THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Getting Started on Closing the Income Gaps: Some Economic Scenarios and Options for Reform and Rebalancing

Date:	19 August 2009	**Report No:**	T2009/1953

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Read in preparation for economic scenarios discussion with Treasury	4pm, Thursday 27 August

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Michael Reddell	Special Advisor, Macroeconomic Group	Withheld under 9(2)(a)	✓
Peter Bushnell	Deputy Secretary, Macroeconomic Group		

Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

19 August 2009

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Executive Summary

The New Zealand economy faces serious and longstanding challenges. The accumulated imbalances and indebtedness are severe. Those imbalances, the product of excessive public and private consumption spending, show few signs of correcting sustainably. [Withheld under section 9(2)(d)

] Perhaps more importantly, there is nothing in the current projections or set of policies that suggests material progress is likely in reversing the large per capita income gap that exists between New Zealand and the average of its OECD peers, or, most notably, Australia.

Significant policy changes are needed to reverse this situation. The per capita GDP growth rate needs to be more than doubled, and maintained at that higher rate for 15 or 20 years. Substantial multi-faceted structural reform is essential if this growth acceleration is to occur, and if resources are move sufficiently from the non-tradables to the tradables sector. The first, and probably the single most important element, should be a thoroughgoing reform of the tax system. Tax reform should be focused on removing the significant biases in favour of consumption, and on providing a tax environment much more conducive to achieving the sort of levels of innovation, participation, savings and investment that New Zealand needs.

Second, there is a range of other regulatory policy settings that materially affect the climate for business, and the ability of resources to move readily to areas where they can be best used. Moving New Zealand much closer to OECD best practice standards would increase the prospects for substantially and sustainably raising New Zealand's growth rates.

Third, Government spending has increased very rapidly (as a share of GDP) in the last few years. Substantially unwinding this increase, more quickly than assumed in the Budget, would support the reallocation of resources from meeting unsustainable domestic consumption demand, and make an environment with lower overall tax rates, itself offering powerful potential payoffs for growth and productivity, more achievable.

[Withheld under section 9(2)(f)(iv)

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Recommended Action

We recommend that you:

a **note** the contents of this paper and discuss with officials at 4pm, Thursday 27 August; and

Agree/disagree.

b **refer** to the Prime Minister.

Agree/disagree.

Peter Bushnell
Deputy Secretary to the Treasury

Hon Bill English
Minister of Finance

Purpose of Report

Introduction

1. A major focus of the Premier House meeting in October will be on strategic choices around the sort of fiscal and structural policy approaches needed to close the per capita income gap with other OECD countries, notably Australia. This paper sets out illustrative macroeconomic scenarios for the path of the economy, as an initial basis for a discussion of the nature of the policy choices ministers will face.

2. Accelerated structural reforms, centred on significant tax reform, will need to be at the heart of any successful strategy to close the income gap. The structural policy reforms discussed in the paper are designed to reinforce the thrust of the six drivers that form the medium-term economic agenda.

3. [Withheld under section 9(2)(f)(iv)]

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4. The scenarios in the paper could be refined and sharpened-up in the lead up to the meeting of Economic Ministers and the Prime Minister in September. [Withheld under section 9(2)(f)(iv)]

Context

5. New Zealand's economy is seriously underperforming:

- New Zealand has persistently failed to achieve per capita income growth sufficient to make any progress in closing the large income gap between ourselves and citizens of other OECD countries, notably Australia (the gap to Australia is currently around 30 per cent).

- Real business investment spending has been relatively modest by international standards.

- But consumption spending (government and private) has run well ahead of income, and to a greater extent even than in other Anglo countries. The increase in structural government spending as a share of GDP has been materially greater in New Zealand in the last few years than in most OECD country (the larger increases have been seen mostly in countries deeply affected by the economic and financial crisis).

