4. THE BALANCE OF POLICIES

The results of New Zealand's economic reforms in terms of growth and employment have been disappointing. Some pain was inevitable during economic restructuring. But the costs of adjustment have been higher than they needed to be, and the benefits have been delayed.

Strong export growth has the greatest potential to lift the New Zealand economy onto a high-growth, high-wage path. Yet export growth has been suppressed by many years of policies that squeezed businesses that compete internationally.

For investors, the most obvious symptom of New Zealand's economic problems has been high real interest rates. This has led many people to perceive that New Zealand's tight monetary policy is the problem. Yet the most successful and resilient economies elsewhere in the world have a history of firm and stable monetary policy.

The longstanding problem for New Zealand is a lack of harmony between policies. Monetary and fiscal policies have worked against each other. Other policies led to cost-plus practices and less concern for productivity or quality.

All of this suggests that any loosening of New Zealand's firm monetary stance would not solve our long-term problems. Rather, monetary policy needs to be supported by policies that:

- control public spending and the growth in taxes
- encourage productivity and efficiency in all sectors of the economy
- encourage people to take work as it becomes available.

The Government can be a major source of uncertainty. As investors perceive that policy settings are stable and predictable, interest rates can fall, allowing investment to grow.

INTRODUCTION

Recent policy reforms have focused on developing a more dynamic and competitive economy. Progress has been made towards securing low inflation, increased labour productivity and increased consumer choice. However, the primary goals of higher growth and more jobs are still to be realised. Instability and imbalances in policies over many years are part of the explanation for this slow progress and the magnitude of the reforms still needed.

The way policies interact with one another has an important influence on who bears the major pressures and costs of change. The ability of different groups to respond to these pressures can have significant effects on overall growth and employment. Particularly important is the relative pressure on those exposed to international competition and those protected from it.

The term "policy balance" is often used to explain the interaction between monetary and fiscal policies. However, policy balance is not solely a macroeconomic issue. It also refers to the way microeconomic policies affect each other, and the interactions between microeconomic and macroeconomic policies. For example, regulatory reforms can support monetary policy in breaking down inflationary pressures in the economy.

The effects of many policy imbalances are often reflected in interest rates and exchange rates. They capture what is going on in the economy now, as well as people's perceptions about what might happen in the future.

This chapter discusses recent movements in interest rates and exchange rates and the way they have been influenced by the mix of policies. It then draws out lessons for the wider balance of policies and emphasises the importance of consistent and coherent policies with a medium-term focus.

INTEREST RATES AND EXCHANGE RATES

Interest rates affect incentives to save and invest, while exchange rates affect the competitiveness of those sectors facing international competition. Both of these variables also influence domestic demand, inflation and asset values. Interest rates and exchange rates are determined by financial markets, and incorporate the collective views of large numbers of people about economic conditions in New Zealand. Markets respond to a complex array of current and expected influences - for example, domestic policies, the returns on investment, investor confidence, and international developments. With the increase in short-term capital flows that has accompanied the global integration of financial markets, any shifts in the focus of policy can quickly be transmitted into movements in interest rates and/or exchange rates.

Interest Rates

High interest rates in recent years have squeezed the financial position of all net debtors, including the Crown. They have also contributed to the decline in asset values (e.g., for financial securities, commercial buildings and rural land). In response, many individuals and firms have cut back on new borrowing and used surplus resources to reduce their debt. This has undoubtedly led to the postponement of some decisions to undertake new investments and buy consumer durables.

New Zealand's capital market is strongly integrated into world capital markets. This means that long-term interest rates are now largely determined by two factors: the level of interest rates overseas and the premium required to cover the additional risks and costs of investing in New Zealand. Only the latter component can be influenced over time by government policies. The risks and costs of investing in New Zealand are influenced by a number of factors:

