CONCLUDING COMMENTS
TO THE MACROECONOMIC IMBALANCES CONFERENCE

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I should like to begin by congratulating the organisers of the conference. There has been an open, vigorous and flowing debate, reminiscent of the New Zealand economics community of the 1960s and 1970s, where a wide range of views were presented as diverse as Wolf Rosenberg on the left through to the economic rationalists on the right, but where the views and their presenters were treated with respect and courtesy, where evidence was given a lot of weight and theory was tested against it, and where ideology was not prominent. I am glad we are moving back to that past.

The big difference is the leadership in this debate has been dominated by overseas economists; while the external contributions were welcome I wonder where the local leadership was.

Early in the conference there was reference to a tight monetary stance in much of the last decade. I want to argue that to the contrary, the monetary stance was dangerously loose. I am referring to international monetary conditions of course, but it raises the question of whether domestic monetary policy can insulate New Zealand from the world. It is a question we need to debate. When doing so, it is worth recalling the belief a few decades back that we could insulate product markets from the world's. We found we could insulate some, but at a cost of intensifying the exposure of the rest of the economy.

Whatever the conclusion of that discussion, we failed to insulate New Zealand over the last decade. We may discuss why that happened, whether we could have done better, whether the costs of doing better would have intensified the pressures on the rest of the economy. Instead today I want to ask about the consequences of loose international monetary conditions on the New Zealand economy, and the fact that one way or another it was easy for New Zealanders to borrow offshore at interest rates they considered favourable.

I am going to explore this statically and dynamically. The static analysis is to look at the nation's balance sheets. It is generally agreed that our external balance sheet is problematic; certainly the credit rating agencies and, behind them, the offshore lenders think so. Their assessments may be subjective or wrong, but whatever our objective assessments, their assessments are over-ridingly important if we want to keep borrowing.

If the external balance sheet has problems, that means that somewhere among the domestic

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balance sheets that make it up there are some which have problems too. As far as I can assess, the corporate balance sheet is broadly sound, as is the financial balance sheet (now that weak finance companies have collapsed out of it). The farm balance sheet is OK, providing export prices remain high. Subject to a caveat I'll mention shortly, the central government balance sheet is also strong, although it is deteriorating. I don't know much about the local government balance sheets, but if they are weak the sector is not large enough to cause all of the external problems. I conclude that the external balance sheet problem is largely matched by weaknesses in the position of households and small businesses Not all of them, but I am guessing that those of the bottom quartile – and perhaps higher – are hardly robust.

The reasons include leaky buildings, the Christchurch earthquakes and the finance sector collapses. But undoubtedly the main one is the over-borrowing of households and the over-valuation of house prices, which are now slowly falling in real terms. The over-borrowing and house price inflation were due to easy access to credit consequent on loose international monetary conditions.

The household balance sheets do not look so bad when human capital is added. That of course assumes that unemployment remains low, but even if it does, the offshore financial community cannot lend against human capital – that requires slavery – and what they are doing is looking through our external account to the financial and physical part of the household accounts and are concluding – in my view correctly – there is something to be worried about. So are the public – for they are deleveraging, that is, trying to improve the quality of their balance sheets by saving more.

Earlier I said there was a caveat about the central government balance sheet. The record is that when the private sector gets in trouble the government commonly bails them out. (This is not unique to New Zealand; Wall Street turned to the US Treasury in 2008.) This propensity of the public balance sheet to be a backstop to the private sector is the reason why the offshore financiers are not as happy with the government's position as they would be if the household balance sheet were stronger. (As a technical point, the government has the ability through the tax system to levy human capital, providing there is not high unemployment and some political willingness.) The implication is that the government needs to include in the calculation of its optimal balance sheet an allowance for the state of the private one. Macroeconomic considerations aside – I turn to those in the next paragraphs – as the private sector's borrowing rises, the government needs to run a bigger surplus, unless that private borrowing is matched by good quality assets.

