Why New Zealand languishes[1]

A speculative hypothesis about our economic decline[2]

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On pretty much any measure, New Zealand was for several decades in the late 19th century and early 20th century among the handful of countries with the very highest average incomes. In the early decades, some of those estimates were probably flattered by compositional effects - few old people, lots of single men, generating higher GDP per capita for any given output per hour worked. But it was more than just compositional, especially as time went on.

We aren't any longer among the highest income countries, even though we have:

- Inherited institutions and social infrastructure that in other similar countries have continued to produce among the very highest levels of incomes (over the last 150 years, Anglo country incomes on average are rivalled only by those in a handful of countries themselves not too culturally dissimilar (eg Netherlands, Switzerland, Belgium).
- Kept in place the rule of law and a reasonably strong respect for private property rights. The record has been far from perfect (one can think – partly to taste - of the oil nationalisation, the RMA, the CERA Act, or the Telecom or Akld airport cases as some examples), but not obviously worse than in most other OECD countries.
- We haven't let the size of government become impossibly large - towards the more modest end of the OECD rankings, and on some measures (eg tax to GDP) not now much larger than it was 60 years ago.
- We've managed to be one of a small handful of continuous functioning democracies, avoiding both revolutions and (at least since the 1860s - the same time as the US Civil War)- the destruction wrought by war in our own country.

In the very long-run, there is probably no reason for despair, or for resigned acceptance of our lot (which I fear is becoming the default position of those who hold the commanding heights in political, academic, and bureaucratic New Zealand). Prosperity is largely determined by people and their deep-seated longstanding cultures and institutions and the technologies those supported (the Easterly et al line about the foundations of a people's prosperity being laid very long ago)

We have seen examples where the relative standing of individual countries has deteriorated for a long time - and by further than New Zealand has - and the decline has eventually been reversed. On Maddison's estimates, Spain, for example, had per capita GDP of 70 per cent of that of the US in 1800, reached a trough of around 25 per cent in the 1940s, and was around 55. per cent in 2010. Chile is beginning to look like another example.

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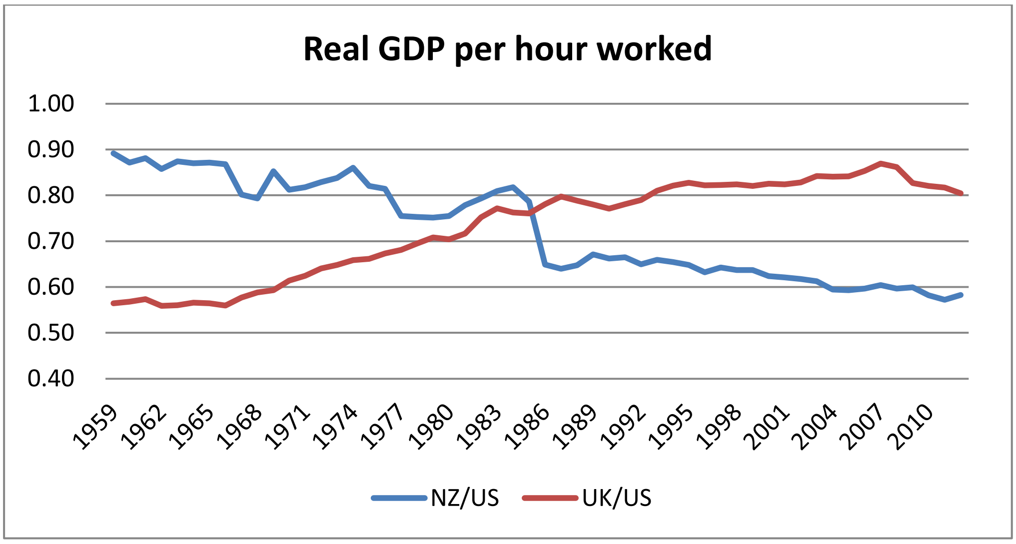
[1] A title prompted by the great value I gained from reading Ian McLean's recent book on long-term Australian economic history, *Why Australia Prospered*

[2] This paper can be read together with my paper for the recent RB/Treasury exchange rate forum (http://www.rbnz.govt.nz/research/workshops/Mar2013/5200823.pdf).

On a less dramatic scale the UK is particularly interesting because of the strong political, cultural and economic ties between the UK and New Zealand. The UK led the Industrial Revolution and had among the very highest living standards for most of the 19th century. Then it went into several decades of relative decline. But the last half century - even including the last few difficult years - have been those of British renaissance. A general and specific story that explains this chart - the decline in relative productivity in New Zealand since 1960 and the rise of the UK - would be a significant contribution.



Mostly, relative decline doesn't just happen. It is mostly the result of choices, and mostly those of politicians. Hardly any political leader has ever set out to make his or her country (relatively) poorer. But many did so. So intent or beliefs aren't what really matter. Effects are. And it is only rarely one single thing that makes a country much richer or much poorer - as McLean argues for Australia, it is often a succession of interacting choices and factors..

So recoveries can happen - not overnight, and typically not without making choices to do something different. Perhaps Argentina and Uruguay might even once again be able to be among the relatively rich. But New Zealand certainly can. Australia provides a good benchmark - not one of the very richest or highest productivity countries in the world, but one that has largely held its own through the post-war 70 years.

New Zealand often hasn't helped itself. Some ways are well-recognised now.

I have in mind particularly the far-reaching regime of import licensing put in place from 1938. Standard literature tells us that licensing regimes of this sort are deeply inferior to tariffs, but whether it was tariffs or quantitative controls, such heavy import protection was a deeply flawed choice, most especially in a country of only around 2 million people. The effective rates of protection for final products were very high even quite late (1970s and 1980s) and the effective tax on the export sectors was also considerable (later in the period, counterbalanced with quite expensive subsidies for manufacturing exports). Investment patterns were deeply skewed, and external trade shares dipped to well below historical levels. It is not surprising to find Conrad Blyth already identifying weak TFP growth as a NZ issue in the early 1960s.

Often referred to in the same breath as import licensing, our foreign exchange controls were another part of the story. Here the point is not mainly about capital controls - ours **in isolation** were probably largely irrelevant for several decades - but about the use of current account controls as, in effect, demand management tools. It was as late as 1982 that Muldoon finally adopted current account convertibility. Singleton argues that New Zealand relied heavily on exchange controls for longer than other advanced countries. Reliance on controls of that sort went hand in hand with quite severe and inflexible financial sector controls - though never loan-to-value mortgage restrictions on private sector lenders. More than in most OECD countries, interest rates were almost completely eschewed as a rationing device, in favour of things like capital issues controls and hire purchase restrictions.

