

PART TWO

Policy and Organisational Issues

Chapter One

Economic Management: Overview

Introduction

The New Zealand economy continues to display one of the most lacklustre performances among countries in the developed world. While there are many bright spots within it, and the external environment is a little more favourable than it has been for some years, the outlook on the whole is not encouraging. The forecasts for the next 18 months are summarised in the following table:

TABLE 1

	<i>Actual or Estimate</i>	Forecast	
	<i>1983/84</i>	<i>1984/85</i>	<i>1985/86</i>
Change in Real GDP (%)	+2	+3	- 1
Change in Employment (%)	- 0.6	1.8	- 0.5
Inflation Rate (CPI %)	5.1	6.0	7.5
Current Account Deficit (% of GDP)	-4.2	-7.2	-6.4

(All figures show change in annual average level over previous year)

The domestic economic expansion, which began early in 1983, is now easing. It has been driven in part by strong growth in overseas markets for manufactures and forestry products, the response to which has been reinforced by the gains in manufacturing competitiveness achieved during the freeze. A substantial part of the stimulus, however, has stemmed from more transient factors such as the expansion in domestic spending associated with very high rates of money and credit growth, and purchases of durables in anticipation of price increases. Because of the slow and uneven nature of the international recovery and serious imbalances in some international commodity markets, the lift in pastoral export prices has been weaker than has occurred during previous international recoveries. The effect of increasing product prices on farm incomes have been further moderated by the operation of the Supplementary Minimum Prices scheme.

Assuming that the international economy remains strong through 1985, as appears likely, the ability of New Zealand to sustain a moderate level of activity will depend critically on at least maintaining the gains in competitiveness that have been made and preventing a resurgence of inflation. That, in turn, will require positive action to deal with the present

serious macroeconomic policy imbalances. Some easing back in activity is inevitable, as real private consumption slows and the deteriorating external situation dampens the rate of money and credit expansion.

Long-run Structural Problems

This current outlook adds to the evidence in the statistical record over many years that the economy is beset with serious structural difficulties and that we have continually failed to make the best of the circumstances we find ourselves in.

The main data on economic performance, looked at collectively and in comparison with other countries, tell an unmistakable story. Over the ten years to 1983, New Zealand's real Gross Domestic Product grew by less than half the average for all OECD countries. For the same period prices increased by nearly one and a half times the OECD average, while the registered unemployment rate increased markedly compared with other OECD countries. This relatively poor employment and growth performance occurred despite a dramatic increase in external borrowing, which had the effect of supporting activity during this period. New Zealand's poor record has not been due principally to low rates of investment. The investment to GDP ratio has been close to the OECD average while our growth rate has remained one of the lowest. The return on this investment has been disappointingly low.

This relatively poor performance reflected, in part, New Zealand's unwillingness to adjust to changing external conditions (in this context the increased external debt represented a shifting forward in time of the adjustment problem). However, this attempt to cushion the economy from the effects of the deteriorating terms of trade did not prevent the community having to face a real relative income loss and a dramatic increase in the rate of unemployment.

Shifting Policy Objectives

These statistics conceal the fact that for some periods we have made significant progress in achieving one objective or another. After the damaging attempt ten years ago to ride out the first oil shock rather than adjust to it, by policies which boosted the domestic and foreign deficits to unsustainable proportions, the external position was brought back into some degree of balance first by the necessary action to contract expenditure and later in the seventies by some growth in exports. More recently, a favourable trade balance has not been sufficient to keep the external deficit at a manageable level because of an expanding invisibles deficit. The forecast is for further deterioration in the external position.

Accelerating inflation during the early 1970s was contained in the mid-1970s, and progress towards a more satisfactory monetary and fiscal policy mix was being made in 1979 and 1980. However, the lid on inflation was lifted after 1980 when the effects of an expanding internal deficit on money and credit growth permitted the inflation rate to rise to 17 percent. The freeze has now seen a drop in the rate of inflation, initially supported by tighter domestic policy that followed from the monetary outflow in 1981/82. Lower inflation probably also owes as much to the effects of a weak economy and lower import prices as to the controls imposed. The price freeze ended at a time when the effects of the reversal of the tight money policies (in autumn 1983) were beginning to be felt. A battery of interventions is being used to hold the line but the forecasts are for a rising rate of inflation. While the level of unemployment is low by world standards it has increased markedly during the last ten years despite some temporary improvements during that period. After rising rapidly in 1977 it was stabilised in 1978, then rose again in several steps. Recently it has been declining with the temporary expansion in the economy.

Why is it that achievements are made in one area and not sustained? The New Zealand experience demonstrates plainly that it is because the Government has devoted all its policies to the solution of the most severe problem for the time being at the cost of its other objectives. An overall balance in policy has been missing, so that one indicator has been improved at the expense of others. Even though world economic performance in general was inadequate in the 1970s, most developed countries have done relatively better than New Zealand in respect of most or all of their objectives simultaneously. Their superior performance is a result of their having adopted policies which have been mutually reinforcing and have been aimed at achieving a better balance between objectives.

The implementation of the freeze illustrates well the difficulty New Zealand has had in achieving policy balance. In theory, price and wage controls are supposed to work because they employ the full authority of the government to persuade people to forgo short term income gains in the longer term national interest. The reality is that public support for the controls is typically gathered by backing off other policies whose proper role is to regulate some other aspect of the economy.

Acceptance of the freeze was dependent on the personal tax cuts in the 1982 Budget. They added roughly \$1 billion to the deficit at the time. This boost to the deficit contributed to the monetary growth in 1983 (which was augmented by a private capital inflow). The Kiwi Savings Stock programme mopped up much of the liquidity but was blamed for unacceptable levels of interest rates. Concern to reduce interest rates in line with the rate of inflation produced by the freeze led to a reversal of that monetary policy and a consequent expansion in money and lending.

The response in turn has been a system of penalties on financial institutions through compulsory Government Stock holdings. Lending nevertheless continued. The monetary expansion, fuelled by the increased deficit the government thought necessary to accompany the freeze, is now a serious inflationary threat itself. The interest rate controls hamstringing the monetary policy action which should be counteracting that threat. Further, at the time the freeze was imposed, the crawling peg exchange rate was abandoned. The subsequent drop in inflation broadly preserved international competitiveness, but the concern to stop the exchange rate from adversely affecting the consumer price index led to a minimal devaluation at the time of the Australian devaluation in March 1983, when conditions were reasonably favourable for the more sizeable move needed to rectify our large external imbalance.

It is therefore fair to say that monetary, fiscal and exchange rate policies were all given as hostages to support the freeze. A reduction in domestic inflation has been achieved at the cost of the other objectives of economic policy. It is in this sense that our economic management has not displayed the essential balance seen in more successful countries.

Inappropriate Interventions

A feature of New Zealand's policy is a heavy reliance on particular forms of intervention in the economy, and a tendency to rely on specific controls rather than general policy instruments. It is clear that many of these interventions are not achieving their objectives and are frustrating the achievement of higher living standards. Why has this occurred? The account of recent history illustrates how the Government has responded to the consequences of unbalanced policies by increasing reliance on interventions designed to suppress the symptoms rather than address the underlying causes of our economic malaise. Other interventions are an overhang from past policies and have ceased to promote-or have even come to undermine-the objectives they once had. For whatever the reasons they were instituted, many malfunctioning interventions are difficult to remove because they have attracted those groups who are able to organise their affairs to benefit from these interventions and who have come to see the advantages they derive from them as a right. The list of interventions that could be questioned is long and reaches into every corner of the private and public sectors of the economy. A few examples are:

- the subsidisation of industry by excessive levels of border protection;
- restrictions on entry into, or prices charged by, business sectors, professional and trade groups;
- unwarranted state monopolies in the communications and energy sectors;

- misdirected social expenditure to support the building industry;
- the protected position of the public service, and wider areas of the state sector such as the education and health systems;
- the protected position of the unions under existing registration procedures;
- the under-pricing of state-supplied goods and services.

Our poorly targeted interventions are a threat to the economy both because they distort the sectors immediately impacted and because they collectively disrupt resource allocation. Resources are locked into areas with low social returns and the general lack of flexibility in resource movements undermines the operation of monetary and exchange rate policy.

Resistance to Adjustment

There are many explanations for the continuing patterns of unbalanced policy but at the core has been an unwillingness to accept realistic limits as to what the government can deliver to various interests and what it can protect them from. In the wake of the oil shocks and the deterioration in our export markets, governments have in many respects sought to resist the changes in production and consumption patterns that are necessary for us to make the most of the world we now have to face. This has been done by providing assistance in various forms to many activities. The rapid growth in government expenditure on assisting industry is one example. More generally, incomes were maintained throughout the community at levels which were not appropriate given the large drop in our terms of trade. The countries that have performed best in recent years are those that took a positive approach to the necessary adjustments, Finland, Japan, Germany and more recently Sweden are examples. While our resistance to adjustment may have been intended to protect living standards, the fast-adjusting economies have in fact coped with the difficulties with less economic and social stress. We have protected subsectors of the economy at the expense of general welfare. To adjust faster we would have needed a steadier monetary policy, smaller government deficits and a freer exchange rate policy. These are fundamental, but they must be supplemented by action to overcome the sclerosis that has built up through the regulation of many markets of the economy, and action to ensure that the main burden of adjustment does not fall on those least able to support it.

Put simply, policies for faster adjustment allow changes in international prices to be reflected in the domestic economy. Ultimately this is the only way to ensure that the country's resources are continually being

allocated so as to achieve the highest national income available. The more that rigidities are allowed to slow down this reallocation the greater is the corresponding loss of income. When world prices move against us, there is an unavoidable loss of income. This emerges as a balance of payments deficit reflecting the fact that we are spending more than we are earning. In the short term the government can only borrow to cover the deficit and/or squeeze domestic expenditure causing lost production and unemployment. The income loss can be offset only by reallocating resources and is prolonged by delaying this adjustment. Positive adjustment policies reduce the period of retrenchment and the amount of borrowing forced on the government following an adverse movement in world prices.

Instability in Macropolicy

A further cause of our poor performance has been the instability in government financial policy, as shown in table 2.

TABLE 2

Monetary and Fiscal Stimulus 1974-1984

Year Ended March	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Real GDP Growth(%) ³	7.2	4.0	1.7	0.1	-2.7	0	2.7	0.7	4.4	-0.2	2.0
Budget Deficit % GDP (%)	2.6	3.9	8.6	3.6	4.5	8.3	4.9	6.2	6.2	5.5	8.7
Annual Increase in Private Sector Credit Deflated by the CPI (%) ²	25.1	-1.9	-2.4	13.6	-0.5	13.2	2.5	4.5	12.3	-7.5	11.6
Growth in Real Disposable Household Incomes (%) ³	4.5	-4.5	3.8	-1.7	-4.3	4.5	-4.3	-1.8	1.1	-4.2	0.1
Change in Real Private Consumption (%) ³	8.7	4.3	-0.5	-3.0	-3.0	1.3	-0.3	0.7	2.1	-1.2	1.8
Change in Total Employment (000) ²	50	21	8	14	-3	13	17	-3	21	-10	+13
Annual Rate of Inflation (%) ²	10.3	13.2	17.2	13.7	14.7	10.4	18.4	15.2	15.8	12.6	3.4
Change in Import Volumes (%) ¹	31.8	2.6	-18.7	4.8	-12.6	11.6	5.3	-2.5	10.3	-8.5	10.7
Terms of Trade (1957 = 100)	112	78	72	79	78	86	82	76	77	74	74

June year on June year
 Point to point (March to March)
 quarter to March quarter
 average levels re-adjusted
 Year on Year.

The two indicators of policy are the budget deficit in relation to GDP and annual growth in private sector credit. The short run variability in employment, production and inflation stems in considerable part from those policy changes. Fluctuations in the world economy explain some of the instability, but much of it was of domestic origin. This can be seen particularly in the credit growth rates in 1978/79 and 1981/82. The current forecasts similarly show a policy-induced instability. These policy changes were intended in part to dampen cyclical movements in the economy but in retrospect the reverse may have been the case. There are many explanations for the failure of fiscal fine-tuning to even out the changes in economic conditions being signalled to us from the outside world and from developments in the domestic economy. Part of the answer is that business decision-makers have anticipated to an increasing degree the policy changes and do not react as intended by the Government. For example, the reason that employment rose by only 1.5 percent in 1982, despite a 4.4 percent real GDP growth in that year, was because firms anticipated the contraction in 1983 and were wary of employing more labour. Not all changes in the economic environment can be anticipated, and the business community faces enough uncertainty without adding the risk of unpredictable government policies. A climate for investment and growth requires steady and predictable government policy.

Experience in all developed economies has shown that people's expectations of the likely course of future events are a very important determinant of their reactions to changing circumstances. If they believe that policy changes are likely to be revised in the future they will react accordingly and discount the policy changes. If policy changes are to have their intended effect they must be credible. Discussions at OECD meetings in recent years have focussed on continuity and credibility as the essential ingredients of a successful macroeconomic policy. Credibility is the key but can only be achieved through a track record of consistency and continuity.

Economic Strategy

Like a supertanker, the economy will not be quickly or easily altered in its speed or direction. The technical side of economic management is difficult enough. That includes the setting of policies in the areas of taxation, expenditure, monetary policy, the foreign exchange rate, wages and employment, market regulations and public sector management. Ultimately the greater difficulties, lie in creating a climate of views and attitudes which is favourable to the use of policies which will benefit the country as a whole. An economic management strategy must involve both.

The foundations of any strategy are an understanding of the workings of the economy and the policies available to the government to influence its overall behaviour. The essential feature of the economy is the web of interdependencies underlying the aggregate statistics which summarise countless decisions taken in people's daily lives. Although the objective of economic management is to get these statistics moving in the right direction, there are no simple relationships between them that can be relied upon in designing policy. Economic policies generally operate indirectly by affecting the environment in which people make decisions. Few policies operate by the Government commanding directly the result it wants. Even in the public sector, the Government must attempt to further its objectives by establishing a favourable incentive structure. In affecting the economic environment, policies produce changes which are both intended and unintended. Effective policy achieves the maximum of the former with the minimum of the latter.

In the background is the question of the chosen role for the government in the economy. While this is often expressed as a philosophical choice between free markets and planning, this is not a helpful distinction for practical purposes. Powerful government influences are at work in all markets all the time—indeed markets cannot function without a set of rules for governing private transactions laid down by the government. This includes such matters as the legal framework for the conduct of commercial affairs. The question for government choice is not whether to intervene but rather to decide what set of interventions is most appropriate for a particular purpose. The menu includes:

- modification of the legal framework within which commercial activity takes place;
- fiscal subsidies or penalties;
- legal restraints on prices, quantities or entry into some activity;
- government ownership in varying degrees of commercial enterprises; and
- direct provision of social and economic services by government departments.

With regard to choosing the most effective policy, the reason so-called market forces are the appropriate touchstone in many areas of economic activity is because most policies are to be judged in terms of how well they succeed in marshalling those forces to achieve greater welfare. Markets generally offer an efficient means for reconciling competing demands so that the government is more likely to achieve its ends effectively by hamassing and supplementing markets rather than suppressing them. In other areas there are good reasons for believing

that appropriate forms of government action may improve market outcomes, and in still others that society would wish to trade a reduction in general efficiency for a more equitable outcome. In all cases, however, there is a need to select the appropriate form of intervention, and to minimise any unwarranted effects on incentives to firms or individuals so that associated costs can be kept to a minimum.

Successful economic management requires simultaneous consideration of all the objectives and side effects of the major policies. Whether one policy is successful depends on decisions in other areas, so a mutually reinforcing overall balance is required. A serious lack of consistency in policies can undermine all of them at once. The current clash between monetary, fiscal and exchange rate policies amply demonstrates this. This essential consistency extends further than these broad scale "macroeconomic" policies to encompass the more detailed "microeconomic" policies as well. Policies aimed at, for example, the assistance of industries through subsidies, tariffs and regulations can be severely eroded by monetary policies which lower our overall international competitiveness. Conversely, industry policies which put barriers in the way of resource flows towards emerging sectors undermine the workings of broader policies such as exchange rate movements which are intended to promote these flows. Exactly the same considerations apply to social policies where, for example, additional expenditures can be required to offset the effects of other policies which are worsening social conditions,

Failure to achieve a reasonable consistency in policy is likely to continue to provoke the search for new interventions which our experience shows produce disruptions and inequities for mostly transitory benefits, if any. The present policy mix has forces pulling strongly in different directions with counteracting effects. There are inevitable collisions in the economic traffic if the signals are jammed or confused.

