THE TREASURY
Kaitohutohu Kaupapa Rawa

Macroeconomic Policy: Making it Work for New Zealand

Speech delivered by
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Introduction

Thank you Jonathan for that introduction, and thank you for giving me the opportunity to be here with you today to give a Treasury perspective on macroeconomic issues. These are challenging and somewhat bewildering times. But for those of us who've been on our fair share of economic rollercoaster rides, they are also intriguing times.

I want to start by congratulating the IPS for hosting three seminars with an economic perspective in the next short while. I understand I will be followed next week by the Opposition's economic spokesperson, and then the following week you are hosting an eminent British economist who will be speaking about the global financial crisis and its implications for macroeconomics. It seems the macroeconomic debate is moving along quite briskly at present, and the three seminars will hopefully give you some fresh and interesting insights.

What is pretty clear to everyone who is following what is unfolding around us is that our perspectives on the economy are being formed in an environment that is now quite

unlike anything I've experienced. Brian Easton captured the mood of many in The Listener last week when he wrote: Everything is so uncertain we cannot accurately predict what will happen and when.

In short, the global economic and financial crisis has led us into uncharted territory. Our economic analysis is being tested and major economies have embarked on a wide range of policy interventions, including the rescue of financial sectors, fiscal stimulus, fiscal consolidation, and quantitative easing.

It is very hard to judge *ex ante* what effects these policies will individually or collectively have in particular markets. These uncertainties are reflected in both the blogs of The Economist and New York Times columnist Paul Krugman, as well as position papers being written by senior staff at institutions such as the IMF.

But despite the fog of uncertainty we have to take a view on the implications for New Zealand. As the agency funded by taxpayers to provide advice on appropriate settings for economic, fiscal and regulatory policy, the Treasury has, I believe, a responsibility to outline transparently the issues that we judge are critical to raising living standards in our country in the wake of the Global Financial Crisis, or the post-GFC world as it is referred to in the financial and economic community.

In New Zealand's case, there is no question that the GFC exposed deep, structural weaknesses in our economy. New Zealand's foreign liabilities must ultimately be serviced by a net flow of goods and services. Rather than finance productive investment, much of the additional borrowing by households and businesses over the past decade or so has served to bid up the prices of housing and farms, which has contributed to an associated increase in consumption spending. These assets appear overvalued and the household debt to income ratio is historically high.

There is also no question that the re-balancing which is taking place in the global economy offers us unprecedented opportunities.

As governments in emerging economies encourage greater domestic consumption in their large, growing, dynamic and increasingly rich economies, we in New Zealand are offered enormous opportunities to shift our economy to growth that is increasingly driven from ever-rising quality goods and services exports.

Treasury's primary role of course, is to provide advice and services on these matters to governments and we are doing that. But we also have a duty to test that advice – there is no monopoly on wisdom after all – and to inform and promote public debate on key economic issues.

It is my intention, therefore, that the Treasury use the next few months to outline publicly the direction of our thinking on the key policies required to permanently raise New Zealanders' incomes in the years ahead.

Today, I will focus my discussion on macroeconomic policy. In particular, I want to discuss why fiscal policy settings are, in the Treasury's view, a critical ingredient in any successful strategy to lift our per capita growth performance.

If I had to summarise what I have to say today in three bullet points it would be these:

- One, having a stable macroeconomic environment and a sound financial system markedly reduces the risks of our economy being derailed by the inevitable next economic or financial shock. Our view is that New Zealand's economic imbalances make us more prone to economic shocks and adverse changes in global investor sentiment than we would like.
- Two, a number of policy arrangements contribute to macroeconomic stability, including monetary policy and macro-prudential policy. The biggest single contribution any government can make to macroeconomic stability is to get its own finances in order – that means sustainable, predictable and "no surprises" fiscal policy.
- And three, there is a need to rebuild the net debt buffer against economic shocks, prepare New Zealand for the longer-term fiscal challenges, and free up resources for tradable sector growth. On balance this leads Treasury to the view that fiscal surpluses be achieved as soon as conditions permit, that is, one or two years earlier than current plans. This view underlines our recent advice to government.