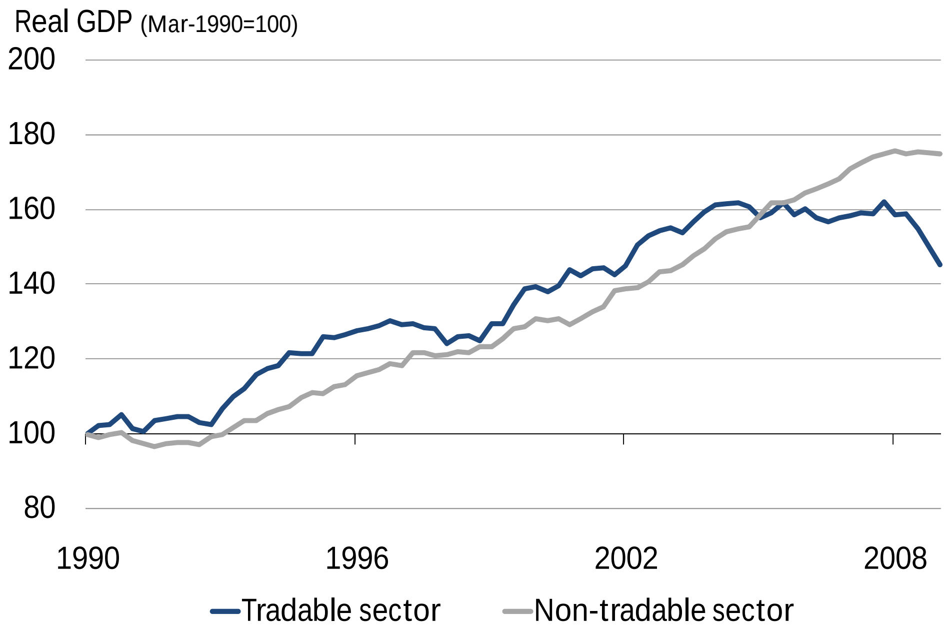
- New Zealanders have accumulated levels of household, corporate and farm debt that are high by international standards.

- New Zealand land (agricultural and residential) and house prices are very high, by almost any relevant measure. These prices are probably unsustainable.

- New Zealand has become progressively more highly dependent on external finance (mostly debt, mostly quite short-term).

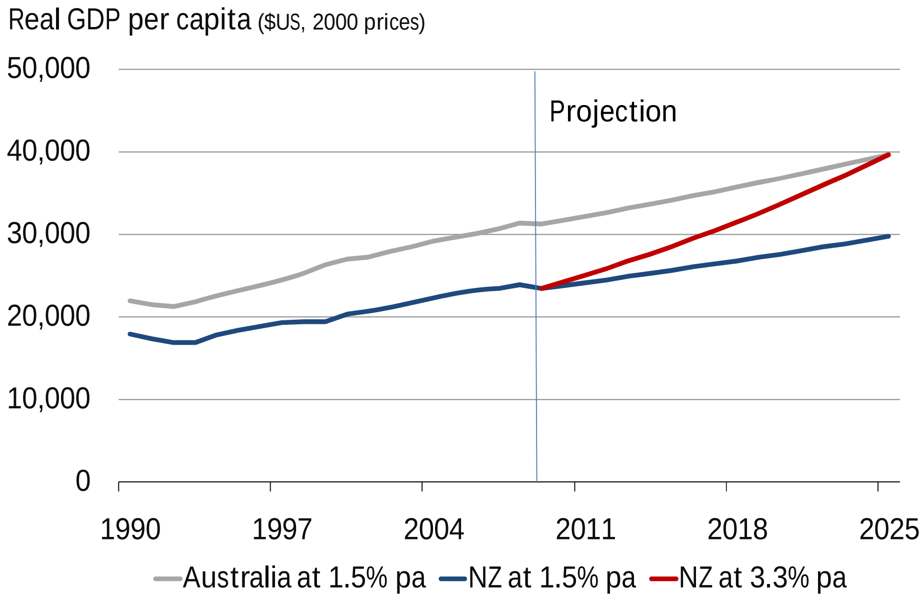
6. The situation has deteriorated over this decade. On current projections, the situation shows few signs of sustainably improving, and could even be deteriorating further.

7. One symptom of the deterioration has been the poor performance of the tradables sector. That weak performance is the inevitable counterpoint to strong domestic demand (including that resulting from large increases in government spending) in an economy that can't generate the incomes our OECD peers can. Overall economic output has grown at a respectable rate over the past decade. But when government and private consumption spending are rising rapidly, and labour is already fully employed, there aren't as many resources left to produce for sale abroad. There is nothing unique or very special about the export or tradables sector, but a sustainable strong economic performance would normally be expected to be mirrored in significant growth in those bits of the economy selling to the wider world market, where there is more scope for scale economies etc to be realised.



8. Some of the imbalances have also been apparent in other developed countries. But in few have the imbalances been as great. In probably no other developed country are the persistent income gaps so pressing: both substantial, and reflected in large net outflows of national citizens (the net outflow of New Zealanders in the last decade has averaged 26000 each and every year, or around 6 per cent of the population in total).

