

ViewPoint

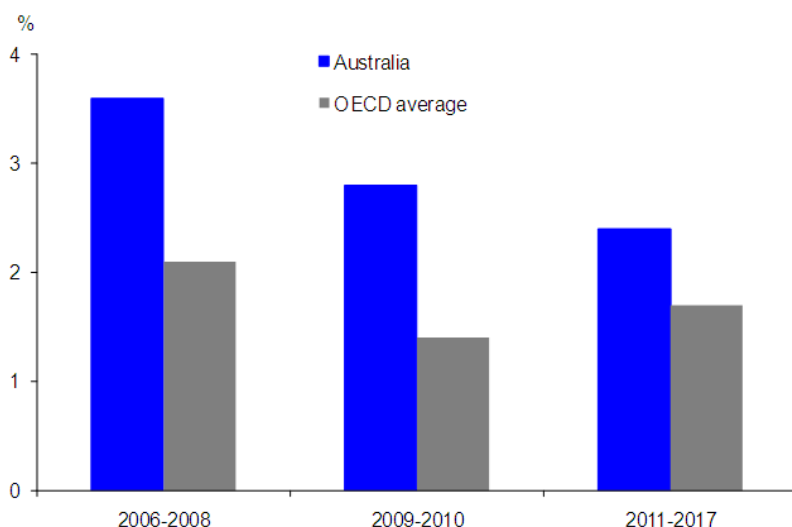
(December 2009)

The Road to 2025

Coming out of the global recession, many regard Australia as a lucky country. It has not only avoided economic contraction, but strong terms of trade, vast mineral deposits, proximity to the Chinese market, and rapid population growth have enhanced the country's future growth prospects (see Figure 1).

The success of the Australian economy is not new.

Figure 1 Estimates of potential output growth

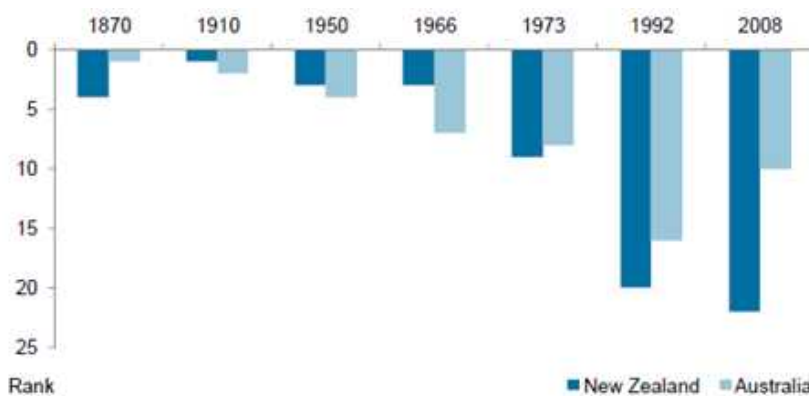


Source: OECD

The success of the Australian economy is not new; in terms of GDP per capita ranking New Zealand was passed in 1973 and has lost ground since (see Figure 2). This decline matters for New Zealand as lower earnings mean lower living standards, with fewer opportunities and fewer choices. In the past ten years, 260,000 people have left New Zealand, mostly to Australia. The migration figure is not a surprise as a recent report showed that average Australian incomes are around 35 percent higher than those in New Zealand; for a family of four, the gap is around \$64,000 a year. Who would opt for a lower income?

The average Australian incomes are around 35 percent higher than those in New Zealand.

Figure 2 GDP per capita rank



Source: Maddison for 1870-1970, constant prices, 1991 Int. GK\$, OECD for 1971-, US\$, constant prices, constant PPPs, reference year 2000

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The 2025 Taskforce was established as part of the Act-National deal to consider the policy settings and other changes that might be necessary to promote productivity growth and to build a stronger and more prosperous economy in New Zealand capable of closing the gap with Australia by 2025. The five member group Chaired by Dr Don Brash released their initial report in November 2009. A total of 35 recommendations were suggested which centre around four main areas: government spending, taxation, government assets and regulation.