A framework for all seasons?

I decided it would be useful in my address today to turn briefly to some early insights into understanding the New Zealand and Australian economies.

The purpose is to use these insights to help us see how their evolution has shaped thinking about the two big economic challenges facing New Zealand. These are enduring challenges for our small, commodity-rich economy: how to reduce the gap between New Zealanders' living standards and those of other developed nations; and how to address our economy's imbalances and associated vulnerability.

In 2008 the New Zealand economics profession marked the 50th anniversary of an article by Alban William Housego (Bill) Phillips, a New Zealander, on the relationship between unemployment and inflation. This article laid the foundations for subsequent work that provided a much clearer understanding of inflation and inflationary expectations.

What is generally less well known is that a year after Phillips published his article, an Australian, Wilfred Edward Graham Salter, published an article examining the issues of full employment and balance of payments equilibrium in a small open economy.[1] The key features of this framework are as follows:

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[1] Salter W E G (1959) "Internal and external balance: The role of price and expenditure effects", *The Economic Record*, Volume 35, Number 71, August, pp.226-238. Salter's paper acknowledges the work of another Australian economist, Trevor Swan, and the analysis is sometimes referred to as the "Salter-Swan" model.

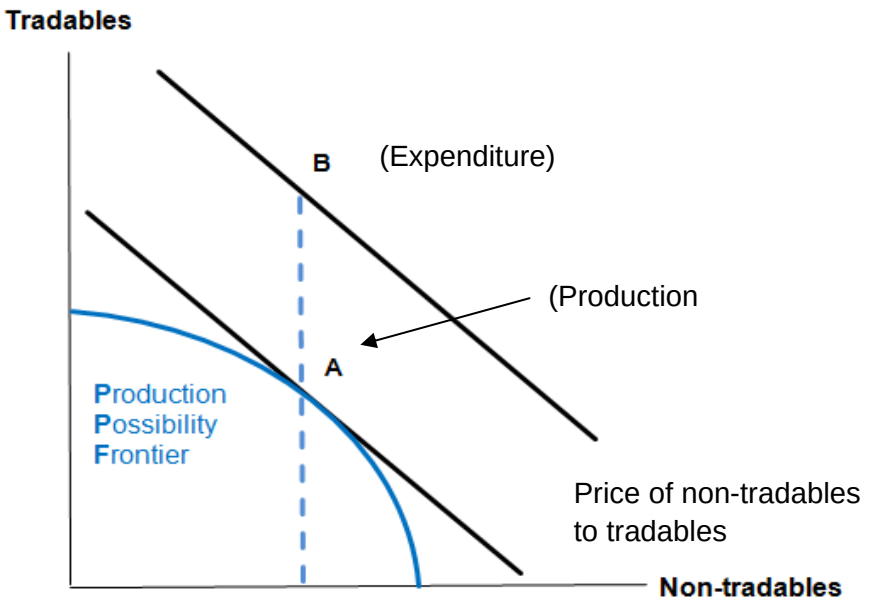
- Tradables are goods and services that are relatively more exposed to foreign competition than non-tradables. Tradables include both exportables and importables. Non-tradables are typically services, although some services are tradable.

- The amount of tradables and non-tradables produced is determined by technology, the amounts of labour and capital, and natural resources.

- The combination of tradables and non-tradables produced, as well as the combination consumed, depends on their relative price, which corresponds broadly to the ratio of domestic prices to world prices – what economists term a "real exchange rate".

Salter's 1959 paper labels the point where the demand and supply of both tradables and non-tradables are equal as "the kissing-tangency point" and further describes it as "a rare and delicate creature". Of course, for New Zealand, the "creature" in the form of approximate balance in the current account – let alone surpluses – has been extinct since the early 1970s and so the diagram shows a situation of internal balance and external imbalance – the gap between points A and B. Point A is where we are producing and B is where we have been consuming.