An important cause of inconsistency in policy and loss of effective management is that in day-to-day decision-making the trees very commonly obscure the woods. Immediate problems are solved but, in taking piecemeal decisions, the implications for the government's broader objectives are lost sight of. The tendency for government expenditure to ratchet steadily up over the years and for the tax base to be eroded are the results of this process. The way around this problem must involve more emphasis on establishing the right process as regards both the substantive analysis and the machinery for deliberating on and executing policy, so as to ensure that all the implications of detailed decisions are accounted for at the time.

An effective way to ensure that an appropriate process is gone through on day-to-day issues is to establish agreed frameworks for the major areas of policy. These provide the criteria by which the government and

its advisers can develop and test proposals. They establish an understanding about what the government sees as desirable and attainable performance objectives from various policy areas. Examples of areas where such frameworks need to be established are:

- planning of government expenditure;
- industrial development;
- agricultural assistance;
- export marketing;
- health;
- education;
- welfare;
- wages and employment;
- tax policy;
- treatment of government owned enterprises (which includes establishing incentives for appropriate pricing of publically provided goods and services);
- monetary policy; and
- financial markets.

Once established, these frameworks permit a more informed discussion of the choice of the most appropriate policy instrument to achieve the government's objectives. This also promotes an informed assessment of whether the policies are consistent or in conflict and whether they compound to an overall economic strategy which will operate to improve the economy at large. In reality, an economic strategy simply is a consistent set of frameworks in which to address specific issues.

Organisation and Management

Economic management would be enhanced by Organisational arrangements (including a Cabinet Committee structure) which promoted the approach to economic strategy outlined above. This would include a forum of Senior Ministers in which the large issues were discussed with Officials and understandings reached about the main directions of policy. Previous structures of Cabinet Committees have not been very effective in achieving this orientation. A heavy proportion of the government's decision-making resources have been allocated to issues

which were either minor or brought forward in a manner which precluded a wider discussion of the most effective way to achieve the government's objectives in relation to the questions at hand.

Another problem is that it has been difficult to take decisions which increase the community's economic welfare over the medium term but which impose short-term adjustment costs on specific groups. In the short term adverse consequences will often be apparent, and the medium term benefits are diffused. Further difficulties arise when the decision-making structures are not conducive to having the range of alternative approaches to an issue on the table at the same time. These problems can be helped by a consideration of Cabinet Committee structures, departmental machinery, the function of the Prime Minister's department and the servicing of the Office of the Minister or Ministers of Finance.

In addition to improving the administrative and decision-making processes within government, much more could be done in gaining public support for new approaches. The decision-making processes themselves constrain the Government's ability to act in the community's collective interest. For example, in the determination of industry assistance policy the decision-making process can be dominated by the "problems" perceived by, and specific to, particular industries or interest groups that have a lot to lose (or gain) from changes in policy.

Part of the solution to this problem is for the Government to make both the losses and gains associated with current measures and policy changes more transparent to the public. Greater transparency could be achieved by public information on the costs and benefits of policies and by exposure of the results of regular reviews of policies.

The opportunities for the Government to improve public understanding arise before decisions are taken, when groundwork can be laid for support for new policies. They also arise after the decision in the public justification of Government's action. Chapter 2 of this document contains a more detailed discussion of ways in which community understanding of, and support for, better economic policy might be promoted.

Economic Policies

The chapters which follow in this report address the important areas of economic policy. The presentations are general and emphasise the approach to a conceptual framework which is taken to each issue. As a guide to the report, a few key points are summarised in the following paragraphs.

a *Macroeconomic policies*: Monetary, Fiscal and Exchange Rate Policies

An integrated approach to macroeconomic policy is presented. This discusses the way in which consistent, stable and predictable macroeconomic policy, in conjunction with a regulatory environment which provides (along with taxation and public sector pricing policies) the appropriate incentives for production, can enable the economy to release its full growth potential. Poor macroeconomic policies, on the other hand, depress economic performance by generating one or more of spiralling inflation, escalating debt, balance of payments deficits, recurring foreign exchange crises, a heavy tax burden, insufficient savings and investment, increasing unemployment and lower standards of living.

The consequences of the current excessive government deficit for economic management are explored to demonstrate the threat which it poses to domestic activity through depressing private investment or creating inflation and a worse balance of payments deficit.

The evaluation of recent policy is described in terms of growing intervention to offset the effects of the deficit on the economy. The effect of the freeze and its associated policies is seen as shifting some very considerable difficulties to the immediate future.

The resolution of the conflicts is not seen to lie in prolonged controls on wages, since these do not attack the fundamental (monetary) source of inflationary pressure, and disrupt the proper functioning of the labour market. The solution lies in resolving the current clash between policies, setting a course and making sure it is credible and is understood. This would reduce the danger of wage bargaining outcomes which are based on mistaken views that Governments monetary policy will validate the results of the wage bargain.

A once-and-for-all increase in the price level is seen as inevitable in making the necessary policy adjustments, though such an upward movement would be restrained by action to regain monetary control, reduce the deficit, maintain wage restraint and introduce more competitive conditions into key markets.

A discussion of the techniques of monetary policy raises the central question of interest rate controls. Besides the disruption they bring to the vital functions of financial markets, they work directly against the primary intention of monetary policy which is price stability through the management of the money supply. They increase the demand for credit growth, at a time when the government is trying to control credit, and they reduce the attractiveness of government securities when selling more of them is the primary means by which liquidity can be controlled. Considering the inflationary pressure building beneath the current wage controls and the worsening balance of payments, monetary control is going to be essential. This requires the removal of interest rate controls and a substantial programme of debt sales.

Interest rate controls also have large, and often perverse, influences on equity. Controls on deposit interest rates are likely to cause an income transfer from households (who are net savers) to the government and business sectors. Controls on lending interest rates will reduce the availability of credit for high risk investments and high risk borrowers. In other words, controlled interest rates will tend to adversely affect small savers and less wealthy borrowers.

The exchange rate chapter examines the role of the exchange rate, in concert with monetary policy, in determining the rate of inflation. Its influence, within an overall economic strategy, on resource allocation and international competitiveness is explained. The need for greater flexibility in exchange rates is discussed and it is suggested that the Government should plan for a floating rate regime. It is stressed that the co-ordination and timing of such a move should be analysed very carefully to ensure that the all-important complementary monetary and exchange control policy decisions are implemented and that a supportive fiscal strategy is in place.

The vital linkages between macroeconomic policies and regulatory and other policies operating in associated markets is brought out.

b Fiscal Policy

Chapter 6 contains a numerical analysis of the fiscal situation, showing the forces driving expenditure and revenue and the areas of discretion. A rough estimate is made of the rate of reduction in the deficit that might follow from pursuing policies in line with the principles and options in Chapters 8 and 10 on expenditure and revenue respectively.

The general effects on the economy of the government's expenditure, revenue and borrowing policies are covered in the macroeconomic papers referred to above, which include Chapter 7. This chapter reiterates the point that fiscal policy has been overused and is ineffective in stabilising the economy. It establishes the nature of the severe fiscal imbalance and comments on the common assumption that reducing the deficit would cause the economy to contract. Details are spelled out of the factors which should be accounted for in deciding on an appropriate target for the deficit. These include the size of the cyclical deficit (i.e. that part of the deficit which is due to the fall-off in activity during a temporary downturn) and the balance of the debt burden between current and future generations. An indicative target reduction for the deficit in the light of all these factors is presented.

Chapter 8 presents the principles behind expenditure and revenue policies which can assist the government to decide whether a particular fiscal policy instrument is the most effective way to achieve the objective in question and, if so, to what extent it should be used.

In making this evaluation it is important to recognise that the resources acquired by the government to finance its expenditures are not available to satisfy the community's desires for various goods and services in other areas. If these resources have a higher social return in these alternative uses the government activity may lower community welfare. The costs to the government of administering the policies and to the public in complying with them are also to be accounted for.

All these things considered, the question in relation to an economic activity is whether a government action, fiscal or otherwise, will improve on what would otherwise occur. For social activities there needs to be a clear identification of objectives and an assessment of the least cost method of provision in terms of resource use which is forgone elsewhere. For example, it may be better in some areas to improve equity through taxes and income transfers than by direct provision of goods and services.

Following these principles there are several large areas of government expenditure that do not give value for money. Examples are assistance to industry and agriculture, poorly targetted social policies, and inefficiency in the management of the public sector.

c Expenditure Planning and Control

The objective of expenditure planning and control is to achieve a pattern of government activity consistent with its equity and efficiency goals, at least cost in terms of monitoring performance, assessing new proposals and reviewing existing policy. It must also be consistent with the Government's fiscal goals and its other macroeconomic objectives.

In order to meet these objectives, changes to the existing expenditure planning and control mechanisms are required. If expenditure control were costless, all government expenditure could be subjected annually to review and assessed against appropriate economic and social criteria. However, for the large bulk of government spending this would be impractical and far too costly. For these spending areas, an expenditure management process is required which provides a formal mechanism to evaluate and review new and existing policy on the basis of a list of priorities.

An expenditure management system should have two main features:

- a to ensure that, wherever possible, detailed review procedures test spending against efficiency and equity criteria;
- b to ensure that general control measures have been established to constrain the level of spending in areas outside the detailed review process, given the limitations in the capacity to undertake detailed reviews.

Chapter 9 reviews this subject which, in so far as it concerns administrative aspects of economic management, also relates to Chapter 13 on the Public Sector and Chapter 2 on the Practice and Organisation of Economic Management.

d Tax Policy

Taxation policy should follow the same general principles of equity and efficiency that apply to government expenditure and is therefore introduced in Chapter 8. A detailed discussion follows in Chapter 10 where criteria for judging the tax system are laid down and then applied to personal, business and indirect tax. The most pressing problem with the present system is the narrowness of the tax base. The present wholesale sales tax applies to only one third of private consumption. The income tax base has been eroded by special exemptions, while fringe benefits and capital gains are largely untaxed. The narrow base adversely affects equity and efficiency. A light tax load provides unwarranted encouragement to some activities while, in order to maintain revenue, tax rates are at distortionary levels in other areas.

Over the years a patchwork of special assistance to classes of taxpayers has built up. These are generally called tax expenditures and have an annual cost of some \$1,500 million. While there is little wrong in principle with the concept of tax expenditures, many of them are in practice a poor method of delivering assistance and, because they are not highly visible, they are barely controlled. It is desirable to review many of the measures and expose them to greater ongoing scrutiny. A first step would be to publish a list of tax expenditures in the Budget.

e Labour and Employment

Chapter 11 establishes that the high levels of unemployment experienced in recent years are a symptom of the more general difficulties in the economy.

There is no room to further stimulate domestic activity in an attempt to raise employment and past experience shows this to be ineffective beyond the very short term. Increased job opportunities will follow from policies to improve economic performance and promote flexibility and adjustment in the labour market. In the short run, the average structure of real wages may need to fall if unemployment is to be substantially reduced. A rapid improvement in productivity could offset this to some degree.

Unemployment is aggravated by rigidities which allow persistent imbalances between supply and demand. Enhanced flexibility in the labour market calls for changes in the Government's role in wage fixing

at both the overall level and in detailed interventions. The costs of permanent centralised wage fixing arrangements could be heavy in terms of lost flexibility.

Improvements can also be made in the way help is provided for those who are at a disadvantage in the labour market and who remain unemployed for long periods. There is a range of employment subsidy programmes presently in place. Some are poorly targeted, the level of subsidy tends to represent a high proportion of the wage, the programmes are generally offered within the award structure (which may itself be an important rigidity) and it is unclear how successful participants are in obtaining unsubsidised work when the subsidy terminates.

f Social Policy

If social objectives are to be achieved, improved economic performance is critical. It is not surprising that standards of individual and social welfare have come under pressure given the lengthy period of New Zealand's mediocre economic performance. A poorly functioning economy limits opportunities for welfare gains and often exacerbates the need for specific social programmes (e.g. unemployment assistance). Moreover, general improvements in social indicators, and our ability to devote more resources in aggregate to improving social programmes, depend upon increases in the community's level of income. However, within the likely resource constraints there still appears to be considerable scope for improving the performance of social policies. The sorts of change that we think may produce such improvements are discussed in Chapter 12. They fall into two categories:

- a those which would target social policies more on the basis of need-which inevitably would require reducing government expenditure on those people with less need; and
- b those which would allow the strengths of market processes to help allocate resources in ways which are more responsive to consumers' preferences and which involve least cost. Examples are government subsidisation rather than provision and increased use of charges which provide signals as to the amount of a good which should be consumed or produced. Such changes could increase prospects for maximising the community's welfare, provided that adjustments are made to income redistribution policies to avoid disadvantaging people on lower incomes. Indeed, a change in emphasis from the promotion of particular social services towards direct income redistribution appears fundamental to achieving greater equity in social outcomes.

Although it may be difficult to win acceptance for some of these changes, the fact remains that without such changes social policy objectives are likely to become increasingly difficult to achieve.

g The Public Sector

The resources used by the public sector amount to around 25 percent of GDP and therefore the efficiency with which these resources are used has a major impact on the growth and general performance of the economy. In examining the potential for improved public sector performance it is useful to distinguish between the “market” activities of the government (where the output is or could be sold) and “non-market” activities (those which, at any point of time, governments have decided should be provided collectively on the community’s behalf).

The first section of Chapter 13 deals with market activities. Since the output of these “State owned enterprises” is or could be sold, they have a close correspondence to private sector enterprises. In looking at the question of their efficiency and the accountability of management for their performance, it is useful to consider the way these issues are resolved in the private sector. In the light of this comparison the paper discusses the obstacles to improving efficiency and suggests ways they might be overcome.

While similar principles of Organisation are applicable to the non-market activities of the government, the nature of their output requires that other techniques be used to ensure their efficiency and management performance. The second section of the Chapter addresses these issues.

h Private Sector Regulation and Industry Assistance

Chapter 14 establishes a general framework for considering matters related to government intervention. It is argued that it is more useful to consider both interventions and market mechanisms (themselves resting on more fundamental government interventions which “set the rules” of economic behaviour) as being tools with which society can increase community welfare, rather than from the “adversarial” perspective of government interventions interfering with the “natural” operation of otherwise unfettered markets. The basic approach, therefore, is to seek that pattern of interventions and private initiatives which contributes the most to national welfare in terms of improvements in efficiency and equity. This framework leads to the view that there is considerable scope for reforming the regulatory and assistance environment within which a number of areas of the domestic economy operate. Examples of this are drawn from the transport, energy, finance and export marketing fields. The regulation of primary produce exporting is of such importance at present that a separate chapter is devoted to it. Chapter 14 also argues that an acceleration in the pace of import protection reform is desirable and that this should accompany changes in export incentives and assistance to the primary sector. The emphasis should be on obtaining a lower, less

arbitrary and discriminatory structure of industry assistance, with appropriate interventions chosen so as to minimise other economic costs. While the reforms outlined will benefit from the appropriate use of fiscal, monetary and exchange rate policies, they also have the potential to make a significant contribution to the effectiveness of instruments of economic management by promoting a more flexible, responsive and internationally competitive economy.

Conclusion

The purpose of this brief, which includes the accompanying volume of current and forecast information, is to set out a framework for approaching economic management from both an administrative and substantive point of view. The economic situation is such that major decisions will have to be taken immediately. Among the most important will be those relating to the administrative structures of economic management which is why they feature prominently in this brief. This urgency to make decisions does not apply to all areas of policy and we see a need in many areas for a period of careful review in order to establish the right frameworks for addressing the issues. Much of the following material on policy issues is concerned with approaches to thinking about those issues and analyses of the relevant situations. Options are presented in some areas and specific decisions suggested where we see a clear-cut case for action. The report is necessarily complex because of these purposes. It summarises the problems the economy confronts, indicates general directions for improved policy and signposts the rest of the document. It is written with a view to having discussions with you, if you so desire, about general or specific points in it as a basis for organising analysis and discussion of the policies of the Government.