9. The gaps to Australia are substantial, and are particularly significant in view of the easy trans-Tasman labour mobility. In both New Zealand and Australia, sustainable per capita income growth on current policies is probably around 1.5 per cent per annum. The Government has articulated a goal of closing the 30 per cent income gap by 2025. To do that, per capita income growth in New Zealand will have to exceed that in Australia by an average of 1.8 percentage points per annum each and every year until then. In other words, the potential per capita income growth rate will have to be more than doubled.



10. The best chance of achieving that sort of sustained increase in the per capita economic growth rate it is through an integrated approach. Such an approach would involve substantial multi-faceted microeconomic reform to ensure that the tax and regulatory structures and the level of government spending are strongly supportive of the growth objective, supported by fiscal consolidation at pace that is materially stepped up from that outlined in the Budget.

11. This paper begins by discussing two no-policy-change economic scenarios. The first is a **status quo** scenario where policy remains broadly unchanged in line with that signalled in the Budget. In this scenario, we continue to live with high, and perhaps rising, levels of external and domestic indebtedness, and fiscal deficits persist for a decade. In sum, little rebalancing occurs. There is also no progress in closing the income gaps between NZ and its OECD peers. The second scenario (**adverse adjustment scenario**) is also one in which policy remains broadly unchanged, but the high level of indebtedness prompts a more significant adjustment, whether prompted by external creditors or by the borrowers themselves. In that scenario, the income gaps could widen further.

12. [Withheld under section 9(2)(f)(iv)

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The exchange rate and the importance of the macro policy mix

13. Making a successful early start on materially closing the income gaps, and rebalancing the economy in a way that reduces the vulnerabilities that have accumulated, is likely to require a reasonably protracted period in which the exchange rate undershoots its long-term average level. Such an exchange rate path would reinforce the signals to firms, and potential investors, about the opportunities available in New Zealand. It would help counterbalance the drag on tradables sector performance from the prolonged period of exchange rate overvaluation this decade.

14. A weaker exchange rate, if not imposed on us by jittery external financiers, is likely to be sustainable only if New Zealand interest rates look much less attractive relative to those abroad than they have done in recent years. In turn, that is only possible, in ways consistent with an expanding and internationalising business sector, if household and government spending (together) is significantly lower, relative to income, than at present appears in prospect.

15. The exchange rate on its own cannot do the job – we can't permanently "undervalue" the exchange rate. Ultimately structural reforms, that make investment more attractive and consumption relatively less attractive, must be at heart of any successful economic programme. But a sustained period of a weak exchange rate - such as we experienced in the early 1990s, and again around the turn of the century - in conjunction with serious structural reform, can help to provide a better environment for structural improvements in the economy to take hold, and for firms to respond more vigorously and confidently to the new opportunities. [Withheld under section 9(2)(f)(iv)

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16. In normal times, the exchange rate tends to move to reflect fluctuations in markets' assessment of the relative cyclical strength of various economies, and the implication of those differences for official interest rates. Our exchange rate tends to be strong when pressure on resources is greater here than in other countries and, hence, when the gap between our interest rates and those in other countries is (or is expected to be) higher than normal. The relationships aren't mechanical or precise, but they explain pretty well the fluctuations in our exchange rate over the last 20 years.

17. The current economic recession in New Zealand, while significant and quite protracted by our own standards, is quite mild by international standards. That is why, on current policies, we should not expect to see any protracted period of exchange rate weakness. Markets appear to expect that New Zealand (and Australia) will emerge more quickly from the recession, with less accumulated excess capacity, than most other OECD countries. Investors appear to be taking a view that the recent flow of economic data mean that our official interest rates are more likely to need to rise – returning to more normal levels - sooner than those in most other countries (perhaps as early as the first half of next year). Even now, the gap between our OCR and the US policy interest rates is a little above the long-term average. Against this backdrop it is not surprising that both the New Zealand and Australian exchange rates are relatively strong. On a trade-weighted basis, our exchange rate is currently about 5 per cent above its long-term average.

18. Of course, exchange rates can be, and are, very volatile[1]. In the short-term waves of pessimism can take the New Zealand exchange rate well away from where the state of the respective business cycles might warrant - that happened earlier this year when our exchange rate fell briefly below 50 cents against the USD. That sort of extreme pessimism, even if it had been sustained, would not have been particularly conducive to lifting our sustainable growth rate. Short-term waves of excessive optimism are also possible: in the current climate we cannot rule out, for example, a period in which the NZD exchange rate moves back above 70 cents.

Economic and policy scenarios

Scenario 1: Current economic situation [Withheld under section 9(2)(g)(i)
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19. Our recent assessment of the economic situation, (see TR 2009/1822.) is pretty much consistent with the market view. In particular, as long as economic/cyclical factors drive the exchange rate (rather than crisis-related fear and extreme risk aversion), it is not inconsistent with the exchange rate settling somewhere around, or perhaps a little below, current levels for the time being. That is a different picture from the economic projections published in this year's Budget.

