THE TREASURY
Kaitohutohu Kaupapa Rawa

# Economic Leadership: When Business Isn't Usual


Speech delivered by

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Good afternoon.

The world is in the midst of what will be a prolonged period of instability and risk. Rapid changes in economic power under way now will mean that the structure of the global economy will be unrecognisable in 10 years' time. And while there are potentially large benefits to New Zealand from these changes, government polices need to support our economy to adapt to uncertainty, and address our historically poor growth performance. Boosting New Zealand's skill levels is an important part of the answer.

## The Treasury's Economic Outlook

First, let's take stock of The Treasury's latest outlook for the New Zealand economy, released on 16 February. Overall, we expect slower growth over 2012 relative to our pre-election update. Our real GDP forecasts have been revised down from 3.4 per cent to 2.8 per cent, followed by a stronger rebound in 2013, peaking at 3.8 per cent.

The outlook, focused on five forces that we expect to shape the path of our economy over the next four years:

1. The global economy, with the key risk being the eurozone.
2. A weakening outlook for commodity prices.
3. Delays to the Canterbury rebuild.
4. Stronger household savings in response to heightened uncertainty.
5. The withdrawal of fiscal and monetary stimulus.

The risks to our outlook are tipped to the downside; from further disruption in Europe, more delays to Canterbury's rebuild, or a slowdown in our key trading partners. Uncertainty, fragility, and volatility are words you should expect to hear much more of over the coming year.

## The Big Picture

But there are some big-picture 'global forces' that have real potential to reshape our economic prospects, if we are prepared to take advantage of them.

### New Economic Geography

The most significant being the shift in economic power from West to East. After roughly 200 years, the economic centre of gravity is moving back to Asia and, importantly, closer to New Zealand. Instead of being 'down under' we are 'much closer'; instead of being at the periphery, the world is moving towards us.

You don't have to look back far to see how quickly this change has occurred. Only 10 years ago, in 2002, the US was leading the global recovery from the bursting of the dot.com bubble. Advanced economies accounted for around 80 per cent of global GDP, and the 'great moderation' was still in full swing – economist and Nobel Prize winner Robert Lucas declared the success of macroeconomics in solving the problem of depression prevention. Now, the current macroeconomic debates remind me of a line from Keynes in 1930: *"we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine"*.

When Standard and Poor's is pointing out that in Europe "*a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating*", you can tell that there is a significant debate going on.

In less than a generation, we have seen a shift in economic power that has massive implications for the structure of the global economy.

These trends had been under way before the global economic crisis, but have accelerated as emerging economies have led the global recovery. Over the next 10 years, demographics will have a profound impact on economic structure. Working-age populations will grow fastest in the Middle East, South America, and South East Asia. By 2030, the size of the middle classes in the Asia-Pacific is expected to be three times larger than those of North America and Europe combined.

Over the next 40 years, HSBC projects that only 'emerging economies' will have average annual growth rates in excess of five per cent. Increasingly the Asia-Pacific will be the benchmark against which others measure their progress, rather than the traditional OECD bloc.

This is a massive shift that will put existing global rules, standards and norms under severe stress. Of course markets such as the US and Europe will remain large, relatively wealthy and influential. However when looking at *growth*, emerging markets particularly the Asia-Pacific, are where the action is and will be.

## The Role of the State

It is the success in many of those emerging markets that has led people to reconsider whether the hand of government should be more or less visible in the economy. State-controlled companies make up 80 per cent of the value of the stock market in China, 62 per cent in Russia and 38 per cent in Brazil. Government-controlled firms can be found in a wide range of industries, from energy and electronics to ports.

Some commentators are pointing to this as a new 'growth model' for others to copy. But, on a closer look, this so-called state capitalism is probably becoming more market-driven than less. State-backed corporate giants seem to be venturing into foreign markets, appointing professional managers and using standard corporate structures to organise themselves.

No doubt the debate about the balance between the state and the market will carry on, and you have to wonder if such debates oversimplify the equation given the number of other players in the economy. In any case the more important point for us is that doing business in these economies is very different to how it has been done in the West. The influence of government and a different business culture means a North Atlantic lens can't be applied to doing business in a state-led economy.

### The End of the Great Moderation: Enter the Age of Volatility

Perhaps the one thing we can be sure about is that the ‘great moderation’ is over. We are living in an age of volatility.

Rightly or wrongly, the presence of a single economic powerhouse has provided a stabilising force in the global economy and has led the setting of global trading rules and economic orthodoxy.

In a world where there are multiple important players, it is less clear how those rules will be set, or which orthodoxy will be applied.