Chapter Two

The Practice and Organisation of Economic Management

Introduction

Most of the accompanying papers analyse and discuss economic problems confronting New Zealand and suggest policies designed to improve economic performance over the medium term. While policy changes are an essential ingredient in achieving this objective, Treasury's experience as the Government's advisor on economic and financial matters suggests that changes in the practice and Organisation of economic management could also assist in improving economic performance. The Organisation of economic management primarily concerns consultative processes, formulation of policy through interaction between Ministers and officials (including decision-making structures) and the communication of the Government's objectives and policies. This paper focuses on these areas and suggests ways in which existing practices and Organisation might be improved. From the Treasury viewpoint decisions in these areas are of interest because they have implications for planning our internal Organisation and determining our role.

The first part of the paper presents a brief discussion of general approaches to economic management. This suggests some broad orientations which could influence the Government's priorities and policies and some principles which underpin our suggestions on the decision-making apparatus. Proposals relating to the Cabinet Committee structure, the Organisation of departments of state (including the Prime Minister's Department), and support for the Minister of Finance are then discussed and developed. The final section of the paper deals with the need to balance sectoral influences on the decision-making process and suggests ways of improving the communication of the Government's objectives and policies which could enhance economic performance.

General Approaches to Economic Management

The formulation of policies to deal effectively with the problems identified in these papers, and with other problems which arise, can be assisted by having regard to some general propositions. The first is that the Government needs to concentrate on the largest (and usually the most difficult) issues and policy areas. It is through the determination of the

“big” policy settings in all areas-macroeconomic policy, market regulation, the pursuit of equity etc.-that the major influences on economic efficiency and community welfare will be brought to bear. While this may appear obvious, we know from the management of our own work that the smaller problems, particularly those with a shorter timeframe, tend to crowd out work on the problems which matter most. This has also been a long standing problem for governments. The decision-making apparatus needs, therefore, to be arranged so as to provide Ministers with scope to deal with problems according to their real priority.

A related problem of economic management concerns the time horizon of issues under consideration. With most policy proposals, the benefits are generally realised over the medium term, once the economy has adjusted to the particular policy change. In the short term, adverse consequences will often be perceived by the public (e.g. the shedding of labour from a firm subject to import competition is likely to be apparent more quickly than the absorption of additional labour by other firms whose cost disadvantages have been reduced). Nevertheless, effective economic management requires that attention be given to the longer term benefits of programmes, since refusal to bear adverse short term consequences of policy changes inevitably delays adjustment, creates its own adverse implications for other policy initiatives, and denies the longer term improvements which are critical to improved economic performance.

Another point is that consistent economic policies are necessary to implement an effective programme. All economic policies interact and thus desirable outcomes will only be possible if coherent approaches are pursued. This requires decision-making structures which enable broad policy settings to be developed and reviewed, ensure individual decisions are congruent with broader policy and allow the Minister of Finance and other senior Ministers to have an overview of the Government’s economic policy.

The above considerations, together with our involvement in economic management as it has evolved over the past decade or so, form the basis for the suggestions on some aspects of the economic policymaking and executive machinery of government made in this paper.

Cabinet Committees

In a strictly formal sense, many Ministerial decisions in the economic arena have been taken by Cabinet in a framework of collective Ministerial responsibility. Cabinet’s agenda is, however, too crowded and the Cabinet is too big to permit a full deliberation on each issue. The bulk of decisionmaking has therefore been delegated to Cabinet Committees.

Cabinet, however, has the role of ratifying decisions made elsewhere and of providing an opportunity for a final review of major policy items or ones which are unresolved at other levels of government.

The presence of officials at Cabinet Committees enables Ministers directly involved in particular proposals to discuss them with the benefit of the best available technical information and advice. This assists in dealing with complex and often inter-related issues and exposes to Ministers a wider range of departmental thinking than would be the case if Ministers were only advised by their own officials.

There is a danger that Cabinet Committees, primarily concerned with making decisions on the day to day issues, will have little time for the exploration of more complex issues and still less for the development of broad policy initiatives. Many of the more important questions of economic policy are complex and inter-related. They cannot be dealt with independently or broken down into component decisions until the overall framework for policy has been established. This requires an opportunity for Ministers to interact with officials on the basis of broad perspectives drawn from detailed analysis. Previous Cabinet Committee structures have not, in our view, always provided adequate scope for such an approach to policy.

In the past many of the major economic decisions (for example, in the areas of monetary, fiscal and exchange rate policies, and taxation) have not been dealt with by a Cabinet Committee. They have been the responsibility of the Minister of Finance. While there are policy issues for which such a practice is inescapable, stemming, for example, from the need for budget secrecy on issues of commercial significance, it tends to isolate the Minister of Finance from other Cabinet colleagues unless there are other effective forms of consultation.

The Minister of Finance has had the responsibility of deciding with whom and on what basis to consult among colleagues before seeking Cabinet endorsement of policies. To the extent that he or she seeks to expose other Ministers to the wider framework of economic policy, the Minister of Finance may wish to do this informally. On the other hand, there can often be advantages in involving senior Ministers in a more structured discussion with officials on the formulation of broad policy settings. This may contribute to a wider understanding of the main economic issues and policy options and thereby assist in maintaining coherent policies. It may also provide a sense of involvement in general economic policymaking and reduce the risk of independent and fragmented initiatives being developed.

Similar problems may arise in the expenditure review area. For example, a problem with the most recent Cabinet Committee structure is the compartmentalisation of the expenditure review process broadly into

current (other than staff) expenditure, capital expenditure and staff. This split is undesirable as it focuses on inputs rather than the outputs of programmes and encourages consideration of narrow parts of policies rather than the wider picture. In addition there is a good deal of overlap in these areas. As a result the same issue may have gone to all three Committees and in some cases to others as well, since expenditure issues can often not sensibly be separated from broader aspects of policymaking. There is room for some consolidation in this area.

The previous structure has also appeared too fragmented, with a large number of standing Committees, some meeting only occasionally. From Ministers' point of view unnecessary Committees are an added imposition on their time or risk becoming considered insufficiently important to warrant their attendance.

In overcoming the above problems, there are some general principles which might be taken into account in considering a more appropriate Cabinet Committee structure in the economic field. These are:

- a each Committee should have a manageable workload. It should not cover too diverse an area so that the Committee can accommodate all Ministers with a legitimate interest and if possible avoid the situation where large numbers of officials are required to be in attendance for the same meeting;
- b overlapping interests of different Committees should be avoided wherever possible;
- c the Committee structure should not be fragmented so as to economise on Ministers' time and ensure a reasonably consistent view across related issues.

A Suggested Structure

a Overall Policy Review

In the interests of promoting a wider understanding of the broad economic policies of the Government and of developing a coherent policy programme, it would be desirable to have a forum outside of the Cabinet itself in which policy development can be considered. Such a body would not fit easily into a Cabinet Committee structure which is conceived of as having primarily executive functions to do with the day to day issues coming before Cabinet. It would in fact sit somewhere between Cabinet and other Cabinet Committees with the chief purpose of allowing a relatively small group of senior Ministers to explore issues in depth. It would be important to ensure that the policy review committee maintained some distance from general executive functions although decisions on

the largest economic problems might be taken in such a forum. Were it to deal with detailed issues it would quickly find it had little room on its agenda for broader policy. To prevent this, the Committee would need to establish a clear conception of its role, which would involve consideration of what it both should and should not do.

High on a policy review committee's agenda should be consideration of the macroeconomic policy settings. These are currently formally reviewed about twice a year—once in the development of the budget strategy and again in a review of policy which Treasury has sometimes seen as useful to present for consideration by the Minister of Finance during the parliamentary recess (known colloquially as the Christmas Reading). These papers could, for example, be discussed by the Committee. In a relatively small group such as this the Minister of Finance may also be able to canvas taxation proposals in a way which is not possible in a larger group.

The group could also concern itself with the overall policy framework for other major areas of economic management which involve a number of decisions spread over a period of time. In areas like industry assistance policy, such a framework is essential if the overall policy thrust is to be maintained. In addition, it may be fruitful to review policy developments in other areas such as social welfare, government owned enterprises, external trade policy or the functioning of the labour or capital markets. What the group should not do is undertake the detailed decision-making of other Cabinet Committees. To this end the Chairman of the group should maintain a tight control of the agenda.

This forum would also provide a vehicle for exposing officials' thinking directly to Ministers with economic portfolios. Thus officials should be present although not in such numbers as to inhibit discussion. In the first instance the presence of representatives of Treasury and the Prime Minister's Department may suffice with the option to call on other officials if so desired.

b Executive Committee(s)

As noted, there is a need to consider improvements in the structure of executive committees in order to improve the efficiency of decision-making. Because economic policies involving fiscal and other instruments are inevitably related, there could be a case for having a single executive committee structure in the economic and expenditure area. This would enable substitutable instruments for achieving the Government's objectives (e.g. direct subsidies or tariffs) to be considered jointly. Similarly questions concerning efficiency and equity in the social service areas and the labour market could be considered by the same body which reviews related expenditure.

More than one committee could be required to handle the workloads involved. One division would be between market and non-market areas of economic activity. The effect of such a division of work would be to enable one Committee to focus on public and private sector problems concerning organisations which are exposed to competition (e.g. the trading activities of the Ministry of Energy and the Post Office, and industry assistance issues). In the remaining non-market area it would be best to aim for a division which could handle both policy and expenditure review issues for the sort of groupings (social policy, infrastructure, general public sector administration, etc.) discussed in the chapter on Expenditure Planning and Control. One or more groupings could be allocated to each Committee so as to avoid either fragmentation or large unwieldy Committees. There would be two advantages of such a division. First, common problems in each area would tend to arise and the Committees would be well placed to take consistent decisions. Secondly, the implications of decisions in one area for another area would have to be recognised. For example, a decision to approve additional expenditure on (say) education would mean that other non-market areas (e.g. social welfare) would obtain less than otherwise, given an overall expenditure constraint.

There are a number of options which could be considered and which might overcome the disadvantages of the existing structure. Common to all of them would be a need for overlapping membership with the policy review Committee and the position and responsibilities of the Chairman would obviously be important in each case. Further consideration to this aspect of the decisionmaking procedures could be given if required.

Ad Hoc Committees

Rather than attempt to devise a structure of standing Committees to cover the whole range of the Government's economic activity, it is probably preferable to restrict standing Committees to a workable number in relation to the normal run of issues and to create Ad Hoc Committees to deal with special problems as they arise. This avoids the problem of standing Committees which become a burden on Ministers' time and are poorly attended. The danger to be avoided is a proliferation of Committees leading to fragmentation and to the risk of special interest groups attempting to operate outside the main forums where formalised procedures act as a constraint.

Many proposals coming before Ministers need not be decided within the Committee structure. Treasury financial delegations, for example, provide for a range of decisions to be taken jointly by the Minister of Finance and another Minister, or by the the Minister in Charge of the relevant department alone or by the Permanent Head. Most decisions falling in

these categories are taken in the context of an existing policy. It is important that as many decisions as possible are delegated to joint Ministers or to a lower level, so that the Cabinet Committee structure is relatively free to take strategic and other significant decisions. In this context, there is a case for re-examining Treasury and other delegations.

Finally it should be noted that this paper has concerned itself only with the structure of Cabinet Committees relating to economic affairs. There have been a number of standing Committees primarily concerned with other issues but these are outside the scope of this discussion.

Departmental Machinery

There may be a case for reviewing the Organisation of departments of state to improve the efficiency of decision-making. At present there are a large number of departments and their advice tends to reflect sectoral views (i.e. the views of their main clients) rather than an economy-wide perspective. As noted below, this often leads to an imbalance in influence on the decision-making processes. One approach would be to internalise trade-offs in related areas by merging some departments' areas of responsibility. Another possibility is to separate, to a much greater extent than currently is the case, the policy advice areas of departments from the operating or implementation areas. Quick benefits in this area are unlikely, but longer term improvements in efficiency are possible. If required we could develop further papers on this.

Prime Minister's Department

Because economic issues loom so large in the policy programme of any contemporary government, the Prime Minister will want to be informed on the broad thrust of economy policy. The Prime Minister's participation in Cabinet Committees (including a policy review group of the type suggested above) is one avenue by which advice and knowledge on economic affairs is accessible. The Prime Minister's Department provides an additional channel for advice and dialogue on economic questions. This could be expanded to assist in the effective communication of the Government's economic policies to other Ministers, backbenchers, pressure groups, and the public.

The most useful way of assisting the Prime Minister could be to consider a reorientation of the Prime Minister's Department towards a role which would place greater emphasis on liaison and advice on domestic affairs, particularly economic affairs. This orientation would need to be reflected in the staffing of the department. If the present mix of responsibilities of the department was retained, a senior economic advisor could be included in the department's staff.

The Finance Portfolios

Consideration also needs to be given to the finance portfolios. In recent years there have been two and at times three finance Ministers. It is doubtful if the job could be successfully undertaken by less than two Ministers. One Minister, in our tradition the Minister of Finance, needs to be free to focus on economic management. At the same time, a wide range of expenditure issues need to be dealt with. In allocating responsibilities among finance ministers the Australian model (though not necessarily the particular titles) of a Treasurer and a Minister of Finance could be considered. One Minister would have primary responsibility for management of the economy. The other would have primary or subordinate responsibility for government expenditure. This involves dealing with Ministers in charge of Departments, and in the case of the larger departments those are often the most senior members of the Cabinet apart from the Prime Minister and the Minister of Finance. The Minister responsible for expenditure matters must therefore have broadly equivalent seniority to be able to operate effectively without continual recourse to the Minister of Finance. There is a case for finance Ministers to resolve a larger number of expenditure issues, such as individual vote allocations, directly with the Minister concerned. The Cabinet Committee system would provide an appeal mechanism, as well as set overall fiscal constraints.

There is possibly a case for a third Minister who might have responsibility for revenue and hence for the departments of Customs and Inland Revenue. This would aid consideration of revenue issues, particularly at budget time, and assist in achieving closer integration of revenue collecting activities. The workload in the finance area is such that a group of three with some shared responsibilities could provide a useful management resource.

As in the past, the finance ministers could have a Treasury staff member in their office if they wished. Such staff would work closely with the Ministers and would need to have their confidence. Their primary role would be to ensure that the line between the Ministers and Treasury is wide open and used profitably. There is, however, little benefit in Treasury officers carrying out routine secretarial functions for Ministers.

National Development Portfolio

This portfolio has been part of recent Ministries and has been associated with an Ad Hoc Cabinet Committee on National Development. Recently the Minister and the Committee have been serviced mainly by the Department of Trade and Industry, although Treasury's resources have been drawn upon quite heavily at various times. The Planning Council has also had links with this portfolio.

In practice it has been difficult to define a role for the portfolio which does not overlap with the responsibilities of other Ministers. The Ad Hoc Committee has mainly concerned itself with rather general publications on growth and development. It would not appear to fit in with the type of committee structure canvassed above (its functions would form a natural part of the responsibilities of a policy review committee). The Planning Council could either be associated with another portfolio (e.g. Finance) or its role could be considered in relation to the type of public information agency discussed later in this paper.

Government and the Community: Consultative Processes and Information

In addition to improving the administrative and decision-making processes within government, considerable scope exists for improving the relationship between the Government and the public. Improving community understanding and acceptance of government policy allows a government a wider choice of policy alternatives, improves policy effectiveness and reduces pressure for policy reversals. However, it is also likely to require a decision-making process that is more open to public scrutiny and influence. This, in itself, is likely to provide some potential for improving the decision-making process by reinforcing pressure for decisions which improve the collective welfare of the community rather than the welfare of particular groups.

a *Balancing Influences on the Decision-Making Process*

The decision-making process can constrain the Government's ability to act in the community's collective interest. For example, in the determination of industry assistance policy the decision-making process can be dominated by the "problems" perceived by, and specific to, particular industries or interest groups that have a lot to lose (or gain) from changes in policy. This bias is reinforced by a departmental structure where administering departments have fragmented responsibilities and develop "client" relationships with sectoral interests.