Figure 1: "A rare and delicate creature"



Salter noted that over time there would be a tendency toward both internal and external balance. This would involve bringing expenditure and production closer together and, as is typically the case in economics, a change in the relative price.

Changes in economic thinking and the nature of the economy mean this framework has evolved in a number of ways:

- The boundary between what is tradable and non-tradable is not fixed – especially compared to 1959!

- For a small economy, tradable goods provide access to bigger markets, economies of scale and therefore opportunities to raise productivity performance. But there is

also considerable scope to improve productivity in non-tradable areas, including government.

- Although sustained external imbalances increase the stock of net external liabilities, the framework focuses on the real side of the economy and does not have an explicit financial sector. In part this reflects a past world of limited private capital flows and the assumption that external balance was equated with an actual balanced current account. In this regard Salter's analysis predates the so-called "consenting adults" view of the current account deficit, which became a touchstone for Australasian policy thinking.[2] Essentially the "consenting adults" view generally argues that current account deficits are not a concern if they reflect private saving and investment decisions.

Pushing out the frontiers

The Salter framework evolved to capture the role of asset prices, capital flows, expectations, and fiscal policy. Nonetheless, its central themes endure in how we consider and quantify issues such as the equilibrium real exchange rate and the path of the economy in both the short and long run. For example, the most recent IMF estimates for New Zealand (April 2010) suggest an exchange rate overvaluation of between 10 to 25 percent, depending on the methodology.[3]

Over the shorter term, Treasury's Budget 2010 central forecast was for recovery and growth in the next few years. Going into December's Half Year Economic and Fiscal Update it appears that households have been even more cautious than previously anticipated in our central scenario. This means that growth in the near future is likely to be even less driven by domestic demand than we expected earlier in the year.

Although we may have been slightly surprised by the apparent speed and size of household responses, this leg of the overall theme of rebalancing is not unexpected. A strong foundation for sustainable recovery will be one that is underpinned by greater national saving and more investment directed into productive enterprise, particularly in the tradable sector. Unfortunately, the high level of the exchange rate is holding back the scope of that sector to take up the slack created by weak household spending, so we are not as yet really seeing in a significant way the other leg of the rebalancing – the shift of resources to tradables.

The Government's aim is to foster a sustainable lift in economic performance through: developing a growth-enhancing tax system; better public services; support for science,

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[2] This approach is often associated with John Pitchford and Max Corden. The "intertemporal" view of the current account emphasises that these saving and investment decisions are based on expectations of various macroeconomic variables, including future income. Arguably, Salter's analysis is not necessarily at odds with these views if one applies a richer perspective to the drivers of external imbalance and accepts that there is uncertainty about how large the long-run net external liability position should be.

[3] The Peterson Institute for International Economics has put the overvaluation at 25% http://www.petersoninstitute.org/publications/interstitial.cfm?ResearchID=1705.

innovation and trade; better regulation, including regulations around natural resources; investment in infrastructure; and improved education and skills.

In the Salter framework, policy reform in these areas works to expand the capacity of the economy. Furthermore, shifting resources into the tradable sector might well have a positive effect on productivity growth. But sustained growth, akin to a continuous outward shift of the production possibility frontier, will require improvements across the entire economy.

Between now and the end of June 2011, the Treasury will begin to outline the broad direction of our policy advice on key economic issues. Our views will be entering into a growing pool of thinking – including the recommendations of independent advisory groups such as the Savings Working Group, the Welfare Working Group the 2025 Taskforce.

Given the nature of the challenges faced by the New Zealand economy there will inevitably be a need to push the boundaries of the policy advice frontier. To assist and inform public debate, the Treasury has recently published an issues and options paper on savings in New Zealand and a joint paper with Statistics New Zealand looking into New Zealand's labour productivity performance relative to Australia. Treasury will continue to publish further research papers in coming months on: economic imbalances and vulnerabilities, the drivers of our exchange rate and interest rates, the size and structure of government, fiscal rules for government spending, and estimates of the structural fiscal balance. I'll focus on a subset of these papers today.