Thus far it is the static story. The dynamic account observes that borrowing is a source of foreign exchange not unlike exporting, so borrowing can crowd out exporting, which it does by driving up the exchange rate. The model here is akin to the so called Dutch disease or Gregory-effect models, where a new export sector crowds out the traditional export sector. Application of the model is usually where the new sector is unsustainable, although it applies more generally. (For instance the rise of refrigerated products at the end of the nineteenth century probably squeezed import substituting manufacturing.) However, in the case of borrowing, the foreign exchange generating may actually reverse as the debt is serviced and repaid.

Now the real exchange rate is the inverse of the tradable sector profit rate. (As an aside I accept the discomfort of mentioning ‘profit’, despite it being central to the capitalist system; I think this the first mention of profit at this conference which, in my opinion, is like a demography conference not mentioning sex.)

A less profitable sector has neither the incentive to expand, nor the internal cash flow to do so, so faced by a high exchange rate the tradeable sector under-performs. Is it no accident that our share of world exports has halved in the last 30 years. We have not been backing fast horses.

A number of presenters have talked about the contribution of the tradable sector to growth, but let me add its most important role. Economic development and economic history both draw attention to the role of a leading sector which drags the rest of the economy along with it. As a general rule – although there are exceptions – the leading sector in a small open economy is in the tradable sector, particularly the export sector. If we have offshore borrowing stagnating the tradable sector via the poor profitability as a result of the high real exchange rate, there may be a temporary stimulation of the economy by additional consumer spending and a property boom, but in the long run there will be poor economic performance. One looks at the performance of the New Zealand economy and concludes QED.

There are a couple of other matters I want to cover briefly . One is that there was much talk about stabilisation but insufficient consideration about stabilisation around what? Getting the medium term trend is critical, well shown by the failures of various international commodity price stabilisation schemes which tended to have overly high expectations of the average price level. (We need to distinguish stabilisation from smoothing.)

In terms of the current situation I want to suggest that the Global Financial Crisis seems to have changed our expectations of the medium term growth track of the economy. I dont think it has changed the growth rate much but the new growth track seems to be lower than the one we thought we were on before 2008. My impression, based on some Treasury work but including an allowance for the Christchurch earthquakes, is that the new track is between 4 and 8 percent lower than the old one. Probably what will happen is that we will go through a period of stagnation or long recession (I hope not depression) for about six and more years in the transition from the high to the low track. A number of issues come out of this, but a crucial one is how we lower expectations to the more subdued economy we are facing.

I’ll be developing this argument at a seminar in about a month; here my point is we need to pay attention to changes in the medium term growth track and conclude that if it involves a step-down we need to accommodate our expenditure expectations; that is the reason why I have been particularly strong advocate of fiscal restraint in recent years.

The final issue I want to address briefly is the proposal of a fiscal commission. There are a number of variants of the proposal; many seem to me to be based upon different constitutional arrangements from those which we have in New Zealand. I have two objections.

First, if the commission is to in some way replace the Treasury I see no need for the duplication. Second, I would have thought one of the themes of this conference – one of the things we have learned since the 1980s – is that fiscal and other macroeconomic policy areas cannot be compartmentalised; it would be retrogression if we were to silo fiscal policy again.

If we need another economic agency it is one to mediate between the official economic agencies and the public, perhaps like the Monetary and Economic Council established in the 1960s. There is an enormous disconnect between the what we economists are talking about and what the public is hearing; I do not think that healthy for a democracy. Such an agency might assist in a reconnection, to help the public understand the issues and to help us understand better the public's perceptions and concerns. .

Illustrative of the disconnect is that the economics profession is, I'm afraid, not trusted by the general public. For instance I personally support mixed-ownership SOEs (in order to deepen our capital markets) but the public does not; the standard reaction is 'you [who?] betrayed us twenty years ago, and we dont trust you to this day.'

Even if we could trust the politicians to appoint to such a council a group who were competent and had a high degree of trustworthiness (rather than the political acceptable and politically correct), it would take the public a long time to warm to it, especially as it would have some tough things to say – like you cannot repeal the laws of thermodynamics, that borrowers need lenders. And yet any new agency in this area would be useless unless there was some public respect for it.

The development of forums such as these may ultimately lead to the profession regaining some of its public status. I fear however, we threw much away twenty-five years ago, and it may take us as long or longer to reverse what has happened since.