

A Health Check on the Economy: How Does it Measure UP ?

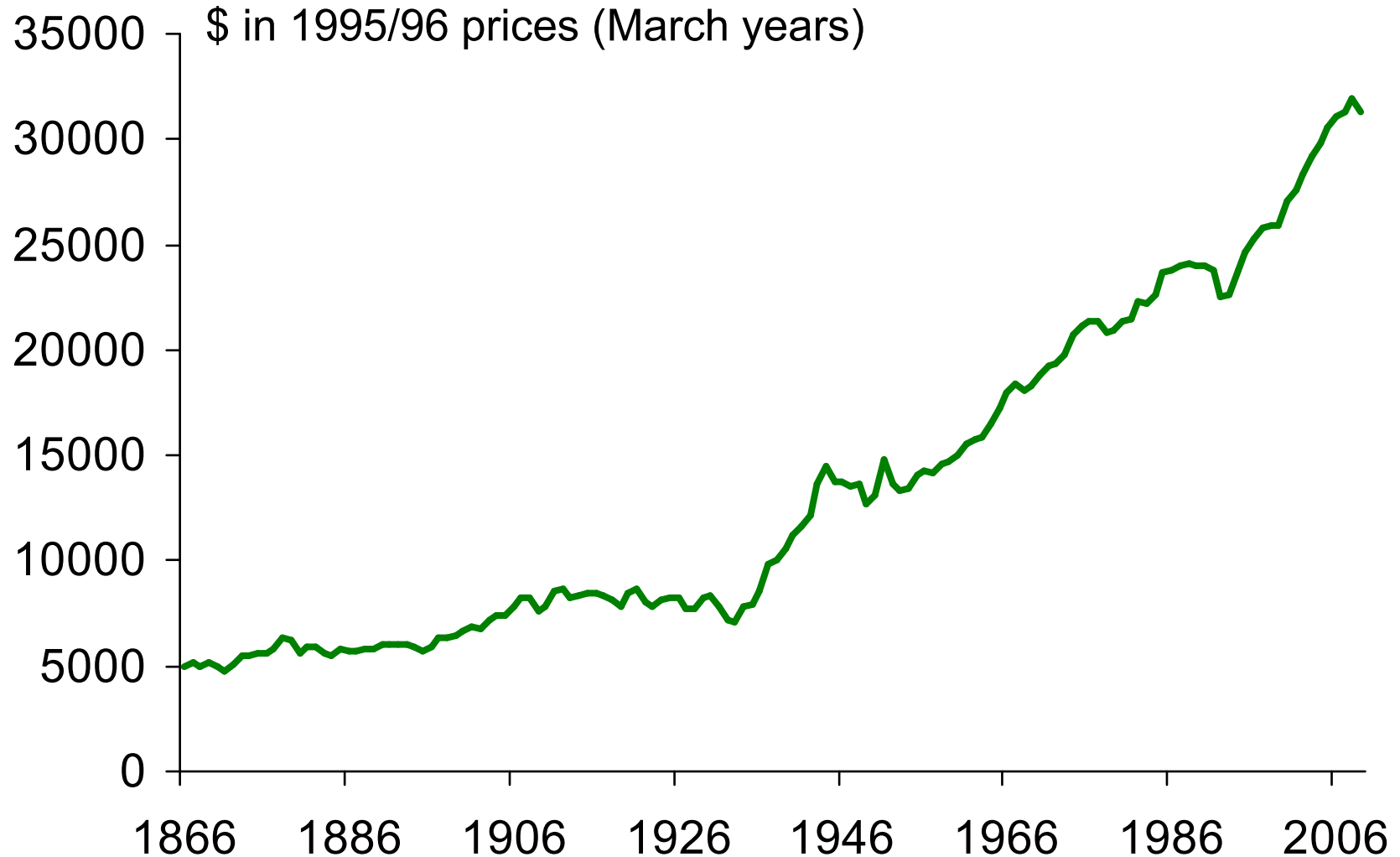
Roderick Deane

Background material for an address to the NZ Retailers Association
at Sky City Auckland on 2 September 2009

Dr Roderick Deane is Chairman of Fletcher Building Ltd & the NZ Seed Fund, & a Director of Woolworths Ltd in Sydney. He is also on the Advisory Board of Pacific Road Corporate Finance and Patron of IHC & Chairman of the IHC Foundation. He was previously Chairman of ANZ National Bank, Telecom Corporation of NZ Ltd, Te Papa Tongarewa (The Museum of NZ), City Gallery Wellington Foundation, & a Director of the ANZ Banking Group Ltd in Melbourne. At an earlier stage he was CEO of Telecom, Electricity Corporation of NZ Ltd, Chairman of the State Services Commission, & Deputy Governor of the Reserve Bank. He was also Professor of Economics and Management at Victoria University of Wellington & a Director of TransAlta Corporation in Canada for some years . Dr Deane is very appreciative of the assistance he was given in preparing this material by the Economics Group of the ANZ National Bank, particularly Khoon Goh, and by Bryce Wilkinson and Roger Kerr.

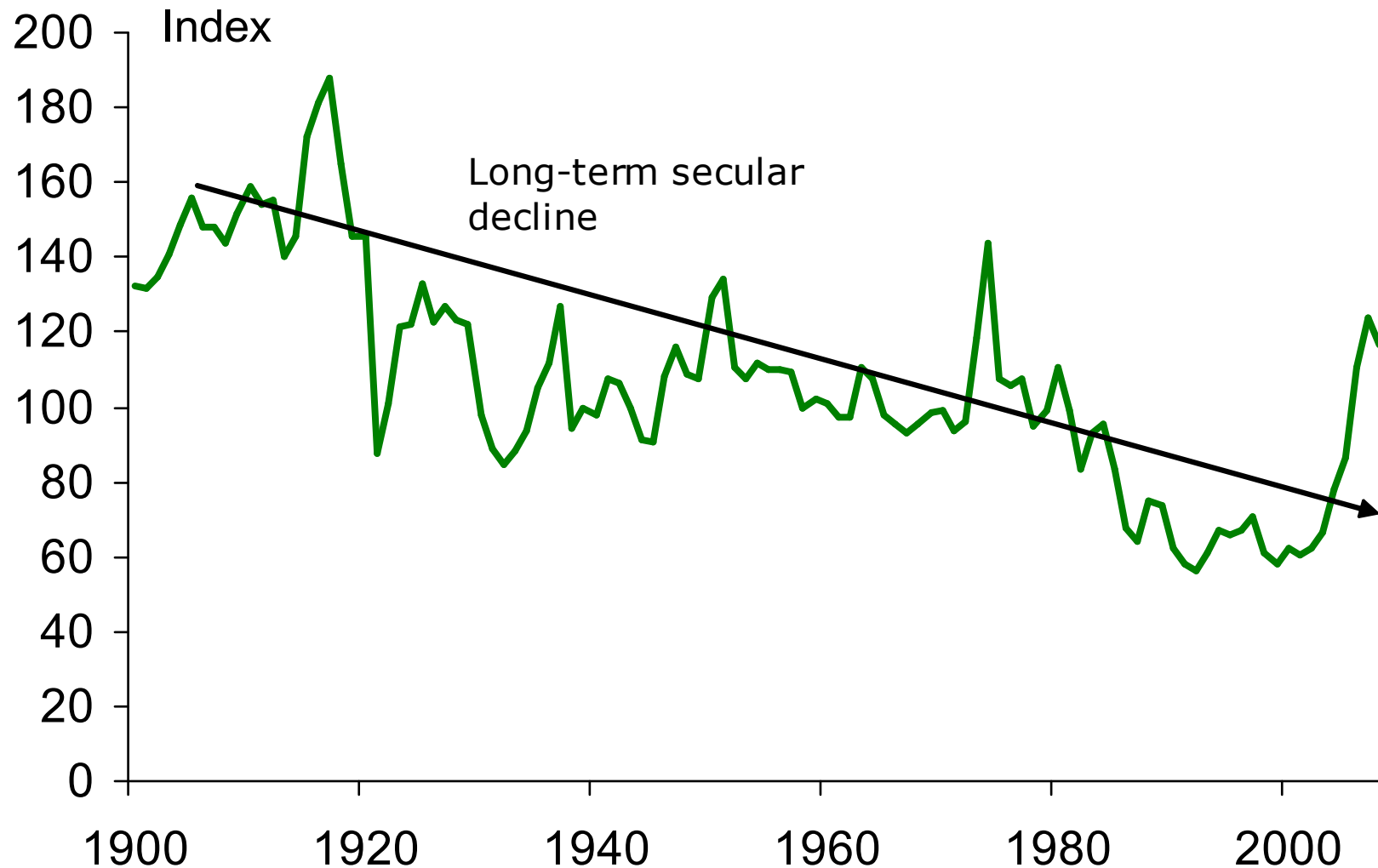
NZ's per capita GDP : a long-term historical perspective

GDP per Capita (1866-2009)



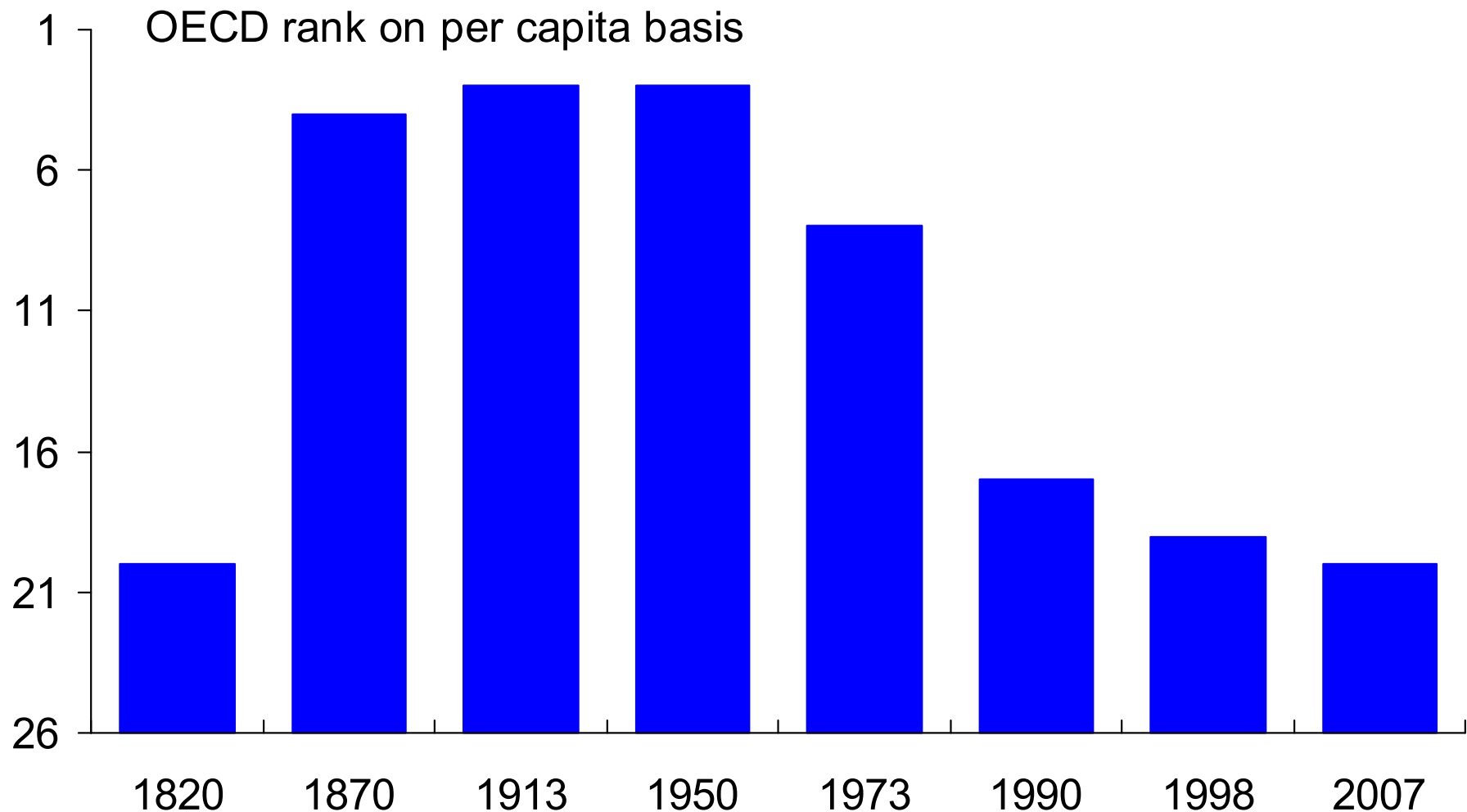
As a commodity producer, NZ's economic performance has been reliant on commodity prices

Real commodity prices (1900-2008)