The paper on economic imbalances sets out the available evidence and how the features of New Zealand's economy and institutional arrangements influence resilience and the confidence of external creditors.

The exchange rate papers compare the behaviour of the New Zealand dollar against other relevant currencies, examine the key drivers of the exchange rate, and assess the policy options. Given the fundamental role the exchange rate plays in the New Zealand economy it is a policy area where we need to be open to new thinking and developments.

And Treasury certainly is open to any ideas, new or old, that could assist the non-tradable to tradable shift. But in keeping with the conclusions of various investigations in recent years, there is not yet a compelling case for New Zealand to change its exchange rate regime, especially when one takes into consideration the requirements for implementing alternative arrangements. The case of Singapore, with its large balance sheet and ability to influence short-term capital flows, is the most obvious example of an exchange rate regime that we cannot easily copy. And even Singapore would be the first to admit that its ability to resist market pressures on its exchange rate is definitely limited.

Finally, our work on the size and structure of government notes that after falling over the 1990s, the share of core Crown expenses to GDP has increased since the turn of the century, from around from around 31% to around 34% of GDP in 2010. Raising the tax or debt needed to finance this expenditure reduces the benefits to New Zealanders from saving and investing and, therefore, dampens our economic growth prospects.

While the economic growth effects of government expenditure depend on the type as well as the level of expenditure, reducing some types of expenditure is likely to boost growth. The government does need to balance economic growth against wider social objectives. But the economic costs of financing expenditure, and the upward pressures of an aging population on expenditure, means that now more than ever expenditure programmes need to meet a high burden of proof.

It's (mostly) fiscal

Of course fiscal policy by itself can't make us rich. Just as balancing the household's cheque book won't make the household prosperous by itself. Nevertheless, getting the household's books in order markedly reduces the risks of it being derailed by the sorts of adverse shocks families and countries face from time to time. And the public sector of course forms a very large part of non-tradable activities, so it is important that it plays its part in the switch we need.

A transparent and reliable medium-term fiscal framework enables investors, potential investors and businesses to make their investment, savings and employment plans confident in the knowledge that the Crown is not going to change the rules half way through the game, potentially seriously disadvantaging them.

In Budget 2010, we were not forecasting a fiscal surplus until 2015/16. This, combined with our net external liabilities as a nation, makes our position vulnerable. One clear lesson of the global financial crisis was that countries with strong fiscal positions were able to respond much more effectively. New Zealand avoided a credit rating downgrade largely due to a comparatively strong fiscal position which balanced concerns about our high level of private sector indebtedness.

The unfolding situation in parts of the Euro area is also a reminder of the risks posed by a combination of economic and fiscal vulnerability. We have many policy factors in our favour to be sure: a flexible exchange rate; a strong Government balance sheet; responsive monetary policy; flexible labour markets; and the fact that our Australian-owned major banks have strong balance sheets.

However, there is no scope for complacency. If things had gone a little differently, external factors could have forced a sharp domestic correction of imbalances. In such a scenario, household spending, and the tax base, would have come under more pressure than they did.

But even in the absence of a shock, fiscal policy can play a supportive role in assisting the economy to a higher and more sustainable growth path. A faster exit from expansionary fiscal policy settings over the next few years would mean interest rates will not need to rise as fast as they otherwise might, which will in turn assist to dampen the exchange rate cycle in the economic upturn. For those of you with any doubt what facilitating an easier monetary stance can do for the exchange rate may I point you to the recent US experience.

For many advanced economies the recent cycle has once again highlighted the ongoing challenge of how to run fiscal policy through both the "good times" and "bad times". In the case of New Zealand, during the latter part of the last cycle the Reserve Bank was quite open about the fact that large increases in government spending were

a factor behind the need to contain inflationary pressures. Higher interest rates in turn reinforced a relatively high exchange rate over this period.