20. Those projections told a story of limited but smooth adjustment. A fairly protracted period of exchange rate undervaluation, combined with a rise in the household savings rate, helped generate a recovery in export volume growth and a decline in import demand growth sufficient to stabilise New Zealand's net external indebtedness. But even that picture was not a pretty one. External debt stabilised with a net international investment position of around 107 per cent of GDP, implying ongoing current account deficits of around 5 per cent of GDP. No other country in modern times has (yet) seen its NIIP stabilise with such a high level of reliance on foreign capital. But the projections assume no externally-induced pressure to adjust our savings and investment patterns.

21. The BEFU forecasts also allowed for a significant correction in house prices, down around 25 per cent in real terms (but reversing only around half the increase in real house prices since 2002). Farm land prices are not explicitly included but the overall projections were probably consistent with avoiding a deep and sustained fall in farm prices.

22. The operating balance, undermined by large spending increases and tax cuts in recent years, improved gradually. But on those projections the operating balance did not return to surplus until the end of the next decade. The overall government balance sheet at the end of the projection period (22/23) looked quite good by international standards. But even on these projections, overall net debt at the end of the projection period would still be around 35 percentage points worse than was projected in the 2008 Budget.

23. Perhaps most importantly, the BEFU forecasts suggested no material progress in closing the income gaps between New Zealand and its OECD peers.

24. The Budget projections were finalised in April, shortly after the exchange rate reached its short-lived trough. As things stand today, the prospects for any sort of successful rebalancing seem much less favourable. The external financing environment is more positive, and international market fears about the risk of a new "great depression" have

[1] Rarely more so than this year. The rise in the TWI in the last six months has been the steepest six month increase in the 24 years since the exchange rate was floated.

largely dissipated. Partly as a result, the exchange rate is now a long way above the levels included in the BEFU forecasts.

25. The difficulties are compounded by the rebound in consumer confidence and in the housing markets. It is not quite clear how far the nascent recovery in house prices will run, but at present it would appear imprudent to assume more than a 10 per cent sustained fall in real house prices, much less than the 25 per cent fall we allowed at BEFU[2]. The untenable imbalances in the housing market are not being unwound in the current recession (nor are they in Australia). Indeed, it is quite possible that over the next year or two house prices could exceed their 2007 peaks. Households appear to have been more responsive to historically low interest rates than we might have expected. And upward pressure on house prices is being reinforced by the stronger net migration inflows. These flows, and higher measured household wealth will, in turn, tend to boost domestic demand (residential investment and consumption). As a result, the reorientation of the economy towards internationally-oriented production rather domestic consumption is likely to be slower and weaker than we had hoped earlier. All else equal, that will probably mean that domestic indebtedness and our external debt (together with the associated current account deficit) reach even higher levels.

26. This scenario is plausible but fragile. In the short-term, there are some positive dimensions: in particular, the unemployment rate may peak a little lower than was previously projected (though even in the BEFU projections, the unemployment rate was projected to peak at only around the level reached in the mild 1998 recession). However, little progress is likely to be made on working out either external or domestic imbalances over the next few years. The one probable exception is the bubble in agricultural land prices and debt: under this scenario, those imbalances work through more rapidly than in the BEFU scenario. For this fragile scenario to play out, both financiers and borrowers have to remain comfortable with unprecedentedly high levels of leverage. As recent comments from Fitch indicate, external vulnerabilities may have receded a little for now, but they have certainly not dissipated.

27. At best, our current medium-term economic prospects appear to be fragile unbalanced growth. There is little in the current policy mix that would make a material difference in terms of closing the income gap, and some initiatives, including the recently announced carbon emissions target, seem likely to act as a further drag on potential growth capacity.

Scenario 2: Adverse adjustment scenario [Withheld under section 9(2)(g)(i)]

28. Despite the high levels of external and domestic indebtedness (not just for households but for firms as well), and severe imbalances in domestic asset markets, our current outlook assumes that only very limited adjustment occurs. Specifically, it assumes that adjustment will not be forced on us by external creditors, and that domestic borrowers will also not, of their own initiative, seek to reverse the substantial leveraging-up that has occurred in recent years.