For several decades New Zealand experienced persistent excess demand. Extremely low unemployment – "bearing as much resemblance to true full employment as high blood pressure does to normal blood pressure" (Low 1961) - was the most visible symptom of this, detracting from the efficient operation of the labour market (including investment in skills), and of business more generally. Inflation wasn't particularly high by international standards, but keeping it in check involved squeezing out some spending - partly no doubt finished consumption goods, and probably also high TFP investment in export-oriented business sectors. We probably didn't help this by markedly appreciating the nominal exchange rate in 1948 - nominals don't change reals in the long-run, but aren't irrelevant in short-medium term either (especially with quantitative restrictions)

For any given level/pattern of desired demand, we had to squeeze as we couldn't borrow. Historically, New Zealand was very dependent on foreign capital - substantially the flipside of the 80-90 years in which general government debt was extremely high (above 90 per cent, and at Depression-era peaks over 200 per cent of GDP). Foreign holdings of government debt alone in the 1930s were in excess of 100 per cent of GDP. New Zealand had relied on its, usually quite ready, access to the London market, deepest in the world then and most readily available for Dominion issuers.

But the post-war decades saw the lowest reliance on external finance in our history (before or since). People will read the fragmentary data in slightly different ways: my take is that the external finance that was raised was increasingly in the form of equity (FDI into the heavily protected sectors[3]) while government debt was run down. With BOP estimates of net income flows abroad of around 1% of GDP (and perhaps a 10% return on equity), it seems a reasonable provisional judgement that the NIIP to GDP ratio was no more than 10-20% of GDP for the entire period from 1950 to the early 1970s.

[3] And thus the odd contemporary debates around foreign investment in New Zealand and Australia. So much of the NZ FDI was coming into highly allocatively inefficient sectors that even if foreign investors were briging knowledge/skills etc that domestic investors might not, it would probably have been better still if most of the investment had never happened at all. And yet Brash/Deane favoured such investment and Rosenberg/Sutch were very wary of it (Sutch's book *Takeover New Zealand* emerging in 1972 around the probable all-time trough in the NIIP).

The NIIP wasn't low because demand was weak (see the labour market, or Low's 1968 statement that it was clear that interest rates should have been higher for most of the preceding 20 years). It wasn't low because a contagious enthusiasm for savings overtook New Zealanders. It wasn't low because a static or aged population weakened the need for investment. Or because heightened policy uncertainty temporarily dampened investment and raised savings. Largely, it was low because there was no effective choice. . Debt markets just weren't functioning the way they had. And the heavy tax on the export sector (combined with entry restrictions such as single-desk sellers), and state monopolisation of various sectors (eg coal mines, electricity, airlines) limited the potential scope/scale of FDI - manufacturing was a ready avenue for FDI, but the rapidly growing housing stock wasn't.

New Zealand was part of the sterling area. The sterling area meant that, in effect, countries like New Zealand held their reserves in the UK, and the UK managed the overall pressure on sterling against (primarily) the USD. Strong New Zealand export receipts from third markets (the UK took around 50-60% of exports by 1960) obviously improved NZ incomes, but they also eased the foreign exchange constraint (a key phrase in the NZ economic debate of the time) for the sterling area as a whole. And, on the other hand, increased effective demand in New Zealand put pressure on the overall sterling area reserves. Despite the deeply devalued real sterling exchange rate (itself a response to the inability of the UK to borrow after the war), the UK external position was never totally comfortable in the post-war decades. The New Zealand government needed permission to borrow in London - and all else equal, increased borrowing by New Zealand, meant increased sterling area imports and a net loss of dollar reserves. The British did not seek to be unduly restrictive - they regarded the continuing operation of the sterling area as in their own interests - and New Zealand identified quite strongly with those interests[4] but access to traditional debt markets was quite limited.

Of course, there was the US market. I don't yet fully understand why we couldn't/didn't borrow more directly there, although it is worth bearing in the mind that the scale of all global cross-border debt flows was very severely reduced post-war and there was no history of NZ raising money in New York. Some NZ debt was raised in the US in the late 1950s, but only on quite onerous terms. Easing the borrowing constraint was a significant feature in the recurrent debates in the 1950s and early 1960s about belatedly joining the IMF and World Bank. The World Bank was introduced to the debate around financing Tasman, and when NZ did finally join the IMF in 1961, amid vociferous opposition from many, easing the borrowing constraint was a key explicit element driving the government of the day (not just remote and precautionary as we might see our membership of the Fund today, but "we might be able to borrow in 12-18 months' time").

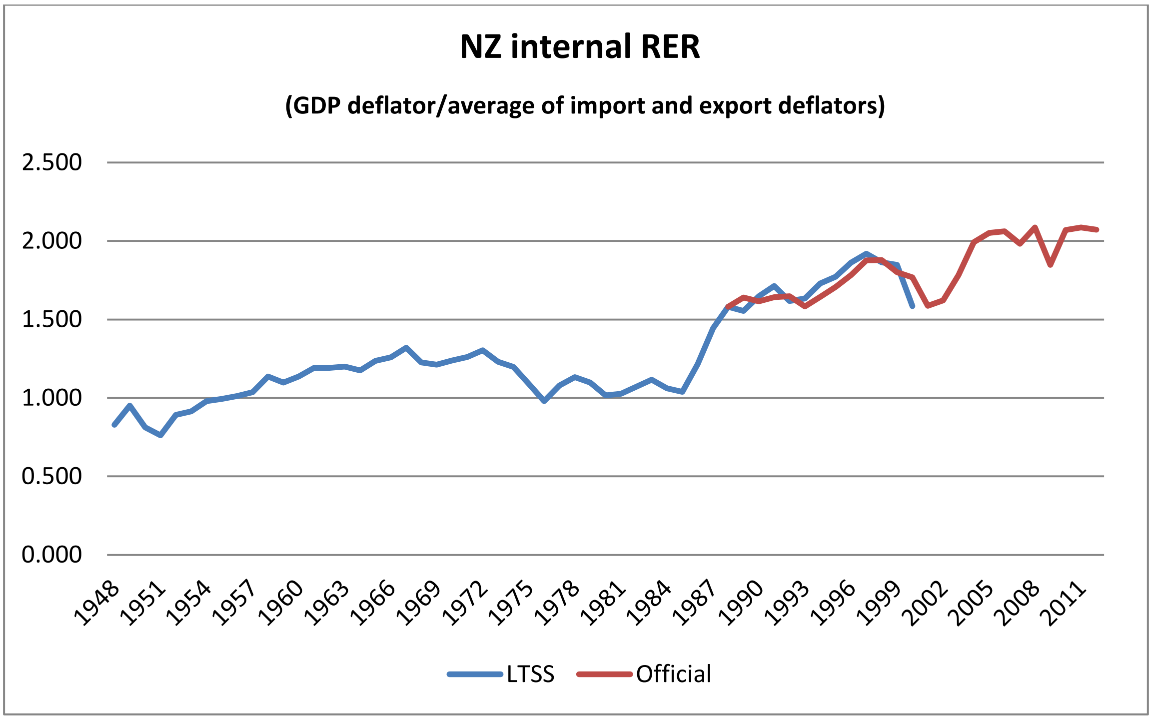
The limited ability to borrow translated into an approach to macro management that moved ("lurched"?) from one period of pressure on the foreign reserves to another. A huge adverse terms of trade shock finally forced a nominal exchange rate adjustment in 1967, but for the most part the mix of financial controls kept the incipient excess demand pressures in check, for aggregate economy purposes.