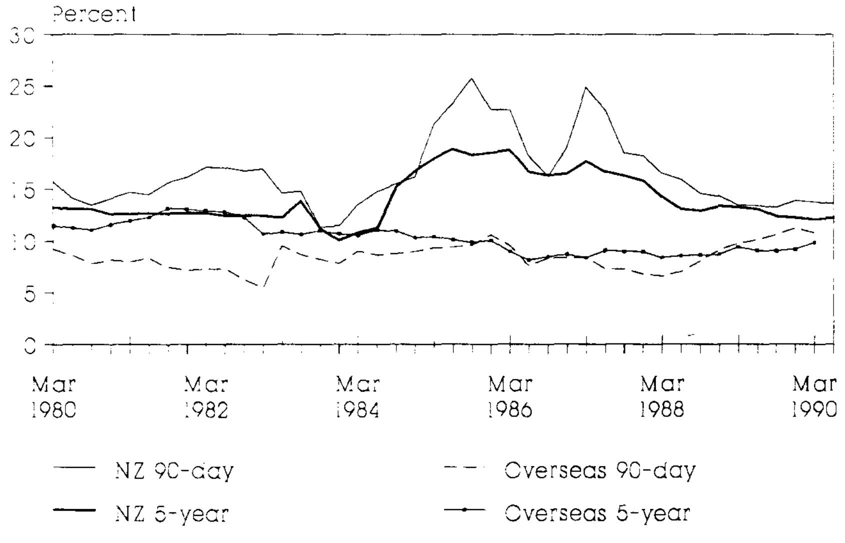
- exchange-rate risk
- unpredictability of future inflation rates
- uncertainties about the impact of future policies
- the taxation regime.

Short-term interest rates are directly affected by the operation of monetary policy. Long-term interest rates are indirectly influenced by monetary policy through the effects on inflationary expectations and perceptions of risk. For example, an easing of monetary policy could lead to a rise in inflationary expectations and higher long-term interest rates.

Recent trends in nominal interest rates for deposits are shown in Figure 4.1. There was a distinct rise in interest rates following the removal of controls in 1984 and related measures to deregulate the financial sector. Short-term rates have generally been more volatile, and higher, than long-term rates. However, both have now declined from their peak levels of 1985 and 1987. Current deposit rates are around 13%-15% and lending rates are around 15%-17% for low-risk customers and projects.

Figure 4.1

Nominal Interest Rates



Overseas rates are weighted averages for our major trading partners
Source: RBNZ and Treasury estimates

In an open economy, low interest rates can only be sustained with sustained low inflation. Securing low and stable inflation would be the biggest single contributor to reducing nominal interest rates. This would assist to lower the element of risk built into interest rates. It is no coincidence that the OECD countries with the lowest interest rates over the past decade (i.e., West Germany, Switzerland and Japan) also had the lowest inflation rates. A credible monetary policy is essential to achieve these outcomes.

As inflation has fallen, interest rates have fallen, albeit at a slower rate. Figure 4.1 shows that the interest premium required to attract funds to New Zealand has fallen over the past three years (to about 2%-3%). Several factors have contributed to the risk premium built into our interest rates:

- The approach to monetary policy has not always been consistent. There have been periods when progress against inflation stalled or when the actions of the authorities were not easily understood. Further, the time taken by New Zealand to secure low inflation has been long in comparison to most OECD countries.

- Little progress has been made on reducing government spending over the past few years. The financial deficit has been contained through revenue increases. The introduction of GST, its subsequent increase and higher government charges have all added to measured inflation.

- The difficulties faced by the Bank of New Zealand and Development Finance Corporation and poor management decisions uncovered by the 1987 sharemarket fall increased the perceived riskiness of New Zealand for investors. Some regulatory responses were seen as likely to increase the risks faced by secured lenders.

- These factors have helped generate constituencies critical of monetary policy. This created uncertainties about how the Government would respond to these pressures, particularly when the overall policy mix was complicating the task of monetary policy.

Interest rates moved up after presentation of the 1990 Budget. The adverse fiscal outlook influences domestic interest rates in several ways:

- The Government must compete with other borrowers for funds. Thus, large deficits can act to push up domestic interest rates.

- The combination of high debt, high interest rates and deficits can raise concerns about the sustainability of the fiscal position. These concerns can be reflected in our credit rating or can increase doubts about the direction of further policy, e.g., the likelihood of monetary policy being eased to accommodate the Government's demand for credit.

