Post-Covid future policy paper for SSANSE/Anne-Marie Brady

Rebuilding New Zealand's Shattered Economy in a post-Covid world

Michael Reddell, Independent researcher at www.croakingcassandra.com,
mhreddell@gmail.com

27 April 2020

New Zealand's economic performance has been poor for decades. Looking beyond Covid-19, we'll need a framework that honestly confronts and reverses those failings.

Key findings

- Pre-coronavirus, the New Zealand economy rested on shaky foundations, having become increasingly inward-focused in recent decades (of rapid growth in world trade) with poor productivity growth
- We need to focus on getting back to full employment as soon as possible, but with a policy mix which positions us for a stronger, more outward-oriented, private sector-led, medium-term future
- That should mean an emphasis on much looser monetary policy, and on measures (lower business tax and immigration) that support a sustainably lower real exchange rate and promote business investment in sectors that will compete internationally.

Executive summary

Covid-19, and the steps taken to contain it, have wreaked havoc with economies around the world. The New Zealand economy had become increasingly inward-looking this century, even at the height of international globalisation: foreign trade had shrunk as a share of GDP, and productivity growth had been consistently poor. We will enter the new era with very high rates of unemployment. Getting back towards full employment must be a policy priority in the next two or three years, but policies to support getting people back to work need now to go hand in hand with measures that encourage business investment in the medium-term. Even in the wake of a pandemic, small economies will be successful only if they are strongly outward-oriented.

What is the problem?

For decades New Zealand's economy has performed poorly: among the worst productivity growth performances, and one of the few advanced countries in which foreign trade has shrunk as a share of GDP, even at the height of the latest age of globalisation. So post-Covid economic policy can't just focus on trying to put things back much as they were last year. We need policies that address both immediate high unemployment and the longer-term structural failings.

Some policy proposals

Monetary policy is the natural tool to use to support getting back to full employment promptly. Looser monetary policy would also lower the exchange rate, which has been out of line with fundamentals for years. Longer-term, keeping numbers of modestly-skilled migrants low will help secure New Zealand competitiveness, and we can also promote business investment by loosening foreign investment rules for OECD (and similar) countries and lowering the rate of taxation on business income. Beyond the immediate crisis, a continued heavy reliance on fiscal policy and government investment activities will reinforce the current inward-looking bias, and compound our structural economic failings.

Analysis

Even when we get through the next few weeks and, we hope, New Zealand returns to "Level 2" in the government's schema, the economy will be a mess. The Treasury estimated that under Level 2 real Gross Domestic Product in New Zealand would still be 10-15 per cent less than normal. Treasury is probably a bit optimistic, but even if they are correct it would still represent the largest slump in economic activity experienced in New Zealand since the Great Depression of the 1930s. Unemployment can be expected to rise commensurately. Some of that might be masked by a new or extended wage subsidy scheme, but the true effective rate of unemployment will almost certainly be materially above the early 1990s peak, which took the best part of 15 years to fully recover from. With whole sectors of the economy shut down - notably (labour-intensive) foreign tourism - it is going to be a difficult road back, even as the fear and uncertainty around the virus (here and abroad, this wave and perhaps others to come) eventually, but perhaps only quite slowly, abate.

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. 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 insulationism 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.

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. 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. And the exchange rate now is not much lower than it was last year. That is no basis for drawing forward spending and activity internally or for drawing demand towards New Zealand by putting our firms on a more internationally competitive footing.

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 ob offer from foreign investment - are already centred in those typically highly productive economies.

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 fewer 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. 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.