



ViewPoint

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Long-term thinking the way out of financial crisis

A look at the economic thinking behind Labour's tax cuts and National's tax package clearly shows a lack of focus on wealth creation in our economy, and this will be increasingly important over the next few years. The election campaign has largely been fought over how what wealth we have will be passed around. The key issues of productivity improvement and investment in productive activity have been lost in the chase for votes. This attitude might have been defensible prior to the financial meltdown, but when finance stutters, trade really does matter. Policies that support the real (tradeable) economy will ultimately determine New Zealand's long-term future.

The competition to pass consumers the biggest handouts takes the emphasis away from the real issues in the election, and streams discretionary spending away from the tradeable economy that makes our wealth. Reducing the support offered to New Zealand's productive sector to fund this spending extends the economic party, but it makes the hangover worse.

Much of New Zealand's economic crisis can be attributed to our continuing current account deficits. These have fuelled our dependence on foreign credit.

The current account deficit can be attributed to two factors:

- A lack of exports caused by a high interest rate, exchange rate volatility, and a lack of incentives to invest in innovation.
- A lack of savings caused by overvaluation of the dollar, which encourages spending on cheap imported goods (given the easy access to overseas credit until recently), and the absence of incentives to save and invest in productive activity.

Generally policy from across the political spectrum has indicated a lack of vision and understanding of these problems. Under Labour, 'internationalisation' has served to drive production away from New Zealand shores; a policy that has even been rejected by the Treasury, who recognise that even the Research and Development (R&D) portions of business can be expected to follow production offshore.

Meanwhile National has disregarded international competitiveness with its plan to scrap R&D tax credits and reduce savings. The lack of foresight shown by the major parties in the Finance and Expenditure Select Committee's report on monetary policy summed up the situation. They recognised the negative affect of monetary policy on the tradeable sector, and both parties have stated the goal of improving the export proportion of GDP to 40% by 2020, yet they recommended no change to the Reserve Bank Act.

Mark Weldon (Chief Executive of NZX) and David Skilling (Chief Executive of the NZ Institute) have fuelled this debate on policies for wealth creation by producing a report called, "Economy on the edge: swan dive or belly flop? A draft strategy for coming out of the crisis stronger." This plan detailed steps to alleviate some of the immediate impacts of the credit crisis and provided some suggestions to shape the long-term future of the economy.

We are not persuaded by some of the short-term measures around provisional tax, or incentives for returning Kiwis, however, some proposals in the longer-term match our own position and those seen in other developed countries.

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Their short-term proposals focused on raising capital by leveraging state assets. They proposed combining State Owned Enterprises (SOEs) to create a larger enterprise, which could be floated to gain extra funding. The centralised structure would allow a greater focus on supporting the growth of New Zealand infrastructure, and the extra capital could be used to drive growth in the SOEs in targeted areas. They also recommended directing savings institutions such as the New Zealand Super Fund to invest a certain proportion of their capital in New Zealand. This initiative has already received some support from politicians. These proposals all have merit but their success depends ultimately on how well the capital is deployed.

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The report supported the retention of the R&D tax credit and recommended that 100% depreciation on capital investment be introduced. These incentives would assist firms that are in a solid financial position to invest further, would encourage offshore firms to come to New Zealand and support innovative start-ups. They encourage innovative firms that are, more often than not, involved in exporting. They will also provide a long-term benefit to the economy.

In their long-term agenda, Weldon and Skilling favour a compulsory savings scheme as an extension of Kiwisaver and eliminating housing speculation bias. They recognise New Zealand's reliance on foreign debt as a source of exposure to the current credit crisis, and a problem for New Zealand's productivity levels and growth. They propose that home improvements not be allowed to be used as a tax write off and recommend that a capital gains tax should be applied to investment properties.

These changes would improve the economic landscape, however, basic changes need to be made to support the tradeable sector. Exporters require a stable and internationally competitive economic environment to succeed. New Zealand's exports have not been able to keep pace with our OECD partners, primarily due to poor and uncertain returns caused by high interest costs and overvalued exchange rates. These fluctuations prevent exporters from accurately gauging returns from their investment, thereby discouraging additional the investment. It is no surprise that local superannuation funds are invested offshore where the returns are higher. Given better local performance, rules around local investment of such funds would not be necessary as local investment would be fundamentally more attractive.

The speculative currency impact varies with the interest rate spread between countries and perceived risks associated with the economy in New Zealand. High interest rate spreads and confidence in New Zealand lead to an overvalued currency, confronting the export sector with both higher costs from increased interest rates, and more significantly, lower returns from export sales. If these conditions persist for any length of time, balance sheets come under extreme pressure, leading to company failure, withdrawal from export markets, or offshoring the activity.

Business decisions are made on the basis of long-term prospects.

The compulsory savings scheme mentioned by Weldon and Skilling could be used to fix this problem. A floating savings rate, or an interest linked savings scheme, would serve the same purpose as interest rates – they would take money away from consumers when inflation rose. This would happen without causing instability in interest or exchange rates for the tradeable sector.

Business decisions are made on the basis of long-term prospects. Often people or businesses will decide where they will be based according to these prospects. Economic stability might be hard to find in the current climate, and supportive tax incentives can help build local productivity, support new start-ups and encourage existing firms to invest in further development. Reducing incentives for productive business to fund our living standards is an unsustainable option. Only by encouraging tradeable activity will we emerge from the economic crisis in a better shape than when we went in.