

## Economic policy and the coronavirus

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Little more than four months ago no one in New Zealand had much conception of the havoc the coronavirus was about to wreak. 13 January was the day the very first case outside the People's Republic was reported and still 10 days until the extreme responses were adopted in Wuhan. Locally, not even the rock lobster industry was yet in focus.

Unfortunately, two months later in mid-March our economic officials and ministers still appeared to be reluctant to recognise the magnitude of what was about to break in full force on New Zealand. A day or two earlier the Governor of the Reserve Bank had given a speech and press conference which minimised the issue, and when the Bank finally cut the OCR a few days later - weeks late - he was still reluctant to concede that a recession was upon us. The government's economic thinking had still been mostly focused on the disruption to our exports to China, and that sort of thinking was still shaping the economic package they announced on 17 March (bulked out with some permanent new fiscal commitments just as we were becoming poorer). In time, they were all simply overtaken by events they weren't ready for.

That is all water under the bridge now. In the end, the modified wage subsidy scheme ended up serving (mostly) as a more-generous income support scheme, and if some portion was poorly targeted at least it was disbursed quickly. Whether it will save many jobs and firms only time will tell but I'm sceptical - the extended scheme after all we focus mostly on the industries least likely to recover any time soon.

Where do we stand now? We will have undergone the sharpest deepest economic slump ever. GDP in the so-called Level 4 was probably 40 per cent below normal and is probably still 30 per cent or so below normal. June quarter GDP could be 25-30 per cent lower than it was late last year<sup>1</sup>. In the 2008/09 recession, by contrast, GDP fell by 3 per cent. GDP often appears as rather abstract, but lost GDP - lost activity - will translate into lost jobs. You can see that in, for example, the reported unemployment rates for April of around 15 per cent in the US and Canada.

As the restrictions continue to wound back there will be some further rebound in economic activity. But even if - as some suggest - 95 per cent or more of people/firms are lawfully able to work, we should not suppose for a moment that economic activity will quickly snap back to 95 per cent of normal. Hotels in Rotorua may have been free to open, but they are unlikely to have many customers.

And even if there is little or no Covid in New Zealand, that isn't so abroad. There is a savage deepening global recession unfolding. Even at home, people are going to be poorer, and

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<sup>1</sup> <https://croakingcassandra.com/2020/05/08/the-macro-outlook/>

will be cautious, nervous, and uncertain. It isn't like a normal recession that results from things that happened previously: this virus still stalks the earth, and even vaccine optimists talk in terms of another 12-18 months of that.

On current policies, even if we get back to so-called Level 1, even if trans-Tasman travel is freed-up later in the year, GDP could still be 10 per cent less than normal.

Probably everyone now recognises that we can't just put the economy back where it was late last year. But, in New Zealand's case in particular, nor should we want to. On some headline statistics we've done well enough: government debt has been kept quite low, inflation has been low and stable, and the unemployment rate was fairly low. But productivity growth - the key foundation on which any improvements in material living standards rests - has been consistently poor since the 1950s and as a result we've slipped progressively further behind other advanced (and newly emerging) economies. In 1950 we were probably still third or fourth in the world. Now we are being overtaken by Turkey and several of the former Communist countries of central and eastern Europe.

A key element of our sustained economic underperformance has been our woeful foreign trade record. Successful economies tend to be ones where foreign trade - exports and imports - is rising as a share of GDP: especially for small countries the wider world is where most of the potential markets are. In New Zealand, the foreign trade share has hardly changed since about 1980, and has been falling this century - the peak years of the latest wave of globalisation. We were once among the most successful trading nations in the world - matched by really high living standards for the times - but no longer. Ministers and officials like to talk about the numerous preferential trade deals they sign, but the data tell their own story. Consistent with all this, business investment has long been fairly low as share of GDP. Firms have just not seen many profitable opportunities here in New Zealand, especially in the outward-oriented internationally competing sectors.

In fact, if one does a simple (and a little rough) split of the economy into the bits that compete internationally and the bits that don't, there has been no per capita growth in the tradables sector at all this century. The per capita level of tradables sector activity was about the same at the end of last year as it was at the end of last century. Instead, all the growth has been inwards-focused, often just barely keeping up with the needs of a rapidly-growing population in a distant and unpropitious location.