29. A second scenario is one in which those pressures build. On a number of measures, domestic leverage is now at levels that have, in other countries, been followed by painful deleveraging. The Japanese experience since 1989 is the most obvious example. Adjustment in Japan wasn't brought about by external creditors: instead,

2 And much less than the adjustment in the United States, where the initial house price boom was no larger than that in New Zealand. It appears that sustained corrections in house prices, unwinding the boom, are occurring mainly in countries such as the United States, Spain, and Ireland, where new housing supply was sufficiently responsive to rising demand to leave a significant over-supply when the respective economies slowed.

overvalued asset markets and excessive domestic debt collapsed under their own weight. In Japan, even once interest rates fell to near zero, there was little net private sector credit demand in the 15 years following the peak of the boom. Even though high household saving rates fell persistently (the household saving rate is now lower than that in the US) aggregate economic activity ended up supported mainly by large ongoing fiscal deficits. The New Zealand shake-out following 1987 was also a painful multi-year period of deleveraging - and the imbalances then were, in most respects, less severe than those New Zealand now faces.

30. As compared to Japan, the current New Zealand situation is different in several respects. On the encouraging side, our fertility rates and population growth are such that underlying demand for housing and physical infrastructure is likely to remain positive. But unlike Japan there is no "buffer" of high savings rates among any sector – even the government is currently projected to be in deficit for a decade.

31. New Zealand's leveraging up has been financed mostly by foreign creditors. That leaves us more exposed to disruptions to the flow of credit: we had foretastes of that risk when global funding markets seized up late last year. It also means that the ongoing health of our banks is of critical importance. The banks are the principal intermediaries of the foreign finance, and their assets are mostly secured on significantly overvalued asset prices,. Should investor concerns materialise, or should domestic borrowers' medium term demand for new credit fall away markedly, lowering sustainable New Zealand interest rates, we could expect to see a much lower exchange rate.

32. Some businesses will always flourish, even if economy-wide deleveraging is underway. But the general outlook would be quite grim. One reason is the probable pressures such a deleveraging climate could place on the financial system and on investor attitudes towards risk, especially if the deleveraging was mirrored in Australia, which shares many of our imbalances. Such a climate would be one in which fiscal consolidation would be both harder and yet more imperative. There would be no leeway for additional fiscal stimulus, and government finances would come under more pressure from prolonged periods of weak demand and underemployed resources.

33. Such an adjustment scenario is a bleak one, although not necessarily unremittingly so. Japan managed reasonable per capita growth over the 90s and 00s, supported mainly by expansionary fiscal policy, falling household savings rates, and also by a robust export sector (at a time when world demand was considerably more robust than it is likely to be in the coming decade, as many economies adjust to an overhang of debt).

34. A prolonged serious undershoot of the exchange rate in New Zealand would certainly see some resources shift towards exporting, but a climate in which firms and households were consistently striving to reduce leverage is unlikely to be one in which the scale of new investment required to close the income gaps would be undertaken. If anything, it is more likely that the income gaps to the OECD might widen further, as the economy adjusted to the consequences of decades of heavy borrowing, unsupported by high rates of productive investment. The distributional consequences of a prolonged overhang of debt could be severe. Net outflows of New Zealanders could well accelerate in such an environment.

Scenario 3: Accelerated structural reform and significant fiscal consolidation [Withheld under section 9(2)(g)(i)]

35. [Withheld under section 9(2)(g)(i)

] [Withheld under section 9(2)(d)]

] [Withheld under section 9(2)(f)(iv)]

36. Overall, New Zealand's microeconomic policy settings have generally provided for reasonably flexible markets. However, to give ourselves the best chance of facilitating adjustment and making progress in closing the income gaps, there are still significant areas where policy action would support adjustment. In view of our poor starting position (with such large entrenched income gaps, high accumulated debts and high costs of capital) it is likely that considerably more far-reaching reform is required than might be the case if we were simply content to maintain our position in the OECD league tables. We need to give ourselves the best possible chance of succeeding, which means attacking the adjustment issues on multiple fronts.

37. Because it affects every economic activity and choice, structural tax reform probably offers particularly significant pay-offs. You have the opportunity for a once in a generation reorientation of the tax system. If the opportunity is embraced, far-reaching tax reform could make a powerful contribution to gradually removing the accumulated imbalances, and to jump-starting a process that, over the next decade or two, could close the income gaps.

38. We believe that tax reform should be ambitious, and commensurate with the scale of the economic adjustment challenges New Zealand faces. [Withheld under section 9(2)(f)(iv)] In particular, it would represent a significant move away from the present profound bias towards consumption. Such a strategy would also enable substantial reductions in income tax rates.