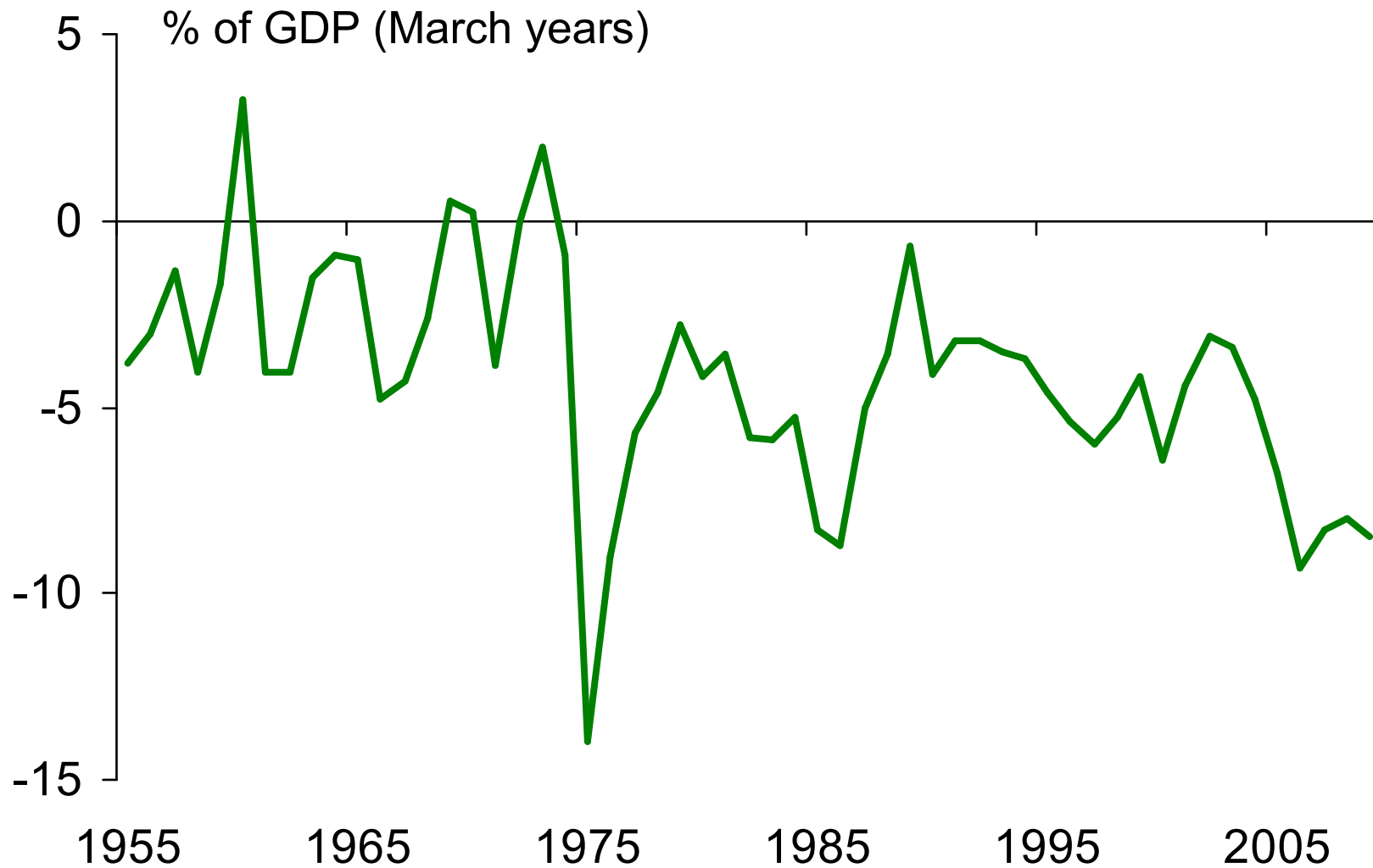
From enjoying one of the highest living standards in the world to below average compared to others

The rise and fall of NZ's relative place in the world: (1820-2007)



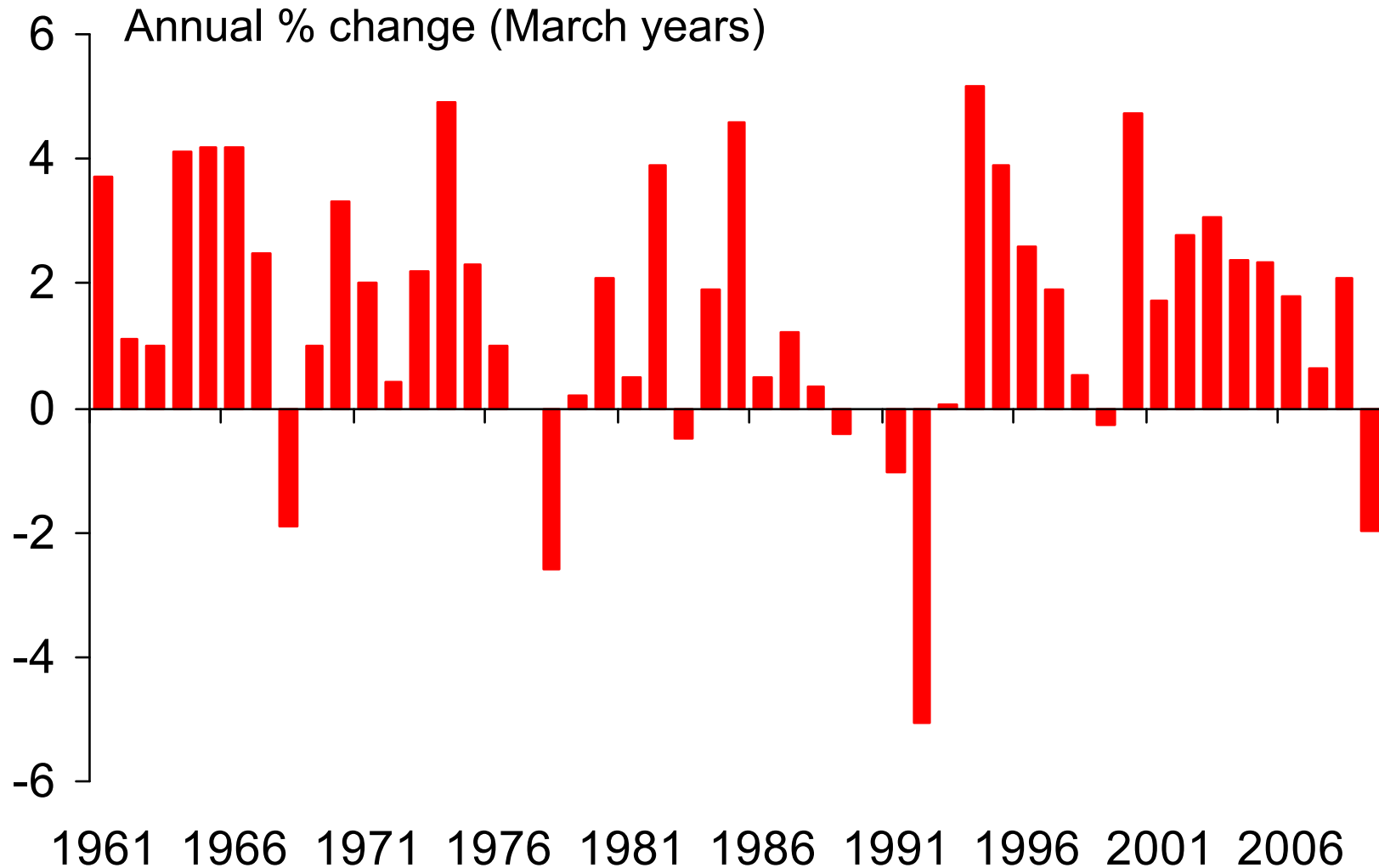
Running external deficits is endemic for NZ

NZ's current account history (1955-2009)



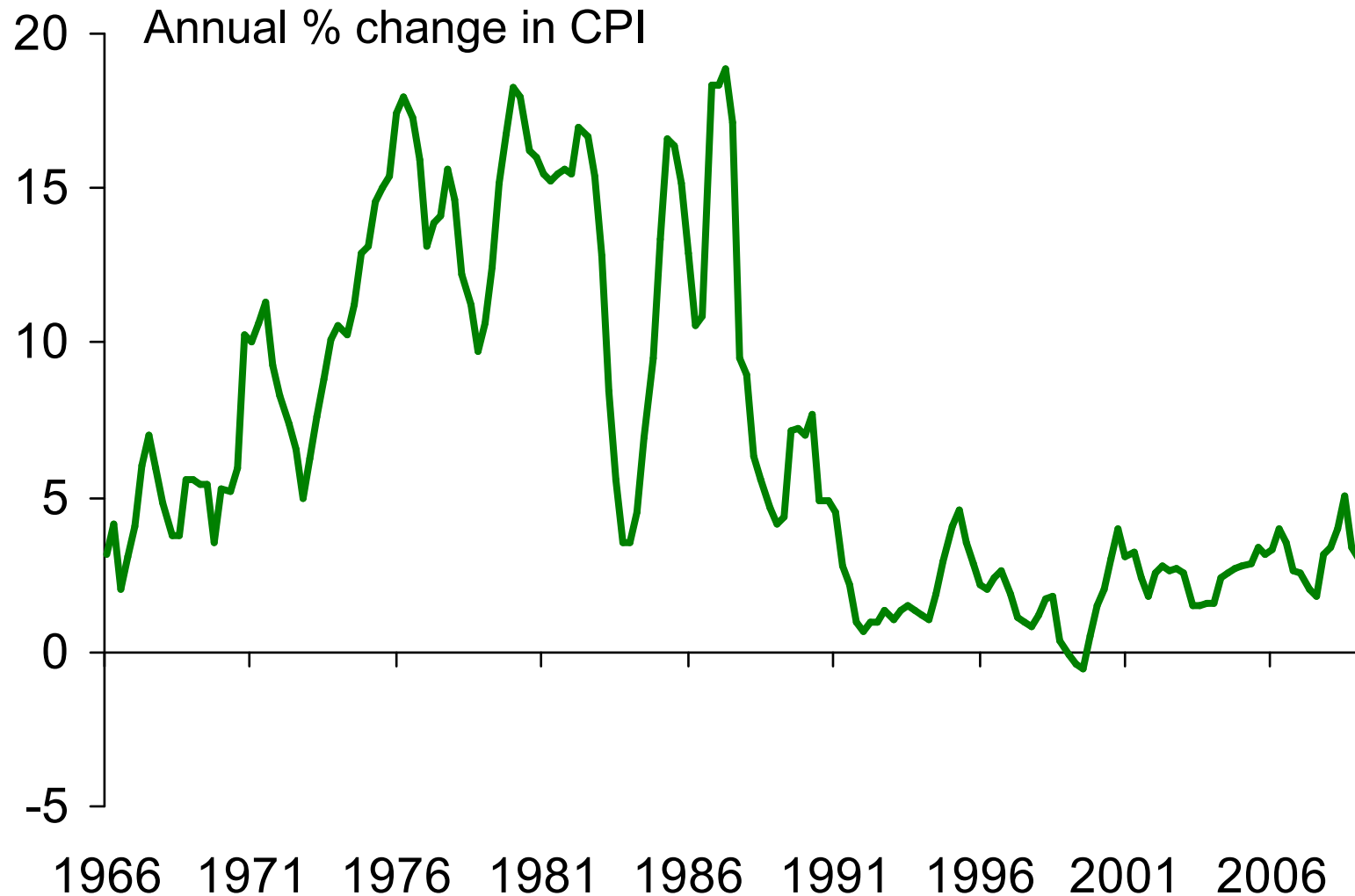
Improved macroeconomic settings has resulted in less volatile growth from the early 1990s...

GDP growth per Capita (1961-2009)



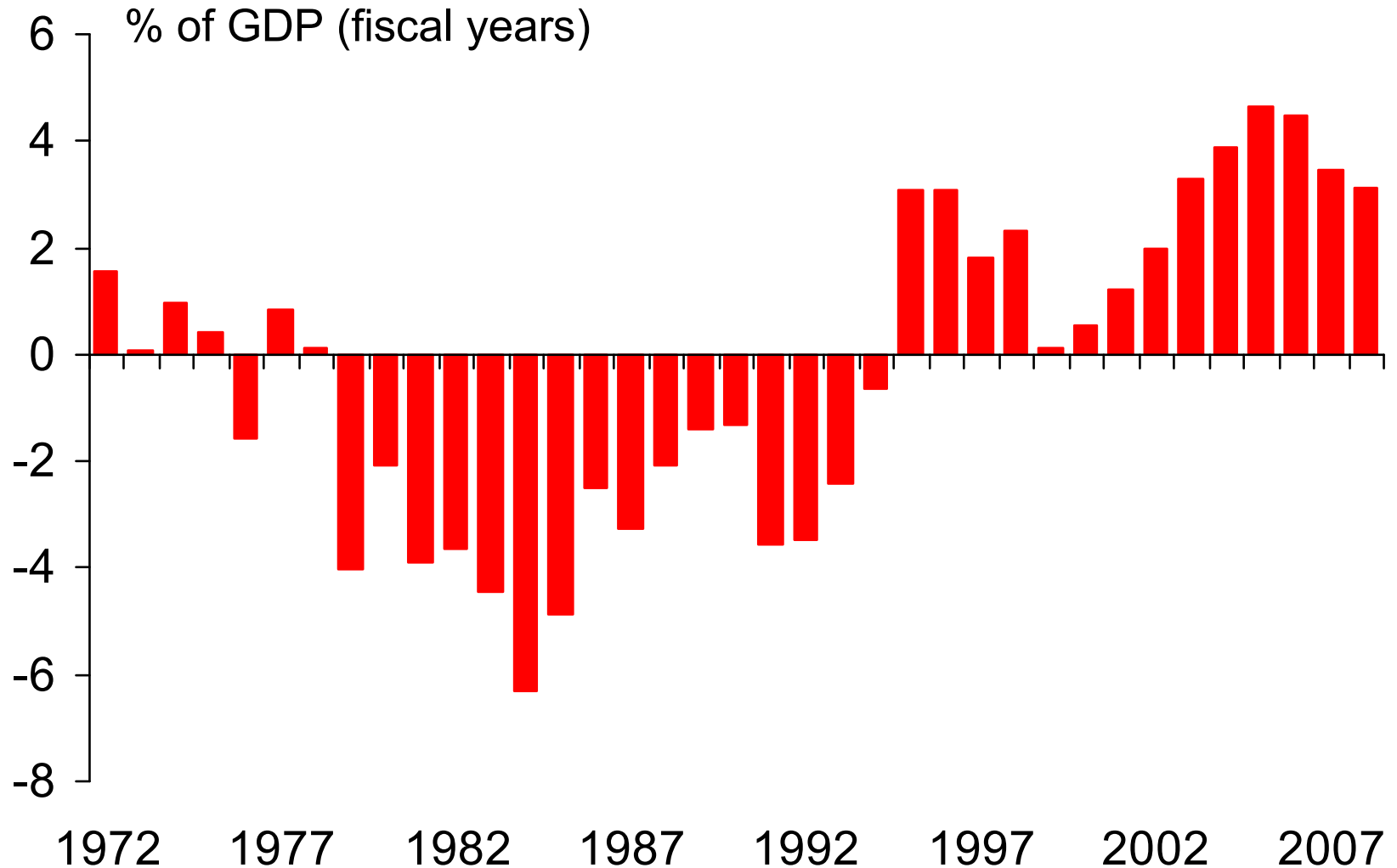
... tamed the persistent high inflation of the 1970s and 1980s...