The economic strategies of several successive governments, led in turn by both major political parties, have accommodated, even encouraged, this imbalanced, inward-looking, growth model, even as they've repeatedly talked of looking outwards.

Even in the wake of Covid-19 an outwards focus remains the only sustainable path - especially for a small country - to a much greater of material prosperity, that might finally again offer material living standards to New Zealanders old and new that match those in the best of the rest of the advanced world. It is going to be harder than it was - travel restrictions for some time at least, and risks of rising protectionism (at a government level) and home bias (at a private level). But that doesn't mean there are credible alternatives. And the private sector - the firms that sniff out the opportunities, and produce and market

the stuff the rest of the world might buy - has to be at the forefront of any New Zealand economic revitalisation.

A more intensely inward-focused path appears to tantalise some. Even recent comments by the Minister of Finance talk of a heavy emphasis on domestic infrastructure spending, and invoke the memory of Michael Joseph Savage. But insulation-ism didn't do us any good the last time it was tried, after the 1930s. More recently, the Think Big strategy of the early 1980s proved an economic and financial disaster. There is no path to prosperity for a small country in simply taking in each other's washing, even doing so on better roads (or railways).

But the government still has a large part to play, including in getting out of the way. The private sector needs to be getting the price signals that enable them to recognise the opportunities our talented people and firms could respond to. As far as possible, we need the short-term signals - about getting people back to work, fully employed, as fast possible - to align with and reinforce those focused more on the longer term.

Left to themselves, economies would heal themselves...but very slowly. Getting an economy back to full employment after a nasty shock is usually primarily the task of monetary policy. Monetary policy can be deployed quickly, and pervasively, and can be readily adjusted back when stimulus is no longer required. Monetary policy operates pervasively, it doesn't cost the Crown money, it influences voluntary private choices, and it works without ministers deciding who or what is favoured. And it doesn't tie our hands in the way that overly heavy use of fiscal tools does.

In fact, modern central banks exist mainly to enable us to use monetary policy actively (in fact one of the lessons of the Great Depression was just how important to recovery after a deep downturn monetary policy flexibility is). Easier monetary policy typically means lower interest rates and, particularly in New Zealand's case, a much lower exchange rate.

Unfortunately the Reserve Bank Monetary Policy Committee, backed by no published analysis at all, has pledged not to cut the Official Cash Rate (OCR) any further, no matter how bad things get. As a result, we have been limited to a mere 75 basis points of interest rate cuts, when in typical past New Zealand downturns - none as severe as this one - 500 basis points of cuts has been more normal. Since public expectations about the future inflation rate have also fallen, real interest rates (adjusted for inflation) have barely fallen at all.

The Reserve Bank will tell you they are purchasing lots of government bonds. That is nice, but almost irrelevant to New Zealand now. In past serious recessions - 2008/09 or 1991 - real interest rate have fallen very sharply, and the exchange rate has fallen a long way too. Right now our exchange rate is only about 5 per cent below where it was late last year. 25 per cent would be more normal. In New Zealand we a "deeply negative" OCR - of the sort former IMF chief economist Ken Rogoff called for a couple of weeks - to get retail interest rates down much nearer zero. Right now, we are in the weird situation where the government is lending at zero interest to businesses that can't get funds elsewhere, while the existing stock of borrowers are still paying materially positive interest rates.

There are, of course, plenty of champions now of a more aggressive continuing use of fiscal policy. A lot has been done in recent weeks to provide basic income support, and to keep workers attached to firms, through the worst of the slump. But once we get past the immediate slump, fiscal policy is much inferior to monetary policy (used properly) for accelerating growth to get back to full employment. There are long lags to getting some projects going, lots of playing favourites goes on in allocation of projects or other spending, and rigorous prioritisation is typically weak.

Perhaps as importantly if we are serious about a more outward-oriented economy, putting a heavy reliance on fiscal policy tends to push up the real exchange rate, undermining competitiveness. As it is, the exchange rate has been too high on average, relative to our poor productivity/trade performance, for at least twenty-five years. Active use of monetary policy supports an outward orientation focused on the private sector, while active use of fiscal policy tends to undermine it. Realistically, public appetite for large fiscal deficits is also likely to fade pretty quickly once the worst has passed. That was the experience in other countries after the 2008/09 recession.