And the spluttering economic recovery in Europe and the US is also likely to be a contributor to more volatility in output and prices.

Some are concerned that future volatility will come from a resource crunch. Will there be enough to satisfy that massive increase in the global middle class?

You will find any number of international commentators making eloquent arguments on these issues, but I doubt there is any consensus yet. The point I want to make here is that with new leaders come new ways of thinking, and new ideas are required to overcome constraints. We don’t yet know how this will all pan out, but we need to prepare ourselves for the possibility that the ‘rules of the game’ are different to what we’ve become used to.

### Summary

Change is already well under way. Volatility and uncertainty has already had a measurable effect on the economic decisions of New Zealanders: household savings have turned positive for only the second time since 1993.

We should expect some ‘growing pains’ as the world adjusts to these new global forces. The Treasury’s Briefing to the Incoming Minister of Finance noted that *instability is likely to be an ongoing feature of the global environment over the medium term*. What I want to make clear today is that we are not returning to the pre-crisis ‘business as usual’ period of strong and stable growth from traditional sources, and I’m not sure we ever will.

## What Does This Mean For New Zealand?

I want to offer some thoughts on what this all means for New Zealand’s place in the global economy, before sharing our policy priorities to help us to respond to these shifts.

It would be wrong to consider that the global forces I outlined earlier are all academic to New Zealand. They aren’t. We simply can’t afford to sit back and think they don’t affect us.

For a start, we have already seen significant changes in the make-up of our key trading partners. We should expect this to continue as emerging economies continue to grow, and we negotiate trade agreements with India and Russia.

How we do business with these trading partners matters. I've seen it myself on visits to China – networks between governments are increasingly important to assist business. Many of our exporters have grasped this difference, but there are informed commentators who are concerned that New Zealand still doesn't know how to do business in economies where government is so influential.

As well as changes in our trading patterns, there will be changes in where we source foreign capital, people and ideas from. Japan, Hong Kong and Singapore are the only Asian economies that feature among our top 10 sources of Foreign Direct Investment. The reality is that a different set of economies is becoming the largest source of global savings, and to the extent that New Zealand needs funds from offshore, we have to go to where the money is. Our banks, for example, will need to start sourcing funds from somewhere other than the United States and Europe.

New Zealand is reliant on stable economic rules and norms, and like most small countries, has a lot to gain from a stable and benign international economic environment. Volatility in this environment will impact on us. We are rule-takers rather than rule-makers, so we need to be able to influence where we can, and be flexible enough to adapt where we need to.

## Our Challenge

New Zealand's challenges in this time of change are not the same as everyone else's. There are some important differences between us and those faced by some other advanced economies. We have a flexible exchange rate, a relatively low starting level of government debt, a healthy banking sector, and a generally flexible labour market compared with many European economies.

However, New Zealand's overall growth performance has been weak for some time – predating the global financial crisis. New Zealand's GDP per capita has been stuck at around 85-90 per cent of the OECD average since the mid 1990s. The decline that occurred between the mid-70s to late-80s has been arrested, but there hasn't been a catch-up. An income gap of around 30 to 40 per cent separates New Zealand from key advanced countries.

New Zealand has recently suffered a loss of competitiveness relative to our trading partners. Our unit labour costs, that is wages compared to productivity, grew faster than many other OECD economies' between 2000 and 2010, making New Zealand a relatively more costly place to do business in.

We've also seen a build-up of imbalances in the economy. New Zealand's stock of external liabilities exceeded 80 per cent of GDP in 2008. Household debt rose rapidly and consistently exceeded 100 per cent of disposable income since 2001.

So our challenge is two-fold: to reduce imbalances and build capability to cope with future global instability; and to boost our growth performance.

Finding the solution to these challenges requires intelligent, not ideological, thinking.

## How Should We Prepare and Respond?

So how should New Zealand address these challenges?

### Improving Living Standards

First I want to make it clear that economic growth isn't our only concern. We launched our Living Standards Framework last year. This Framework makes it clear that economic growth matters because it contributes to higher living standards for New Zealanders. Our concept of living standards includes incomes but also education, health, social and environmental factors. In many cases, these factors are aligned with and support a growing economy, but it is important for us to recognise possible trade-offs.

It also is important that our advice considers the impact of policies on individuals and groups of individuals as much as on aggregate or average measures. This reflects how we think about equity: we need to think about building the capabilities of all New Zealanders, so that they have the opportunity to fully participate in society. This is a much broader concept of equity than that encompassed by simple measures such as income inequality, which is too often the sole focus of equity in the public debate.