Consumer price inflation (1966-2009)



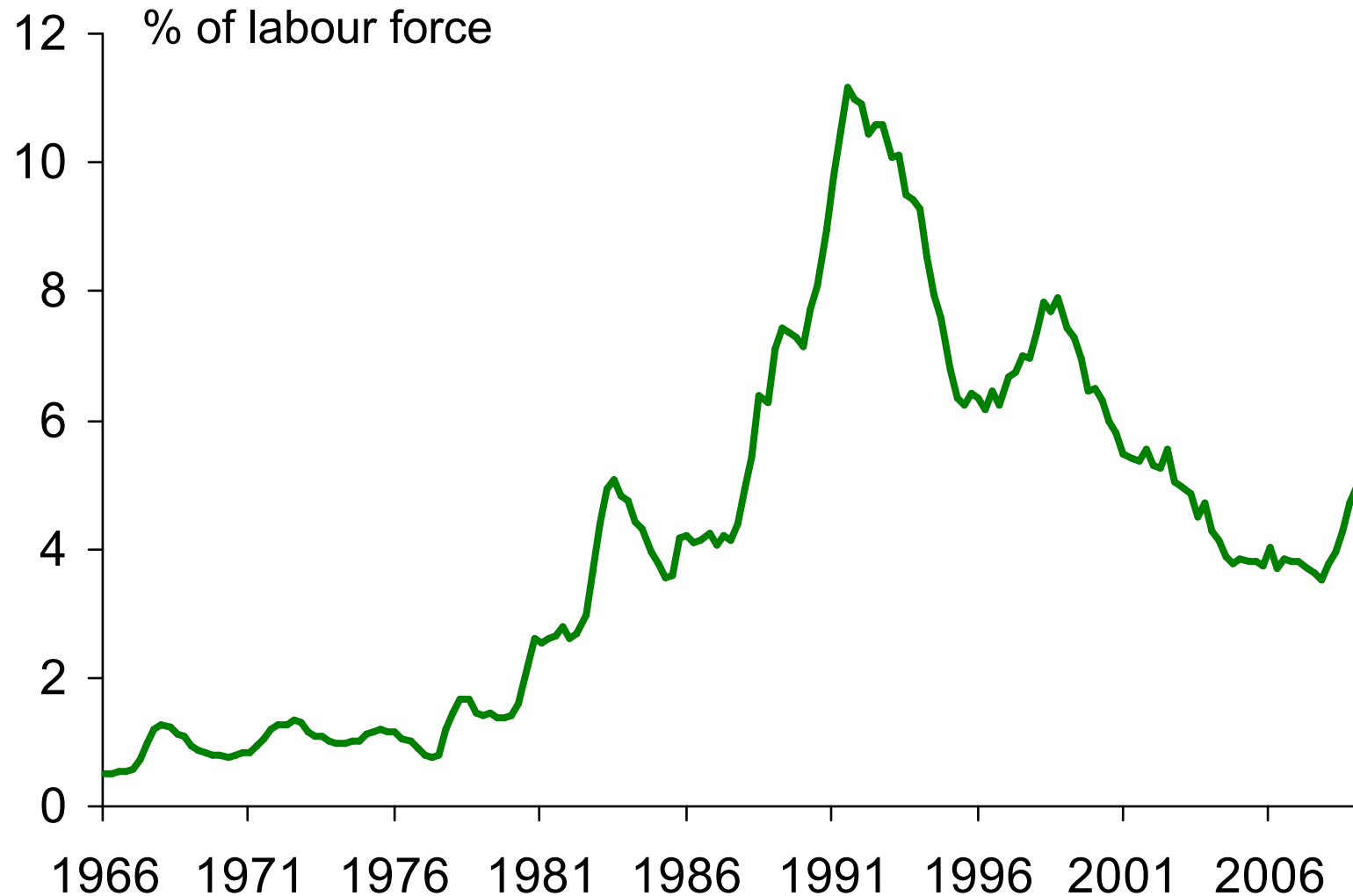
... turned around decades of fiscal deficits...

Fiscal balance (1972-2008)



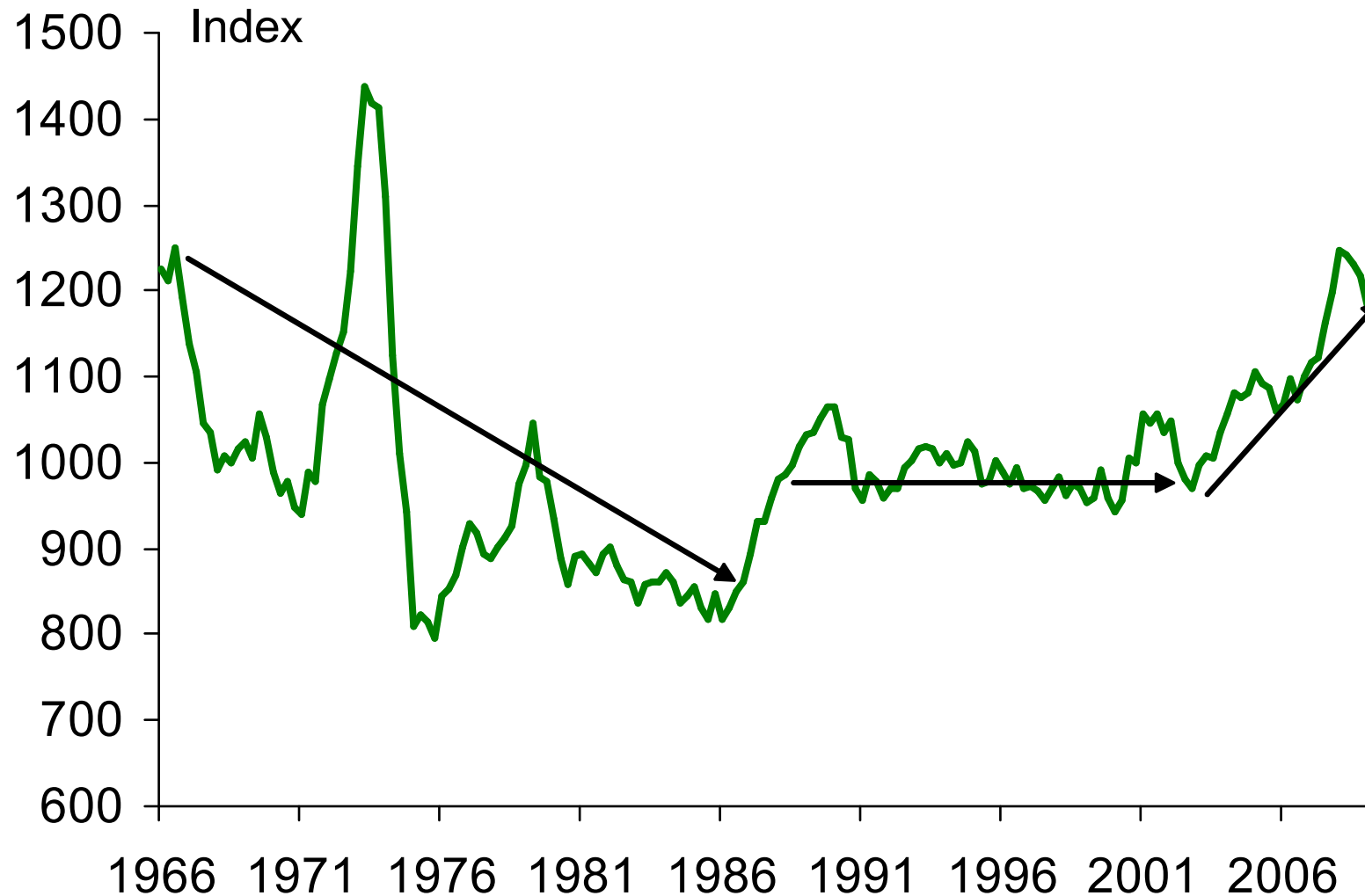
... and made the labour market more flexible, lowering the double digit unemployment rates of the late 1980s and early 1990s

Unemployment rate (1966-2009)



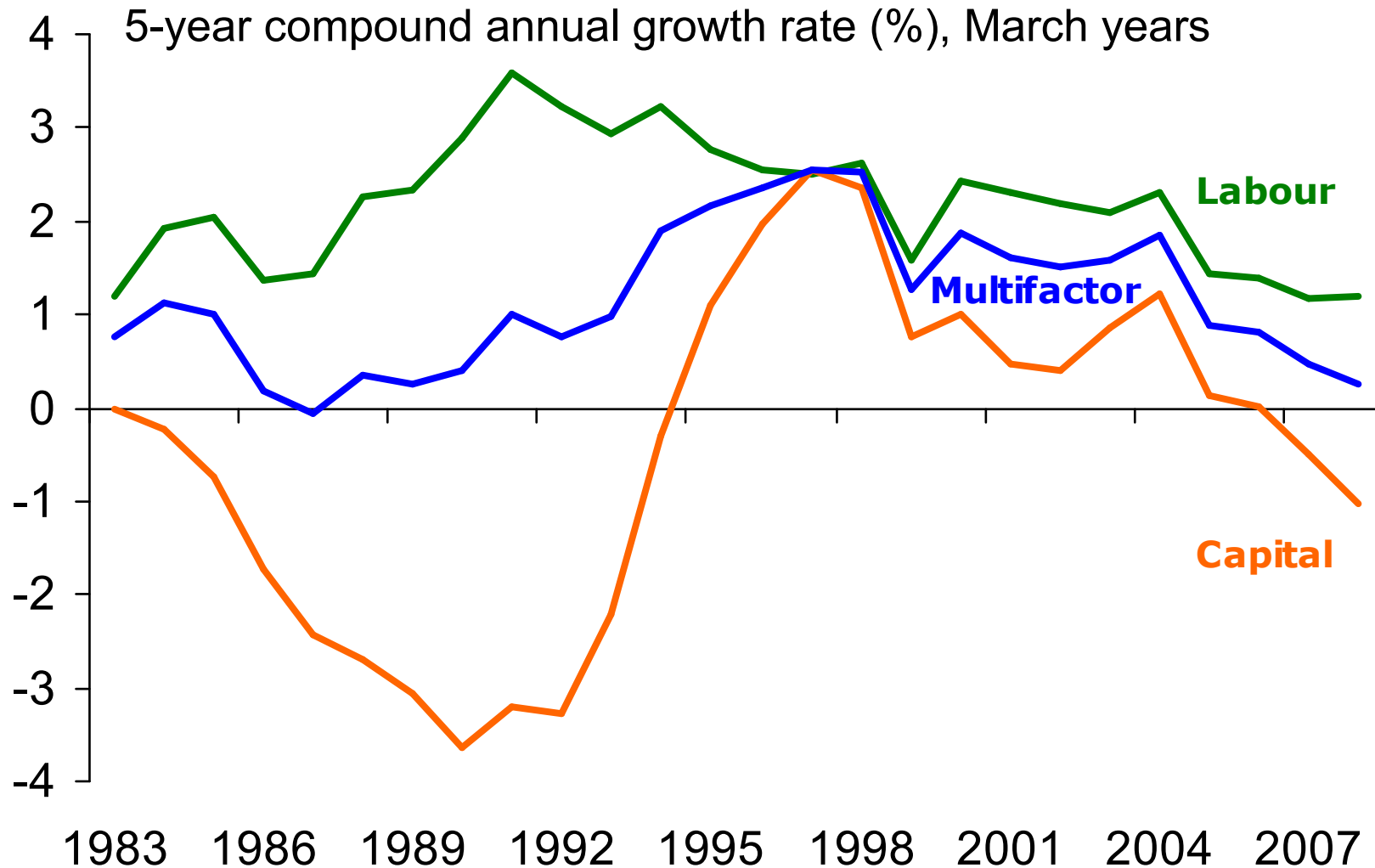
NZ's terms of trade has lifted after decades of decline or stagnation

NZ's terms of trade (1966-2009)