Part of the solution to this problem is likely to lie in a reorientation of the Ministerial decision-making process to focus senior Ministers' attention on the economy-wide implications of important decisions. However, the Government can also exercise a strong influence on the balance of private sector pressure on that decision-making process. Using protection policy as an example, the present bias in favour of protecting interests threatened by import competition is a result of a number of factors. First, although reducing protection will benefit consumers and relatively non-protected producers elsewhere in the economy, these groups may not be able to

accurately identify their potential gain. Even if the collective gain is large and correctly perceived, the gain to individual consumers and producers may be small and uncertain. On the other hand, protected interests are better placed to identify their losses and respond through well organised pressure groups despite their relatively small numbers. Secondly, the loss incurred by protected interests is likely to be highly visible to the public, and directly attributable to the removal of protection, while gains to the rest of the community are less obvious and likely to be attributed to the normal commercial efforts of expanding industries rather than to changes in protection policy.

One solution to this problem, which has been canvassed widely in international discussions on structural adjustment issues and has been adopted in a variety of forms, is for the Government to make both the losses and gains associated with current measures and policy changes more visible to the public. Greater transparency could be achieved using two complementary approaches:

- i the establishment of a process by which the costs and benefits of current measures and major policy changes can be quantified and made available to the public. The public credibility of these estimates is likely to be improved if the agency undertaking this task were substantially independent of government and had a statutory responsibility to undertake and publish this type of work on its own initiative. The agency would also, on the basis of requests from the Government, be asked to provide publishable advice on major public policies which confer special advantages on specific private sector interests. Although a new agency with new terms of reference would be required, the functions of such an agency could usefully incorporate functions currently carried out in a number of other organisations (e.g. the IDC, tariff review committee, New Zealand Planning Council);
- ii a process of review of a wider range of government measures on a regular basis. At present, government expenditure and some tax measures are subject to annual review as part of budget preparations. However, not all budget items are treated alike (e.g. tax expenditures are not quantified in the budget tables) and many forms of government intervention (e.g. tariffs, import licences, regulations, government procurement procedures) are not exposed to public scrutiny through the process of regular review. This results in a bias in favour of the use of less transparent, and quite often considerably less efficient, forms of government intervention.

An agency which could undertake such tasks should be guided by the economic criteria for government intervention in the private sector which are discussed elsewhere in this brief. In many instances its role would

be to promote a more neutral economic environment so that private decisions would be less distorted by forms of government assistance or regulation. In others the criteria will suggest that forms of government involvement are appropriate where benefits exceed costs, and the task of the agency (or a unit of it) would be to advise on the preferable design of government programmes. While other departments will have a role in advising the Government on policies of this type (such as market promotion or technology development), the allocation of responsibility to one agency for advice on major proposals which involve the channelling of public assistance to private sector beneficiaries could facilitate a more rigorous and consistent approach to decision-making.

Increasing the transparency of alternative forms of intervention and subjecting a wide range of intervention to regular review and public scrutiny would strengthen the Government's ability to place specific sectoral interests in the wider perspective of the national interest and prove a valuable complement to more open decision-making. It would also help identify the costs associated with alternative forms of intervention and, at the same time, make it easier to substitute more efficient for less efficient forms of intervention. The discipline of regular public surveillance would reduce the discretion of public officials in interpreting what is in the community's best interests and, therefore, reduce the influence of "client" groups on departments with sectoral responsibility.

Detailed proposals for improving the transparency and review of alternative forms of government intervention in a number of areas could be developed for consideration.

b Improving the Communication of Government Policy

Improving community understanding and acceptance of government policy is an important feature of economic management. Lack of community awareness of the nature of the problems facing the economy and of the link between policy and economic performance constrains governments' ability to select between policy options. It is also extremely important that economically important groups have a good understanding of the nature of the Government's economic programme and its commitment to follow that programme through. Greater understanding of the future course of policy would promote a climate of certainty and confidence in which the private sector can better plan and invest. It could also improve the effectiveness of new measures and reduce the associated costs. For example, if a government's commitment to control inflation is widely understood and its policies are credible, then the expected future rate of inflation will be reduced. This in itself will reduce upward pressure on costs and prices and the output loss that is often associated with the process of disinflation.

The opportunity for the Government to improve public understanding and acceptance of its economic policy occurs at two separate points. First, before any major decisions are taken there is often a need to develop a constituency for the proposed policy change. Where the objective is to build a constituency for change in a discrete area of policy, more active use could be made of public enquiries, government White Papers and the publication of other material analysing the economic problems and trends which are the background to the Government's concerns.

If, on the other hand, the objective is to build a constituency for a change in a broad area of policy, which simultaneously affects a range of interest groups, then a broader consultative process (e.g. national conferences) could play a constructive role despite the substantial commitment of both Ministerial and bureaucratic resources required if success is to be achieved. However, this type of process needs to be carefully handled to avoid encouraging the belief amongst particular interest groups that consultative processes will provide a vehicle for furthering their particular interest.

The second opportunity for improving community understanding and support for government policy occurs after decisions have been taken, through publication of the analysis behind the Government's decisions and the rationale on which the decisions are based. The Government could assist the public's understanding of the consistency between individual decisions by publishing documents which describe the framework of the Government's thinking and the principles that will guide the development of any programme over a number of years. Documents which could play a part in this process would include the preparation of a medium term fiscal strategy and a budget statement and appendices that contained more data and information than has traditionally be supplied. A modest public economic information programme which has been initiated by Treasury could usefully be expanded. Finally, where the public credibility of a policy is critical for its success, there are gains to be made in designing the policy so as to enable the public to monitor the Government's commitment to the announced course of action. For example, some announced criteria for governing the conduct of monetary policy would have the advantage of giving the public regular information on the Government's success in meeting its objectives (and thereby enhance the impact of policy on inflationary expectations).

Specific proposals in both of these areas could be developed for further consideration.

Chapter Three

Macroeconomic Overview: Monetary, Fiscal and Exchange Rate Policies

Introduction

This paper describes the essential interactions and interdependencies between the Government's fiscal (expenditure and revenue), monetary policy and exchange rate decisions in the context of recent experiences in New Zealand and overseas. It discusses in broad terms how poor decisions in these areas can inhibit economic performance while putting enormous pressures on governments to try to suppress symptoms by direct controls rather than by attacking causes directly. Treasury's views about how these decisions should be co-ordinated are briefly outlined. The immediately following papers examine the role of each type of instrument in more depth.

Variations in government monetary or fiscal policies have the potential to substantially affect, at least in the short-run, the overall levels of income, output, employment and prices. Exactly how the economy is affected will be determined in part by the Government's decisions concerning the exchange rate, with fluctuations in monetary and fiscal policies expected to have a greater effect on the balance of payments and a smaller impacts on prices if the exchange rate is fixed rather than floating. These so-called macro effects (i.e. economy-wide effects) result from the cumulative impacts of these policies on all sorts of pricing, investment, output and employment decisions at the micro (individual transaction) level.

Whether or not such changes in policy are beneficial depends on whether or not they contribute to better decision-making at the micro-level generally in the economy, leading to an improved use of resources in the areas most directly affected. For example, erratic swings in monetary policy are likely to cause confusion about the Government's future policy actions in this area and therefore about future interest rates and rates of inflation. Such uncertainty can only inhibit investment and employment decisions in the private sector and hence impair economic performance. Similarly, frequent swings in fiscal policy may result in a poor use of resources within the public sector while generating uncertainty in the private sector about future government policy actions. Such uncertainty generally undermines people's confidence in taking longer term decisions and is particularly unsettling in the areas directly affected by the particular policy changes.

Stable and predictable monetary, fiscal and exchange rate policies, in conjunction with a regulatory environment which provides (along with taxes and public sector pricing policies) the appropriate incentives for productive behaviour, can enable an economy to realise its full growth potential. This potential will itself be heavily determined by more fundamental factors such as the rate of growth of labour and capital resources, the pattern of resource allocation and the uptake of new technology.

A poor combination of monetary, fiscal and exchange rate policies, on the other hand, can seriously depress economic performance by generating one or more of spiralling inflation, escalating debt burdens, a poor exporting and import substituting performance, recurring foreign exchange crises, very high current and/or future tax rates, and substantially reduced incentives to save and invest productively in the domestic economy. The persistent external deficits since 1973/74 and the accompanying trend growth in unemployment are clear indications of a domestic cost structure which is too high. Policies to reduce domestic unit output costs relative to our trading partners would improve the balance of payments while raising domestic output, employment and incomes.

Fiscal Policy

The Government's fiscal operations consist of its expenditure, revenue and borrowing programmes. Changes in these programmes have a considerable impact on economic activity, both directly and indirectly by altering household and corporate incomes, relative prices, and therefore expenditure levels and patterns.

Taxes have not kept pace with government current expenditures during the last decade so that a growing proportion of current expenditures has been financed by borrowing. In addition, the Government has had to borrow in order to finance both its own capital expenditures and its lending activities. The fiscal deficit (the overall borrowing requirement) has become very large in recent years, both absolutely and relative to gross domestic product. The pervasive implications of large deficits for monetary policy, the structure of the domestic economy and the balance of payments are discussed in the Macroeconomic Fiscal Policy paper.

Monetary Policy

Monetary policy is primarily concerned with ensuring that the domestic public debt is managed so as to avoid liquidity build-ups in the private sector, particularly amongst the major financial institutions, which are large enough to be a threat to monetary stability. For example, the large

increase in Treasury Bill holdings amongst the trading banks which occurred in the period from October 1982 to March 1983 had the potential to provide the banks in particular and the financial system in general with the liquidity base from which they could expand lending. The subsequent sales of Kiwi Savings Stock I from March to June 1983 were successful in stripping these liquid assets out of the banking system.

Unfortunately, since then, concern with the level of interest rates likely to be generated by an active public debt sales programme designed to finance the large fiscal deficit in a non-inflationary way, resulted in decisions which allowed the banking system to almost fully recoup its holdings of public debt by March 1984. During this period bank lending accelerated sharply.

Interconnections Between Monetary, Fiscal and Exchange Rate Policies

The previous paragraph has illustrated the first connection between fiscal policy and monetary policy. Large fiscal deficits reflect an unwillingness by a Government to take hard expenditure and revenue decisions, perhaps because of concerns about their possible immediate effects on employment or prices or their implications for the incomes or welfare of those benefitting from government programmes. The immediate effect, however, is to simply transfer those concerns into a monetary policy dilemma over interest rates and inflation.

Pursuit of a tight monetary policy in order to curb monetary pressures is likely, if the fiscal deficit is large, to generate higher interest rates, particularly if the debt has to be sold at a time when private sector activity and demand for credit are strong. High interest rates raise the interest burden of the public debt, thereby aggravating the original source of the difficulty—the overly large fiscal deficit. They also threaten to disrupt domestic activity through a variety of mechanisms. First, interest sensitive expenditures such as investment may be reduced, generating the very downturn in the economy which the decisions leading to the large fiscal deficit in the first place were seeking to avoid. Secondly, and alternatively, the high interest rates could be offset by a monetary injection from the overseas exchange transactions as people sought to hold funds in New Zealand. The effect would be to provide the banking system directly with liquidity (as they sell surplus foreign exchange to the Reserve Bank in exchange for cash), so undermining the ability of the original debt sales programme to achieve effective monetary control. In this case the effect would be to allow the domestic cost structure to rise, and exports to decline relative to imports. In the case of a floating exchange rate, the effect is to appreciate the exchange rate, thus squeezing the sectors exposed to foreign competition directly. This is the United States experience in the last year or two.

To avoid such effects, a government may be tempted to apply direct controls on interest rates (to stop them from rising) and/or on foreign exchange inflows. However, controlling interest rates only suppresses the symptoms of the intense competition for funds. Indeed, to the extent that interest rate controls increase the demand for funds and reduce the supply (by reducing incentives to save), they intensify that competition. Similarly, attempting to tighten controls on foreign exchange aggravates the domestic shortage of funds. The inevitable outcome is the development of fringe markets and artificial rationing devices which impair the ability of both households and businesses to gain access to funds on reasonable terms.

Another option a government could take is to ease up on monetary policy by selling less longer-term debt and risk an upturn in inflation at some future date. This option, in conjunction with an inflexible exchange rate, tends to increase domestic demand and imports while squeezing exports, so causing a deteriorating balance of payments position and forcing the Government to borrow overseas, thereby still aggravating the fiscal deficit position (particularly at the high real interest rates prevailing overseas in recent times) while also threatening to undermine our credit rating. At the same time, the higher interim level of economic activity from this option generates pressures for domestic wage and price increases which, under a fixed exchange rate regime, would further threaten our international competitiveness. The dangers are obvious, as is its relevance to our immediate situation. The exchange rate paper draws out the need for greater flexibility in the exchange rate in order to reduce such risks.

The end result of such policy combinations depends on circumstances prevailing at the time. In Australia's case, the strength of the private capital inflow from overseas last year was such as to force a choice between losing monetary control and allowing the exchange rate to float. Given that the Government is the sole entity in the economy with the responsibility and ability to control the money supply and ultimately the rate of inflation, and given the advantages of market determined exchange rates (see the following paper), this was probably a wise decision. Even so, floating the exchange rate in conjunction with a large fiscal deficit and a tight monetary policy is an undesirable policy combination. The effect, as the United States economy is currently demonstrating, can be to keep the exchange rate at, or drive it up to, a high level, inhibiting exports and promoting imports by reducing the competitiveness of those industries trying to compete with foreign competition. The costs of this depend upon the degree to which the size of the underlying fiscal deficit is justifiable in terms of the criteria outlined in the accompanying macroeconomic fiscal policy paper. If the foreign borrowing (whether from private or public sources) is essentially to finance current consumption, then the effect is to penalise future generations,

Probably the most frequent outcome of large fiscal deficits, certainly in New Zealand's experience, is that governments feel unable either to take deliberate action to correct the fiscal problem or to sustain the high interest rates implied by non-accommodating monetary policy action. Instead, to suppress the inevitable inflationary forces, direct controls are placed on wages and possibly prices and interest rates. A variant of this theme is an incomes based policy which aims to restrict wages and prices by coercion, and/or agreements to provide special interest groups with some compensation in other policy areas in return for a period of "voluntary restraint". Typically, this compensation is costly in fiscal terms and/or in terms of the rigidities introduced into the economy. In short, regardless of what devices are used to try to suppress the symptoms of more fundamental policy imbalances by means of labour market interventions, the long-run costs are high. The labour market is not allowed to perform its primary role of matching the supply and demand for labour of varying skills and experience, and any tendency to rising unemployment is exacerbated.

The Proper Co-ordination of Macro Policies

— *Monetary and Fiscal Policies*

As described in the previous section, there is no conjunction of policies of direct controls and monetary and exchange rate policies which can resolve satisfactorily the problems generated by the size of fiscal deficit we have been experiencing in recent years. Of the alternatives, that adopted in the the United States of monetary control in conjunction with a floating exchange rate regime would appear to be the best in that it has permitted inflation to be effectively controlled without recourse to the sort of regulatory devices which simply replace the costs of inflation by the costs to the economy of direct controls.

The best policy option is clearly to tackle the root cause of the difficulties by reducing the fiscal deficit. This would then permit monetary policy to be harmonised with exchange rate policy in controlling domestic inflation and reducing the domestic cost structure relative to our trading partners, so promoting output and employment in our internationally exposed industries.

These two policies need to be harmonised for this purpose because monetary policy actions will be unable to prevent us from importing the average rate of inflation amongst our trading partners unless the exchange rate is adjustable in line with monetary conditions.