[4] See, for example, Muldoon's comments on the 1966/67 devaluation, around the perceived possible risks to the UK position.

This discussion means that I have concluded that I was wrong to make anything (as I did in my note last year on why are NZ interest rates so high, or in the recent exchange rate forum paper) of the fact that actual NZ interest rates had not been higher than those in other advanced countries until the post-liberalisation period. They should have been higher. The imbalance between desired savings and desired investment imbalance at the "world" interest rate would have warranted them being so in open and competitive financial markets. In other words, it looks as if the incipient excess demand pressures were similar in character in the post-war period, through to perhaps 1973/74, as they have been in the last 20 years or so. As in the last 20 years or so, so during the post-war period, there wasn't anything particular unusual about New Zealand's inflation rate (or, indeed, its aggregate fiscal policy).

In another recent paper, I built a discussion of the post-liberalisation period around the (lack of relationship) between a relative CPI-based external real exchange rate measure and New Zealand's deteriorating relative (terms of trade adjusted) productivity performance. An alternative way to look at the question is through the lens of an internal measure of the real exchange rate - the ratio of non-tradables prices to tradables prices. Several NZ authors (incl Easton and Bertram) have proxied this for NZ by calculating the ratio of a GDP deflator to the average of import and export price series[5].

One would expect to see this series trending upwards with economic progress - while there is plenty of scope for technological progress in the non-tradables sector generally, there are many more (labour-intensive) non-tradables items with limited scope for technical progress.

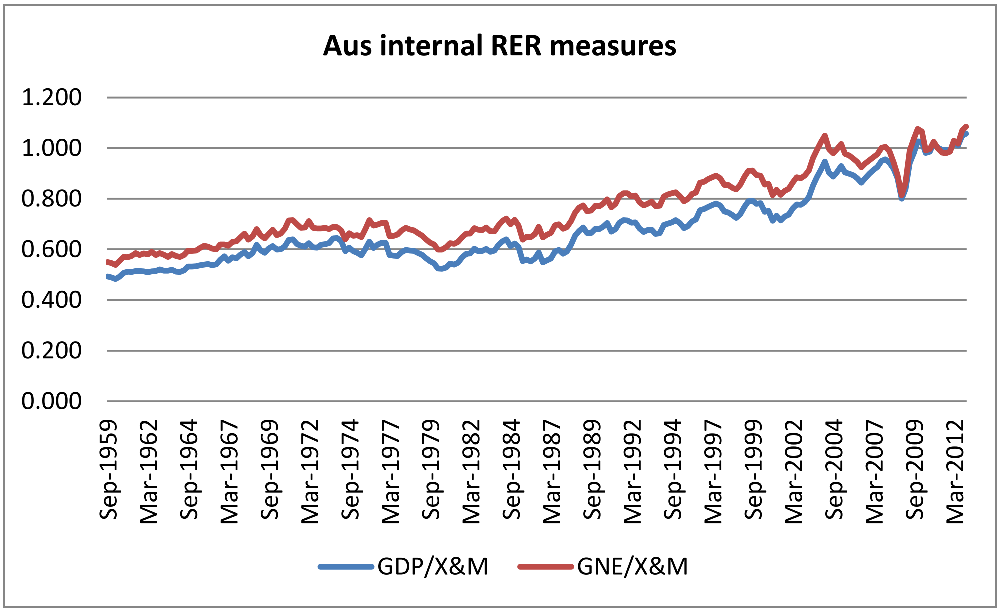


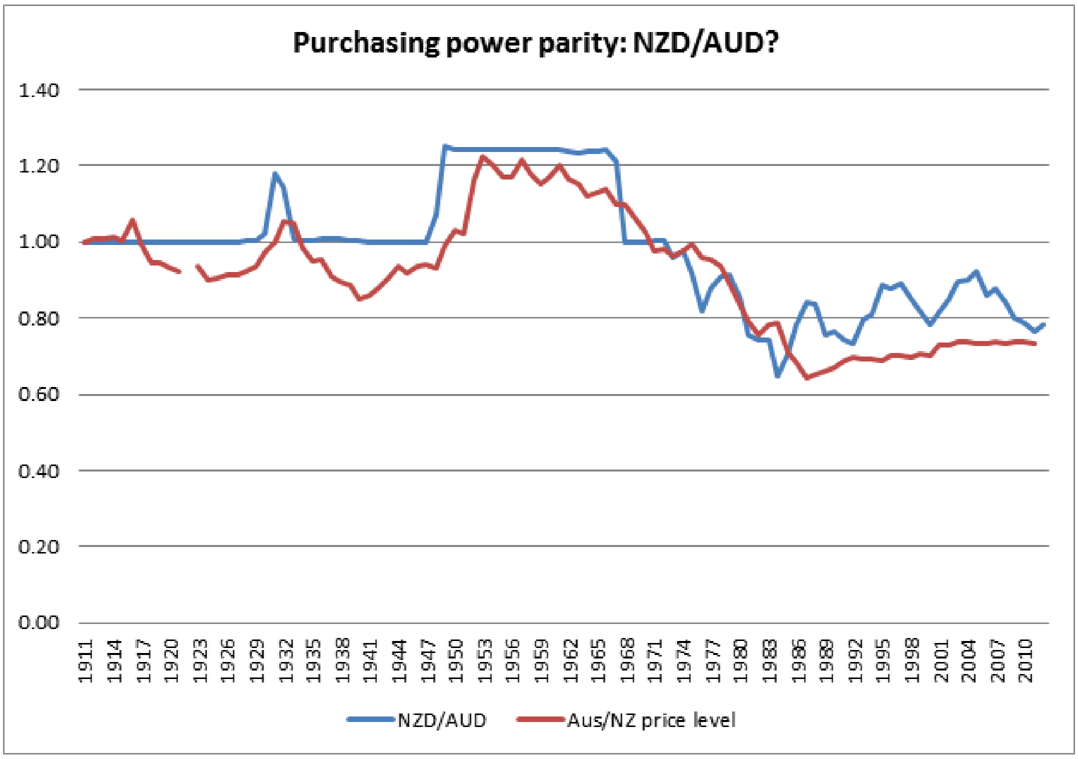
What is striking about the New Zealand chart is how strongly the line has trended upwards over most of the period, despite the very poor (relative to other countries) aggregate productivity performance. Australia has official national accounts deflators back to 1959, and over the period

[5] The pictures don't look materially different when GNE deflators are used in the numerator.

since then its internal real exchange rate appears to have risen about as much as New Zealand's (and consistent with that, PPP appears to have held on the NZD/AUD going back a century).