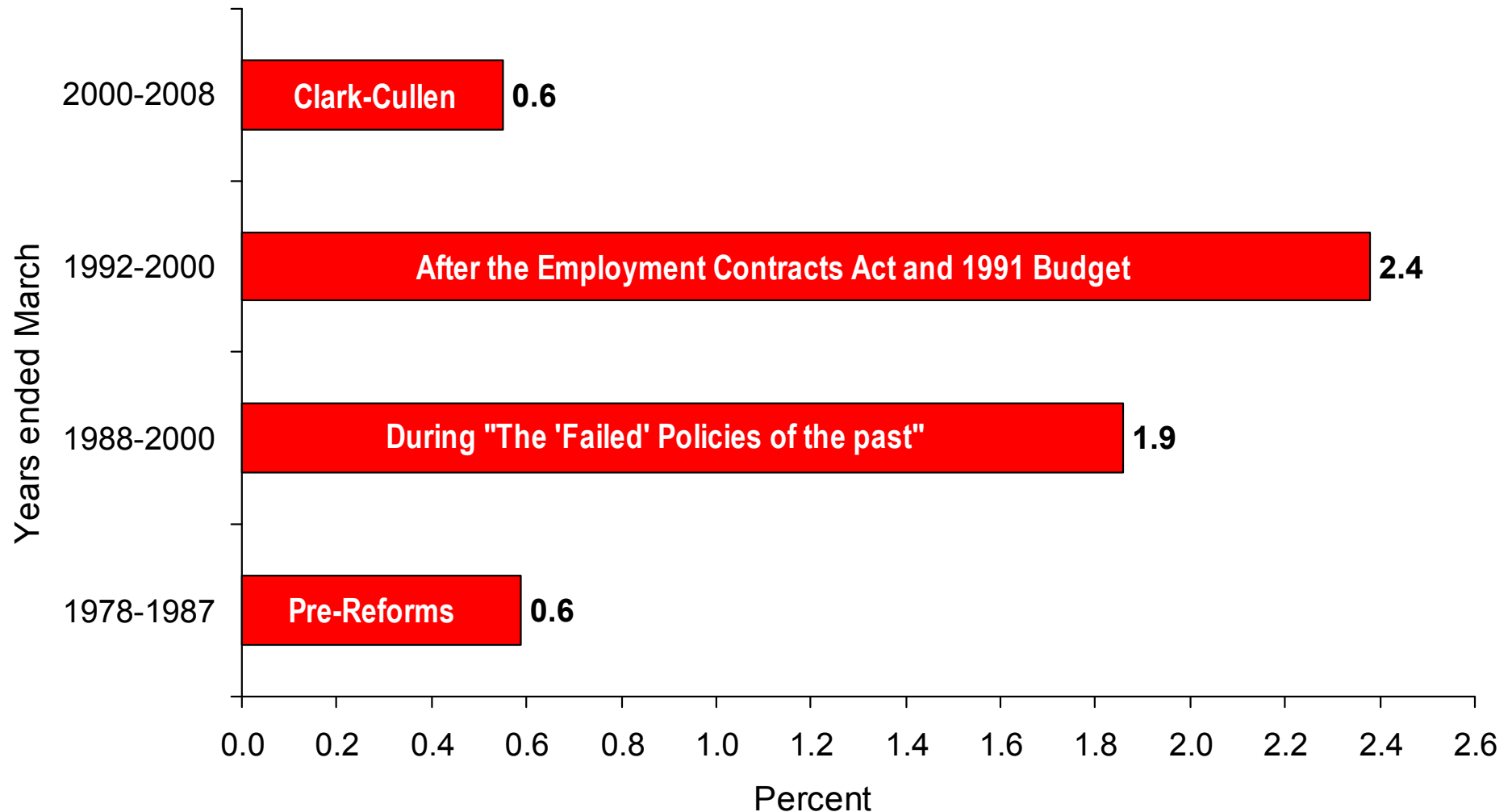
NZ's productivity performance

Productivity in the measured sector (1983-2008)



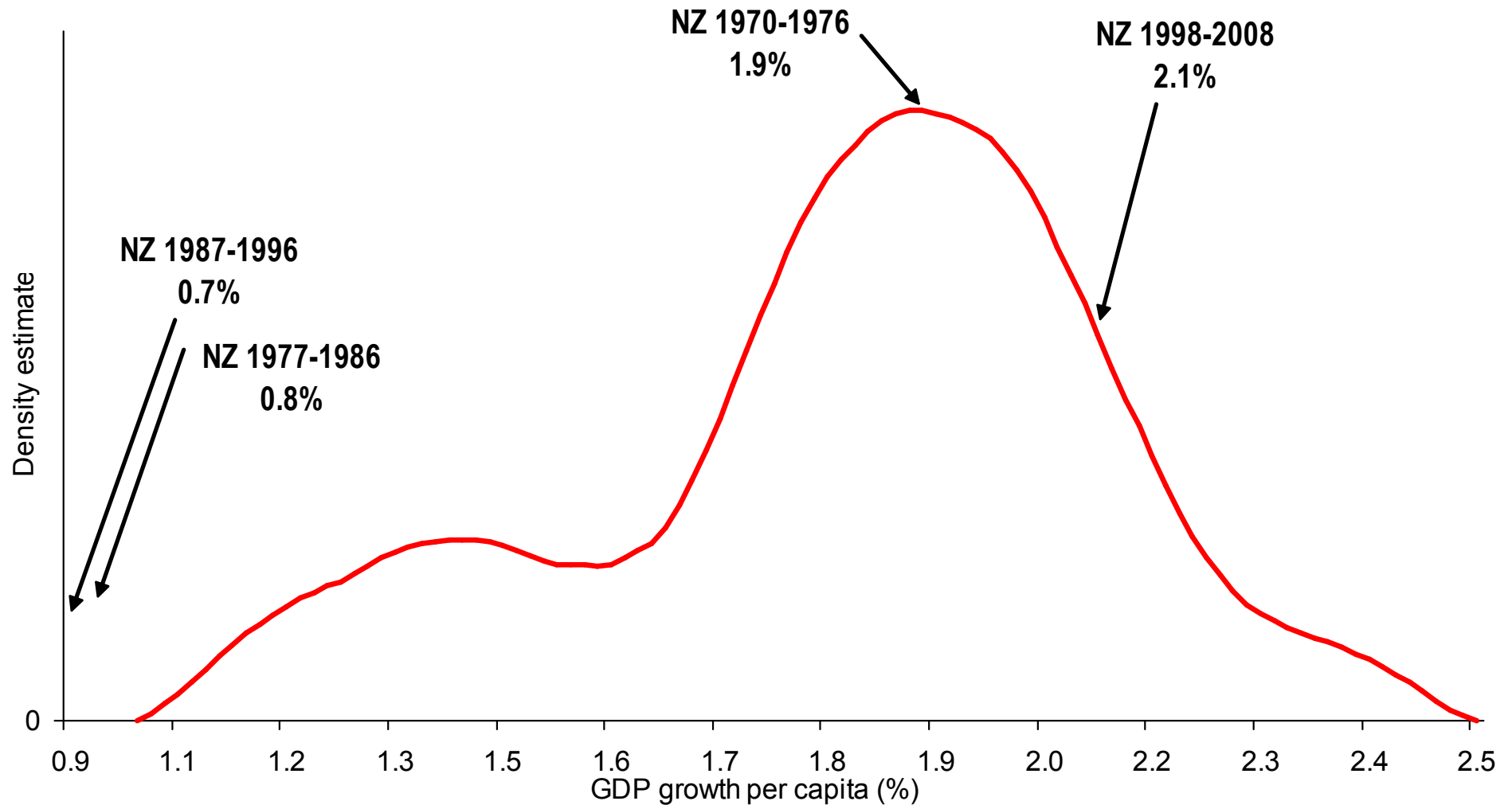
After economic reforms, productivity growth accelerated then slowed post 2000

Trend Average Annual Multifactor Growth Rate

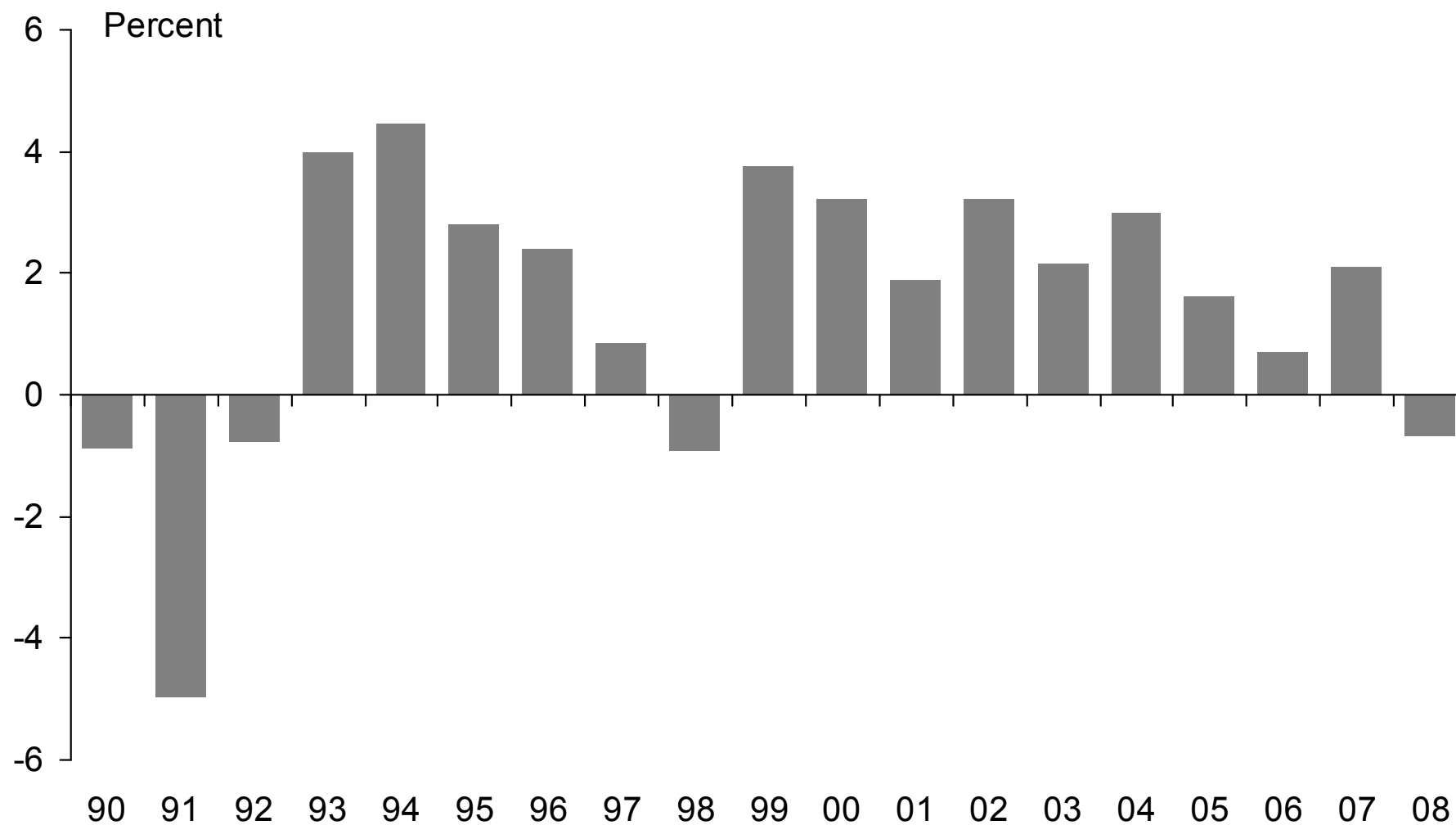


NZ moved from being a below average performer to an improved performer

Distribution of per capita growth rates for advanced countries, 1870-1998



NZ's growth rate improved after the reform period (GDP per capita; calendar years)



NZ thus benefited substantially from the mid-80's to mid-90's economic reforms

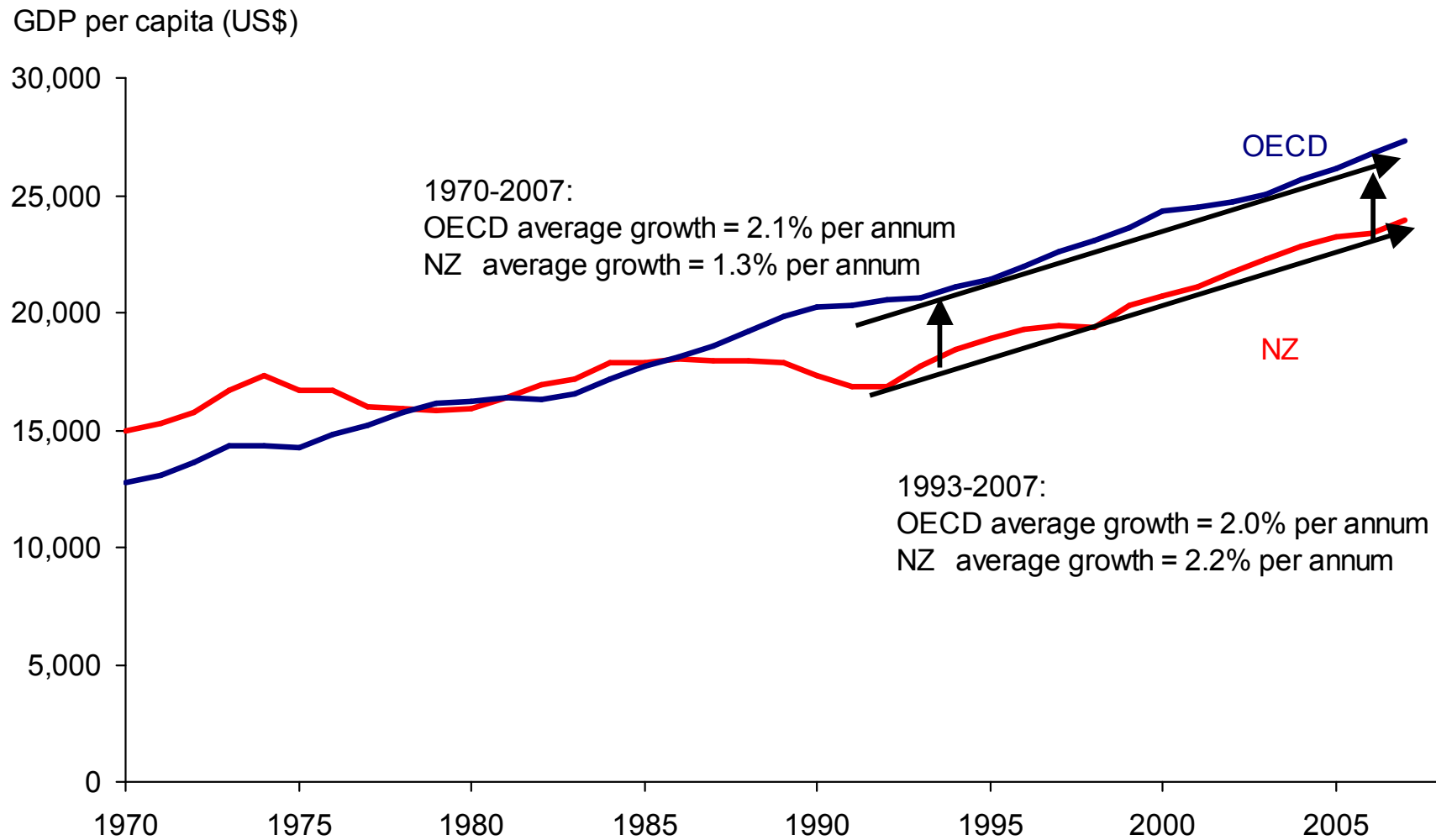
A reminder on the Reforms

- Monetary and fiscal policy vastly improved
- Dollar floated
- Low inflation achieved
- Labour market transformed
- Internal regulatory structures dismantled
- Income taxes reduced
- Size of government scaled back
- Government offshore debt eliminated
- Budget moved to surplus
- Corporatisation/privatisation delivered
- Exchange controls/import licensing abolished
- Tariffs greatly reduced
- Price, wage and dividend controls abolished