This is because, under a fixed exchange rate regime in which exchange controls are not fully effective (which they cannot be), current account

and capital flows in the balance of payments will have the potential to dominate in the longer run any monetary policy actions of the authorities. For example, an expansionary monetary policy would lower domestic interest rates in the short run and lead to an expansion of spending which increases domestic prices, costs and imports while putting a cost squeeze on the exposed sector of the economy and inviting a capital outflow. The imposition or tightening of foreign exchange controls may inhibit the capital outflow for a time, but this is at the expense of prolonging the cost squeeze on the exposed sector. Similarly, recourse to import protection and export subsidies may permit domestic inflationary pressures to be sustained for longer (but at the same time causing welfare losses arising from their uneven incidence across activities). Sooner or later, however, the resulting balance of payments deterioration drains cash out of the economy, imposing a credit squeeze until the domestic cost structure is restored relative to that of foreign competitors. Although this process may be slow and painful, the upshot is that the domestic rate of cost inflation cannot deviate permanently from the world rate (in broad terms) under a fixed exchange rate. In this manner, fixed exchange rates provide a form of monetary discipline for governments which may otherwise be disinclined to take the policy action necessary to hold the domestic inflation rate at or below that of their trading partners. The reverse also holds. Under a fixed exchange rate, an attempt to run a **non-**accommodating monetary policy can be frustrated by the sort of capital inflow from overseas recently experienced by the Australians.

A regime of flexible exchange rates breaks this link between domestic and foreign rates of inflation. By exercising monetary discipline (which in practice, generally requires small fiscal deficits), an economy can in principle achieve, beyond any short-run disturbances, a domestic rate of inflation less than that of its trading partners in conjunction with an appreciating exchange rate. The key point to be noted here is that controlling inflation to a level at least as low as that of our trading partners is not a technical problem over the medium term.

— *Monetary Policy, Inflation and Incomes Policies*

The factors which cause economies to experience persistent inflation are reasonably clear. The pressures on governments to adopt soft options at the expense of future rates of inflation arise in a large number of ways, but the most common would be a desire to stimulate the economy for short-term output, income and employment gains, knowing that the linkages between monetary expansion and price inflation are not particularly stable or predictable in the short-run; nor are they necessarily fast acting. Once inflation has gathered momentum, it is difficult to stop, both because of concerns about the possibly contractionary effects of

tighter monetary and fiscal policies and because inflation diverts attention from causes (overly expansionary monetary and fiscal policies) to symptoms such as the depreciating exchange rate and the fruitless debate as to whether or not wage increases are causing price increases or vice versa.

Again the focus on symptoms can tempt governments to try direct controls on wages, prices and the exchange rate (e.g. the 1982 freeze and the associated cessation of the crawling peg exchange rate regime) in order to try to reduce the rate of inflation directly without contracting the economy. In terms of economic performance, such a reaction is misplaced. The problem with inflation arises from the costs that inflation imposes on the social, economic and political system. Imposing controls on prices simply means that the costs of the underlying causal policies are experienced in different ways: for example in queues and shortages and through the incurrence of greater risks and transaction costs in coping with and/or circumventing the regulations.

The freeze imposed in 1982 was successful in reducing the measured rate of inflation sharply, apparently without major distortions in the early period when financial conditions were supportive and large tax cuts had been made to preserve the purchasing power of the majority of salary and wage earners. However, monetary policy has been insufficiently supportive since Kiwi Savings Stock I was taken off the market and the tax cuts have contributed to the current unsustainable fiscal deficit position and so cannot be regarded as a permanent source of income gain for salary and wage earners. Freezing the nominal exchange rate in conjunction with the expansionary monetary and fiscal policies since June 1983 has undoubtedly contributed to the fragile foreign exchange position at the time of the snap election announcement.

What this implies is that the effect of the freeze and associated policies has been to shift into the immediate future some very considerable policy difficulties. Government expenditure has not been reined in to make room for the 1982 tax cuts. Raising direct and/or indirect taxes to reduce the deficit, and perhaps allowing the exchange rate to depreciate, will aggravate pressures for wage increases. Wage adjustments, however, to the extent that they go beyond what employers would have freely negotiated, jeopardise international competitiveness, the balance of payments and employment growth; on the other hand, to the extent that they are fully reflected in prices, wage increases imply renewed inflation. Any general wage adjustment forces the Government to make a difficult choice between easing back on monetary policy and the exchange rate and allowing the increase to be quickly absorbed into prices, or to keep a tight rein on these policies and (perhaps in conjunction with price controls) allow real wages to increase as a cost to the employer at the risk of aggravating unemployment.

The resolution of these conflicts is not likely to lie in prolonged controls on wages. The wage controls are almost certainly reducing employment in some areas by making business decisions more difficult generally and depriving employers of the ability to bid competitively for the particular type of labour they require. Rather, the solution lies in the Government firmly making up its mind what its objectives are for monetary, fiscal and exchange rate policies for the immediate future, and making sure that these are well understood and implemented in a credible manner so that employers and employees are not likely to agree to wage increases based on a mistaken view about government policy intentions.

For the immediate future, some adjustments to a combination of taxes, public sector prices, the exchange rate and/or wages which put up the general price level are probably inevitable but action to reduce misdirected forms of government expenditure, regain monetary control, secure restraint in wages and other costs, improve productivity and introduce more competition into other markets can affect this tendency to a significant extent. The essential focus of policy will be to ensure that this is a once and for all adjustment rather than a permanent increase in the rate of inflation. Ideally, policy should be directed at achieving in the medium term a zero rate of inflation.

Conclusions

The economy is suffering from serious imbalances internally and externally. These need to be addressed by better macro and micro policies which must achieve a downwards adjustment in our cost structure (productivity adjusted) relative to our trading partners. Fiscal, monetary and exchange rate policies must be harmonised and co-ordinated to avoid destabilising and disrupting the economy. Sustained expansionary monetary and fiscal policies, especially in conjunction with fixed exchange rates, are a particularly bad policy combination because of their unfavourable effects on the exposed sectors of the economy and the pressures they produce on governments to try to suppress the symptoms of poor policies by direct controls. Overly large fiscal deficits impose nearly impossible burdens on monetary policy in practice. Jointly, monetary and exchange rate policies are the key determinants of the long-run inflation rate.

Unpredictable fluctuations in macroeconomic policy are to be avoided because they frustrate the operation of markets. Macroeconomic policies should be harmonised in a credible, understandable and readily predictable manner. The key requirements for macro policies in the immediate future are a consistently tight monetary policy in conjunction with a determined and phased programme for reducing the fiscal deficit and a more market-determined exchange rate.

Chapter Four

Monetary Policy

Introduction

As discussed in the macroeconomic overview paper, monetary policy is concerned with controlling the overall level of liquidity in the economy in order to control inflationary pressures. Because the lending policies of financial intermediaries are related to the level of liquid assets they hold to cover contingencies, an active public debt sales programme which reduces these liquid assets is likely to reduce the rate of growth of money and lending in the economy. It achieves this result through the process of raising market interest rates, which promotes saving and discourages borrowing.

This paper discusses the techniques of monetary policy in some detail. The first section describes the essential characteristics of an efficient financial system. Subsequent sections cover the objectives of monetary policy, the various instruments of monetary policy and provide an outline of the main areas requiring policy action.

Functions of the Financial System

The role and function of the financial system is, broadly, to operate the payments system and to provide markets which satisfy and reconcile the needs of borrowers and lenders. The manner in which financial institutions bridge the gap between the diverse objectives and requirements of borrowers and lenders is generally referred to as the process of financial intermediation. While lenders are interested in preferred combinations of safety, liquidity, and rates-of-return for their savings, a one-to-one matching of lender with borrower is unlikely to provide this. Financial institutions reconcile these needs by offering suppliers of funds safety and liquidity, and by using the funds for loans and investments having varying degrees of risk and liquidity.

Competition between financial institutions will force them to provide a range of savings opportunities which enable, and induce, people to forego current consumption in favour of savings. Competition between institutions for funds to on-lend will ensure that savers earn an adequate and fair return on their savings. Savers, after allowing for their preferences as to risk and liquidity, will allocate their savings to institutions offering the better return (which, as well as the explicit interest rate offered, may involve a guarantee of finance at some time in the future).

For financial institutions to be able to offer attractive savings opportunities/packages to depositors and investors, they must allocate the funds they have available in the most efficient manner. This involves seeking the highest rate of return (adjusted for risk) available on their lending and investment activities and minimising their own administrative costs (reflected in the margin between average lending and borrowing rates). This competitive process forces financial institutions to seek out the most profitable investments : for instance, it places a responsibility on institutions to identify those sectors and those businesses with potential for growth and in which investments are likely to yield rates of return sufficient to enable the repayment of the loan. In the market for consumer funds, some institutions engage in relatively specialist provision of hire purchase finance for cars, consumer durables etc. Likewise, in the market for housing mortgage finance it is common, worldwide, for specialist institutions such as Building Societies to cater for mortgage demand by offering “bundled” saving and lending services (for instance, a savings programme or an established relationship in exchange for access to a mortgage loan at some future date).

In general, then, competition between financial institutions will result in the provision of a range of savings opportunities for their customers who deposit funds with them, and will force institutions to allocate their loanable funds in the most efficient manner. By standing between lenders and borrowers, financial institutions are able to pool funds, thereby reducing individuals’ risk and reducing the overall costs of financial intermediation.

Policy Objectives

There are three broad areas with which monetary policy is concerned, although the main macroeconomic role is that of monetary control directed at restraining inflation.

A Efficient Financial Intermediation

The success of financial markets depends on the availability of a range of financial alternatives for both lenders and borrowers of funds. As outlined above, a competitive environment will force institutions to allocate their funds efficiently and to offer a sufficiently high rate of return on savings so as to attract deposits. The key element for policy here is the regulatory environment. It is vital that regulations do not hamper competition, innovation and responsible risk-spreading.

Regulation of the financial sector can have significant effects on the distribution of income and financial wealth in the community. Interest rate controls will have large, and often perverse, influences on equity.

For instance, it is often forgotten that the household sector is a net saver, the business and government sectors net borrowers. Thus, controls on deposit interest rates may cause an income transfer from the household to the business and government sectors. Controls on lending interest rates will reduce the availability of credit for high risk investments and for loans to high risk groups. In other words, controlled interest rates will tend to adversely affect small savers and less wealthy borrowers, including small businesses.

The general point is that controls, and interest rate controls in particular, represent an inefficient means of achieving specific distributional or equity objectives. While some groups may obtain finance at interest rates lower than they otherwise would have, they may well not be the intended “target” group of the measure. Indeed it is likely that in general such measures will have perverse effects, accentuating the differences in income and wealth within the community, while reducing the safety and efficiency of the whole process of financial intermediation.

B Price Level Stability

Inflation is a problem-and price level stability an objective-because of the way in which inflation tends to obscure the price signals which are fundamental to the working of a market economy. Changes in relative prices are signals to producers and consumers to change the pattern of their resource use. The more clearly and accurately these signals are conveyed, the more efficient will be the operation of markets and the more efficient will be the pattern of resource use within the economy. Where all or most prices are increasing, the variability of relative price changes over short periods tends to increase, thus obscuring price signals. Further, the impact of high inflation on accounting procedures and taxation systems developed during times of low inflation tends to generate distortions in effective tax burdens which can have far reaching effects on resource use in the economy. Finally, inflation has substantial distributional effects, generating arbitrary redistributions of wealth and income between different groups in society : for instance, between those owning houses and those renting; between those earning current incomes and those living off their savings (e.g. the elderly); between those wealthy or sophisticated enough to shift their income into assets yielding capital gains and those unable to do so.

The key to reducing inflation over the medium term, and of ultimately achieving price level stability, is a debt sales policy aimed at restraining the growth of money and credit aggregates. Monetary policy, in conjunction with a flexible exchange rate, can achieve desired changes in trend rates of inflation, although in the short-term a variety of other influences can affect the price level (e.g. changes in the prices of key

inputs to production such as energy, labour; exchange rate; indirect taxation). Short-term movements in the rate of inflation either above or below trend growth rates do not represent a problem in themselves—rather, they represent the process of adaptation of the economy to various supply and demand shocks. Generally, the more rapidly these adjustment processes are allowed to operate the better.

While control of money and credit aggregates is essential for controlling inflation, or the growth in aggregate nominal incomes (nominal GDP), it is important that, in the context of pursuit of an anti-inflation strategy, the distinction between ultimate objectives (inflation) and intermediate objectives (money and credit control) is maintained:

a *Ultimate Objectives*

Monetary policy should be directed at price level stability or, more generally, the control of inflation or nominal GDP, as an ultimate objective. In a longer term perspective it should be recognised that monetary policy can be targetted at either the domestic rate of inflation, or the exchange rate. If the Government aims its monetary policy at an inflation objective which differs from world rates of inflation, then the exchange rate must be free to move (i.e. either a floating exchange rate, or a “crawling peg” arrangement of some sort). The attempt to run a looser monetary policy than the rest of the world (our trading partners) with a fixed exchange rate would tend to generate a balance of payments deficit and capital outflows, which would in turn tend to tighten domestic monetary conditions again. On the other hand, the attempt to run a tighter monetary policy than the rest of the world, with a fixed exchange rate, would tend to generate a balance of payments surplus and capital inflows, which would in turn loosen monetary conditions. The expected long run result with a fixed exchange rate is that New Zealand would tend to end up with the world inflation rate (and world monetary growth rate).

b *Intermediate Objectives*

The criteria for choice of intermediate objectives (such as various monetary aggregates) are that they must bear a reasonably stable relationship to the ultimate objectives of policy, and that they must be controllable by use of the instruments of monetary policy. As suggested above, the appropriate intermediate objectives for controlling trend inflation rates are trend growth rates in money and credit aggregates. There is, however, no simple stable relationship between particular monetary and credit aggregates and inflation in the short-term and only approximate relationships in the longer-run. This will be the case in general, because of continuing processes of financial innovation and because of changes in the regulatory environment, all of which can change the pattern of deposit flows

within the financial system and affect the growth of various monetary aggregates. For example, in the United Kingdom after 1979, the new Government moved to targetting M3 growth as the main intermediate objective directed at reducing inflation. However, associated deregulation of the financial sector generated a movement of funds back from fringe institutions into the banking system, increasing bank deposits more than would otherwise have been the case and thus increasing M3. Under these circumstances the attempt to hold M3 growth within the initial target range resulted in a much tighter monetary squeeze than had been intended. The result was a much more rapid fall in inflation than was expected, coupled with a severe recession. The lesson from that experience is that all financial variables (money and credit aggregates, interest rates, exchange rates) provide information as to the degree of monetary stringency or ease. In the British case, while M3 was tending to increase at rates above the targetted range, other indicators of monetary policy were telling a different story; e.g. M1 was growing slowly, interest rates and the exchange rate (floating) were high. Accordingly, policy should not focus unduly on any one indicator of monetary conditions. A number of aggregates (M1, M3, private sector credit) as well as interest rates must be monitored in order to assess monetary conditions. Over the medium term the differences in the growth rates of various aggregates will differ less than over the short term, and will tend to increase with and determine the growth of nominal incomes and inflation. As a rough rule of thumb, money and credit growth rates should be broadly in line with the sustainable real growth objective plus the desired inflation rate.

C Zntegrity of the Payments System

Financial institutions, like any business, must take full responsibility for managing their own portfolios without the expectation of any support from the monetary authorities. Thus, fluctuations in liquidity arising from all sources are simply a part of the operating environment of the financial institutions; part of their role, and their expertise, is to arrange their portfolios of assets and liabilities so as to protect themselves against such fluctuations. It is important that regulations on the financial sector do not unduly hinder the ability of and reduce the incentive for institutions to adequately provide for the risks associated with fluctuations in liquidity.

There is, however, an obligation on the Government to ensure the stability of the payments system as a whole, because of its social good aspects. The payments system is sometimes likened to a form of social capital, like law and language, which cannot be allowed to disintegrate because of flow-on effects arising from the troubles of particular financial institutions. Interventions to safeguard the payments system should

always be based on actual or potential problems which threaten the entire system, not just a particular institution.

Intervention in an institution-specific way should only occur if there are serious grounds for thinking that the collapse of a particular institution might cause a collapse of the banking system as a whole. To do otherwise would tend to reduce the incentives that management, shareholders and depositors otherwise have to conduct their affairs responsibly and with due regard to risk. Where there is a system-wide shortage of liquidity, the appropriate action is to intervene on a system-wide basis, with the Reserve Bank conducting an open market purchase of securities so as to ease liquidity.