39. There is a variety of income tax reduction options (e.g. harmonisation at a single maximum rate, or focusing more heavily on reducing capital income tax to promote savings and investment), each of which could be expected to have significant long-term growth benefits. The less ambitious the increases in other rates (GST, land tax, CGT), the more hard choices would be required around where to concentrate income tax reductions. Issues here include choices and judgements around the significance of the risk of losses of highly-skilled labour if taxes on labour income were not reduced against the benefits in terms of encouraging investment (and savings) if income tax cuts were focused more heavily on capital income. Analysis is underway on which option we would recommend. The Tax Working Group is also looking at these issues.

40. We also need to focus on improving the regulatory environment in both product and factor markets. For example, a new OECD study finds that New Zealand's product market regulation is around the middle of the pack, quite similar to Australia's. But there is a significant gap between our product market regulation and that of the best OECD countries. Research evidence suggests a direct link between how close we are to best practice, and likely improvements in productivity growth.

41. On the labour market front there is a variety of perspectives. Some cross-country indicators suggest that the labour market regulatory environment is pretty good. But that isn't the perception of local firms. We need to vigorously get to the bottom of these issues, and ensure that the overall environment - regulation, tax, benefit policies – are all consistent with encouraging resources to flow to the most productive uses, and to ensure that the labour is available to maximise growth opportunities.

42. The environment is which capital can be marshalled and deployed also needs work. This includes things like further reform of the RMA, completing the review of the Building Act (among other things to improve the responsiveness of housing supply), the overseas investment review, and the tax environment for investment. State ownership of firms in the productive sector is also now more extensive than in many OECD countries. Across all these areas getting closer to the OECD frontier would better position us for closing the income gaps.

43. Natural resources provide another area of focus. This includes sound and realistic pricing regimes for water and carbon, and minimising obstacles to innovation in areas where comparative advantage is likely to be strongest. It may also mean providing leadership to help bring about a greater role for external capital in our major primary sector processing companies.

44. Government expenditure has increased very rapidly in the last five years. [Withheld under section 9(2)(g)(i)

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Historically it appears to have been very difficult for countries to achieve anything like the sort of growth acceleration sought, and the reallocation of resources to the tradables sector, in the face of large increases in the size of the state. [Withheld under section 9(2)(f)(iv)

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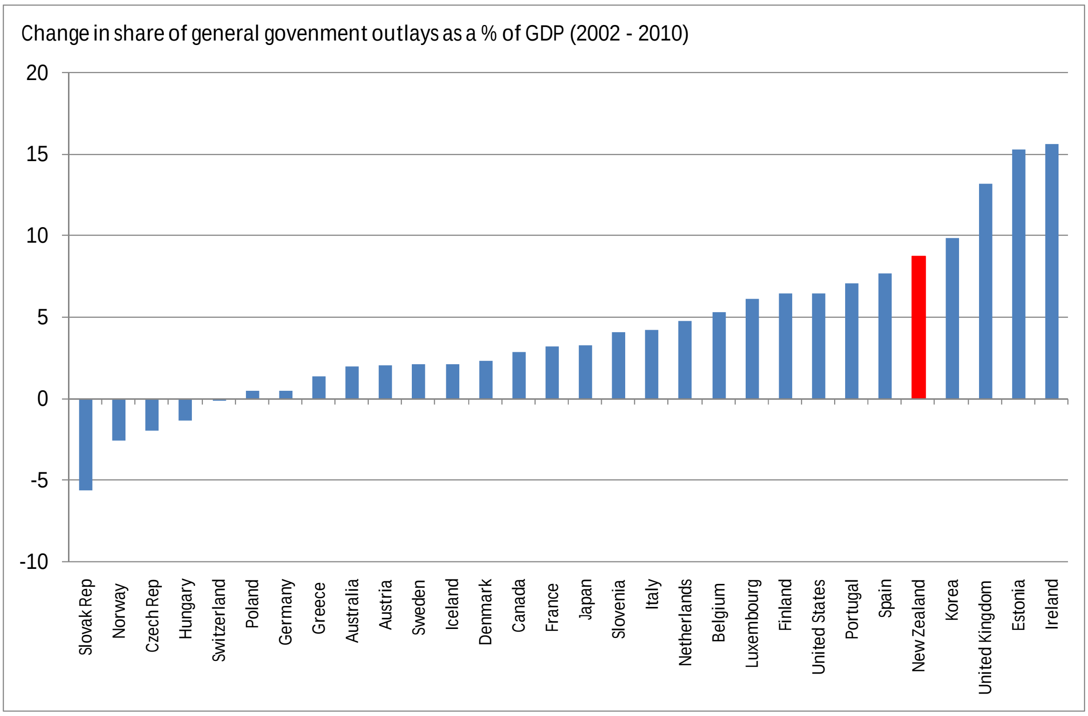

Source: OECD

45. The 2009 Budget envisaged only a very gradual process of returning to surplus and cutting the level of expenditure. The medium-term projections in the Budget also relied on a steady increase in the tax burden on the economy. The case for earlier and more substantial fiscal consolidation is much stronger than it was earlier this year, when the 2009 Budget was being shaped. The pressing priorities driving the decisions in the Budget were managing the risk of a credit rating downgrade, and at the same time providing support to demand in the midst of a recession. Having dealt with that initial situation, some more significant adjustment is now warranted.