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It was interesting to note that our very own taskforce has very similar tastes to Washington D.C. based institutions such as the International Monetary Fund (IMF), the World Bank, and the US Treasury Department. In 1989 John Williamson described a standard reform package for crisis-wracked developing countries, commonly referred to as the “Washington Consensus” or the “Neoliberal Agenda”.

The agenda included a set of ten economic policies:

1. Fiscal policy discipline;
2. Redirection of public spending from subsidies toward broad-based provision of key pro-growth, pro-poor services like primary education, primary health care and infrastructure investment;
3. Tax reform – broadening the tax base and adopting moderate marginal tax rates;
4. Interest rates that are market determined and positive (but moderate) in real terms;
5. Competitive exchange rates;
6. Trade liberalisation – liberalisation of imports, with particular emphasis on elimination of quantitative restrictions (licensing, etc.); any trade protection to be provided by low and relatively uniform tariffs;
7. Liberalisation of inward foreign direct investment;
8. Privatisation of state enterprises;
9. Deregulation – abolition of regulations that impede market entry or restrict competition, except for those justified on safety, environmental and consumer protection grounds, and prudent oversight of financial institutions; and,
10. Legal security for property rights.

Twenty years later, the 2025 Taskforce has proposed 35 recommendations which can easily be mapped with this standard ideological reform package except for a few minor adjustments (see Table 1). In particular, interest rate and exchange rate management were ignored; these omissions should come as a surprise.

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Table 1 Comparison of the Neoliberal Agenda and 2025 Taskforce Recommendations

Neoliberal Agenda	2025 Recommendations	Taskforce
Fiscal discipline	1, 2, 3, 4, 5, 6,	
Public Expenditure Priorities	7, 8, 9, 10, 11	
Tax reform	12, 13, 14	
Interest rates	No comment	
The exchange rate	No comment	
Trade policy	30, 33, 34, 35	
Foreign Direct Investment	31	
Privatization	15, 16, 17, 18, 19, 20, 21	
Deregulation	22, 24, 25, 26, 27, 28, 29, 32	
Property Rights	23	

Based on our existing monetary policy framework, the Reserve Bank of New Zealand (RBNZ) uses the Official Cash Rate (OCR) as a policy instrument to maintain price stability. The level of the OCR is set to keep inflation between one and three percent, on average, in the medium term. Since the OCR dictates the level of overnight interbank cash rate, interest rates in New Zealand are not entirely market determined.

Other factors aside, the interest rate differential is a major determining factor in exchange rates. In most cases, if a country has a relatively high interest rate compared to the other countries, the demand for its currency is likely to be high, (largely set by the global prevailing risk appetite) and results in an inflated exchange rate. Given the interest rate in New Zealand is set by the central bank it should be relatively easy to keep the exchange rate at a competitive level. In fact New Zealand operates one of the most independent float exchange rate regimes. Thanks to high international commodity prices and the domestic housing bubble, the one tool (the OCR) one target (inflation) monetary regime has significantly increased the cost of capital and pushed the exchange rate to historical highs. These factors combine to have a serious impact on New Zealand's tradable sector and long term growth potential.

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If an increase in productivity is necessary to close the gap with Australia then more investment is required in the real economy. For this investment to happen reform of the monetary system is necessary.

The outcome of the 2025 Taskforce is useful, but it failed to grasp the real nettle. It ignored the "plank in the eye" of our economy, absent investment in productive enterprise, and retreated to the comfort of a decades old ideological prescription that has seen New Zealand continue to slip with respect to Australia and the entire developed world. Where is the pragmatism to realise that the policy prescription hasn't worked and adjustments need to be made?

Cost cutting has its place, but who has built a business with only a focus on costs; much more important is a focus on growth. Quoting RBNZ Governor Alan Bollard, "we talk about catching up with Australian incomes, but we have better chances of taking advantage of their growth". What the government needs to do now is to make sure the tradable sector can take advantage of other markets by creating a favourable environment for firms that operate in the tradable sector.

We can only hope the future reports from the 2025 Taskforce can demonstrate some independent thinking.

It is time to be radical, the Washington consensus has demonstrably failed New Zealand so we need to think, act and behave differently. We can only hope the future reports from the 2025 Taskforce can demonstrate some independent thinking.