So, we need a more aggressive easing of monetary policy (against which big announced bond-buying programmes really don't get anywhere near the heart of the issue). That needs a change of mind from the Reserve Bank or it needs the Minister of Finance to use his reserved powers to compel them to do so. The Reserve Bank Act was mainly designed to protect us against inflation-prone Ministers of Finance, but is also built to protect us against central bankers insufficiently focused on the downside risks, and doing too little to get us back towards full employment. When the economy is going backwards, when there is little appetite by firms to invest, and a strong precautionary motive to save, we need the OCR to be quite deeply negative for a time.

But we also need mutually reinforcing longer-term reforms, focused on creating an environment for New Zealanders to prosper, on the back of strong internationally competitive business operating here. Even though New Zealand's prosperity was built on foreign investment, we no longer attract that much of it, especially in outward-facing sectors. Part of that is about an overvalued exchange rate – the prospective returns just are not there for domestic or foreign investors. But our screening regimes and investment restrictions don't help, and are likely to be a particular drawback in the period ahead, when many countries will be hoping for foreign investment, and many foreign corporates will find it easier - including politically - to stay close to home. There are risks around foreign investment from countries where the state (or Party-State) is a dominant influence, but perhaps we should look seriously at a regime in which we remove all foreign investment restrictions and screening rules for investments from entities (substantively) based in other OECD countries and advanced countries like Singapore and Taiwan. After all, much of the leading edge technology and management strengths - among the most important gains on offer from foreign investment - are already centred in those typically highly productive economies. Unfortunately what we've seen from the government is a rushed piece of legislation to make it harder for foreign investors to enter New Zealand.

And if we are serious about a more outward-oriented investment-led economy, we need to look again at our rates of taxation on business income. Our company tax rate - the one that matters for foreign investors in particular - is now in the upper quartile for OECD countries. In a small remote country, without huge amounts of savings of our own, we can't afford to impose heavy tax burdens on potential investors. And in the longer-term most of the burden of high business taxes isn't borne by businesses or their owners - they can choose projects elsewhere - rather by New Zealand workers, in the form of lower productivity and lower wages.

One of the main reasons why our economy has become so inward-looking may seem counter-intuitive. We have used government policy to promote large annual inflows of non-citizen migrants - temporary and permanent - each and every year. Unfortunately, we have been encouraging these people to come to one of the most remote countries on earth, in an age when personal connections, concentrations of expertise, and integrated supply and production chains have become increasingly important. Being so remote, no matter how smart our people or how innovative our firms we are simply badly-placed to prosper in this sort of global economy, especially with one of the most rapid rates of population growth of any OECD country. Perhaps it would be different if most of the migrants were exceptionally highly skilled, but that simply isn't the case either. Instead, we encourage lots of people to come - bettering their own family positions - only to find relatively few highly productive opportunities here. Instead, it has resulted in an economy that is focused mostly, for its growth, on building to meet the needs of more people. Our one substantial city is not known for its outward-oriented industries: instead the business of Auckland is largely (a) building Auckland, and (b) servicing the rest of the country.

So hold back on the number of migrants in future - a permanent annual flow of, say, 15000 non-citizens would be much smaller than we are used to, but similar in per capita terms to Obama's United States. Doing so would help keep the real exchange rate down, and free up resources for the outward-oriented businesses that the lower exchange rate - and other policies proposed in this brief - would make possible. And those competitive outward-oriented firms would be able to afford to pay better wages to New Zealand workers. By contrast, our current export industries have been struggling with a perpetually overvalued exchange rate, which in turn has generated the endless demand for cheaper migrant labour.

Is there a place for more infrastructure spending? Possibly, but recall that the typical quality of the major projects - road or rail - that have been approved by governments in the last couple of decades has not been high. Projects are often over-specified, even where there is a strong economic case for something to be built. We will need a ruthless focus not on the nice to haves, but on the projects that really will add to the external competitiveness of the economy.