The Balassa-Samuelson hypothesis suggests that should not have happened. Discussion around Balassa-Samuelson tends to focus, in practice, on developments in the tradables sector.





If there had been a severe shock emanating in the tradables sector that had given rise to our deteriorating relative performance (climate change or disease, say, had rendered our farmers half as productive as they were before), then all else equal, we should have expected to see the classical Balassa-Samuelson response. The profitability of the tradables sector at world prices would have tended to shrink, driving down demand for labour and the market clearing wage, as non-tradables producers lowered their real wage offers to absorb the marginal additional available labour. The prices of labour-intensive services in the non-tradables sector should have fallen relative to (world-determined) tradables prices.

But real wages being set on the basis of productivity/profitability in the tradables sector is not a general proposition. Real wages should clear the labour market, and shocks can come from either sector.

What then if the most important series of sustained "shocks" (or, better, "pressures") over recent decades emanated in the non-tradables sector? If, for example, persistent strong domestic demand for resources (ultimately labour) – perhaps fuelled by a series of government policy choices (thus, not properly internalising all the costs and benefits) - had bid up the domestic price of labour, and crowded out investment and activity in the tradables sector? Real wages would tend to rise even if there had been no improvement in tradables sector productivity. It can't happen without limit, but it can happen for quite some time - and the reopening of access to international debt markets (from the 1970s in particular) extends how long the imbalance can run for.

Of course, over the decades New Zealand real wages have not kept pace with those in the rest of the advanced world - but in much of our discourse we implicitly accept that real producer and consumer wages are in some sense too high when - talking of external RER measures - the conventional wisdom accepts that there is a substantial long-run overvaluation of the real exchange rate.

Rapid population growth might tend to have exactly that effect, especially when the population growth is in the form of "people like us" - either our children, or relatively-skilled migrants. (Poor illegal unskilled Mexicans in Texas or California create a different series of demand/supply balance pressures.) That might be particularly so when new house-building was provided with strongly preferential access to credit.

But it isn't just the resource pressures associated with rising populations that can give rise to such effects. So too can government initiatives that directly skew demand towards non-tradables (thus the result in some of the literature that rising government consumption, whether or not the deficit changes, tends to lift the real exchange rate). Consider, for example, the huge increase in education participation (upper secondary and tertiary), and the change in teacher-pupil ratios (school system) over the post-war 70 years - education being labour-intensive and (to date) showing limited productivity growth. At least in respect of tertiary education, New Zealand went from having one of the lower participation rates to one of the higher (and as we know, even allowing for data problems, returns to tertiary education do not look particularly high in New Zealand). Same, in principle, could go for health spending or, indeed, imprisonment rate choices. Changes in private tastes towards, say, much larger houses will also tend to produce a rising real exchange rate - although, if purely a matter of private tastes, probably without any welfare consequences..

In looking for good stories that fit as many of the stylised facts of the New Zealand growth and financing story as possible, it is important not to let the perfect be the enemy of the good. Specifically, it is important to remember how few genuine data points we have in thinking about long-run growth performances of advanced economies. As Ian McLean notes in his book on Australia, cross-country parsimony is admirable, but often insufficient. We have to pay attention to the idiosyncrasies of individual country experiences, and of the possible role of combinations of circumstances. Thus, we know that natural resources have sometimes been a "curse", but in other countries - with good institutions - they have been a blessing. Context matters.

What of population and migration? We know that not all countries with fast-growing populations appear to suffer a material drag on growth in per capita income or productivity. One might think of Australia, for example, or (to a lesser extent[6] in the 20th C) the US. But neither is slow population growth, or even decline, necessarily inconsistent with rapid per-capita/per-hour growth (the Eastern European OECD countries highlighted in my recent exchange rate paper are examples). And we know that immigration can make a hugely positive difference to average incomes in the recipient country - one need only think of the counterfactual for NZ, Canada, the US, Australia, South Africa, Chile, Argentina or Uruguay without the Western immigration[7]. But that process involved, in essence, swamping the previous native population by importing immensely more successful and productive cultures (embodied in people from those cultures).

Successful countries (or regions) tend to attract people, and many people tend to leave home for more successful countries when they can. Since for its entire modern history, New Zealand has offered living standards vastly in excess of those in most of the world, the fact that people are interested in migrating here has never told us very much interesting about our own growth or con(di-)vergence prospects.

But we also know some other things. Dowrick and Nguyen, for example, found that rapid population growth in post-war advanced countries had come at some apparent cost in terms of per capita growth rates[8]. And that over recent decades, the OECD country with the very fastest population growth (and largest net inward migration) has languished with New Zealand near the very bottom of the OECD's productivity growth rankings (with per capita income very similar to our own). And the recent IMF working paper documents in more detail (longer time period, and individual sub-periods) the negative correlation between population growth and TFP growth - the gold standard of growth – illustrated briefly in my own recent paper[9]. Various studies suggest that net emigration from eastern European EU members has been good for the per capita incomes, or wages, of those remaining at home.

We also know that large one-off population shocks have been absorbed - whether the return to France from Algeria, to Portugal from Mozambique and Angola in the 1970s, or the post 1991 initial return of former Soviet Union Jews to Israel (though one idly wonders whether the same could be said for the post 1948 influx of Palestinians to neighbouring states). In none of those cases, of

[6] Lesser partly because of the five decade of very low inward migration in the US after WW1.

[7] Although in respect of most of those countries it is at least possible to argue that over the long sweep of history the migrants' descendants are not better off than they would have been if the migration had never occurred (NZ, Chile, Uruguay and Argentina all now having material living standards lower than those of the UK and Spain).

[8] Which in many ways should not surprise - choosing a third child rather than settling for two tends to lower that family's lifetime per capita accumulation of wealth.

[9] De Michelis et al is well worth reflecting on, even if it offers data to reflect on, more than definitive answers. The authors attempt to argue that one should be relaxed if higher hours worked growth, or population growth, reduce TFP growth – but never elaborate their argument. Labour has a disutlity, while TFP has none.

course, were the immigrants apparently a source of fresh dynamism, accelerating productivity and per capita growth in the recipient country.