Outcome: Business sector adaptability hugely increased

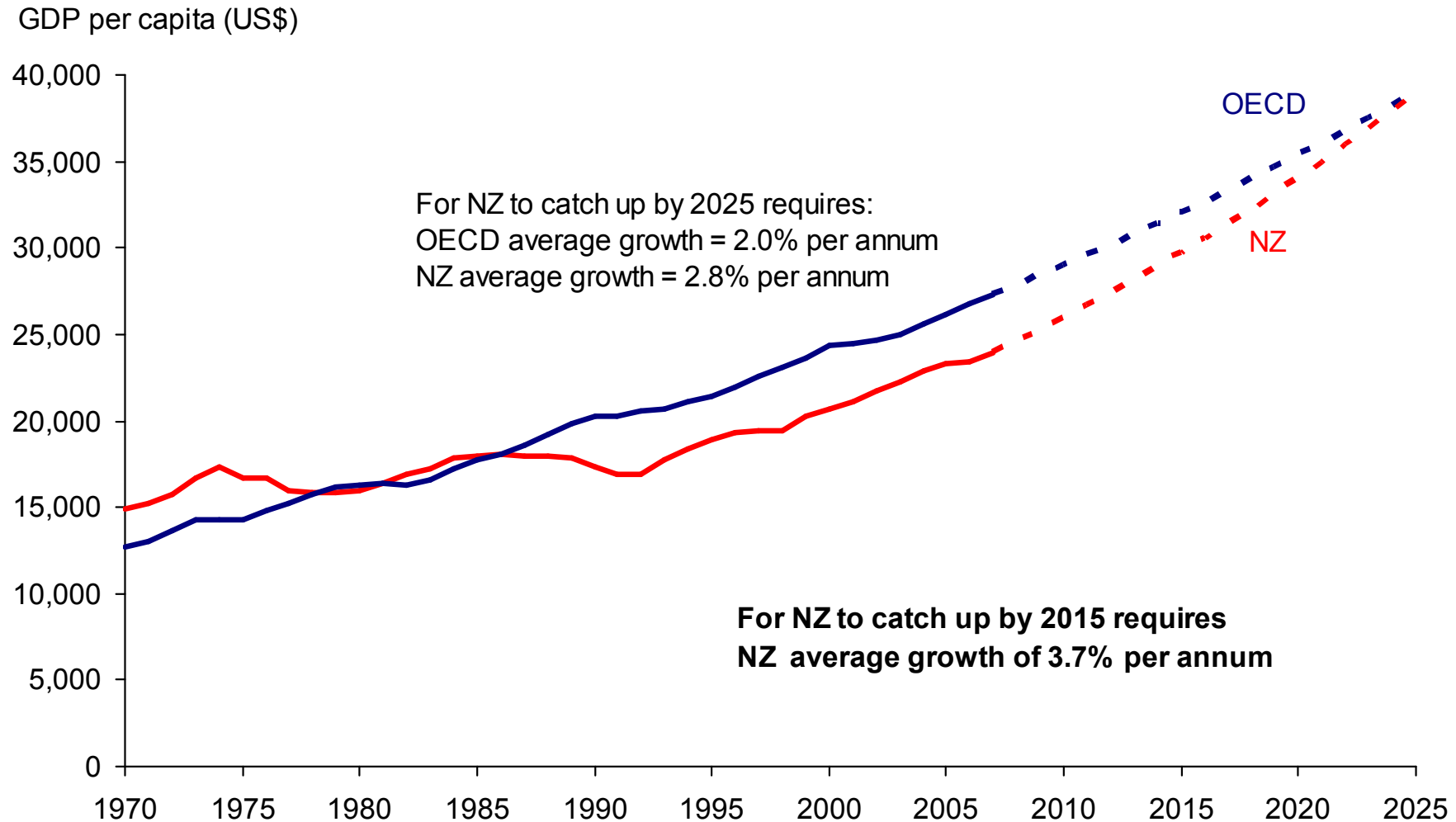
The relative decline has been arrested

GDP per capita



But closing the gap requires something a lot more

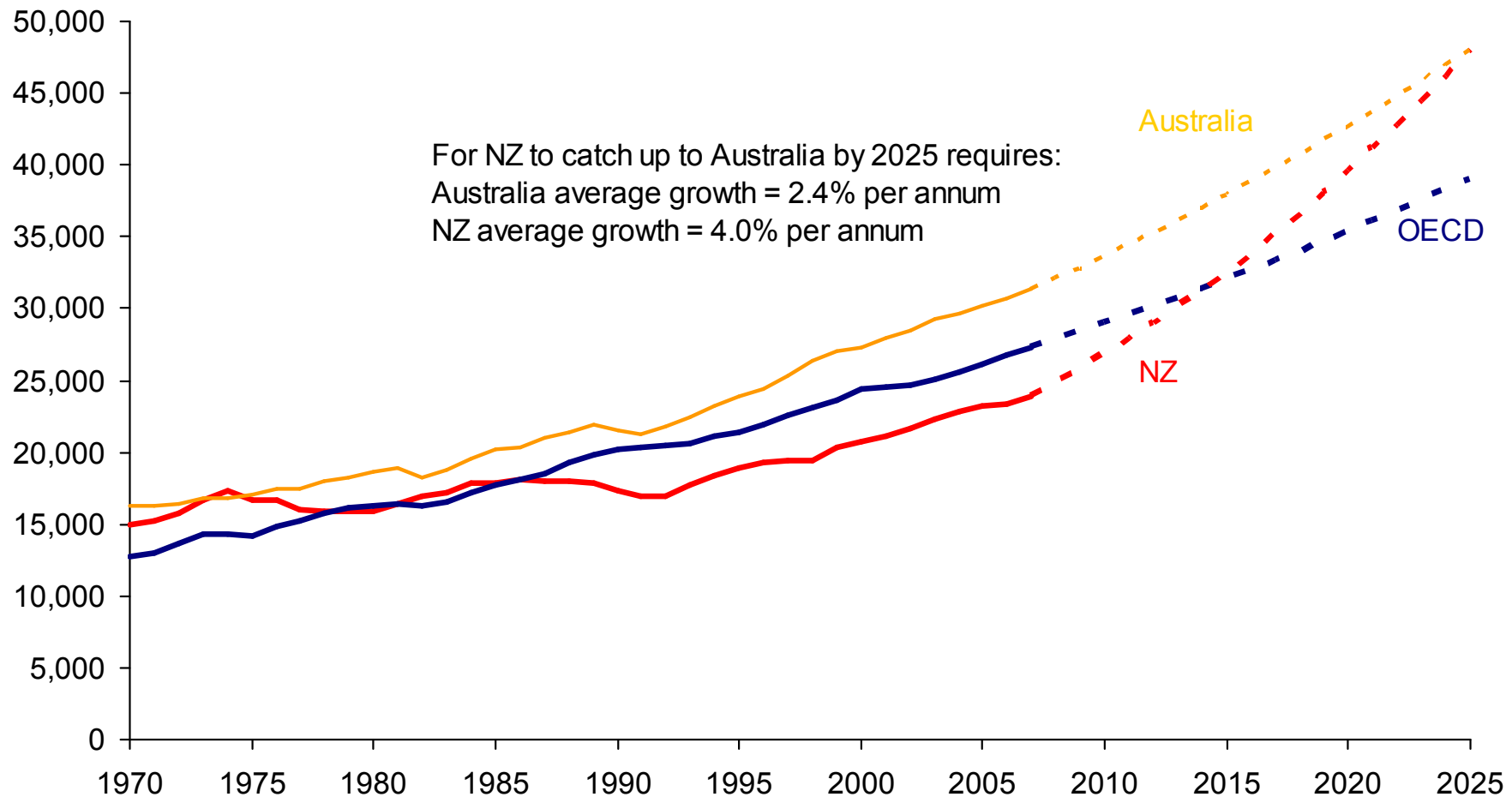
It took us 20 years to fall down the ladder. Assuming OECD real GDP per capita growth of 2.0 percent, NZ needs to grow at 2.8 percent to close the gap by 2025



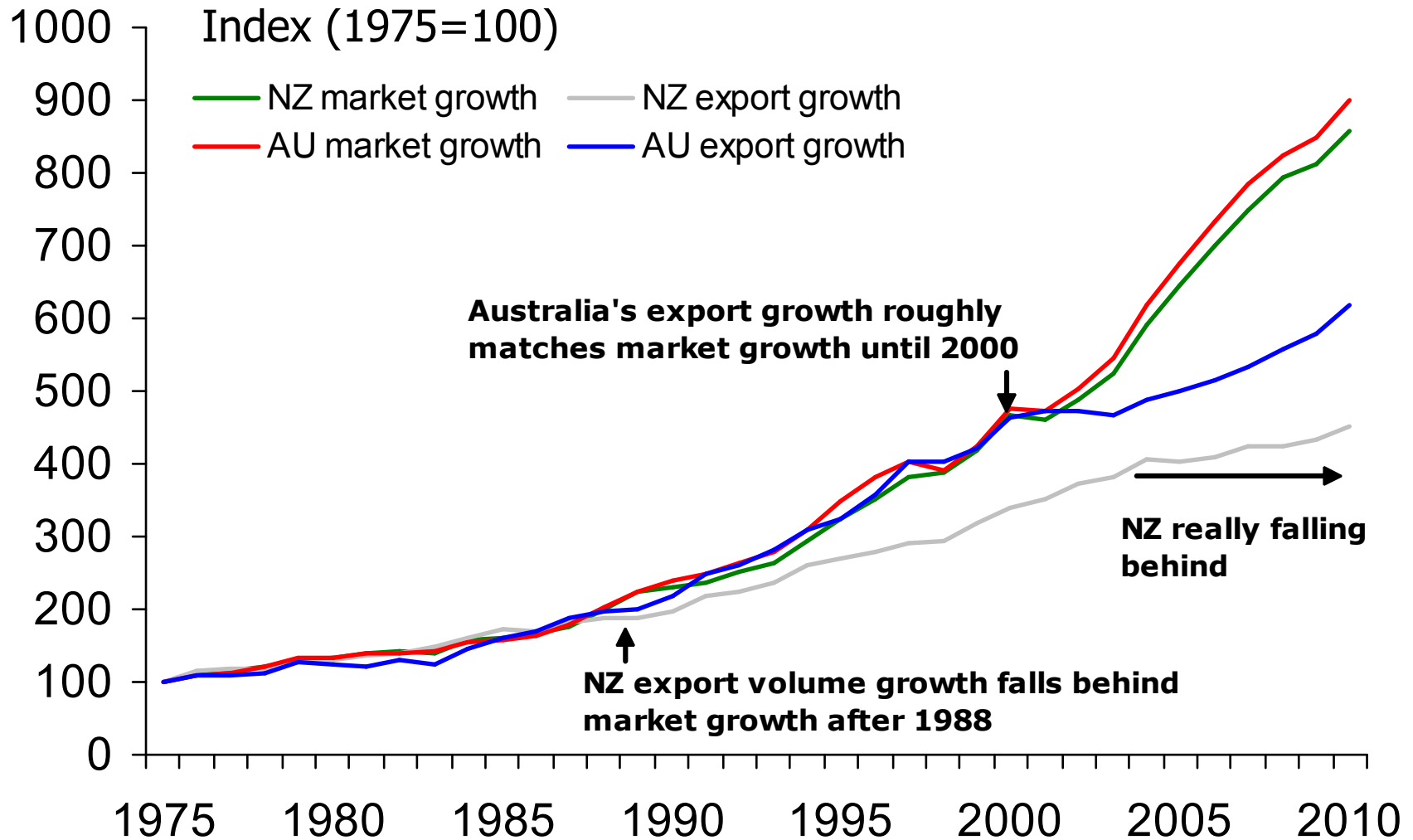
Catching up with Australia poses an even greater challenge

NZ's per capita GDP was similar to Australia's in the mid 1970's. In 2007, NZ's per capita GDP is around 24% below Australia's. In order for NZ to catch up to Australia by 2025, per capita GDP growth has to average 4% per annum, almost twice what has been achieved in the past decade.