Financial institutions, by their very nature, are susceptible to a crisis of confidence in the financial system where people try to cash their deposits (e.g. a run on a bank or banks). It is in such circumstances that the Central Bank must provide the cash necessary to meet such crises, thereby dispelling them. Any such cash injections would have to be reversed when the crisis subsided.

The potential conflict between an anti-inflationary monetary policy and prudential interventions which ease liquidity pressures (through either an established discounting arrangement or a “lender of last resort” facility) arise because the latter works through injecting additional cash into the financial system, while an anti-inflationary monetary policy is concerned with restraining the growth in cash injections to the economy. There is, however, no necessary conflict in practice, as financial crises of the type discussed above are rare and, if managed properly, generally temporary.

Instruments of Monetary Policy

The following sections discuss the instruments of monetary policy which can be used to influence monetary conditions in pursuit of the objective of price level stability. We are here concerned primarily with those policies which can be used to control the rate of growth in the money and credit aggregates, and the growth in liquidity of the financial sector. The next section provides a background as to the determinants of financial system liquidity, and money supply growth.

— *Determinants of the Growth in Liquidity and the Money Supply*

Net injections or withdrawals of cash into or out of the economy are the outcome of four influences:

- a the fiscal deficit : an excess of Government expenditure over revenue is financed, in the first instance, by drawing on the balance of the

Public Account at the Reserve Bank, or by going into overdraft in this account. The effect is a cash injection into the financial system. By contrast a fiscal surplus would result in net payments into the public account, and cash withdrawals from the financial system. Although the annual fiscal balance has been consistently in deficit for many years, there is a marked quarterly seasonal pattern within each financial year, with a large fiscal surplus in the March quarter (because of the large tax flows) and large deficits in the June and December quarters particularly;

- b the overseas exchange transactions (OET) balance (current account plus private capital account balance): the OET balance is the net cash balance with the rest of the world, measured over some period. The purchase of foreign exchange from the Reserve Bank (paid for with New Zealand dollars) results in a cash withdrawal from the financial system; conversely, sale of foreign exchange to the Reserve Bank (e.g. by an exporter) causes a cash injection into the domestic financial system. Accordingly, an OET deficit (current account and private capital account) will cause a cash withdrawal from the financial system;
- c Reserve Bank influences : the Reserve Bank, through its lending to producer boards, as well as seasonal compensatory deposit payments to trading banks (designed to spread the monetary effects of the tax drain to the Government in September and March), has a direct effect on cash injections to and withdrawals from the financial sector;
- d maturities and redemptions of government securities : the repayment by the Government of maturing government securities, and the repayment which occurs when securities are redeemed early (e.g. when people redeem their Kiwi Stock holdings) generate cash injections into the financial system. This also occurs when Government Stock and Treasury Bills are discounted (sold to) the Reserve Bank by, primarily, the trading banks.

The total net effect of all of these sources of injections can be offset by the sale of government securities, either retail issues such as Kiwi Stock, Our New Zealand Bonds and Inflation Adjusted Savings Bonds, or wholesale market tender sales of stock. Sales of Treasury Bills, which are of short maturity, are not considered to be a viable monetary policy instrument because, with present discount policy, they can be cashed at the Reserve Bank at notice and at low cost. They are best considered as near cash, and a build-up in trading bank holdings of Treasury Bills would be considered an easing in liquidity.

The following table provides an illustration of the above influences for the 1983/84 year.

TABLE 1
PRIMARY LIQUIDITY INFLUENCES (\$M)

Fiscal Deficit	+2984	
Reserve Bank Influences		
— compensatory deposits	-99	
— other accounts	-184	
Combined Fiscal/Reserve Bank Injection		+ 2701'
OET Account		
— current account	-992	
— private capital account	+ 432	-560
Net Primary Influences		+ 2141
Plus : Maturities, Redemptions and Discounting		+ 2296
Less : Retail Debt Sales and Other Absorption		-1976
Less : Tender/Tap Stock Sales		-2528
R e s i d u a l		-147
Build-up(+), Fall(-) in Liquidity"		-214

Notes to Table 1

- This figure differs from the Consolidated Borrowing Requirement figure (\$2817.3 million) in table 3 of the paper, Macroeconomic Effects of Fiscal Policy, by the amount of the Reserve Bank indemnity (\$116.7 million). The indemnity has no effect on liquidity and is therefore not included in the primary liquidity influences table.
- * Change in Treasury Bills outstanding. This figure does not include those stock with less than six months to run to maturity, although they are effectively Treasury Bills,

Apart from the scale of maturities, redemptions and discounting (which in 1983/84 was large because of enforced discounting of stock by the trading banks during the period of the first Kiwi Stock) the main source of the \$2,141 million net primary influences was the fiscal deficit. To offset the impact of this, the debt sales at the bottom of the table had to be correspondingly larger.

It should be noted that the table above does not indicate:

- a whether the degree of tightness in liquidity at the beginning of the period (March 1983) was adequate. In fact, it was not, which is why Kiwi Stock 1 was introduced at that time;
- b how the pattern of liquidity injections and withdrawal varied through the year;
- c whether liquidity was tight enough to restrain rapid growth in lending by financial institutions;

d the degree to which tighter liquidity would have reduced the cash drain through the OET accounts.

The following table illustrates factors determining the growth of the money supply (M3):

TABLE 2
MONEY SUPPLY (M3) FORMATION—1983/84 YEAR (\$M)

M3 at beginning of period				16107
Primary Influences				
Fiscal Deficit	+2984			
Reserve Bank Transactions*	-184	+2800		
OET		-560	+ 2240	
Plus : Private Sector Credit growth			+ 1670	
(Annual Increase)..			(15.5%)	
Less : Net Debt Sales to the Non-M3 sector..			-1949	
Residual			-72	
M3 at the end of period (Mar& 1984				17996
(Annual Increase)..				(11.7%)

- Excludes compensatory deposits, which are not included in monetary aggregate statistics, but which do affect domestic liquidity and are therefore included in the earlier table.

It should be noted that the OET component of total primary influences is a feature of the fixed exchange rate regime. If instead the New Zealand dollar was floating and the Government stopped borrowing overseas to defend the exchange rate, there would be a zero influence from the OET because the exchange rate would adjust until private capital flows offset any current account deficit or surplus. The considerable instability that the OET influence can have on domestic monetary conditions, particularly when the conduct of monetary policy has been inadequate, would instead be transferred to movements of the exchange rate.

The above table illustrates that growth in the money supply (M3) is the result of two distinct components:

- a the net primary injections into the reserves of the financial system, less debt sales to the non-M3 sector; and
- b the increase in lending by the M3 institutions (private sector credit growth).

The following discussion focusses on the instruments of monetary policy which might be used to control these influences on monetary growth. A number of instruments have traditionally been used to influence the intermediate and ultimate objectives of monetary policy. The key criterion for choice between them must be the efficiency with which an instrument enables ultimate objectives to be achieved.

— *Debt Policy/Open Market Operations*

As is clear from the liquidity table above, cash injections into the financial system from the fiscal deficit and other sources can be offset by sales of government securities. An active public debt policy is all that is required to restrain the growth in liquidity. Of course, the larger the fiscal deficit, then in general the more active will public debt policy have to be. An increasing OET deficit will also reduce the liquidity of the financial system, but it is important that debt sales policy not be reduced to offset such a deterioration in the OET. This would be to accommodate a worsening of the OET balance, and would require further overseas borrowing as a substitute for the domestic debt policy which would have prevented it.

The ability of financial institutions to expand their lending depends primarily on their liquidity and on the extent to which they can attract deposits available for on-lending. An aggressive debt policy can redirect lending from the private sector to the Government. This can occur either by people or businesses lending directly to the Government instead of holding deposits at various types of financial institutions, or by institutions themselves on-lending to the Government instead of to the private sector. In each case the flow of new or increased deposits available for on-lending by the financial institutions is reduced. Thus an active debt policy is sufficient to restrain the growth in liquidity and thereby restrain the growth in lending by financial institutions to the private sector. The tender system of stock sales is the primary instrument for this purpose, The tender system does illustrate, however, that to achieve specific quantity objectives -which is what is required for monetary policy-interest rates must be free to move to the levels necessary to effect the debt sales required. These interest rate responses are the key to modifying borrowing and lending behaviour. This is essentially the system of monetary control used in virtually all OECD countries.

Achieving targets for the growth of a monetary aggregate such as M3 will generally involve attempts to restrain both lending and reserves growth. Thus as well as restraining the lending growth of the M3 institutions to the private sector by controlling the growth in liquidity, the scale of injections into their reserves must be limited. This latter requires debt sales to the non-M3 sector (as in Table 2). While close attention is given to the movements in M3 itself, and of the debt sales going to the non-M3 sector, as noted earlier this is only one of a number of potentially useful indicators of monetary conditions.

The overriding aim of debt policy is to convert cash injections into government securities that are relatively illiquid. Generally, the longer the time to maturity of an investment, the less liquid it is. An active debt sales programme should be pursued in the wholesale and retail markets so as to achieve a debt maturity structure that achieves the objective of monetary control at least cost to the Government (the taxpayer).

In all of the discussion so far it has been assumed that purchase of government securities are made voluntarily, because the interest rate is attractive. Debt policy does not require coercive measures, such as ratio requirements, in order to achieve monetary objectives. Furthermore, non-coercive sales of public debt best meet the efficiency criterion for choice of instrument. This is so because, in an environment where interest rates are free to adjust to market pressures, the interest rate effects and pressures of debt policy will be transmitted evenly throughout the entire financial system.

Another feature of, debt policy is Reserve Bank *liquidity management* activity. While debt policy could be conducted through regular tenders, the monetary environment can change rapidly and there is therefore an issue as to how, and at what price, financial institutions can obtain cash to settle each day in the event of an unexpected tightening in liquidity (through, for example, a sudden flow to the Government, or outflow through the OET). At present all government stock are discountable at the Reserve Bank at a fixed margin in relation to market rates. This means that, for trading banks at least, cash can always be obtained, albeit at some cost.

The principles are clear, however. A penal (costly) discount facility is required, so that the tightening of liquidity achieved by debt sales cannot easily or cheaply be reversed by the discounting of government securities. Coupled with this is a need for a greater reliance on day-to-day open market operations (e.g. the purchase by the Reserve Bank of some government securities) for handling unforeseen system-wide liquidity pressures.

These issues are currently under review and will be reported on elsewhere.

— *Ratios*

In general, ratios involve a requirement that a fixed proportion of deposits (on the liability side of a financial institution's balance sheet) or investments (on the asset side) must be invested in government securities. They have thus been viewed as a way of easily and cheaply achieving debt sales, and often as a way of limiting the ability of the *ratioed* institutions to expand their lending. If an institution had substantial liquid reserves available for lending, an increase in its ratio could effectively require it to lend these funds to the Government rather than in whatever way was consistent with the type of business it was engaged in.

The apparent advantages of ratio policy apply only in the short-run, however. What a binding ratio does is to lower the overall rate of return of an institutions assets, which, if profitability is to be maintained, reduces the rate of return the institution can offer to its depositors. Thus the competitive position of a high-ratioed institution is reduced relative to a low-ratioed institution, and similarly of ratioed institutions generally relative to fringe financial markets which have no ratio. An example of the latter would be the large solicitors' mortgage market in New Zealand. The process whereby deposit flows are drawn away from the central institutions-in New Zealand the established institutional housing finance lenders have high ratio requirements-means that the borrowers and lenders sacrifice many of the advantages of institutional financial intermediation; the result is a loss of liquidity and increased risk for lenders, and a reduction in flexibility of terms of the loan for the borrower. The effect is a significant reduction in the efficiency of financial intermediation and, in this case, of the efficiency of the domestic mortgage market. The effect on equity in such circumstances is also likely to be adverse. It is likely, for instance, that the increased financial sophistication required to arrange for first, second and perhaps third mortgages, all possibly having to come from different sources, represents an obstacle which impacts more heavily on the less wealthy and the less knowledgeable.

While aggressive use of ratios could undoubtedly influence the lending ability of a particular institution, or class of institutions, the growth in deposit substitutes (such as the solicitors' mortgage market and the commercial bill market) will tend over time to reduce the meaning of established monetary and credit aggregate indicators; their information content would be reduced and thus their usefulness as indicators of the success of policy in the pursuit of ultimate targets would be undermined (as in the UK experience referred to earlier). What counts for monetary policy is the total lending occurring in the financial system, not the lending of just some institutions. Credit aggregates are simply proxies for the wider concept.

The ratio system applying to trading banks-the Reserve Asset Ratio (RAR) system-operates rather differently from the broader and more general system of public sector security ratios applied to other financial institutions. The RAR system is now widely regarded as inadequate in a number of aspects. This provides the opportunity for a fundamental review of its future. There are many problems associated with the public sector security ratio system in general. They will also be reported on. The general objective should be to move away from reliance on ratios as soon and rapidly as is feasible in order to improve both the effectiveness of monetary policy and the efficiency of the financial system.

— *Interest Rate Controls*

The fundamental point with interest rates is that it is impossible to control both the quantity and the price of credit. The tender system illustrates this: there is a direct trade-off between the cost of Government domestic borrowing and the quantity of debt sold. Where an attempt is made to increase debt sales without lifting the interest rates paid on government securities (e.g. by an active use of ratio requirements), distortions to the competitive position of various institutions occur, the pattern of deposit flows change, and monetary control is undermined. The recent monetary history of New Zealand exhibits this clearly : monetary control has relied to a significant extent on ratio policy, and with little success.

While interest rate controls might effectively reduce the ability of a particular institution or class of institutions to compete and thus to expand lending, they will certainly not permit control of aggregate lending. Interest rate controls work directly against the intent of monetary control. This occurs because controls on lending interest rates will increase the demand for credit, while restrictions on the interest rate offered on government securities will also reduce debt sales, increase liquidity, and leave financial institutions well-placed to meet the increased demand for credit. Controls on deposit rates will also reduce the incentive to save via the holding of interest earning financial assets of various sorts.

A comprehensive set of interest rate controls are in place at present. They are in direct conflict with the aims of monetary policy, and significantly reduce the efficiency and safety of the financial system. The controls on deposit and lending interest rates severely restrict the flexibility of financial institutions in meeting their day-to-day liquidity flows and financing needs. As noted in earlier sections, interest rate controls also have adverse effects on equity, significantly disadvantaging the small *saver* and less wealthy borrowers. We recommend moves immediately to remove interest rate controls as an instrument of monetary policy and of financial sector regulation in general.

— *Lending Controls or Instructions*

Lending controls or guidelines-in so far as they are observed at all- reduce the efficiency of the financial sector by reducing competition. The imposition of lending guidelines as a substitute for an active debt policy inevitably reduces the credibility of the monetary authorities. So long as growth in liquidity occurs, financial institutions will expand their lending. Binding lending controls, without control of liquidity growth, will generate changes in deposit flows and the creation of deposit substitutes in uncontrolled areas, which will undermine the intent of the controls. With active debt policy, lending guidelines and controls are unnecessary.

Current Situation

Separate papers will outline recent monetary developments, projections for monetary growth and an outline of the debt programme requirements over the coming year.

Main Areas for Policy Action

It is vital that the current tightness in liquidity, due primarily to OET effects, is maintained. The debt programme will need to draw on both the wholesale and retail markets. It is also important that the tender system be used more flexibly, with an acceptance that yields in the tender will vary from tender to tender. It would be desirable to move away from the almost complete reliance on indexed stock in the tender, back to more use of conventional fixed interest securities; this will enable a better balance to be achieved among cost, type of instrument and maturity. This can only be achieved, however, with acceptance of a more flexible interest rate policy.

– *Immediate Action*

We will be recommending immediate action to remove the following regulations, most of which have been imposed over the last year:

- a the mortgage interest rate regulations (11 and 14 percent);
- b the lending interest rate regulations (15 and 17 percent);
- c the financial services regulations;
- d the interest on deposit regulations;
- e the 1 percent lending growth instructions;
- f the marginal government security ratio applied to the finance companies.

A separate paper is available, recommending the removal of some longstanding but arbitrary interventions. These include the present 30 day rule which prevents the payment of interest on deposits of less than 30 days; the non-payment of interest in cheque accounts; and the 3 percent interest rate restriction on ordinary savings accounts.