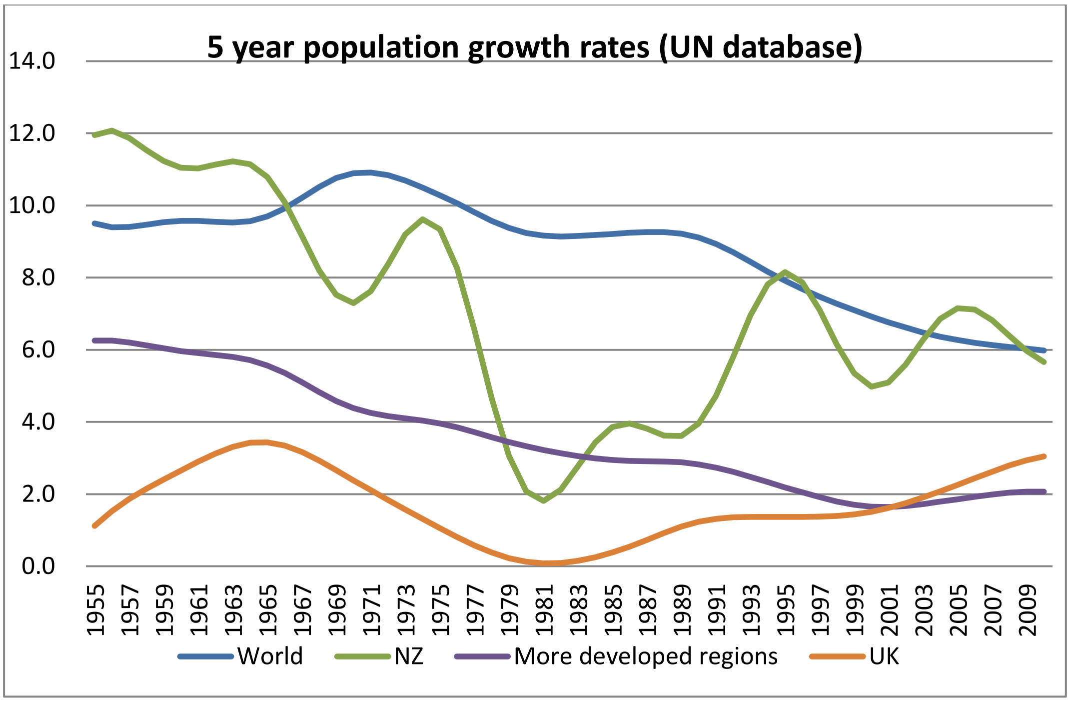
So when we approach the New Zealand historical story, we should be open to examining the specifics of particular historical periods and episodes, including the wider policy and economic context.

Much of the late 19th and early 20th century net immigration to New Zealand (which still ebbed and flowed with the cycle, with material net outflows in the 1880s for example when Australia was at the peak of its huge boom) reflected a tradables sector "shock". (Although it was very expensive to get to New Zealand), immigrants and settlers were opening up new lands to production, and falling transport costs and the advent of refrigerated shipping amounted to a hugely positive tradables sector shock, lifting the population capacity of the country at high wages and high rates of return. Rapid population growth will still have tended to contribute towards factor price equalisation, all else equal, but from a point where the marginal returns in NZ were high and improving. Through this period, as far as we can tell, national savings weren't particular high - rather the heavy investment needs of the rapidly growing economy were met by a huge accumulated negative net IIP position.

One could probably generalise this story to encompass much of the New World migration in the 19th century (including the great westwards migration in the US itself, which Belich treats similarly). Large increases in labour supply were complementary to the new found opportunities.

By the middle of the 20th C, the situation for New Zealand was rather different - the new land was largely settled and producing, and technological change in the key export sectors was no longer as rapid (relative to other producers). The terms of trade were quite high, but we counteracted the effect with a significant effective tax on exports (through the pervasive domestic protection).

Into this period, we nonetheless had one of the fastest rates of population growth of any advanced economy. That was partly a matter of a high birth rate (higher than in many countries) but also of quite rapid inward migration. British migration was largely unrestricted during this period, but government policy actively encouraged the inflow, including through assisted migrant schemes.



Of course, inward migration increased the labour supply. But remember that the dominant narrative through this period was seriously excessive **demand** for labour (organisations like the RB ran marketing campaigns to attract basically unqualified 15 year old school leavers)[10]. There is no sign that the excessive demand arose from a fast-growing highly productive export sector - indeed the export share of GDP contracted. The demand arose domestically - and not from highly expansionary fiscal policy (rather the contrary), nor rapid expansion in private credit fuelled by unduly easy monetary policy. The most plausible candidate hypothesis is that the strong domestic demand impulse was associated with the very rapid growth in the population.

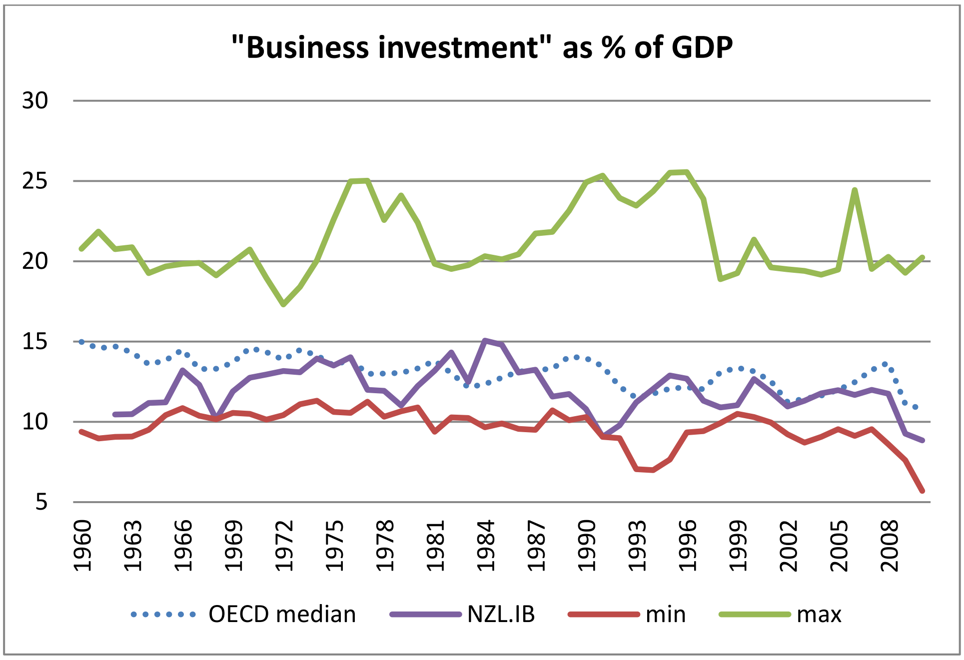
Considerable resources had to be used to facilitate building the capital stock associated with the rising population - ie just to maintain the capital stock per person/worker/hour. Migrants add labour supply but they also add lots of demand - their own consumption needs, and capital stock requirements (largely domestic, so the input-output tables say)[11]. The tendency was reinforced by the policy emphasis, in a period of financial repression, on making finance available, at fairly generously concessional interest rates, for house building. In the business investment sector, plenty of investment occurred - but of course it tended to be concentrated where the incentives were right - - the fast-growing domestic demand sectors, and especially those where import licensing meant that local production was the cheapest way to get their products into New Zealand markets. The point was recognised by various analysts through the period – I included references to Horace Belshaw and Frank Holmes in my earlier paper, and was interested to find an article in the 1961

[10] With real interest rates similar to those in other advanced economies through this period, and unimpressive productivity growth, there is nothing to support an argument - such as that made by NIckell (repeated by Mervyn King) around UK immigration in the last decade - that rapid immigration has tended to ease aggregate demand and inflationary pressures. At world real interest rates, New Zealand experienced grossly excessive demand.