GDP per capita (US\$)

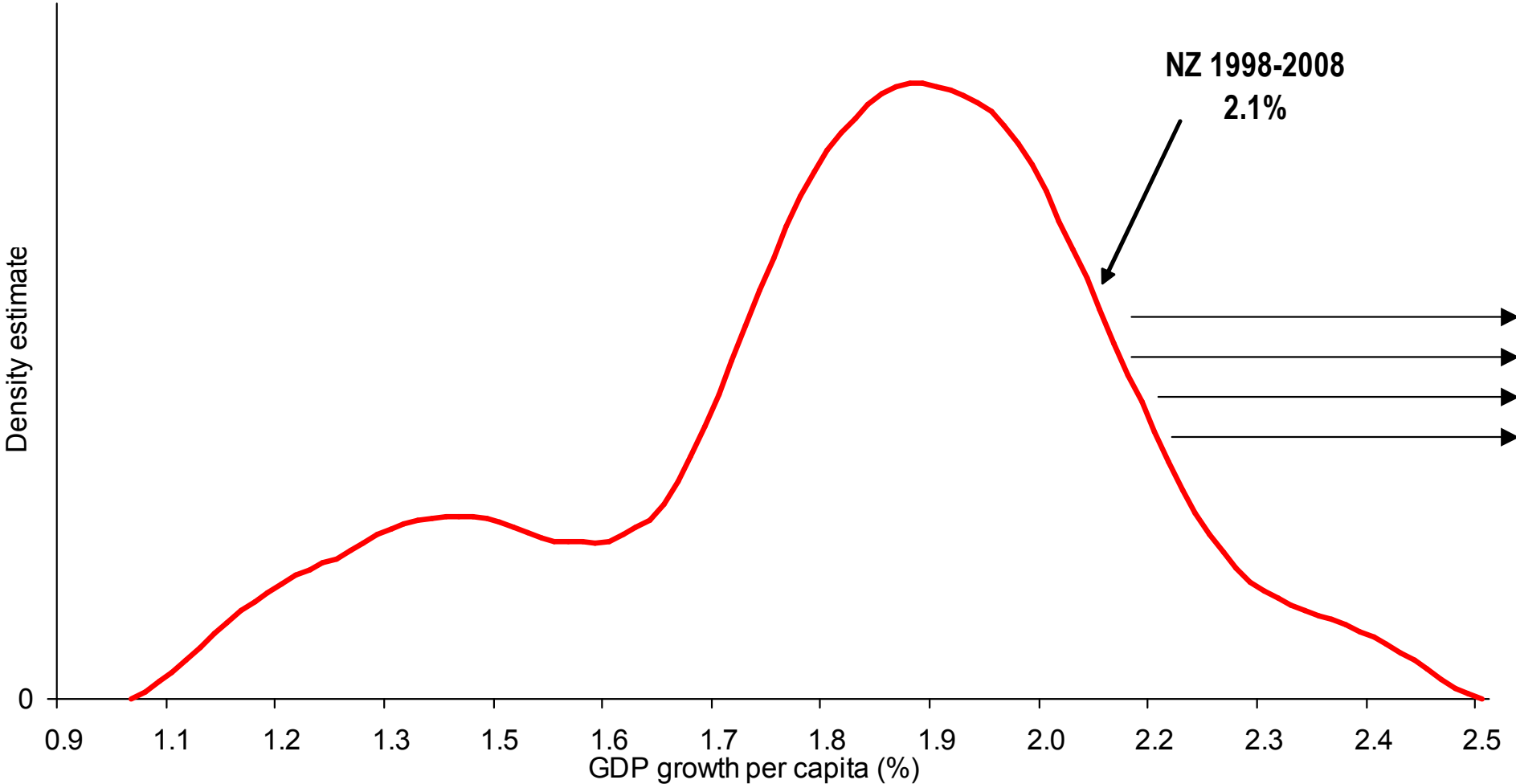


NZ and Australia cumulative market and export volume growth



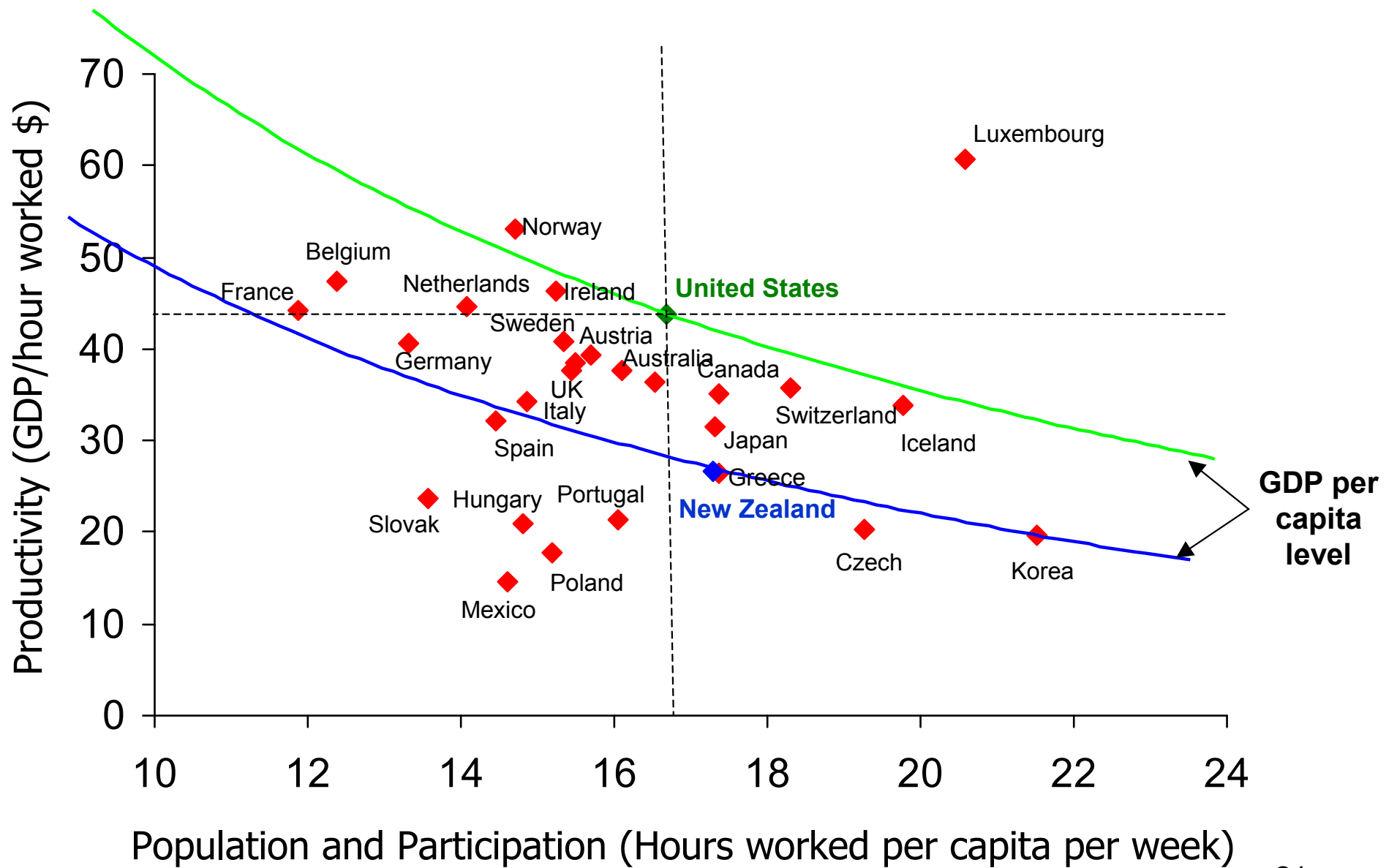
We are here, but we need to be there...

Distribution of real per capita growth rates for advanced countries, 1870-1998



Sources: Angus Maddison, *The World Economy: a millennial perspective*, OECD, 2001. Statistics NZ.

Work harder or work smarter



But we continue to rank lowly in the OECD stakes

OECD Nation Rankings

Richest nation: Luxembourg

High income: Norway, USA, Ireland, Iceland, Switzerland

Middle/high income: 13 nations including Australia, UK, Canada, France, Japan

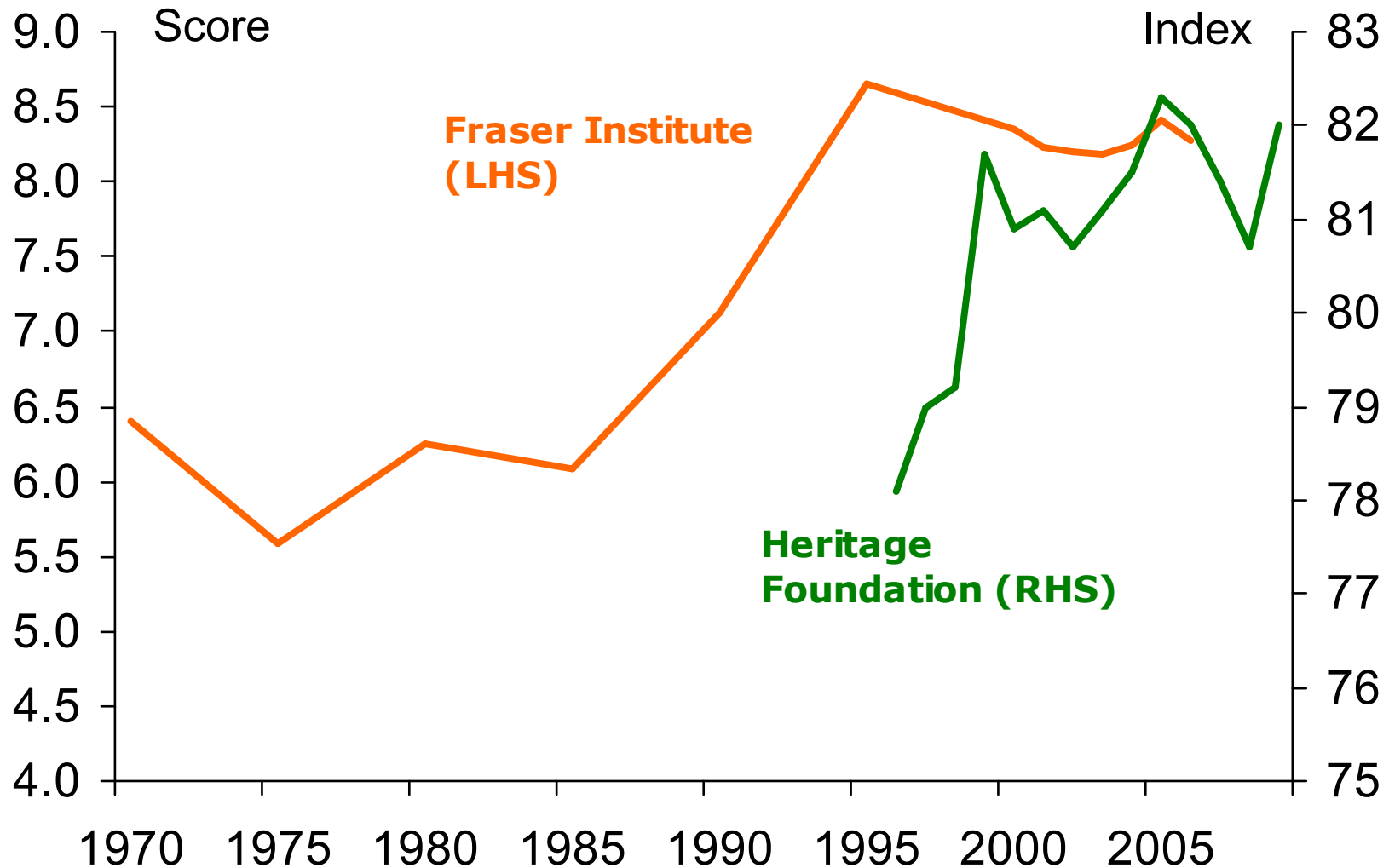
Low/middle income: New Zealand, Spain, Greece, Korea, Czech

Lowest income: Mexico

Rankings based on purchasing power, taking into account the cost of 3000 items, from a litre of milk to building a house

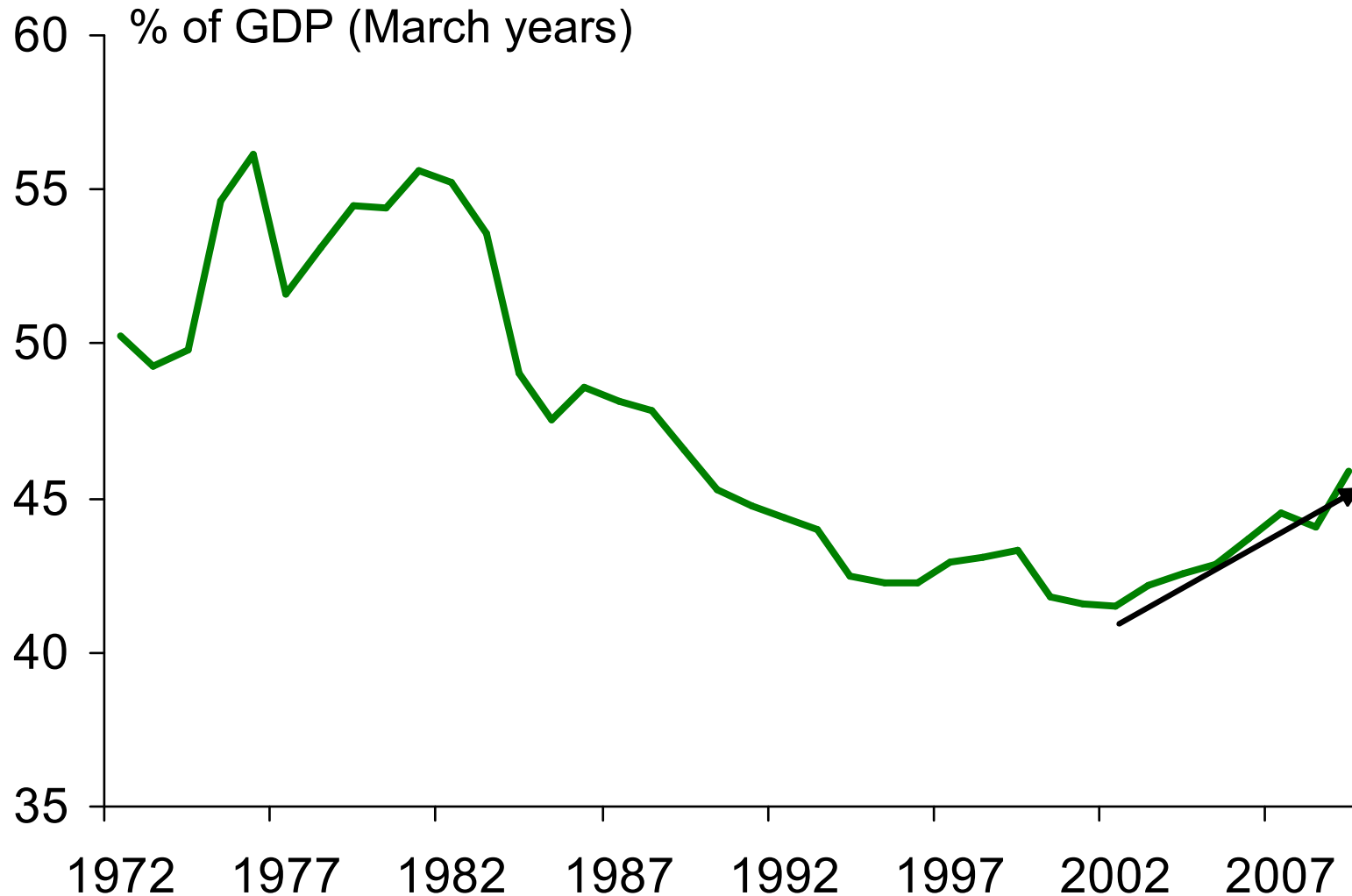
Are we starting to slide backwards on the competitiveness front?