– *Pipeline Issues*

A number of issues are under investigation at present, and will be reported on over the coming months.

The main issues under review in the area of ratio policy are:

- a the operation of the trading bank reserve asset ratio system, and possible alternatives;
- b rationalisation of the system of public sector security ratios;
- c the housing/farming ratios on life offices and superannuation funds.

The main issues under review in the area of liquidity management and monetary policy are:

- a the possibility of moving to a tender system for Treasury Bill sales;
- b Reserve Bank discount policy and the option of a more active Reserve Bank stance in short term liquidity management through active open market operations.

A number of other structural issues are also under investigation with a view to reform:

- a exchange controls; the restrictions on trading bank and other financial institutions borrowing overseas and their holding of overseas assets- this relates to the question of the system of exchange rate determination to be pursued;
- b entry into banking;
- c ownership of quangos;
- d trustee status and government guarantees;
- e prudential supervision.

Further material will be submitted on any issues which require elaboration.

The Reserve Bank have been consulted in the preparation of this paper.

Chapter Five

Management of the Exchange Rate

Introduction

The speculation against the current exchange rate for the New Zealand dollar since the announcement of the snap election is symptomatic of the fundamental imbalances in the economy and the fact that the exchange rate and the foreign exchange market have been prevented from coping with these imbalances effectively.

This report discusses the nominal exchange rate in terms of the market for foreign exchange, describing how the exchange rate is ultimately forced to adjust according to the underlying supply and demand for foreign exchange. The effects which government interventions in the economy generally, and in the foreign exchange market in particular, have on the market for foreign exchange (and hence the pressures on the nominal exchange rate) are analysed.

The reasons for the long-standing imbalance between the private sector's supply and demand for foreign exchange are examined within this framework and the options for dealing with the immediate problems are discussed. This includes an evaluation of the case for moving towards a more market determined exchange rate and the pre-requisites for such a move. It is concluded that achieving a better balance in the foreign exchange market, and a better economic performance generally, requires a considerable tightening of monetary and fiscal policies, in order to reduce internal and external imbalances, together with a significant degree of deregulation in the foreign exchange and financial markets so that market forces can operate more effectively. Flexibility in the exchange rate is highly desirable for helping the economy adjust to changing circumstances. Such adjustments are likely to be achieved most efficiently with a floating exchange rate. However, such flexibility by itself is no panacea, since it cannot compensate for poor underlying monetary, fiscal and regulatory policies.

A The Nominal Exchange Rate and the Foreign Exchange Market

The nominal exchange rate is simply the price at which one currency is exchanged for another-or in the case of New Zealand, the price of foreign exchange in terms of New Zealand dollars. A depreciation represents a rise in the price of foreign exchange, an appreciation a fall in price. The

nominal exchange rate is determined by the supply and demand for foreign exchange and the underlying factors influencing these flows. Government policies will affect the supply and demand for foreign currency and ultimately the price which can be sustained for it.

In the case of a flexible exchange rate regime, pressures on supply and demand simply affect the price of foreign exchange (that is the exchange rate). The tendency will be for the nominal rate to move to restore equilibrium in response to changes in the supply of and demand for foreign exchange which arise from trade or capital flows.

Where the exchange rate is fixed or managed, adjustment to remove external imbalances will take place through the effect that the flow of foreign exchange has on domestic prices. An excess of demand over supply of foreign exchange (for example) will result in an external deficit, with a consequent domestic monetary contraction. The credit squeeze will act to reduce aggregate demand resulting in a reduction in the demand for imports and exportables, and will increase the willingness of private investors to hold funds in New Zealand to take advantage of the higher domestic interest rates which occur. These changes will reduce the demand for foreign exchange and increase the supply until equilibrium is restored at the fixed nominal rate.

Adjustment is achieved, therefore, either by a change in the nominal exchange rate *or*, if the nominal exchange rate is fixed, by movements in the domestic price level to validate the nominal exchange rate. In both cases the outcome of these different adjustment mechanisms on the real factors in the economy (for example, consumption and output) is identical once the adjustment is fully worked out. The two aspects of exchange rate adjustment are incorporated in the definition of the so-called “real” exchange rate. The real exchange rate is defined in terms of how high our domestic cost structure is relative to the exchange rate-adjusted costs of our trading partners, and is a measure of New Zealand’s competitiveness in international markets. The higher the real exchange rate, the higher our relative cost structure and the less likely it is that we could achieve external balance at low levels of unemployment. The adjustment processes described restore external balance through a movement of the real exchange rate.

B *Factors Affecting the Supply and Demand for Foreign Exchange*

It is necessary to consider the effects which external shocks and government intervention (in the economy generally and in the foreign exchange market in particular) have on trade and capital flows, and therefore on foreign exchange transactions, and the way in which government actions can prevent (or assist) adjustment.

— *Terms of Trade Shocks*

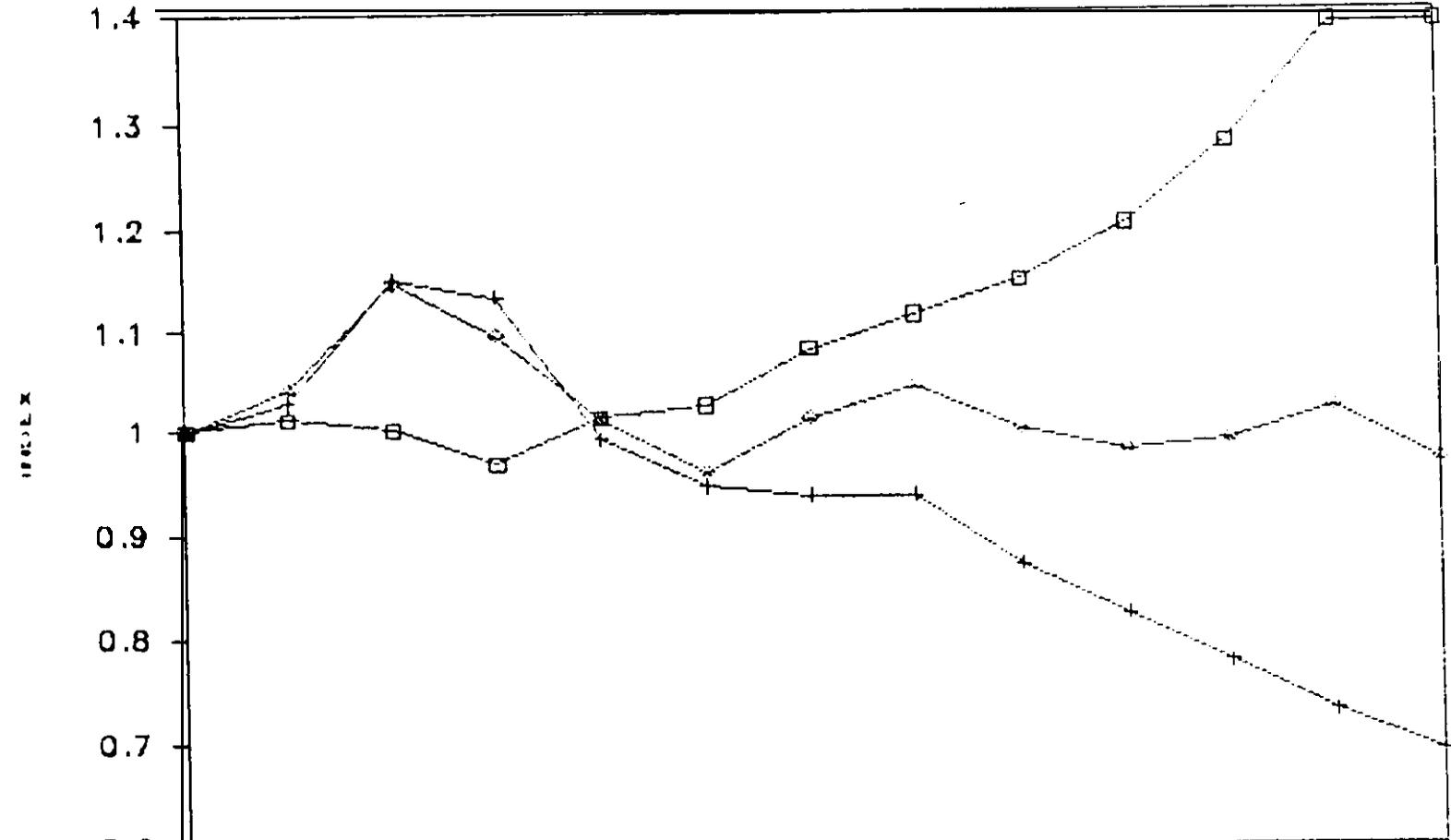
Where the terms of trade move against New Zealand, that is, export prices fall relative to import prices, the supply of foreign exchange will fall relative to demand, putting downward pressure on the real exchange rate. The most substantial influence on the terms of trade in the past decade has been the changes in the relative price of oil. The two oil price rises are estimated to have reduced New Zealand's underlying terms of trade by roughly 15 percent each. Substantial adjustment of the real exchange rate would therefore have been expected during this period. This did not occur.

— *Inflationary Domestic Policies*

Inflationary domestic policies put pressure on the nominal exchange rate by raising the demand for imports (and foreign exchange) while reducing exports (reducing the supply of foreign exchange) as increased domestic costs erode exporters' competitiveness. The result is an external deficit (on current account) which exceeds private overseas borrowing. Devaluations in response to the imbalance which are not accompanied by associated actions to reduce inflationary pressures allow these pressures to persist. The effects of such a futile inflationary spiral are shown in the attached graph which demonstrates how successive devaluations since 1970 have simply served to offset the degree to which the domestic rate of inflation has exceeded that of our trading partners leaving the real exchange rate approximately unchanged.

Graph 13: Real and Nominal Exchange Rates

1972-1984 BASE 1972=1



In the absence of a devaluation, adjustment to eliminate the external imbalance would normally be achieved by the foreign exchange outflow resulting in a domestic monetary contraction (as the banking system loses liquid assets in purchasing foreign exchange from the Reserve Bank) and eventually a lowering of the domestic inflation rate relative to our trading partners. This is essentially what happened in mid 1982, when a very rapid credit squeeze occurred in conjunction with the sharp external loss of foreign exchange that resulted from the downturn in the Australian economy (and the decline in exports to Australia). This monetary contraction undoubtedly suppressed inflationary pressures and was instrumental in achieving the very substantial reduction in the rate of consumer price inflation. The resulting improvement in international competitiveness led to an increase in exports and decrease in imports and a rise in the net supply of foreign exchange. However, recent expansionary policies have again boosted imports sharply and increased the external deficit, despite the upturn in demand for our manufactured exports.

An ongoing external adjustment problem arises where the government has allowed the domestic cost structure to squeeze export and import competing production, giving rise to an external deficit which exceeds private overseas borrowing. The situation can persist if the government runs a fiscal deficit after internal borrowing which is large enough to provide the banking system with the cash needed to finance foreign exchange purchases from the Reserve Bank. The foreign exchange the Reserve Bank holds to meet this demand is obtained by government borrowing overseas or by running down reserves built up from earlier borrowings or periods of net foreign exchange inflows. The mechanism of domestic monetary contraction described above is therefore prevented from operating. The effect is that the real exchange rate will not adjust to reduce the external deficit as long as the government is ready, willing and able to continue with its overseas borrowing programme.

If government borrowing approximates that which would be undertaken by individuals (in the absence of exchange controls), then overall welfare need not be reduced by a high level of public borrowing. However, the very rapid rise in the overseas public debt in recent years has been accompanied by low increases in investment to GDP and savings to GDP ratios. For example, in the period 1976-1984, overseas borrowing to GDP was 2.0 percentage points above its long run average (1962-1984) while investment to GDP was only 0.9 points above its 1962-1984 average. As well, the fact that a significant proportion of the borrowed funds have been directed into a number of large projects whose rates of return are suspect, suggests that government actions have held the real exchange rate above the level that would have been attained in the absence of such interventions. This has inevitably biased domestic consumption

towards export and import competing commodities while at the same time reducing their profitability relative to non-traded goods. The result has been to reduce the efficiency of resource use, to inhibit the reduction of the current account deficit in the balance of payments that would otherwise have occurred, and to distort capital flows away from private sector investment in favour of lower return, government financed projects and domestic consumption. The foreign exchange problem is exacerbated by the growing public debt burden caused by the persistent external deficits which have been maintained during the last decade.

The obvious solution to this external adjustment problem is for the Government to reduce that part of its fiscal deficit which is not covered by appropriate internal borrowing, either by increasing its domestic borrowing and/or reducing the originating problem of the fiscal deficit. The resulting monetary contraction will put downward pressure on domestic costs while encouraging a higher net private capital inflow and reducing downward pressures on the exchange rate. A tight monetary policy is an essential part of any non-inflationary solution to the current foreign exchange problem. As government overseas borrowing is reduced, individuals may themselves choose to borrow overseas either directly for investment (if the rate of return on domestic investment exceeds the costs of overseas borrowing) or for current consumption (in which case they are, implicitly, trading current for future consumption). Any resulting external current account deficit would not be a cause for concern, and would merely be reflecting individuals' choices between current and future consumption.

– *Interest Rate Controls*

Controlling interest rates at below market determined levels decreases the willingness of private investors to hold funds in New Zealand. The result is an increase in demand for foreign exchange as investors seek higher returns outside the country. Interest rate controls are therefore an additional factor putting pressure on the exchange rate and foreign exchange reserves. They also inhibit private capital flows (supply of foreign exchange) which would otherwise finance the deficit on the current account.

– *Expectations of a Devaluation*

The demand for foreign exchange will rise substantially when there is an expectation of a devaluation. This expectation may arise when it is perceived that the government's policies are inconsistent with the prevailing nominal exchange rate. For example, since the announcement of the general election there has been a continuing outflow of foreign exchange with a consequent drain on foreign reserves.

– *Exchange Controls*

While heavy overseas public borrowing tends to maintain a higher exchange rate than would otherwise occur, exchange controls attempt to *protect* the nominal exchange rate in the face of an overly high domestic cost structure. Foreign exchange controls are pervasive in New Zealand's foreign exchange market. Their primary function is to inhibit flows of capital out of New Zealand (that is, to reduce demand for foreign exchange at the given exchange rate). This emphasis has evolved in response to the long history of balance of payments deficits and the perceived need to defend overvalued nominal exchange rates. The controls operate by restricting the range, volume and speed of foreign exchange transactions, and channel overseas funds into the banking system and ultimately the Reserve Bank and Treasury. They can thus be seen as the analogue of import controls on trade transactions, with similar motivations and deficiencies.

The controls effectively prohibit all foreign exchange transactions except for those subject to specific exemption or consent. The extent to which the controls are binding varies considerably. In practice all current account transactions are freely approved and some are effectively free of control. Restrictions are imposed on direct inward and outward investment flows, short-term overseas borrowing, draw-down periods and debt-servicing repayments, individual outward portfolio investment, the timing of repatriation of proceeds of current account transactions, foreign currency holdings, and currency transactions between residents. Although the controls are not applied under certain conditions, the reporting and routine application requirements alone involve substantial administrative and compliance costs for foreign exchange dealers, their customers and the Reserve Bank.

Exchange controls impose broader costs in terms of their impact on the efficiency with which resources can be used in the economy. Effectively they impede a smooth process of interaction among the foreign exchange market, the broader domestic financial market and foreign asset markets, hindering the adjustment of both domestic interest rates and the nominal exchange rate towards levels accurately reflecting the relative availability of and demand for resources. They also restrict the ability of local companies and individuals to organise their resources efficiently and in particular to accommodate the risks associated with foreign exchange transactions. In a relatively unrestricted market, these risks may be accommodated through either forward exchange transactions or short-term financial transactions. Although the New Zealand forward market has been substantially freed from specific controls, its effectiveness is restricted by controls on spot transactions and by the overall thinness of the foreign exchange market which reduces the opportunity to hedge

exchange rate risks. An example of the current limitations of this market is the fact that it ceased to provide businesses with forward exchange cover (except where matching transactions were available) soon after the election announcement. Any moves towards a more market determined exchange rate regime must be considered in conjunction with moves to allow businesses to insure against exchange rate risk in a more efficient forward market. However, the removal of controls would not affect government choices about how the nominal exchange rate should be determined. Under either fixed or flexible rates, it is desirable to promote an efficiently operating market for foreign exchange.

