The State of the New Zealand Economy

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A commentary on disconnects in the New Zealand economy

Prepared for Ann Pettifor of Prime Economics and The Policy Observatory, Auckland University of Technology

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About this report

This report is one in a series prepared for Ann Pettifor's visit to New Zealand in September 2016. The reports provide background information on challenges facing the New Zealand economy and society, and are available on The Policy Observatory website.

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Dr Ganesh Nana

The Country

A narrow resource-based export-dependent economy, facing population-stressed regions that are at the very start (and heart) of the export value chain.

A policy framework that is extremely adept at effective management of a system, but with a conspicuous absence of governance oversight. This lack of governance is consistent with the presence of blurred objectives or targets, accompanying a silo approach to success indicators.

Hence, conventional targets (e.g. GDP growth, inflation and government debt control) are easily achieved; but are confused as desirable outcomes. The confusion between means and ends (mirroring that between outputs and outcomes) is compounded when the achievement of some targets lead to a worsening of well-being.
Indeed, the lack of clearly defined outcome goals mirrors the absence of governance oversight.

Consequently, there is a growing disconnect. There is an economy that ticks the boxes in terms of conventional indicators. But outcome indicators such as homelessness, child poverty, and housing affordability are strained as opportunity and income inequality, wealth distribution, and social cohesion are questioned.

Scene Set

In 1882, the first shipment of frozen meat destined for Britain left New Zealand. Little were we aware at the time that our economic history for the next 100+ years was cast. Yes, our fortunes would be tied to our now undeniable status as an international trading economy.

By the mid-1960s New Zealand had become seemingly prosperous on the sheep's back, with meat and wool tracking over 60% of the nation's export earnings. A further 25% came from butter, cheese and related dairy products. Our specialisation was further pronounced when noting that about half of the nation's earnings were derived through sales to Britain.

With access to overseas exchange closely restricted, exchange earnings were the binding constraint on activity – with fluctuations in commodity prices (such as the Korean War wool boom and the 1957/58 slump in the terms of trade) – being the platform for the domestic economic cycle.

This seeming paradise (or what some call 'the good old days'), began to unravel in 1967 when Britain decided to apply for EEC membership. In an ironically poignant moment, the British Prime Minister Harold Wilson stated to the Westminster House, "There are highly important Commonwealth interests, mainly in the field of agriculture, for which it is our duty to seek safeguards in the negotiations. These include in particular the special problem of New Zealand …"

The Export Challenge

Arguably, Britain's entry into the EEC only brought into crystal clarity what was always implicit – our inherent vulnerability as an export-dependent, but narrowly focussed, resource-based economy. Further, once global exchange rates lost their Bretton Woods anchor, the accompanying potential loss of market access made the overseas exchange constraint ever-more obvious. This was perhaps starkly evident in the wake of the early-1970s oil price shocks, culminating in the annual shortfall in the overseas exchange totalling close to 14% of annual GDP in 1975.

Policy responses evolved from ongoing efforts to conserve foreign exchange through a combination of demand management, regulation of imports, quotas and licensing and, of course, diplomatic efforts to protect our 'special problem' status and retain access to our main market. Glaringly obvious it may have been, but it needed to be stated in the 1978 Budget Speech – "Looking beyond our present circumstances, our future depends on our ability to export". Superficially, one would be justified in asking whether much had indeed changed in the 96 intervening years since 1882.

The Paradigm Shift

Since the 1980s, freer international capital movement and flexible exchange rates have seen thoughts (and concomitant policy frameworks) render the overseas exchange constraint hypothesis redundant. Economic policy now paid paramount attention to the control of price inflation. This was seen as necessary and sufficient in setting a climate for efficient allocation of resources across a range of economic activities. Indeed, the market efficiencies engendered by inflation control would accelerate productivity gains as ruthless market dynamics would weed out the laggards.

As per received wisdom, New Zealand policy officials enthusiastically identified monetary policy as central to inflation control. Further, officials successfully contracted out (to the Reserve Bank of New Zealand) the implementation of monetary policy under the guise that a simple rule would be imposed by a group of technocrats. A standard inflation versus growth rule (if growth too high and so inflation too high then tighten monetary policy, and vice-versa) avoided arguments that an unelected body was determining policy.

The implicit argument and agreement being that the government - being the only institution with mandated authority to act - would set the rules. A Policy Targets Agreement (PTA) would encapsulate this contracting out. This would imply that discretion (i.e. trade-off decisions) would not be available to an unelected or unaccountable body.

The Paradox

For close to 2 decades New Zealand remained unquestionably wedded to the notion that inflation control was necessary and sufficient for desirable outcomes. Accompanied by prudent fiscal management and government remaining on the side lines, economic prosperity must eventuate. However, the results were less than convincing. The conundrum was best illustrated by the OECD assessment in their review 2009 Economic Survey of New Zealand:

> *New Zealand is paradoxically at the forefront of the OECD in adopting policies in many areas that have been shown to lead to high per capita income, and yet it still ranks toward the bottom end of the OECD's productivity league. …. But, the root of the problem is a structural deficiency in the capacity to produce tradable goods and services (p. 10).*

In other words, we've done what we've been told to do by putting in place policies that have worked elsewhere, but that hasn't solved our productivity problems. And, 'paradoxically' is probably code for we really don't know why.

But the mystery is not that difficult to unravel. Note the stated importance of the tradable sector – i.e. the reappearance of overseas exchange as, if not a constraint on, then definitely a prime driver of economic fortunes.

While policies may have worked elsewhere, their appropriateness for a small, open economy reliant on a large primary base persistently facing trade barriers needs to be questioned. And the 'structural deficiency' may have something to do with the lack of investment in the export sector. A lack of investment that is likely to be the collateral damage from the interest rate and exchange rate settings necessary for inflation control.