Economic Freedom Index (1970-2009)



Labour's share of national income has been rising...

Compensation of employees as % of GDP (1972-2009)

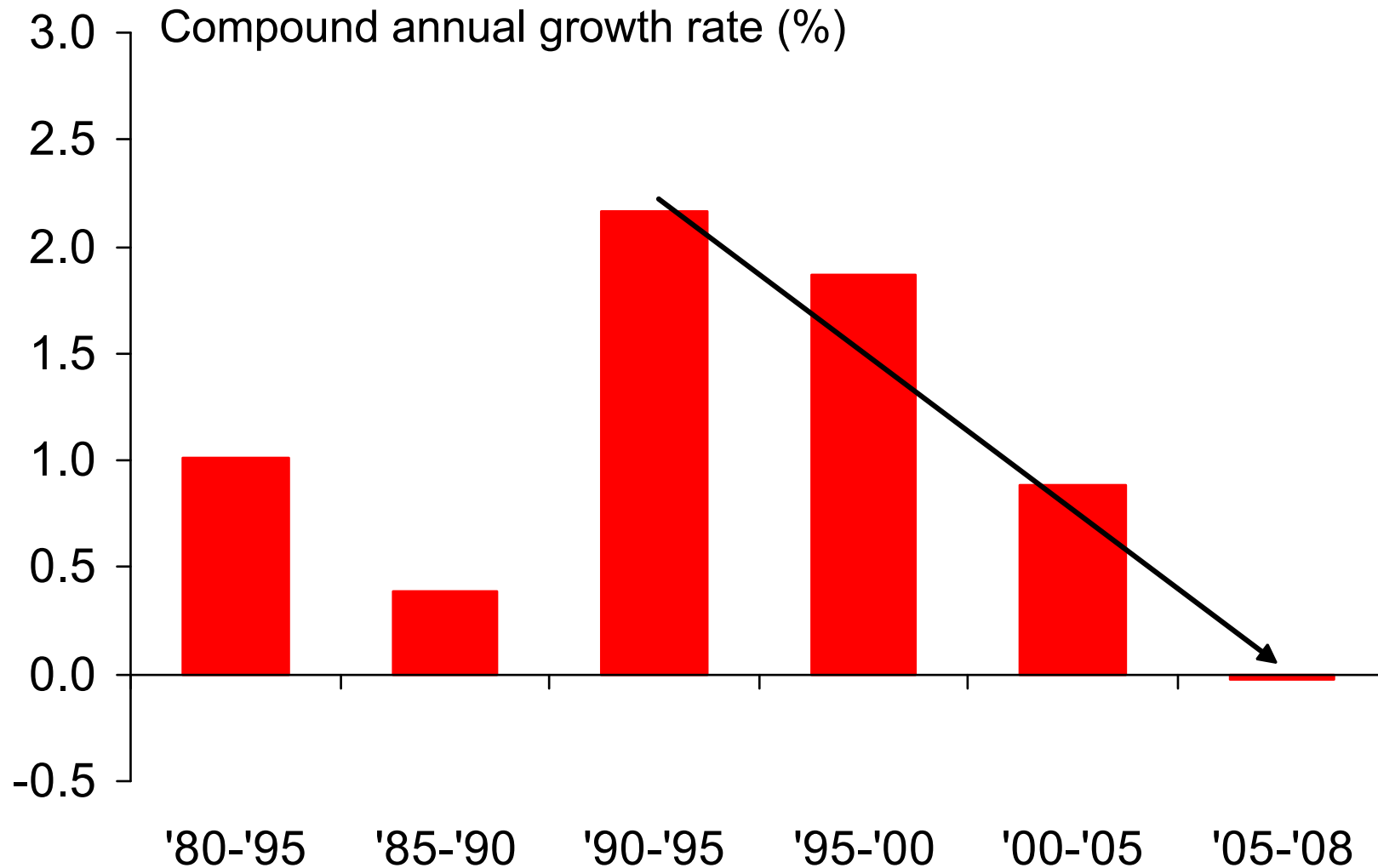


... yet labour productivity growth has been heading lower



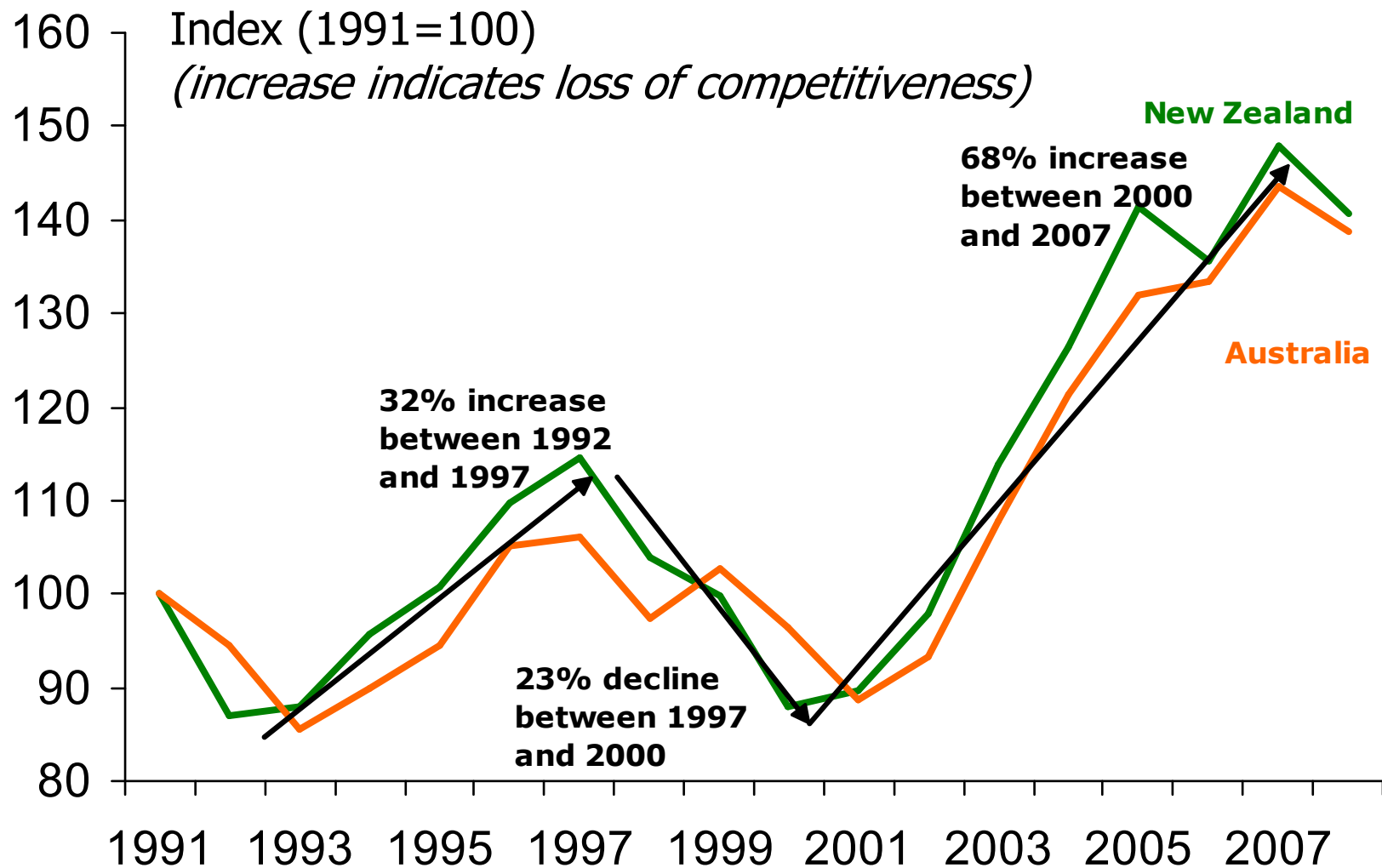
And so has multifactor productivity growth

Multifactor productivity growth



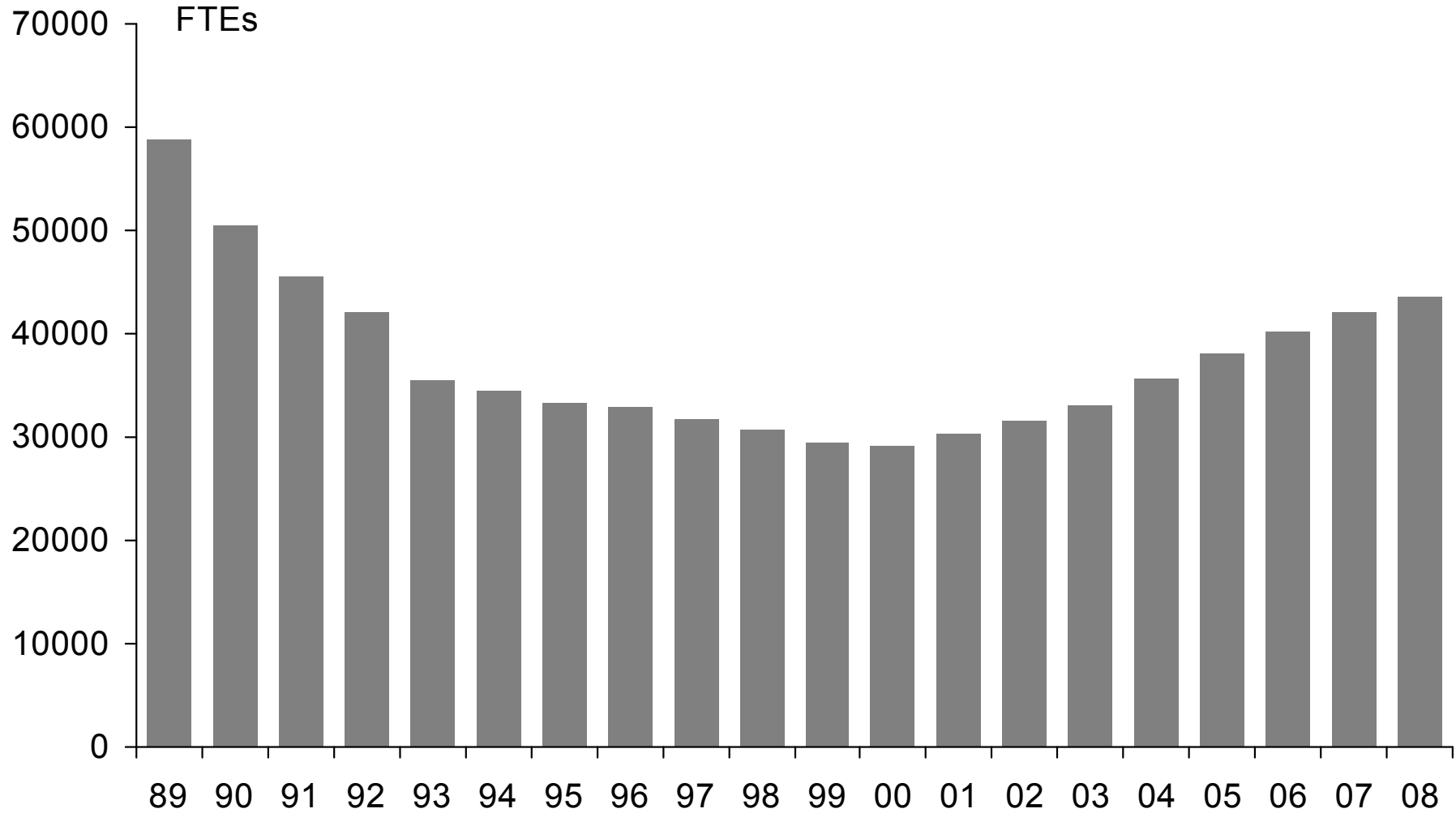
NZ's competitiveness declining again

In terms of relative unit labour costs, NZ was 13th in world for Global Competitiveness in 1999. Since 2000, NZ has lost competitiveness, ranking 24th in world in 2008/09 according to the World Economic Forum.