There is talk too of a renewed focus on building houses. Maybe, but recall that (a) population growth is likely to be lower in the next few years, and (b) the biggest obstacle to housing affordability is not too few houses, but the artificial scarcity of (actual and potential) urban land created by a succession of central and local body land use restrictions. I fully support significant liberalisation of land use: it would make housing more affordable,

and that has to become a priority, if only as a matter of equity and social justice - but housebuilding (especially state-led housebuilding), and even cheaper housing, isn't a route to a high-performing economy in the long-term, and it won't be needed to get us back to full employment in the shorter-term if we get the wider policy settings right for the private sector to pursue opportunity here and abroad.

Turning inward is simply not a sensible option for New Zealand – perhaps not for any country, but particularly not for small, remote New Zealand with such a poor productivity and trade record. Domestic demand isn't unimportant, but much of the focus - whether in getting back to full employment quickly or building a more prosperous New Zealand in the medium to long term - simply has to be outwards, improving the competitiveness of operating businesses from New Zealand and taking on world markets. And it needs to be private sector oriented, not state-led.

The business of government should be getting the policy settings right and then letting business get on with it. For now, that means an aggressively easier monetary policy - interest and exchange rate adjustment more akin to what we usually see in severe recessions - and beyond that action on foreign investment regulation, tax, immigration, and competition in domestic services sectors. An unduly heavy use of fiscal policy - while superficially attractive to some - will cut against the sort of adjustment the country needs. More infrastructure spending may need to accompany the growth in the outward-oriented business sector, as that growth happens, it should not be looked to as a leading part of either the immediate recovery or a longer-term strategy. The external environment has got tougher, and may stay that way, and we haven't done well in the wider world in recent decades, but there is no credible or sustainable alternative if we are serious about both full employment and medium-term prosperity.

We'll eventually recover: much bigger disasters - the World Wars - didn't put us on a permanently lower path of GDP. But remember how poor our previous performance was: decades of relative decline, with really poor productivity growth and no success at all in growing foreign trade as a share of GDP.

So looking forward we need macro policies that put us aggressively on a path back to full employment, but they need to be working hand in glove with an approach to broader economic policy that looks outward, not inward<sup>2</sup>; that looks to provide a favourable climate for business investment and productivity growth - the only secure foundation for high incomes. And we need hardnosed prioritisation of what new spending the government does do, recognising that for now we are poorer.

Finally, in 2008/09 we threw a lot at the economy, responding to a recession that also wasn't homegrown. The OCR was cut by 575 basis points and a lot of fiscal stimulus was in the works. But it still took until 2017 - ten years – for the unemployment rate to fall back

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<sup>2</sup> For more on this, see my recent Policy Brief  
<https://www.canterbury.ac.nz/media/documents/oexp-arts/research-centres/ssanse/Rebuilding-New-Zealands-shattered-economy-in-a-post-COVID-world.pdf>

even to 4.5 per cent. This is a much much bigger economic disruption. We must do what it takes to prevent any repetition, and all the scarring of individual lives that such persistent unemployment would entail. Doing so will have to involve both fiscal and monetary policy. But there isn't limitless fiscal capacity, and at present monetary policy is largely spinning its wheels, doing little that makes much difference where it counts. That can't be allowed to continue.

Unfortunately, in combination fiscal policy and monetary policy look to be doing too little. We are doing a fair job of helping offset some of the dramatic income losses of the last few months, but that isn't going to get us back anywhere near full employment any time soon. And there are quiet weird distributional aspects to the policy mix the government seems content with. For example, letting monetary policy sit on the sidelines means that our older citizens (with more bank deposits than most) keep earning reasonable returns, while those in their 20s to 40s - hardest hit by the downturn, and the future taxpayers – are stuck with the sorts of real interest rates that made sense last year, but not this year.

And if government policy is doing too little to get the economy back to full employment any time soon, sadly there is no sign of any policy - thinking or action - that might seriously lift our longer-term economic performance by creating better conditions for New Zealand based firms to take on world markets more successfully. We risk ending up limping back to full employment, 5-10 years hence, and finding that through it all – and despite our success so far on the Covid front - we've drifted even further behind other advanced countries. Combined with the additional debt burden we'll have taken on in the meantime that is a bleak prospect for people like you - or my kids - starting out in the next few years. The risk is that once again more New Zealanders just find New Zealand a great place to grow up in, but also a great place to leave for better opportunities abroad. Many, of course, return, but huge numbers never do. We are poorer for their loss. We've failed them when for so many that is the best economic choice they have.