46. Circumstances have also changed. In particular, six months on, and looking towards next year's Budget, we now appear to be moving towards a recovery, here and abroad. And that recovery seems less well-balanced, and involving less resource reallocation, than had seemed likely earlier. [Withheld under section 9(2)(f)(iv)]

47. In the Budget projections, the operating balance was projected to remain in deficit for 10 years, returning to surplus in 2018/19. We have developed a couple of options for faster fiscal consolidation. [Withheld under section 9(2)(f)(iv)]

[Withheld under section 9(2)(f)(iv)]

[Withheld under section 9(2)(f)(iv)]

48. [withheld under section 9(2)(f)(iv)

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49. [withheld under section 9(2)(f)(iv)

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[3] Government investment spending is not cut in this scenario, consistent with the priority the Government has placed on such spending.

[Withheld under section 9(2)(f)(iv)]

[Withheld under section 9(2)(f)(iv)]

50. How do cuts in government spending help? By reducing the government's own direct demand for goods and services, and reducing the amount of money being transferred to households, material reductions in domestic demand would be likely. Even though some government spending cuts would be partly offset by additional private spending, the consistent evidence here and abroad is that, all else equal, the net effect on domestic demand of such spending cuts, by themselves, would be contractionary. However, this effect would be offset by more stimulatory monetary policy. In setting the OCR and commenting on future prospects for the OCR, the Reserve Bank would give considerable weight to well-foreshadowed significant cuts in government spending, occurring over three successive years. All else equal, such cuts could be expected to result in the OCR being set lower than it otherwise would be for several years. That might mean actual OCR reductions, but more probably would simply limit the need for OCR increases over the next few years). Our own initial modelling of this front-loaded consolidation scenario suggests an OCR difference of perhaps around [withheld 9(2)(f)(iv)] basis points.

51. Markets would also be expected to respond to the lower actual and expected OCR by and as a result the exchange rate could be expected to fall. All sorts of factors influence the exchange rate, including choices by authorities in other countries. But for any given set of external circumstances, the tighter New Zealand's fiscal policy is, the looser our monetary policy is likely to be and, as a result, the lower the exchange rate. One possible scenario might see a period of 3-4 years in which the exchange rate

settled well below its long-run average (somewhat akin to the period of undervaluation over the turn of the century).

52. In such a scenario, with a reasonable prospect of a sustained period of undervaluation, firms operating here (or considering doing so) would face both weaker domestic demand and a more attractive pricing position for expanding in overseas markets. With imports also becoming relatively more expensive, the environment would be more favourable to the sort of resource and expenditure switching the economy needs. There are some parallels to the situation in the early to mid 1990s. At that time, large cuts in government spending, at a time when the world was moving out of recession, helped facilitate lower domestic interest rates and exchange rates. That, in turn, helped reinforce the foundations for a period of relatively strong economic growth through the mid 1990s.

Issues and risks

53. [Withheld under section 9(2)(f)(iv)

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54. [Withheld under section 9(2)(f)(iv)

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55. None of this is mechanical, and there is a lot of uncertainty about the overall domestic and international economic outlook. However, any growth surprises should normally be allowed for in subsequent monetary policy adjustments: monetary policy remains the most flexible tool for short-term macro management. With the OCR at 2.5 per cent (still high by international standards), and generally expected to rise from here, we have more leeway to cope with surprises, using conventional macro tools, than most other countries do. Most other countries are, therefore, more constrained in their ability to make serious progress on fiscal consolidation.

56. Another obvious question is about the scope for resources to switch to the tradables sector at a time when the world economic recovery is likely to be subdued. [Withheld under section 9(2)(f)(iv)

] Second, indications are that for small countries in particular, export volume growth is quite feasible in this sort of international environment, when the exchange rate is favourable. We would not, of course, stand by that conclusion should the world economy once again slow very markedly. That remains a risk - and the vulnerabilities around China in particular remain very real. The advantage of choosing to adjust, rather than being forced to adjust, is that to some extent the precise timing can be flexible.