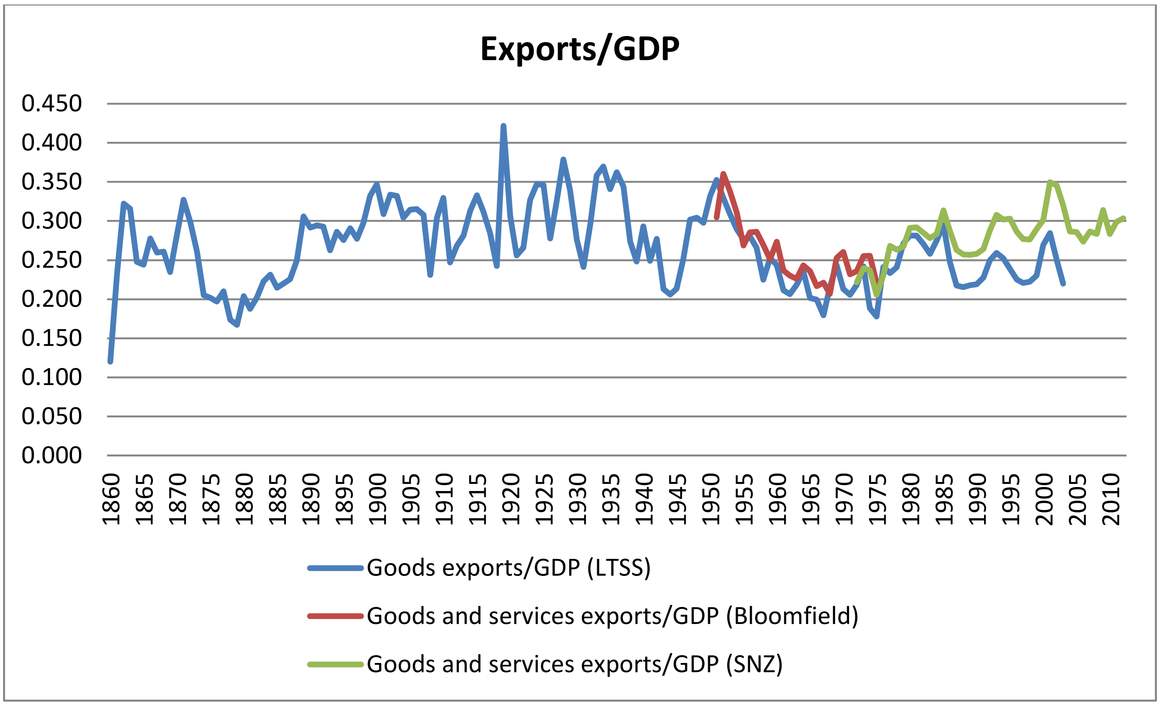
[11] Children, in the near-term, don't add labour supply, but also don't consume as much or need as much additional capital stock.

Reserve Bank *Bulletin* reporting the views of a visiting UK academic on NZ's economic policies and performance, highlighting exactly the same issue.

In a period of persistent excess demand - with national savings rates that, on best available estimates, were nothing spectacular by international standards, and largely closed foreign debt markets - non-tradables and other sheltered sectors did relatively well and internationally competing sectors did relatively poorly. Data from the OECD suggest that business investment languished below the OECD median as early as the early 1960s (when the data start), despite the needs of a well-above-median rate of population growth.



(Absent the data) one can only imagine how bad the picture would have looked with a focus purely on investment in internationally-competing industries. My story is, in a sense, one in which the wage structure was largely led from the non-tradables sector, associated particularly with rapid population growth and modest savings rates, with the export sector something of a residual. Some individual firms and farms flourished, but the overall story was one where too few found the environment (cost structure/access to credit) conducive to expansion. We never shared in the rapid expansion in global trade in the last few decades - exports to GDP now are at best no higher than they were in the interwar period, even after the removal of most import protection. (We know too that our export value-added as a per cent of GDP is well below what would expect for a country of our size).



Of course, the story is never totally black and white: Brian Easton has highlighted the way in which some New Zealand manufacturing export industries had developed by the 1960s (not just exporting into protected Australia) and, for a time, direct subsidies materially boosted the volume of manufacturing exports but….the overall (relative size of the) export sector was shrinking. I found it interesting that Douglas Copland, speaking in 1960, described New Zealand as having the most overvalued exchange rate in the Western world; a point of view seconded at the time by Brian Philpott, an expert on our own economy.

Rapid population growth and strong inward migration did not continue indefinitely. New Zealand markedly tightening inward migration in 1974 and in the following years saw a fresh wave of New Zealanders leaving (previously seen briefly in the 1880s, 1930s, and late 1960s - but this time, while fluctuating cyclically, largely unabated to today).

It is interesting that the one period since WW2 when the internal real exchange rate measures dipped sharply and for a sustained period was during the 1970s and early to mid 1980s. Changing population growth can't be the entire story - there is something similar in for example the Australian and US data. The sharp change in real oil prices and the weak terms of trade must be part of the picture. But equally, if rapid population growth had contributed to excess demand and high wage and a leading non-tradables sector in the 1960s and 1970s, then the sharp reversal in population growth (dropping below advanced country average population growth rate for the only time in post WW2 history) is at least consistent with a falling real exchange rate, of the sort one observes. Weak population growth meant very weak house-building during those years, helping put downward pressure on wages and (relative) non-tradables prices. .

Of course, through this period NZ put itself through yet another of its policy own-goals - the huge Think Big investment programme (the only time from 1960 to now when NZ's business investment to GDP was above the OECD median for several successive years). It is less clear what these projects meant for pressure on domestic resources and the real exchange rate - they were hugely capital intensive projects (financed mostly externally), and probably put much less pressure on demand for domestic labour (and hence non-tradables prices) than the somewhat comparable sized Christchurch repair and reconstruction process is likely to involve. And by around 1986, those pressures had largely passed - there was no ongoing tradables sector impetus to labour demand or wages.

In the late 1980s a huge amount of valuable reform was put in place, designed to open the economy internationally and to expose domestic factor and product/service markets to much greater competitive pressure. Removing import protection removed a significant tax on the actual and potential export sector. But the huge shrinkage of the previously protected sectors, freeing up large amounts of domestic labour, looked as though it required a significant reduction in the internal real exchange rate, to reabsorb the labour and grow a new, internationally competitive sector[12]. As Sebastian Edwards noted in his 1990 paper for Treasury, a fast-growing export sector appeared to be an essential aspect of successfully transforming the New Zealand economy. Edwards has also highlighted just how important the deep depreciation of the Chilean exchange rate was as the (even heavier) protection was removed in Chile.