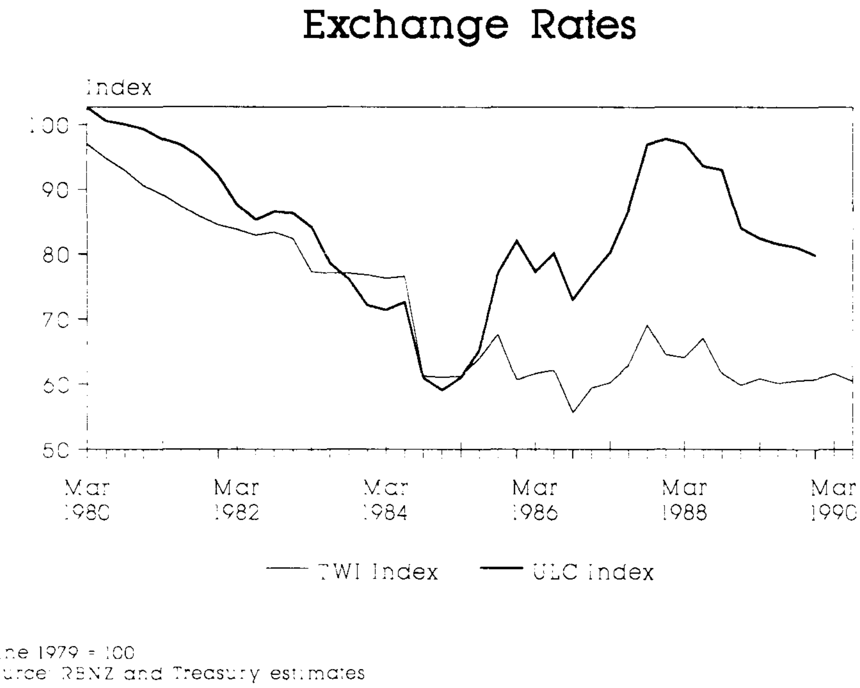
- Taxes can affect interest and exchange rate levels. The flow of capital between countries is influenced by concerns about after-tax returns. Fears of future tax increases would tend to raise the pre-tax returns sought by investors.

Exchange Rates and Competitiveness

The **nominal exchange rate** influences the short-term competitiveness of exporters and import-competing industries. As shown in Figure 4.2, the trade-weighted nominal exchange rate has fluctuated but without any clear trend since the currency was floated in March 1985. But the nominal exchange rate is only part of the story. Many other factors influence whether New Zealand businesses can compete internationally.

The **real exchange rate** is a concept which adjusts the nominal exchange rate for other factors affecting competitiveness. One measure of the real exchange rate - which compares unit labour costs in the manufacturing sector with those of our major trading partners - is shown in Figure 4.2.

Figure 4.2



Most measures of the real exchange rate have followed a similar path since the 1984 devaluation: appreciating (indicating a loss of competitiveness) from the float in March 1985 to around 1987-88 and depreciating (indicating a gain in competitiveness) during the past two to three years. The magnitude of the change is sensitive to the measure and base period used. For example, the unit-labour-cost index shows manufacturing as now being less competitive than it was in June 1984, but still better off than in the early 1980s.

The real exchange rate is not a policy indicator which can be targeted or controlled by the Government, except possibly in the very short term. Movements in competitiveness over longer-term periods are affected by our inflation and productivity performance relative to those countries with whom we compete.

The real exchange rate can fluctuate for reasons that would not justify a policy response (e.g., changes in the terms of trade). However, a persistent competitiveness problem foreshadows a balance of payments problem, and may indicate serious policy imbalance, with the exposed sectors taking an undue share of the pressure on the whole economy. The correct response in such circumstances is to address the cause of the policy imbalance (e.g., a large financial deficit or a bias against exports resulting from import protection) and increase the pressure on the sheltered sectors (i.e., those immune from overseas competition) to contain costs and increase productivity.

Underlying concerns about the real exchange rate and the current account deficit is concern about the slow growth of our exports over a number of years. Policy has affected the profitability of exporters in a number of ways. For example:

- The length of time taken to secure low inflation has kept upward pressure on both interest and exchange rates.

- Higher taxes and charges have added to the overall costs of business.

- The gradual reduction in import protection compared to the rapid removal of export assistance has reduced export profitability relative to other activities.

- Entrenched labour-market practices have made it harder to secure better work arrangements.

- The ability of sheltered sectors, like local government, to pass on their costs has reduced the profitability of exporters.

- Reforms in major areas such as resource management, capital market regulation, and company law have created uncertainty about future business costs.

The greater pressure placed on the exposed sectors to adjust has led to some reduction in output, but more generally to a major loss of jobs as survival depended upon rapid reductions in cost structures. Given the lack of flexibility in wages and work practices, employers have reduced their labour costs by reducing staff numbers.

The current outlook suggests that the economy will continue to face large current account deficits. The faster further improvements in competitiveness take place, the less need there will be for overall private spending restraint. Policies that support resource switching and reduce in a durable manner the costs imposed on the exposed sectors of the economy are essential.