57. Front-loading fiscal adjustment is likely to have some other attractive features. The BEFU forecasts, and our moderate adjustment case, both require sustained fiscal restraint for at least the next decade. Moreover, fiscal drag - the non-indexation of tax brackets - plays a material part in keeping the debt tracks on target. Fiscal drag sounds innocuous: in fact it would mean that by 22/23 the average wage earner would be paying the top marginal tax rate. [Withheld under section 9(2)(f)(iv)]

Likely impact

58. [Withheld under section 9(2)(f)(iv)] Indeed, the limitations of the modelling tools we have available mean that even in preparation for the Premier House meeting we will only be able to do a limited amount of formal modelling analysis. We would, however, plan to continue to marshall research evidence to help illustrate the likely benefits of reform packages and to outline the implications of the various alternative choices.

59. No economist or policy adviser can guarantee that any particular package would be sufficient to close the income gaps, or to generate any particular growth rate. However, it is likely that a package of measures of the sort of scale and breadth discussed in this note would be required to generate the sort of growth the government's indicative target would require.

60. The nature of the adjustment would depend in part on the scope of the package. In particular, the extent to which fiscal policy adjustment could be front-loaded would materially affect the scope for shifting the fiscal/monetary policy mix and supporting restructuring, and a shift towards tradables production, with a sustained period of an undervalued exchange rate.

61. In a front-loaded fiscal package, accompanied by significant tax reform [Withheld under section 9(2)(f)(iv)] we could see something like the following sort of features:

- Materially weaker consumption (relative to income) and lower house prices.

- Materially stronger business investment (foreign and domestic), profitability and employment in tradables sectors of the economy.

- A materially lower exchange rate for several years. These effects would not be permanent and the size/length might depend in part on the success of the reform strategy in stimulating new investment. The more competitive and attractive the overall business environment the more quickly the exchange rate will revert back towards long-term average levels.

- Lower farm land prices.

- Interest rates and a domestic cost of capital more in line with international norms.

- A materially stronger fiscal position, including scope for overall tax cuts in future years (because the fiscal drag assumption is no longer carrying much of the burden of fiscal adjustment as it was in the Budget).

- Unambiguously stronger export growth. Import growth is more ambiguous, but weaker consumption would probably broadly balance stronger (imported) investment.

- The overall current account deficit would probably be lower over a three to five year horizon (especially given the lower interest costs on the existing stock of debt).

- As confidence took hold that a sustainable economic transformation was underway, the current account deficit and NIIP could even be larger for a period than they are on present projections. Large increases in investment, of the sort likely to be needed to close income gaps and lift labour and multi-factor productivity, need to be financed from somewhere. The imbalances accumulated over decades cannot be worked off in the very short-term. However, even if the net international investment position was larger for some time, it would be grounded on more secure foundations than those at present. Large current account deficits are not typically a problem if they reflect sustainable well-balanced growth prospects (e.g., the Singapore experience in the 1960s and 1970s, with very large current account deficits and very high export-led growth rates).

62. In any large-scale reorientation of the economy it would be foolish to pretend that there are no risks, and no likelihood of unintended consequences. It is possible, for example, that resources could move into tradables production more slowly than we would usually expect, and as a result the unemsployment rate in particular could stay higher (or high for longer) than is currently projected, even with the benefit of a shift towards a looser monetary policy. This paper is in the nature of a scoping exercise, and as more detailed options were worked, we would also develop a fuller and more intensive assessment of the various risks, interdependencies, and areas where the uncertainties might be particularly large.

Concluding Observations

63. The discussion in this paper has sought to illustrate some alternative economic scenarios and to outline the general scope of some alternative policy responses. It is important to emphasise the sketch nature of the pictures painted. They are sketches for two reasons: some of the analysis is at an early stage, and the overall situation is highly uncertain. It is, for example, possible that the apparent revival in the domestic housing market could soon collapse under its own weight (of accumulated overvaluation, and the fear of rising interest rates). Or that the stronger exchange rate could seriously undermine reviving business and consumer confidence. Or events internationally could see optimism about a nascent gradual global recovery snuffed out. And in coming months the exchange rate could easily trade in a range 15 per cent either side of where it is now, as sentiment ebbs and flows.

64. But whatever these uncertainties there is little sign that the accumulated imbalances in the New Zealand economy being worked off, and or that conditions are in place that would allow any material closure in the substantial income gaps. [Withheld under section 9(2)(f)(iv)

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65. We look forward to discussing the issues in this paper with you at the session scheduled for 4pm on Thursday 27 August.