I am working to embed our Living Standards Framework as the cornerstone of our policy-making process and I will be talking about this work in more detail over the coming year. But to give you an idea, we are looking into how we can measure progress in achieving our vision of higher living standards. This will ensure greater consistency and transparency of our policy advice and, ultimately, improve its quality. It's about doing a better job of telling the story, to Ministers and to the public, of how our advice on economic growth supports higher living standards.

### Shock Absorbers

New Zealand's fiscal buffers have been important in maintaining living standards in response to the global financial crisis and the Canterbury earthquakes. But as a consequence, our strong fiscal position has been eroded.

In the short term, the most significant thing government can do to address our economic imbalances and build resilience is to return the budget to surplus. Doing so will reduce pressure on our interest and exchange rates. This is critical to support the tradeable sector of the economy.

Once the budget surplus is restored, the focus needs to turn to reducing the government's debt. The Treasury supports the Government's aim of reducing net debt to 20 per cent of GDP by 2020 to restore buffers against future shocks.

If the world was subject to another severe economic shock, New Zealand unlike some other developed economies still has room to react with monetary policy. Any fiscal policy response would need to walk a fine line between supporting economic growth and maintaining fiscal and broader economic credibility with international lenders.

The longer-term challenge is to address the pressures of an ageing population. Real trade-offs will have to be made in order to manage the coming pressures of higher superannuation, health and aged care costs. We will need to consider how those trade-offs affect different sectors of the population and different generations. Once again, business as usual isn't an option. The next Long Term Fiscal Statement will be published around this time next year, and will outline a range of options to meet these pressures. Yesterday I announced an external panel of independent experts and commentators who will help to test the assumptions and analysis behind the Statement.

Improving New Zealand's ability to cope with uncertainty and volatility also means addressing imbalances in the economy, in particular between savings and investment. Restoring the government's fiscal position will help, but we also see a case for wider policies to lift national savings.

The Treasury also sees a greater role for using fiscal policy to avoid adding to pressure on interest and exchange rates, as evidenced over the mid-2000s. For example, we recommend changes to the Public Finance Act to require governments to have regard to the way that their spending interacts with existing economic cycles. We have also recommended that governments assess their past performance against their fiscal strategies, in order to learn lessons from the past and increase incentives to adhere to their plans.

## Get Growing

So reducing imbalances and improving the resilience of the economy will provide us with a good base for improving our economic growth performance. But we need to go further.

Fundamentally, we need to address New Zealand's competitiveness problem. We know that New Zealand does relatively well on a lot of indicators. In fact, OECD modelling suggests that on the basis of our good performance across a number of measures, our GDP should be around 20 per cent above the OECD average. This tells us that there are other factors holding back our economic performance.

The Treasury is recommending a wide and ambitious range of structural policies that aim to address the causes of our underlying weak growth performance. Sharing some of those with you today is part of our wider programme of listening and testing our thinking externally.

To prepare and take advantage of the dynamic international environment, strengthening New Zealand's international connections become even more important. I spoke about this topic last year and what I said then still holds. Building and extending our international relationships and reducing barriers to flows of people, goods, capital and ideas is critical.

And as well as the direct connections, the quality of our domestic business environment is crucial to how we perform in the global market. This should be mainstream thinking. We simply can't afford to think that, for example, the quality of our domestic regulation or our infrastructure doesn't affect our firms' ability to compete with the rest of the world. Our *Briefing to the Incoming Minister* outlines a range of recommendations for domestic policies to make New Zealand more internationally competitive. These range from improving our management of natural resources to boosting business-led research and development.

## Education

You might have seen this week's Listener where I said that, if I had my arm twisted, really hard, I would pick education as the single biggest issue we need to tackle to raise our living standards. Education is fundamental for a number of reasons:

- A skilled workforce is crucial to raising growth and productivity. The potential growth impact of lifting student achievement is significant. Our analysis suggests that if overall student achievement[1] was lifted to among the top in the OECD, GDP would be 3-15 per cent higher by 2070.

- Better skills make us more adaptable - a valuable trait in the rapidly changing global economy. There is general agreement that NCEA level 2 is the minimum required to succeed in the modern economy.

- Education is like a factory for opportunity and ideas – it should give our young people the chance to better themselves, regardless of their background.

Improving New Zealand's skills requires action on many fronts but today, I want to focus on the school system.

Our advice on schooling in our *Briefing to the Incoming Minister* has created quite a bit of debate. I am pleased it had that effect and I want to expand a little on what we said. For those of you who would like more, a short evidence brief will be posted on the Treasury's website today.