But, given that many continue to see us as at the forefront of the OECD in adopting the 'right' policies, the paradoxical mystery remains.

Mission Creep

In the light of its less that glowing success, what is truly paradoxical is the expectation for monetary policy, and the central bank, to now achieve even more than simple inflation control.

This expectation means that the original (if implicit) agreement in the delegation and contracting out of economic policy power has blurred. The realisation that inflation control on its own may not be sufficient for economic prosperity, has accompanied calls for a more active central bank across a range of measures in addition to inflation control.

Under the guise of its regulatory role and its oversight of financial stability, the central bank has been granted further powers to set lending criteria and directives, including proclaiming region and sector dimensions to such criteria.

Breathtakingly, commentary now implies that the central bank has a critical function in the control of house price affordability. Yes, the house price bubble is doing untold damage to NZ's future economic (not to mention social/community) potential. But this was not the agreed target for allowing monetary policy to be put in the hands of a group of technocrats. New Zealand is now at a stage where not only is monetary policy contracted out, but economic policy has been effectively delegated to an institution with no mandate, and minimal accountability.

Moreover, with the policy framework devoid of any governance oversight it is also now unclear as to what is the intent or objective.

Inflation control should be rightly seen as a means to an end, not an end in itself. But there has been little clarity as to what was the desirable end goal. Some pointed to market efficiencies, productivity gains and improved competitiveness. These, though, merely implied that the desirable outcome being sought was a smoothly functioning economy virtuously abiding by textbook rules. The means continued to be confused with the ends. Even the economist's foundation objective of maximising utility was lost.

A Refreshed Version

New thoughts have developed since 2009. One refresh points to enhancing Auckland's metropolitan city status and to position it as the growth engine of New Zealand. The benefits of agglomeration are acknowledged, as is the increasing concentration of twenty-first century economic activity in urban and mega centres. This also fits neatly into the ongoing narrative on the imperative to diversify away from resource-based dependency and capture benefits along the value chain beyond the production stage.

At the same time microeconomic gains continued to be expected through re-oriented government services focussed on improved market efficiencies. Alongside this Business Growth Agenda, was a stated target to lift exports to 40% of GDP (currently just under 30%).

However, this prospect is hindered by two aspects. In the first instance, there is a considerable lack of agglomeration in the development of Auckland. And, further, there appears little appetite to ensure future growth fits with the intensification and agglomeration model. In the second instance, this approach lacks an understanding of the core disconnect between the population stressed, but export-critical, regions and the metropolitan Auckland.

The Regional Disconnect

The notion that New Zealand can develop an economy outside its dependence on its raw resource base remains more a symbol of hope than a reflection of strategic intent. The 1960s economy where 85% of export income came from dairy, meat, and wool has been replaced by one where some two-thirds (66%) of merchandise exports are raw resource reliant. Including services export income, and noting tourism is heavily dominated in attractions in regional New Zealand, an overwhelming 62% of external income is directly reliant on the health of regional (non-metropolitan Auckland) New Zealand.

But this is the very same regional New Zealand that is increasingly stressed by a static or shrinking population. This demographic stress is reinforced by the structure of the resource-dependent export industries, which are not relatively labour-intensive. With sparse employment opportunities, the drift of population to metropolitan Auckland continues. This leaves the regional ratepayer base struggling to fund local infrastructure, which in turn is needed to maintain and improve productivity of resource-dependent sectors. The cycle is perpetuated by central government funding models driven by population numbers that sees core community (or soft) infrastructure (such as education and health services) withdrawn to larger centres.

The (de facto) Response

And so we revert to what we know and do well – management, as opposed to governance. The PTA is not the only example. There is a Resource Management Act, but no Resource Governance Act. And there is a Fiscal Responsibility Act to rein in government, but no overarching response as to why or for what purpose? And there is a range of compliance obligations for local government to fulfil, but little in the form of defined objectives or outcomes being pursued.

GDP growth continues to be cited as the measure of performance, yielding rock-star status for the NZ economy. But, the quality of this performance in terms of well-being outcomes continues to be overlooked.

Asset price inflation (previously farmland, now houses) continues to be the route to prosperity, while the increasingly tenuous link to income growth is similarly overlooked. Consequently, those with assets will continue in their relatively favourable situation, while the position of those that rely on income will relatively worsen.

About The Author

Dr. Ganesh Nana is a first generation New Zealander. Ganesh has over 30 years of experience in the field of economics including business consulting, research, tutoring and lecturing in New Zealand and the UK.

He is Chief Economist of BERL (Business and Economic Research Limited), which was established by a group of economists in 1957 and remains a privately-owned New Zealand company. BERL has developed to become the leading provider of a broad range of economic research, analysis, advice and consultancy for business enterprises, organisations, iwi, institutions, community groups, industry associations and public sector clients. BERL's operating ethos is 'making sense of the numbers'.

At BERL Ganesh has worked on a wide range of projects, including development strategies; cost-benefit analyses; labour market projections; infrastructure assessments; and examining policy options. The imperative for New Zealand's competitive export-oriented economy to be strengthened has been a common theme throughout most projects. Over the past few years Ganesh's work has seen a focus on the Māori economy and incorporating this information into a nation-wide modelling framework. The growing importance of the Māori economy to the nation's future economic prosperity can no longer be ignored.

Ganesh is an experienced conference speaker and is a regular commentator on the New Zealand economy for various media.

About The Policy Observatory

Based at Auckland University of Technology, The Policy Observatory is a lens on public policy in Aotearoa New Zealand. We both conduct and commission research on economic, social and environmental policy issues, with the intention of publishing results in a form that is accessible to the general public. We work in a collaborative, networked way with researchers across institutions and in the private sector. Ultimately, we are concerned with how policy advances the common good.