But then we changed migration policy too. Migrants brought (and bring) their labour, but not their houses, roads, factories. As in many other Western countries, financial liberalisation and cultural change were lowering New Zealand national savings rates, from already quite modest levels (despite the improved public finances). Of course, this time round we could borrow internationally, and the rationing was done by price - but the result ends up being much the same - investment skewed towards the non-tradables sector, and overall business investment pretty subdued by OECD standards, despite the fairly rapid rate of population growth[13]. The internal real exchange rate accelerates strongly - and although now more cyclical, with the nominal exchange rate fluctuations and more-muted pass-through, there is little sign of the trend abating. This time Cline and Williamson, rather than Copland, call our real exchange rate as among the most overvalued in the West.

One symptom of our badly skewed post-war economy might be the dramatic rise of Auckland - a city which even the Auckland Council describes as import-led (ie the quintessential non-tradable region of New Zealand). In 1945, Auckland and London both made up around 15 per cent of the populations of their respective countries: London today is still around 15 per cent of the UK population, while Auckland is around 30 per cent of NZ. Nothing comparable has happened in the other, more successful Anglo economies (including Ireland, where the Dublin population as a share of the total had risen since 1945, but was largely unchanged in 2011 from pre-growth surge 1971)[14]. There has never been any sign that Auckland has been the export leading-edge of the economy. Migrants tend to flow towards large cities, and although there has been displacement of New Zealanders out of Auckland it is far from full.

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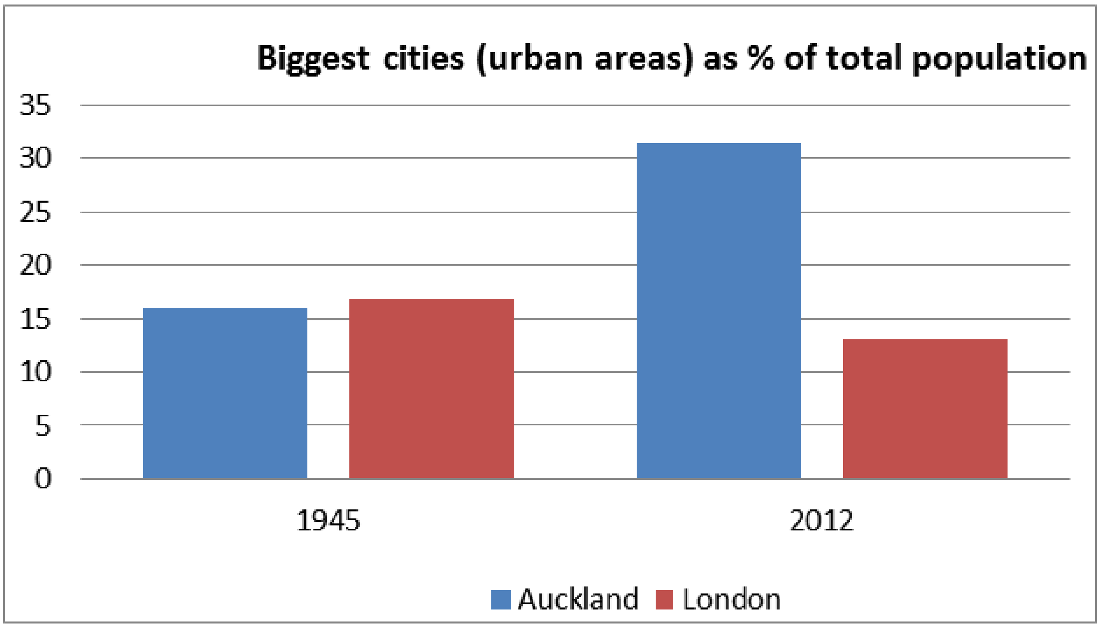
[12] Although this was also the period when some of the more enthusiastic Douglas acolytes were heard to cast doubt on the importance of the tradables sector of the economy (there was, after all that comparative advantage in takeovers…think Hawkins, Judge et al)

[13] Materially slower than in the 1950s and 1960s, but not much slower relative to the other advanced countries (our usual benchmark when posing a “why has NZ languished?” type of question.

[14] The NZ numbers also aren’t just a reflection of general urbanisation: for the other dozen or so “main urban areas” the share of the total population is little changed from 1945 to the present.

This is not to argue that Auckland is in some independent sense a drag, but that its super-charged population growth is a symptom of the imbalances that have been present in New Zealand for decades. I'd assert - and consistent with the speculative tone of this note - that a New Zealand with a lower real exchange rate, and a lower rate of gross inward migration, would have been a New Zealand in which Auckland would be a much less significant part. Those who emphasise agglomerationist ideas might see that as a bad thing, but I think the onus is on them to demonstrate the importance of those ideas in the NZ story, given that our largest city has seen very rapid population growth (by advanced country standards) over the last 75 years, while our productivity growth has been appallingly bad.[15]



The contrast with Australia is striking. For the most part, it isn't that policy in Australia has been consistently so much superior to New Zealand's across the board. There are still areas today - taxi regulation is my favourite hobby-horse example – where they seem well behind. But, for somewhat similar post-war policies, they (a) were less restrictive than we were, (b) in a larger economy the adverse effects of protectionism were somewhat less severe, and (c) they took major steps earlier to open the economy (eg Whitlam's overnight 25% cut in tariffs). But, and I increasingly suspect that this is most important, they had an emergent important new tradables sector opportunity, the rise and rise once again[16] of the mining/minerals sectors. The removal of the ban of exporting iron-ore and the increasingly heavy investment in the minerals sector represented a genuine new opportunity[17] (akin to the new lands of the 19th C) supporting growing Australian incomes, and enabling the country to sustain quite rapid population growth without holding back materially per capita incomes.

[15] And while I personally believe that land supply should be much more responsive to demand, and obstacles to that such as the rating system should be reformed, conflicts on this score seem in many ways like a huge and unnecessary diversion: without the policy-led population growth, there would not be the same pressure on house prices and debates around intensive vs extensive urban development. See Japanese and German house prices over the last two decades.

[16] "again" because in the 1860s gold was the most important export for both New Zealand and Australia

[17] McLean reports data showing 12 minerals for which Australia is one of the countries with the 3 largest reserves, and 5 for which Australia has a third or more of total reserves.

Sometimes, immigration results from almost totally non-economic factors. The large-scale historical one-offs discussed earlier fit that category (Portugal, France, Israel). We can sensibly evaluate the economic consequences of those inflows, but that provides little basis for assessing whether it was good policy. From an Israeli perspective, one could argue much the same for the provisions that allow any Jewish person to migrate to Israel - it is intrinsic to the entire national project and vision that gave rise to the state of Israel.