– Tariffs and Export Assistance

The supply of foreign exchange is increased by export assistance and demand is reduced by import controls since they increase the attractiveness of foreign exchange earning and savings activities. The result is that the nominal, exchange rate can be sustained at a higher level than would otherwise be the case. The provision of high levels of support in these forms to export and import competing producers inevitably results in disparities in rates of assistance amongst activities within these sectors. Such policies tend to reduce the efficiency of resource use, adversely affect growth, and lead to increasing fiscal costs.

Adjustments to the nominal exchange rate could be expected to make a positive contribution to the process of trade liberalisation,, facilitating shifts in resources between sectors. It would therefore substantially reduce the “need” perceived by domestic industry for government assistance, and reinforce the credibility of a government commitment to promoting a more flexible economic structure. The arguments for liberalisation of trade policies and the necessary accompanying measures are discussed in the chapter on government intervention in the private sector which covers industry assistance issues.

C Nominal Exchange Rate Determination-The Options

Countries have a wide range of choice about how to manage their exchange rates. On the one hand, firm policies can in principle be designed to preserve a rigidly fixed nominal exchange rate with adjustment then occurring through the quantities of foreign exchange transacted. A rigidly fixed exchange rate would imply acceptance of broadly the same rate of domestic inflation in the medium term as was occurring in the economies of the trading partners against whose currency the exchange rate is fixed. At the other extreme with floating exchange rates, the price of foreign exchange (that is the nominal exchange rate) will adjust freely to equate supply and demand. Flexibility in the nominal exchange rate allows national authorities to operate an independent monetary policy so that

the domestic rate of inflation can permanently diverge from the world rate without resulting in external imbalance. In between are a variety of options for adjusting administratively determined exchange rates as circumstances dictate.

In New Zealand, between June 1979 and June 1982, the nominal exchange rate was fixed against a basket of the currencies of our trading partners in a crawling peg arrangement in which frequent adjustments were made to take into account such factors as the excess of New Zealand's rate of inflation over that of our trading partners. Since June 1982, the exchange rate has been fixed against the basket (except for the March 1983 devaluation) in order to assist in achieving the Government's inflation objectives. During this entire period, the Government has had to defend the exchange rate by a heavy cumulative overseas borrowing programme. The freezing of the exchange rate in conjunction with the expansionary monetary and fiscal policies since mid-1983 and the associated increase in import volumes have contributed to the current foreign exchange difficulties.

The choice of exchange rate regimes in practice is not between fixed and flexible rates-exchange rates rarely remain rigid for long periods-but revolves around the question of what sort of regime is adopted and how frequently the rate is moved. Choice between the different regimes must be based on the effect each has on the efficiency of operation of the foreign exchange market and the wider effects it will have on the economy.

— *Administratively determined nominal exchange rate regimes*

Administered nominal exchange rate regimes were the norm in the first part of the post-war period (and are still maintained to a degree by some major countries, at least in terms of currency blocs). However, there has been a marked shift away from such a policy choice in the past fifteen years, for reasons which are not confined to the inflationary experience of that period.

- a Under a discretionary regime, exchange rate adjustments tend to be made infrequently against the basket as circumstances dictate. When a change in the rate occurs, it may need to be large to restore lost competitiveness. These large infrequent changes are disruptive for the economy as a whole and particularly for the export sector. Government intervention will increase the risk to decision makers who, in making investment decisions, have to interpret not only the effect of market shocks but also anticipate independently the actions of the government. On the other hand, administered exchange rate regimes with a high degree of automaticity in their operation (e.g. some forms of crawling peg) may also fail to be sufficiently flexible in changing circumstances.

- b With a fixed rate supported by government intervention, taxpayers may stand to lose a great deal from one way speculation against the dollar. Individuals, by observing official exchange rate setting behaviour, endeavour to anticipate future movements in the rate. The losses associated with the Reserve Bank's activities in the forward exchange market in 1982 are an illustration of this problem.
- c Under an administered regime, Ministers are frequently required to deliberate on the complex issues affecting the determination of the rate and to take decisions with information which can never be complete. The effect is to politicise the issue, generating pressures for direct interventions that focus on symptoms rather than causes. An artificially pegged exchange rate usually fails to clear the market for foreign exchange and thus wrongly concentrates attention on a "balance of payments problem" rather than on the underlying cause of a domestic cost structure which is too high relative to our overseas competitors; it inadequately rewards exporters and thus promotes pressure for "incentives" and subsidies; it inappropriately encourages imports and prompts calls for protection which is often supplied to internationally uncompetitive activities; it implies that the logical solution to the problem (devaluation) will be "inflationary" (rather than involving an essential degree of relative price flexibility) and it diverts attention from the real issues (real wage inflexibility, the fiscal deficit, monetary control, and so on).

— Floating

A more flexible and responsive system could be achieved by floating the exchange rate. There are a number of important advantages of a floating exchange rate by comparison with the current fixed regime:

- a under a floating exchange rate regime, the exchange rate will vary in a highly visible way with fluctuations in supply and demand conditions, and the information generated will enhance the ability of the price mechanism to indicate changing market opportunities and thus assure responsiveness to changing circumstances. In an economy beset with major structural macroeconomic imbalances (the external deficit, the fiscal deficit, excessive money supply growth, unemployment) there is obviously a need to give more appropriate price signals. With a floating exchange rate, there is less risk that poor monetary and fiscal policies will impoverish those industries exposed to world trade while generating spiralling external debt problems.
- b Governments do not have sufficient information to set a pegged rate, or adjust progressively a crawling rate, to an optimal degree. What

is fundamentally required in the economy as a whole is relative price flexibility in a number of inter-related markets-those for labour, products, money and foreign exchange-sufficient ideally to achieve simultaneous equilibrium in each (or, more practically, at least to move towards this).

- c Floating the exchange rate allows greater latitude to pursue an independent monetary policy, and will strengthen its effectiveness in achieving domestic price level objectives.
- d In addition, it would help us ease out of the protection/export assistance/exchange control bind we are now in without having to make very complicated judgments about an appropriate path for a pegged rate. It could be argued that a mix of this sort, reducing frontier distortions along with devaluation, need not push up inflation overall but instead may involve a series of relative price changes which tend to offset each other.
- e Where the nominal rate is fixed, the price and quantity (resource reallocation) changes that must occur elsewhere in the economy will be magnified. A floating exchange rate would help share with interest rates the burden of short term fluctuations in financial flows where these are significant. In Australia, the Government saw this as a substantial advantage of moving to a float. With a pegged rate much of the weight of short term fluctuations in financial markets is absorbed by interest rate volatility. The risk associated with volatility in the exchange market can be more readily hedged (through, for-example, forward markets) than can interest rate volatility in conjunction with uncertainties about government changes in the exchange rate.
- f If official net overseas borrowing continued to be undertaken with a floating exchange rate, at least the amounts could be pre-determined and the programme phased down in a progressive manner in contrast to the present ad hoc arrangements. Of more analytical relevance, a planned net repayment programme for debt could be scheduled and adhered to.
- g Speculative pressures, which are at present likely to induce delayed and arbitrary official responses and can present huge windfall gains to professional operators at the expense of the taxpayer, can be handled more efficiently. Under a floating regime, the (desirable) process of speculation involves gains and losses to private market participants only.

— *Conditions for Floating the Exchange Rate*

The current “thinness” of the foreign exchange market raises the possibility that an immediate move to a market determined rate would produce volatile fluctuations in the exchange rate with inadequate means

for businesses to insure against such disturbances. Currently the Reserve Bank limits the amount of reserves which the trading banks and other foreign exchange dealers can hold, as well as the amount of overseas borrowing they can undertake. A removal of these restrictions to allow the holding of higher levels of reserves is essential for “deepening” the foreign exchange market. There may also be a need to remove binding exchange controls to permit an improvement in the efficiency of the foreign exchange market’s operation and increase the number of traders.

It is desirable that exchange controls which are significantly restricting the potential of companies and individuals to accommodate foreign exchange risk be removed early on, in particular those relating to the timing of repatriation of export earnings and to short-term borrowing overseas.

A more gradual approach could be adopted to phasing in outward portfolio investment by individuals and to liberalising overall patterns of inward and outward investment. It must, however, be emphasised that the removal of constraints on these flows is essential to the longer run efficiency of the foreign exchange market. It should be noted that such initiatives would not preclude the maintenance of controls over direct foreign investment if they were considered necessary.

A successful float of the exchange rate (i.e. one which does not exacerbate inflationary pressures unduly) is critically dependent on appropriate monetary and fiscal policies being put in place. A tightening of monetary policy, a reduction in the fiscal deficit and the freeing of interest rate controls are essential if demand for foreign exchange is to be reduced so that floating does not result in a very large depreciation of the nominal rate or large private capital outflows covered by large public overseas borrowing to defend the rate. Foreign exchange reserves are currently at a very low level as a result of speculation against the dollar. It may be necessary to build up reserves before the exchange rate is floated.

D Adjustment

There are several adjustment paths that could be envisaged for progressing towards freeing up the exchange market and for changing the way in which the nominal exchange rate is set. Although all options have the tightening of monetary policy and the freeing of interest rates as an essential pre-requisite, choice amongst them depends critically on whether the government supports a move towards floating the rate, the timing of such a move, and the state of other government policies. Provided these are compatible, our view would be that a move to a largely market determined exchange rate regime would be practicable and desirable in the fairly near future, and that interim policy should be shaped with this intention in mind. Choices may be pre-empted to some extent by the

current precarious exchange market situation, but we see the essential agenda for discussion as being the sequence of macropolicy and market liberalisation moves, and the communication of their implications to the public and to labour market participants in particular, which would facilitate the smooth introduction of a floating regime.

Conclusion

Our immediate foreign exchange market crisis and the rising external public debt burden reflect a long-standing imbalance arising from domestic policies which maintain a domestic cost structure which is too high in relation to that of our trading partners. Improvements in our current account balance are necessary to reduce our overseas borrowing. This will require a combination of appropriate monetary and fiscal policies in association with allowing nominal changes in the exchange rate.

Exchange controls are permitting imbalances in the economy to persist and are adversely affecting the efficiency with which the foreign exchange market operates. The successful deregulation of the foreign exchange market is heavily dependent on the removal of restrictions on domestic interest rates and on the nominal exchange rate being close to its market equilibrium level.

It is noted that countries have a wide choice about how to manage their exchange rates but that a choice between regimes must be based on the effect each has on the efficiency of operation of the foreign exchange market and the wider effects on the economy. It is concluded that the most efficient method of achieving nominal exchange rate adjustment is to float the exchange rate. However, it is noted that problems might be experienced if the rate is floated immediately.

Chapter Six

Fiscal Outlook

Introduction

This paper discusses the forces evident in expenditure and revenue over the last 10 years and comments on the implications for the fiscal position in the period ahead.

A trend perspective

a *Expenditure*

Over the last 10 years, net government expenditure has steadily increased as a proportion of GDP. During the period 1975/76-1977/78, net expenditure averaged 35.4 percent of GDP; during 1978/79-1980/81 it averaged 37.5 percent; and during 1981/82-1983/84 it averaged 39.7 percent. In 1984/85 net expenditure is forecast to be 40.6 percent of GDP, based on current policy decisions.

Two components of expenditure have in particular significantly contributed to the overall increase during this period. Debt servicing costs and spending on Social Services have consumed an increasing share of net Government expenditure. This is particularly marked in the case of debt servicing, which has risen from an average 7.5 percent of net expenditure in 1975/76-1977/78 to a forecast 16.1 percent in 1984/85. Spending on Social Services (primarily Social Welfare) has increased in proportion to other expenditure to a lesser extent: from an average 25.2 percent of the total in 1975/76-1977/78 to a forecast 29.3 percent in 1984/85.

Other elements of spending have varied in their contribution to overall growth. Within the Development of Industry category, for example, spending on Land Use declined steadily as a proportion of total net expenditure until the introduction of the Supplementary Minimum Prices scheme exerted a strong upward pressure. This is forecast to ameliorate significantly over the next few years with the phasing out, on the basis of existing commitments, of the SMP scheme. Spending on Other Industrial Services has been strongly influenced by spending on job creation subsidies, growing steadily from an average 1.9 percent of net expenditure during 1975/76-1977/78 to a forecast 4.1 percent in 1984/85, levelling off thereafter.

On the basis of current policies these trends are likely, on balance, to continue to exert an upward pressure on government expenditure in the period ahead. Existing commitments with respect to benefits (entitlement and indexation policies) indicate that Social Services will continue to increase as a proportion of total expenditure, while the structural expenditure ratchet arising from the cumulative effect of past deficits on public debt, debt servicing costs and thence to future deficits, will remain. Over the next three years, the combination of spending in these two areas is expected to rise from 42.7 percent of net expenditure in 1983/84 to around half in 1986/87.

b Revenue

As with net expenditure, revenue has steadily increased as a proportion of GDP over the last 10 years. During the period 1975/76-1977/78, revenue averaged 29.9 percent of GDP; during 1978/79-1980/81 it averaged 31.1 percent; and during 1981/82-1983/84 it averaged 32.9 percent. In 1984/85 it is forecast to be 33.8 percent of GDP, based on the existing structure of the taxation system. (That is, existing rates and thresholds are assumed to remain unchanged throughout the year.)

Within that total, several trends are evident during the period. Taxation has fluctuated only slightly as a proportion of total revenue, with some growth in interest, profits and miscellaneous receipts over the last 10 years. The proportions of tax collected by means of direct and indirect taxation remained largely unchanged through to 1983/84, when the combination of the restructuring of the personal income tax scale in late 1982 and a reduction in company tax collections (-17.5 percent compared with 1982/83) dropped the proportion of direct tax in the total from an average of 75.2 percent between 1975/76 and 1980/81 to 72.1 percent in 1983/84. In 1984/85 direct taxation is forecast to make up 73.3 percent of the total. Within income tax, company tax collections have fallen steadily in proportion to the total—from an average of 18.2 percent during 1975/76-1977/78 to 10.4 percent in 1981/82-1983/84. Some increase is expected in 1984/85, when company tax is forecast to constitute 13.0 percent of income tax, resulting from a combination of factors: a lift in company profitability during 1983/84; the termination of some investment allowances; the replacement by Forestry Encouragement Grants of tax deductibility of forestry expenditure; and the change in tax treatment of life insurance companies and building societies.

Implications for the deficit

Over the last 10 years net expenditure has increased on average in relation to GDP by 4.3 percentage points, while revenue has increased by 3.0. The deficit has correspondingly widened from an average of 5.6 percent

of GDP between 1975/76-1977/78 to a forecast 6.8 percent in 1984/85. If existing trends in the growth of expenditure and revenue continue in the period ahead, by 1986/87 net expenditure would constitute 41.9 percent of GDP, while revenue would make up 34.7 percent. The deficit would widen to 7.2 percent of GDP, around \$3,200 million. Such a continuation of existing trends would be consistent with a slight rise in average effective tax rates over the period and the delivery of a significant degree of assistance through tax expenditures (revenue foregone) and budgetary means.

Whether or not that gap will continue to widen in the period ahead obviously depends on the configuration of future expenditure and revenue decisions. An indication of the impact discretionary decisions could have in the period ahead is provided by the estimated fiscal savings which might result from the kinds of policies which would be in line with the principles set out in the accompanying chapter "Fiscal Policy : Expenditure and Revenue Principles". For example, the combination of more selective targetting of assistance measures, the pricing of Government goods and services to reflect the cost of their production, and a shift away from reliance on import licensing as the means of delivering protection to domestic production, could generate a reduction in the deficit of as much as \$2,400 million by 1986/87 (i.e. to around \$800 million or less than 2 percent of GDP). Notwithstanding the possible impact of such a reduction on economic activity, the figure does indicate the impact discretionary policy decisions can and will have in the period ahead.

Conclusion

If current trends continue the gap between expenditure and revenue will continue to widen in the period ahead. Discretionary policy initiatives do, however, have the potential to alter those trends significantly and generate a substantial reduction in the deficit.