LESSONS FOR POLICY DESIGN

The above discussion illustrated some of the interactions between various policy measures, and their influence on the economy. Actions aimed at tackling symptoms of policy imbalance (e.g., loosening monetary policy to get down interest rates or exchange rates) risk aggravating policy imbalances over time. By themselves they do not create the more competitive cost structures and productivity needed to deliver strong economic performance.

High real interest rates, loss of competitiveness and high unemployment all indicate policy imbalances. Some of these pressures were an inevitable part of the restructuring being faced and the need to secure low inflation. However, these pressures have been aggravated by slow adjustment in the parts of the economy less exposed to foreign competition.

Policies need to be consistent with achieving a clear set of medium-term objectives. In broad terms, macroeconomic policies should aim to provide a stable and predictable environment for economic decision-makers. This requires better balances between monetary and fiscal policies. Regulatory reforms need to be directed at improving flexibility and productivity in the economy. This points to the importance of labour market reforms, lower tax burdens, and progress in some major regulatory areas. A better balance of policies would provide the best prospects for improving competitiveness, and sustaining growth of output and jobs over the medium term.

It will take time to convince the private sector that the Government is committed to a set of coherent and consistent policies. Until the private sector is confident about the direction of policies, it will remain reluctant to take major risks or commit resources to new investment. Economic prospects are also affected by the uncertain outlook for the world economy. For these reasons, changes in policy balance will take time to bring about a significant improvement in growth and employment.

Quick results are not common in our own experience and that of other countries. Therefore goals must establish in the minds of economic decision-makers and investors that it is the country's long-haul economic performance that matters. For this reason medium-term fiscal and monetary policy goals should be adopted and achieved. They should only be changed if such changes can be carefully explained and then consistently pursued to offset as rapidly as possible the inevitable loss of credibility from changing targets. Without this, the change can be interpreted as a sign that the Government will change those targets whenever the going gets tough.

With this in mind, New Zealand's current economic difficulties suggest the following approach to achieve a better balance of policies:

- **Monetary policy should continue to be focused on achieving medium-term price stability.** This is the most valuable and lasting contribution that monetary policy can make to the health of the economy. Inflation creates uncertainty and biases in the decision making of households and firms, and produces inequities in the distribution of income and wealth. Small savers, the elderly and those on low incomes are usually the worst affected. There is no doubt that the process of reducing inflation - through the influence on interest rates and exchange rates - has imposed real costs on the economy. But these pressures will ease as the inflation rate falls and inflationary expectations adjust. Over the longer term, low inflation will help to sustain a low-interest-rate regime and improve competitiveness. Although looser monetary policy might provide immediate relief for some sectors, such gains are unlikely to last and would not compensate for the longer-term damage from higher inflation and a loss of confidence in the sustainability of economic policy.

- **The operation of monetary policy should allow the exchange rate to respond to real shocks,** particularly those that affect the external performance of the economy (such as a decline in the terms of trade). This would take some of the pressure of adjustment off interest rates and provide the relative price changes needed to stimulate the tradables sector. However, nominal exchange rate changes can also have an effect on inflation. A depreciation, for example, would increase the domestic price of imports, and could feed into higher wages and prices throughout the economy. Monetary policy needs to resist these second-round pressures, if exchange rate changes are to have sustained effects on real economic behaviour and competitiveness. In New Zealand, the competitive advantages provided by devaluations in 1967, 1975 and 1984 were all eroded by higher inflation within two to three years. The depreciation in 1988 has proved to be more lasting, because of the improved credibility of monetary policy and productivity gains in the economy.

- **It is essential that a substantial fiscal consolidation occurs over the next three years.** Uncertainty about the fiscal outlook is being reflected in interest rates and investor confidence. Large fiscal deficits cannot be sustained. The manner in which the fiscal consolidation is achieved is also important. The more the adjustment can come from savings in expenditure the more positive the effects on domestic costs and interest rates are likely to be. The increased taxes and charges used to finance expenditure have added to the costs faced by exporters and import-competing industries. Even with measures being taken to reduce the deficit it will be some time before investors are confident that the fiscal position is under control and that they can look forward to stable or declining tax bills. Investors will be mindful of the difficulties faced by successive governments during the past 15 years in correcting major fiscal imbalances.