The heart of the issue is not class size, but better student achievement and teacher performance. New Zealand's school system generally does well in international comparisons and our best are among the best in the world. But three out of 10 students didn't achieve NCEA level 2 in 2010, and whatever anyone says, that's not success. We know that young people who leave school with low or no qualifications are more at risk of unemployment, welfare receipt and low wages. And their children are also at greater risk of poor life outcomes. The economic and social costs of educational failure are too high – and the benefits of success too great – to be ignored.

Educational achievement is critical to enabling social mobility and addressing issues of inequality. And yet in New Zealand, whether your family is wealthy or poor has a

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[1] Treasury analysis, drawing on Hanushek and Wößman (2009): If overall student achievement was lifted by 25 PISA points (putting New Zealand with the top performers in the OECD), GDP would be expected to be higher than it otherwise would be by 3-15% by 2070.

greater influence on a child's success at school than in most other developed countries.

A common misconception is that low achievement is concentrated in particular schools or communities. In fact there is wide variation in achievement within almost all schools – the widest in the OECD. Addressing low achievement is about improving the system as a whole.

It is all very well to highlight a problem but offer no solution. I don't believe that three out of 10 students are simply too hard to teach, or are incapable of learning basic skills. The system is failing some students. To be sure, not all children are school-ready on their first day, and not all children come from families that are willing and able to support their learning. But then some of these students benefit from great teachers who inspire and guide, and help them achieve their potential. Others, however, get lost in the system, put in the too-hard basket, or fail to have specific learning needs identified and addressed.

The central theme of our advice is that, within schools, it is the quality of teaching that ultimately matters most to lifting student achievement. As McKinsey's well-known study of 2008 put it: "The quality of an education system cannot exceed the quality of its teachers."

Evidence suggests that the best teachers can get up to a year's worth of additional learning from students. Professor Raj Chetty from Harvard University found that students who benefit from great teaching do better as adults across a range of measures. We think policies to raise the quality of teaching will have substantial economic and social benefits in the long run.

The latest international thinking emphasises the importance of looking across the range of tools to develop, support and reward teachers. This ranges from initial teacher education to teaching standards to appraisal, and remuneration and opportunities for career progression.

We see room for improvement across all these dimensions. To be clear, we are not talking about crude performance pay or bonuses on the basis of test scores. Rather, for example, a set of standards that distinguishes a developing teacher from a master teacher, with remuneration consistent with those roles. Measurement is hard, as always, but the egalitarian notion that all teachers are equally effective is simply not borne out in the evidence.

There are a number of ways we could assess teacher quality. For example: judgements about whether a teacher has reached a higher standard could be made on a mix of information, including in-class observations by other teachers, direct observations by principals, and student and parent feedback. And, yes, data on how much students in the teacher's class have progressed over the course of a year could be one such input, but only one. Essentially I'm describing a more robust career progression process for teachers, much more consistent with what occurs in other professions.

Let me briefly mention another area where we think policy change would help lift the performance of the school system – data.  I find it frankly incomprehensible that data on student achievement is seen as dangerous.  Yes, data can be misinterpreted and misunderstood.  But its value is immense and all organisations need data and information to help them improve.  The Treasury is no exception - public scrutiny keeps the pressure on us to lift our game.

Finding better measures of student progress year on year would allow teachers and principals to discuss what works, and adjust their approach if needed.  For teachers, data is a tool to help them do their jobs better.  There may also be a case for making that data in some form available to parents.  Without good information, parents often use poorer alternatives like raw NCEA results, school decile, or class size as indicators of quality.

And on that point, we've never said that class size doesn't matter.  Far from it.  But we are in a world where governments, like households, have to make trade-offs and use their resources where they get the best results. Very modest increases in class size, say on average one or two students per class across the system, would be unlikely to have a significant impact on achievement.

Class size matters, but the quality of teaching matters more.

We think redirecting that expenditure towards strengthening the teaching profession and supporting the better use of data would deliver better bang for our buck in improving student achievement.  That's the prize.

## Conclusion

I want to close by reiterating my message about a time of continued instability and change in the global economy and the case for change so that New Zealand can thrive in this environment.

The Treasury is ready to respond to the challenge of a volatile global environment. Our policy priorities are designed for a time of uncertainty, and we are ready to adapt our thinking as the world continues to change and as we learn from experience and new thinking.

To be able to fully take advantage of shifts in economic weight, New Zealand needs to address the underlying imbalances in our economy and historically weak growth performance.  Ours is not a simple story of more markets or more government, but requires action on a range of fronts.

Today I have explained our priorities for education policy, a topic close to my heart.  I hope that this has given you a better understanding of our position and a sense of how important boosting New Zealand's skills is, if we are to achieve higher living standards.

Thank you, and I'd be happy to take your questions.