As it turned out, the tradable sector has been largely stagnant over the past decade, while the non-tradeable sector, including the public sector, expanded. While it is true that New Zealand wasn't unique in this, that shouldn't diminish concern.

Restraint in future spending arises because although the fiscal accounts were strong going into the GFC, New Zealand has experienced one of the largest changes in the OECD in terms of shifting from surplus to deficit. This was made up largely of permanent tax and spending initiatives, not temporary fiscal stimulus.

In the financial year that ended on 30 June 2010, the baseline operating spending of the core Crown – that is to say departments, ministries and funding for public services such as health and education, but excluding State Owned Enterprises, was $64 billion, or about 34 per cent of GDP. That's around $15,000 per capita.

The Government has committed to limiting the increase in discretionary spending – in the form of the operating allowance – within a maximum of $1.1 billion per year (growing at 2% per year). Even so, Treasury projections show the Crown's net debt rising sharply over the next few years before gradually returning to a more prudent 20 per cent of GDP by the early 2020s.

This lower operating allowance compared with recent years has seen the Government reduce the amount of new operating funding available to almost all state agencies. Indeed, most agencies will not be receiving any new funding.

A direct positive spin-off for both taxpayers and the wider economy of the lower operating allowance is that, over time, this will embed a greater focus on efficiency, effectiveness and innovation as a priority for all state sector agencies with spill-over effects for total productivity in the economy given the state sector is such a large component of the total economy.

Finding efficiencies and sticking to the $1.1 billion operating allowance is relatively easy to achieve in the short-term. But with each passing year, the task of finding ever more efficiencies within baselines will get tougher. In addition, attention will need to be paid to the Government's capital spending and the efficiency of its overall balance sheet. With something like $230 billion of Crown assets involved the way we manage these can make a big difference.

Another avenue for managing the fiscal situation is to strengthen the framework that policymakers work within, including the role of the operating allowance.

There are a number of spending areas that have historically been treated as being outside of the direct or immediate control of Ministers and which have increased Government spending in any given year, sometimes by significantly more than the total size of the net operating allowance. Many of these spending areas have elements of automatic price indexation and/or defined entitlements that are sensitive to fluctuations in uptake. Examples include welfare spending, KiwiSaver, and formula-driven funding for educational institutions.

In the past the spending growth in these areas has simply been updated, passed through and has not been required to be directly traded off against other spending via the Budget process. If we look at the growth in core Crown expenses, excluding one-off non-cash items, we can see annual increases of between $3 billion and $5 billion between 2004/05 and 2008/09, but with the proportion of those increases not covered by the operating allowance growing from around 20% to almost 50% in 2008/09.

In some cases it would not be appropriate to trade off these items with discretionary spending within the operating allowance. For example, offsetting higher than expected unemployment spending would work against the so-called automatic fiscal stabilisers. But in other areas it may be appropriate to weigh up these forecast changes against choices being made within the operating allowance.

Finally, New Zealand, like many other developed economies, will face accelerating fiscal pressures related to population ageing, starting from this year.

We have no doubt that adjustments will be required in the years ahead to get the long-term fiscal projections onto a sustainable footing. But in order to meet the fiscal challenge, the government will have to make changes to what it does, not just how it does it.

Conclusion

Many elements of the somewhat uniquely Australasian economic thinking started in the late 1950s had a formative influence on economic policy thinking in the two countries, including my own and the Treasury's. Indeed, many of the economic policy changes that I have closely observed or been involved with can be seen in the context of the framework outlined above:

- Reforms to trade protection to reduce the implicit tax on exporters;
- Increasing product market competition and labour market reforms to improve resource allocation;
- Tax reforms to improve investment and saving decisions;
- Monetary policy reform to keep inflation low and stable; and
- Fiscal policy reform to increase transparency and sustainability.

