation due to over-weighting near-term demands.

We also understand the importance of our financial stability and currency issue roles. We need to prudentially regulate in a manner that is both sound and efficient in all its forms – cost, allocative, and dynamic efficiency. This means we 'bridge the principal-agent gap'.

Doing so means we can be unpopular with the regulated industries (the agents), which can be noisy at times. We insist on an adequate capital buffer to absorb losses, internal capability to manage the shop, and 'skin in the game' via directors attesting to these factors. We also insist on transparency so that customers and competitors can keep an eye on each other. Likewise, for the large, systemically important, banks we insist on failure management capabilities – where we can step in and keep the bank going so that the whole system doesn't fail.

We can also be unpopular with wider New Zealand, as shifting interest rates and/or implementing and altering the loan-to-value ratio that banks are allowed to lend at, are often not immediate vote winners. These activities directly cut across our human instinct for instant gratification, despite in the long-run maintaining a stable financial system and reducing the scale of financial volatility and/or crises.

We aren't here to win votes, but we are aware that our stakeholders are demanding more from us, and we are responding. As a result, we have developed a new vision for the Bank, we want to be *A Great Team, Best Central Bank*.

All of our strategic priorities work towards this goal. We have visualised 'our island' that we will always move towards on the horizon, one that all New Zealanders can be proud of and that Tāne Mahuta – our Bank – can stand tall on. To reach 'our island', we need to be aware of the long-term forces shaping the global economy, the very things we have just been talking about. These factors will have a significant impact on the allocation of resources, and the future wellbeing and stability of the New Zealand economy.

We are embarking on, amongst other things, our own climate change strategy – focused on our own activities as well as our regulatory duties with concern for financial stability. We need to factor climate change issues into our concern for financial stability and efficiency.

To be most effective, we are committed to working cooperatively on these issues, in particular harnessing the New Zealand Council of Financial Regulators (COFR) to provide longer-term leadership. COFR includes the Bank, the Treasury, the Financial Markets Authority, and the Ministry of Business, Innovation and Employment. As part of our commitment, the COFR are discussing their own 'island' or vision, so as to best identify work effort and prioritisation – moving beyond a 'show and tell' group.

And we will continue to use our strong international reputation and connectedness to work with other central banks, international financial institutions, and global regulators to further our understanding and, perhaps even, show leadership in places such as the South Pacific.

Collaboration and a long-term vision are critical to growing the wider financial ecosystem that lies beneath the branches of Tāne Mahuta. At present, the systemically-important banks dominate Tāne Mahuta's ecosystem. The important insurance sector is also patchy, both in customer coverage and competitiveness.

Life insurance, for example, has a low coverage rate across New Zealanders and a high premium-cost compared internationally. Meanwhile, general insurance has better coverage, but the industry is heavily concentrated in the number of providers. Health insurance is also complex, with the state-owned Accident Compensation Commission providing some cover, with the rest of this sector's insurance provision highly concentrated. Industry concentration, low coverage, and high costs are not the greatest look for an efficient system.

In 2007, I co-authored a speech with Dr Alan Bollard, the then Governor. We outlined the important role of the financial system and the unique challenges and weaknesses of New Zealand. Since then, and following the Capital Market Taskforce, led by our late-friend Rob Cameron, some things have changed and improved, much hasn't.

The growth of the NZ Super Fund, the depth of the Kiwisaver funds, and enhanced financial market regulation (with the birth of the Financial markets Authority) are great outcomes. Likewise, it is positive to see the Treasury committing to deeper bond issuance over a longer horizon, to keep New Zealand in the market and providing a yield curve benchmark. And it is encouraging that the Reserve Bank insisted on core liquidity measures for the banking system, as well as robust capital levels, and failure management capabilities. In addition, the insurance sector has a clearer regulatory regime.

However, much has not changed. Our listed equity market remains small relative to the economy, banks remain dominant in intermediation, and it is difficult to invest outside of the listed market in any scale with access limited. We still concentrate most of our investment in housing equity – rather than productive equity – relying on leverage from offshore borrowing. This is not a formula that will create 'capital deepening' in our economic efforts.

A vibrant and healthy financial ecosystem requires deep capital markets, with a long-term horizon, to best allocate capital in Aotearoa. We have much to work on to remain sustainably prosperous, but we are committed and long-term focused.

Meitaki

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