At other times, large immigration inflows will be a response to fresh opportunities and shocks arising in the recipient country - to help take advantage of, and capture the full benefits from, those new "technologies" broadly defined. One might reasonably think of the great 19th century migrations to the New World (including New Zealand) in that category. Or the migrations from the sub-continent to the Middle East resource states, or the internal migrations to the coastal cities of China. Ireland in the 1990s probably fits this category. If one could count a government-skewed pattern of savings and undervalued exchange rate, then migration into Singapore probably also fits this category. In none of these places - recipients of large inflows of migrants, responding to emergent real economic opportunities - were there large scale outflows of natives.

For these sorts of cases, migration will still have sectoral implications within recipient economies/regions, but there is little reason to think it likely to be harmful and probably good reasons to think that it is typically net beneficial to the receiving economy: increased labour supply complements the resources the local economy already has (be it high savings, a new natural resource opportunity, or some superior policy settings). Whether in some sense immigration is a net positive for the natives of the recipient country - whether, for example, it is in some sense necessary to maximise the benefit of the new opportunity - is more arguable: Norway, for example, has been transformed (in income league tables) by the exploitation of oil and gas, and has experienced only middling rates of population growth.

New Zealand has had no similar shock or new opportunity - or at least, not one that we ever gave ourselves the chance to realise[18]. (Re)convergence doesn't happen in a fit of absence of mind; it takes effort, focus and consistent alignment of policy choices, to ensure that the government is not a barrier (always unintended) to strong sustained per capita growth. After decades of heavily taxing the export sector, through the interaction of direct protection and the resource pressures of a rapidly rising population, it seems reasonable that a prolonged period of a fairly weak real exchange rate would have been appropriate/required, to spark the re-internationalisation of the New Zealand economy, and the sort of growth in market-competitive tradables production that has typically been at the heart of convergence stories abroad, especially in small countries. Measures that boosted non-tradables demand were the last thing this economy needed.

At the point of liberalisation, we had nothing for the much increased flow of new migrants to be complementary too - not the domestic savings, not the business tax structure, not some new fast-growing tradables sector. The market - the choices of our citizens to leave - was telling us something about opportunities and returns here - those signals were ignored or (worse, since an example of bureaucratic and political hubris, oblivious to the critique represented as the knowledge problem) treated as something that policy need to directly reverse. In many respects, the pressures

[18] I include here the possibility that New Zealand has very large mineral resources.

and choices of the 1950s were perhaps more pardonable than those of the 1980s and 1990s - however well-intentioned the latter were.

We need to be rather more hard-headed, and modest about the ability of policymakers to add value. Citizens face incentives, and are generally best placed to respond to those incentives. They can reproduce at faster or slower rates, they can stay or they can go. They can spend more or less heavily in education and the associated bunch of skills/signals (mostly the latter, I would argue with Bryan Caplan). And they can choose to save and invest - mostly, in aggregate, with a better track record than actual governments (no matter, the potential gains from idealised govt action in some literature).

There is an angst in New Zealand bureaucratic circles around savings, and a sense of a need to "do something". Actually, doing nothing (on savings specifically) is likely to be a better path, and safer for NZers). Reading a lot of the old NZ literature, I was struck by how few references there were to savings - even though, as the high external debt (pre 1940 and post 1970) or tight controls suggest, t desired savings appear to have typically lagged investment. At a household level, no one has produced convincing evidence that policy settings around savings (ie tax treatment of savings instruments, or the interaction with the welfare system) can credibly explain much about why NZ savings rate should be lower than those in other advanced countries - and there has been a lot of stability in savings through some quite different regimes in this area. My prior in this area remains one that the government needs to ensure that its own savings are appropriate (having regard to the high rate of public sector investment in NZ) and then should get out of the way.

I was struck recently reading John Gould's book on economic growth in history, who observed that a large proportion of household net savings (across countries) is in fact business savings - the retained earnings of unincorporated business enterprises. That chimed well with my sense that business savings generally gets too little conceptual attention in NZ discussion on savings. As Michael Pettis put it recently in discussing China, it isn't the accumulation per se that matters as getting the conditions right that shape the incentives to accumulate. Businesses save when the economic returns look, and prove favourable. They don't save when the incentives to accumulate - an overvalued exchange rate, and investment skewed towards housing and public infrastructure simply to support a rapidly rising population - aren't there. A much lower real exchange rate, arising from a materially lower policy-induced rate of population growth, would materially alter the relative prospective returns, and would be likely to lift materially business and national savings rates[19].

I would argue that savings "policy" is largely a red-herring, perhaps quite costly one - in its own right, or because of the way it distracts from the real issues.

A final point

For completeness, I wanted to bring the size and distance arguments into this paper. They are often run as a major part of the story of New Zealand's relative decline - and receive nodding affirmation from too many of the great and the good.

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[19] Materially lower rates of taxation of capital income would work in the same direction. I was struck to find an MEC survey in 1962, reporting that even then our company tax rate was among the highest in advanced countries. Much lower today, it remains not low by international standards.

I don't argue as a matter of principle that either is necessarily unimportant, but I just don't think either fits with the stylised facts or is necessary in a reasonably parsimonious account of New Zealand's post-war experiences. Distance seems likely to matter, in levels terms. With identical policies, I think NZ will always be poorer than Belgium.

But if size and distance are a very important part of the post-war (and post 1990) story of widening income and productivity gaps, we should not have seen persistent excess demand, persistent need for either high real interest rates (or tight controls) , or a high/overvalued real exchange rate. The market can deal with fundamentals moving against a country - low opportunities and returns tend to lead to relatively low real interest rates, declining non-tradables prices, and some buffering in the form of a lower real exchange rate. We just have not seen any of the macro stylised facts - short of the bottom line, weak productivity growth - that a hypothesis built around the rising importance of size/distance should have led us to expect.

Conclusion

There is no reason why NZ productivity and incomes should not once again be among the upper half of the OECD grouping. But it won't just happen. We aren't the victims of external circumstances, and we can't count on external events restoring our erstwhile glory. New Zealand policymakers - well-intentioned always - have to take most of the responsibility for our continued decline. And here I would include those of the Douglas-Richardson strand, in some ways, as well as those of the Savage-Nash-Sutch strand, - and, of course, the majority who failed to do anything much at all (perhaps at least paying heed to Popper, on the merits of the piecemeal) In a very small country, which prospered for a long time, it seems that the idea of a strongly rising population as a normal and desirable feature took hold, even when the underpinnings that would have made such an approach sensible were no longer (or, perhaps, not for now) present. To end with a couple of relevant clichés, all that glistens is not gold, and sadly there are none so blind as those who will not see.

29 May 2013