The world has changed significantly in the last 50 years: the emergence of a multi polar global economy in the wake of the demise of empires; declining barriers to cross-border trade in goods, services and investment; commodity shocks; deregulating economies; one world via the internet; and financial shocks.

And because the world changes and because our perspectives on the economy change, it's vital to test our frameworks and policy settings regularly. Of course, this is a wide ranging brief that captures Treasury's work as well as the analysis of others, both domestic and international. For example, just days before the announcement that Professor Peter Diamond was to be awarded the 2010 Nobel Prize in Economics, Professor Diamond was at the Treasury sharing his views on tax and saving policy.

In terms of macroeconomic policy, the tyres have been kicked through the work on Supplementary Stabilisation Instruments, the Finance and Expenditure Committee Inquiry into Monetary Policy, and the 2006 Macroeconomic Policy Forum hosted by the Reserve Bank and the Treasury.

The Treasury, in-conjunction with the Reserve Bank and Victoria University of Wellington, will in June 2011 host a high-level policy forum whose main purpose is to obtain a better understanding of New Zealand's macroeconomic imbalances. In many ways the keynote speakers will bring us full circle in connecting current economic thinkers back to Phillips and Salter. For example, one of the keynote speakers, Professor Sebastian Edwards (University of California) also participated in the 2006 Forum, and has stated that:

> …there is a generalised belief among New Zealand analysts that in spite of all the structural reforms, there has not been enough adjustment. In particular, there is a feeling that the tradables goods sector, or more precisely exportables, has not responded in the way that was expected, and has not become the most dynamic sector in the economy. … Moreover, the recent New Zealand pattern of sectoral growth can hardly be considered as sustainable in the long run. There is, in fact, little doubt that in a small country with factor endowments such as New Zealand's the bulk of growth should come, in the future, from exports.[4]

So it seems appropriate that these issues are the subject of further analysis, notwithstanding that Sebastian wrote these words in 1990.

Another key note speaker for the 2011 forum, Professor Philip Lane (Trinity College in Dublin), comes from an economy in the midst of a significant banking and fiscal crisis. Philip has worked extensively on external imbalances, fiscal policy and real exchange rates. Finally, Professor Craig Burnside (Duke University in North Carolina) will bring perspectives on the role of asset prices and housing markets.

I will look forward to seeing how contemporary economists build on the work started 50 years ago – and in particular, the lessons emerging from the global financial crisis, the role of global imbalances and adjustments; and the perspectives provided by an increased focus on balance sheets – both private and public sector.

When Phillips and Salter were writing their articles the New Zealand and Australian economies were broadly level pegging in terms of per capita GDP. Regardless of how one interprets their economic thinking in today's context, we know the paths of per capita GDP in the two economies have diverged markedly. That gap, and the risks associated with our large net external liabilities represent major challenges.

The direction of change from here is, in the assessment of the Treasury, clear.

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[4] Edwards S (1990) "Stabilization and structural adjustment in New Zealand: Some analytical aspects", paper prepared for the New Zealand Treasury, August.

The Treasury's responsibility to Ministers is to provide advice on the fiscal, economic and regulatory policy settings required to raise our economy's potential growth rate, to increase our per capita growth performance and, ultimately, to elevate the living standards of New Zealanders.

To close the gap with other countries, with which we typically compare ourselves, requires something in the order of a 4 percent annual real GDP per capita growth rate. The Treasury will be outlining the direction of our thinking in terms of growth enhancing policies that will give us the best chance of achieving this type of growth rate. Over the next little while I plan with senior Treasury colleagues to outline the direction of what that growth-enhancing advice will be.

Today, I hope I have made clear that it is fundamentally important that we regularly assess our fiscal settings in the light of new information about what other governments are doing and how our relative fiscal position stands and will stand in the years ahead.

It is critically important to ensure that governments' fiscal policy settings maximize the chances to fully leverage the benefits offered by the adoption of specific growth-enhancing policies.

Thank you. I am happy to take your questions.