- **Growth in government spending needs to be constrained.** The growth of total spending (which is increasingly dominated by welfare expenditure) should be kept within the revenue that can be raised by:

  - a company tax system which is competitive by comparison with other countries

  - a personal tax system that does not undermine incentives to work or discourage people on benefits from seeking work

  - a goods and services tax system which is based on a comprehensive base at a single rate.

  The current fiscal situation threatens to undermine these conditions. The growth in expenditure has been financed by increasing tax burdens, one-off sales of assets and finally an increasing deficit. This has created a vicious cycle that has dampened economic activity, discouraged investment and reduced the incentives to work. Breaking this cycle requires the growth in spending to be checked and put back in step with revenue growth arising from an expanding economy rather than from higher taxes on a stagnant economy. To achieve this will require some combination of:

- improved efficiency in the delivery of social services
- controls on tax and benefit abuse
- more effective targeting of support to those who really need it
- lower benefit levels.

None of these are politically and technically easy. However, the alternative is to allow the vicious cycle to build up further and create a worse problem for the future.

- **Disinflation and faster growth will be assisted by measures to break down "indexation linkages".** In the short term, an incomes policy may help to weaken the inflationary cycle of higher prices and higher wages. However, an incomes policy would limit the relative wage movements needed to attract workers into areas of highest productivity. Such arrangements create pressures on the Government to compromise other policy objectives. Competitive markets together with firm consistent macroeconomic policies provide the best prospects for breaking down and avoiding "indexation linkages". Increased competition, including access to imports at lower tariffs, limits the scope for higher costs to be passed along in higher prices, and for justified wage increases in one sector to be reflected in similar, unaffordable wage increases elsewhere in the economy.

- **Import liberalisation needs to continue.** Assistance programs for agriculture and exports were removed in the mid-1980s. By contrast, protection for producers selling on the domestic market has been removed more gradually and is still high for a number of industries. Protection is effectively a tax on exporters, through both the direct effect on import costs and the indirect effects on domestic costs and the exchange rate. Therefore, given the potential of the export sector to create jobs and growth, it is important to push ahead with the announced programme of trade-policy reforms. This includes the removal of all remaining licence restrictions by the end of 1992 and the reduction of most tariffs to 10% or less by 1996. These changes will significantly reduce the remaining distortions, including the anti-export bias, in the trade regime. The phased programme allows industries time to adjust, while providing a greater degree of certainty about the future environment for investment decisions.

- **Regulations require careful design and review.** Regulations exert powerful influences over economic activity. They affect the scope for competition and risk-taking. They influence the costs of investment, employment and finance. This argues for careful consideration of major areas of regulation such as resource management, company law and capital markets.

- **More rapid progress is needed on labour-market reform.** Although the system of industrial relations has become less centralised, it still does not deliver the adaptability needed in a competitive and growing economy. Of particular concern is the system of national awards, which is unresponsive to the particular circumstances of individual businesses and their workers. Given the difficulties of negotiating changes in work practices within enterprises, employers have often responded to increased competition and slow growth in domestic demand by laying-off workers. Labour-market reform can help to break down the attitudes and practices of the past. Even so, the response in terms of increased employment may take some time to emerge.

- **Labour-market reforms need to be supported by the tax and benefit system.** Present benefit structures provide little financial incentive for many people living on unemployment and family-income benefits to seek full-time employment. By placing a floor under the wages which people will accept, benefits can also reduce the number of jobs on offer. New Zealand's rates of unemployment benefit relative to minimum and average income are high by comparison to many other OECD countries. The outcome is a higher level of dependency and high cost structures for New Zealand producers. The need is to design and administer income maintenance systems that take account of the incentives they place on people to seek work.

CONCLUSION

The balance of policies influences who bears the pressures and costs of change, and affects confidence about the stability of the policy environment. Past policy imbalances have had a significant influence on the performance of the economy.

Poor export performance over a number of years is the consequence of policies that have weighed more heavily on the exposed sectors of the economy. This has been compounded by uncertainties over the future direction of policy. A better balance of policies would improve the competitiveness of exporters and import-competing industries.

With this in mind, monetary policy should continue to be focused on achieving medium-term price stability. Low inflation will help to sustain low interest rates and improve competitiveness. Fiscal consolidation, especially through expenditure savings rather than tax increases, will also reduce pressure on interest rates and improve investor confidence. Over the longer term, improvements in competitiveness will have to come from lower costs and higher productivity. Further regulatory changes, including import liberalisation and labour-market reform, will support the development of a more dynamic and competitive economy.