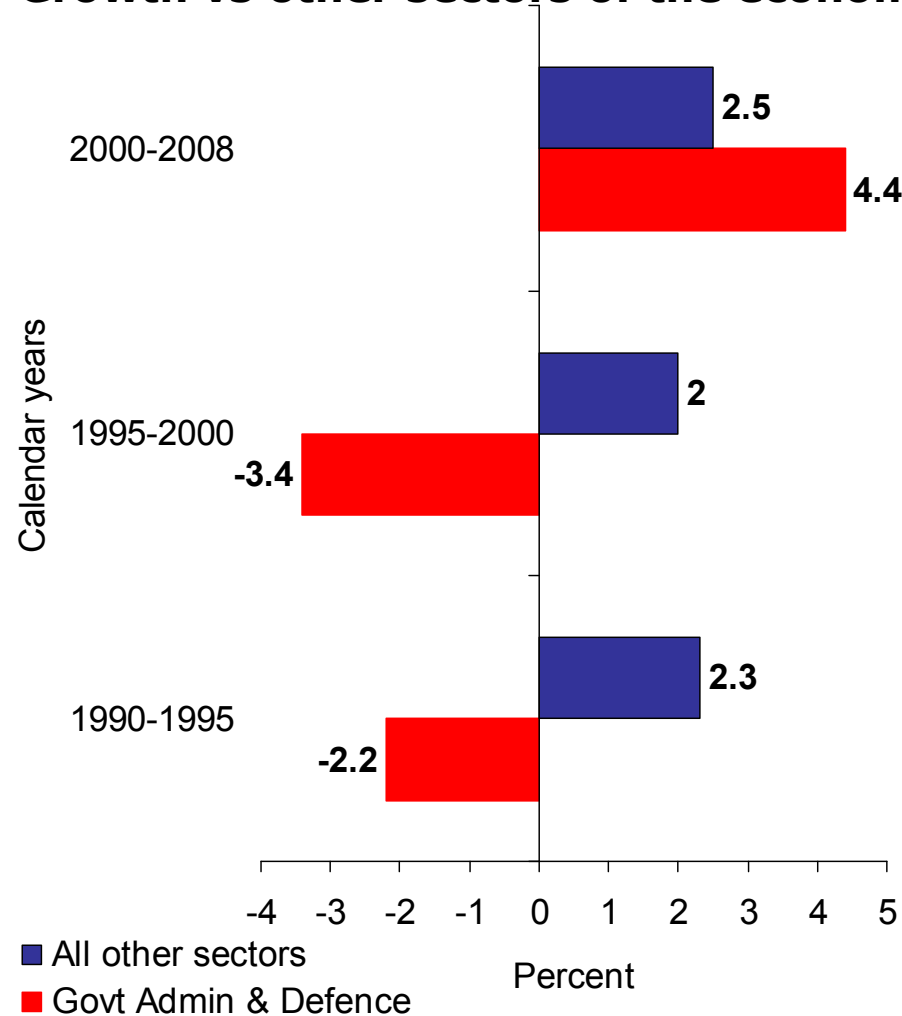
Core public service employment growth : down then up

Core Public Service staff (June years)

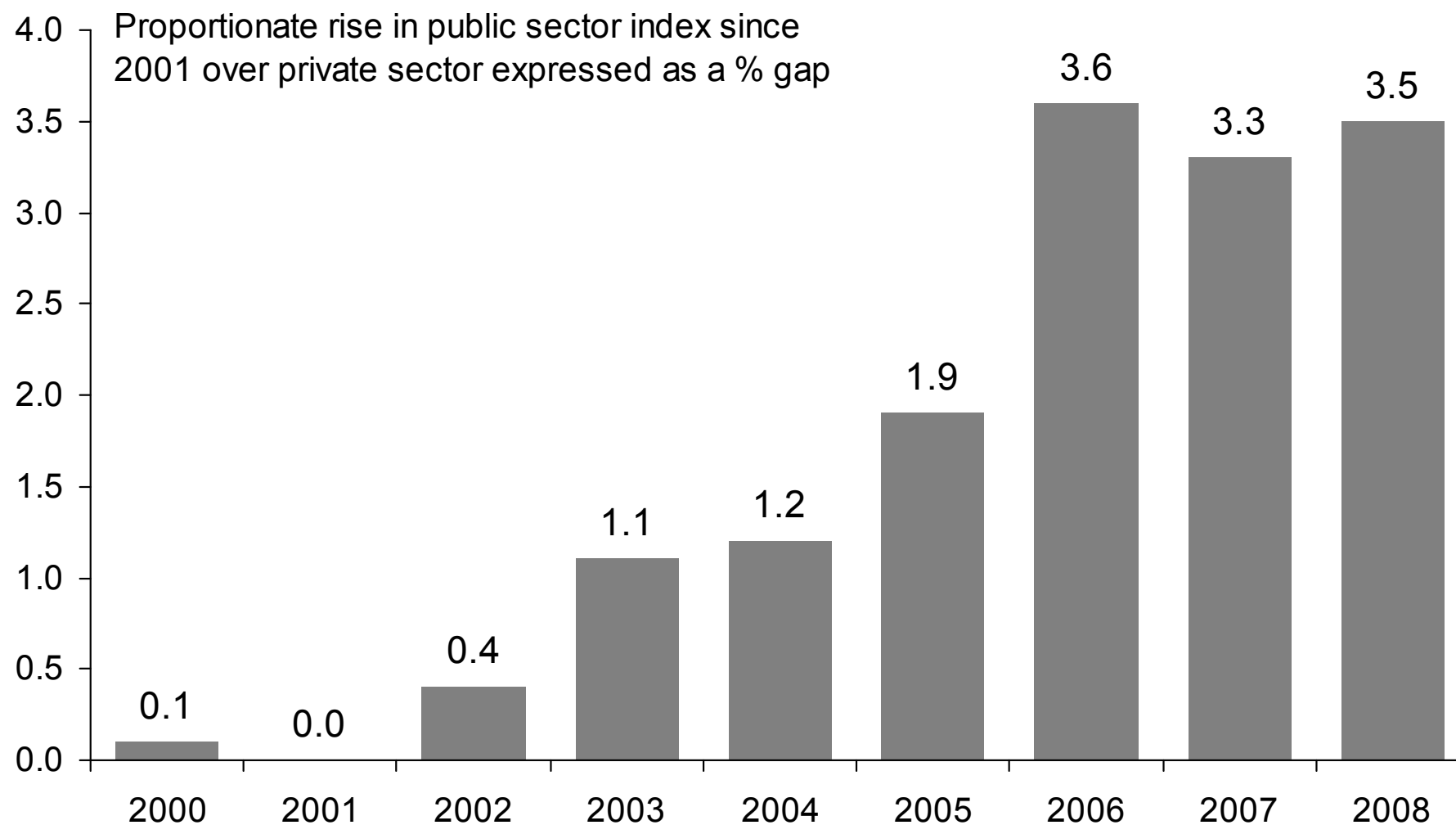


Core public service employment growth

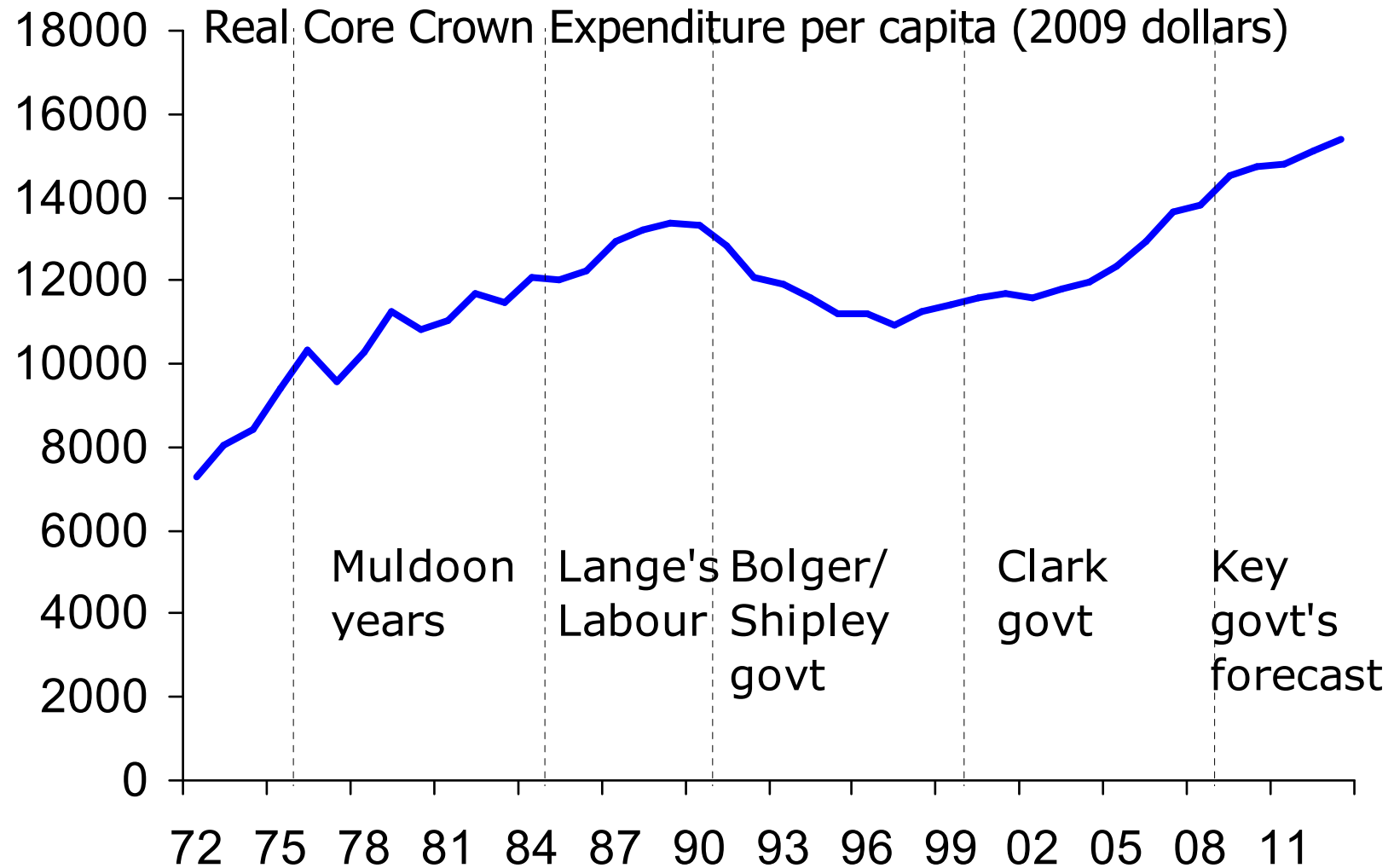
Growth vs other sectors of the economy



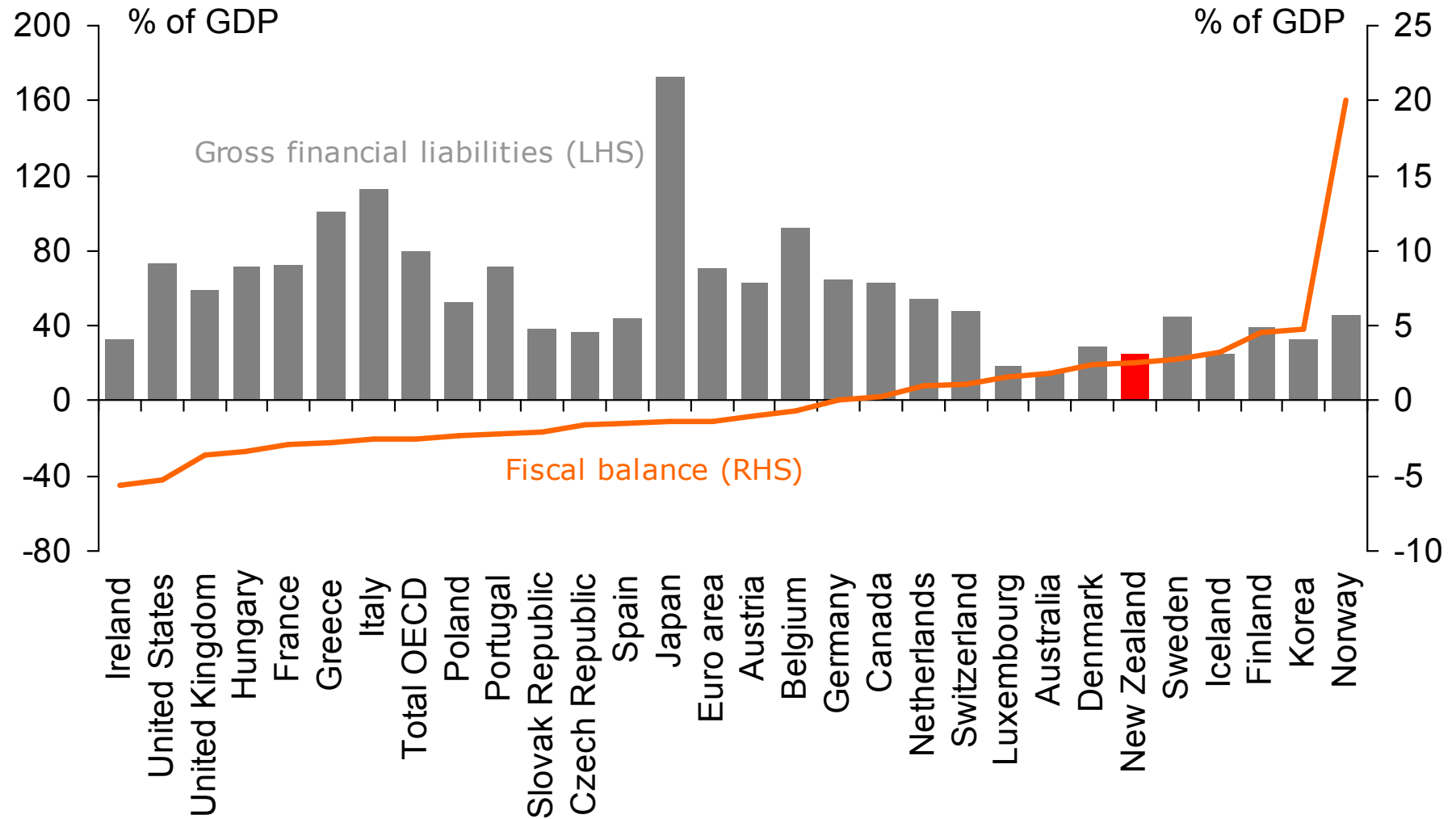
Real unit labour cost: public sector rise in excess of private sector



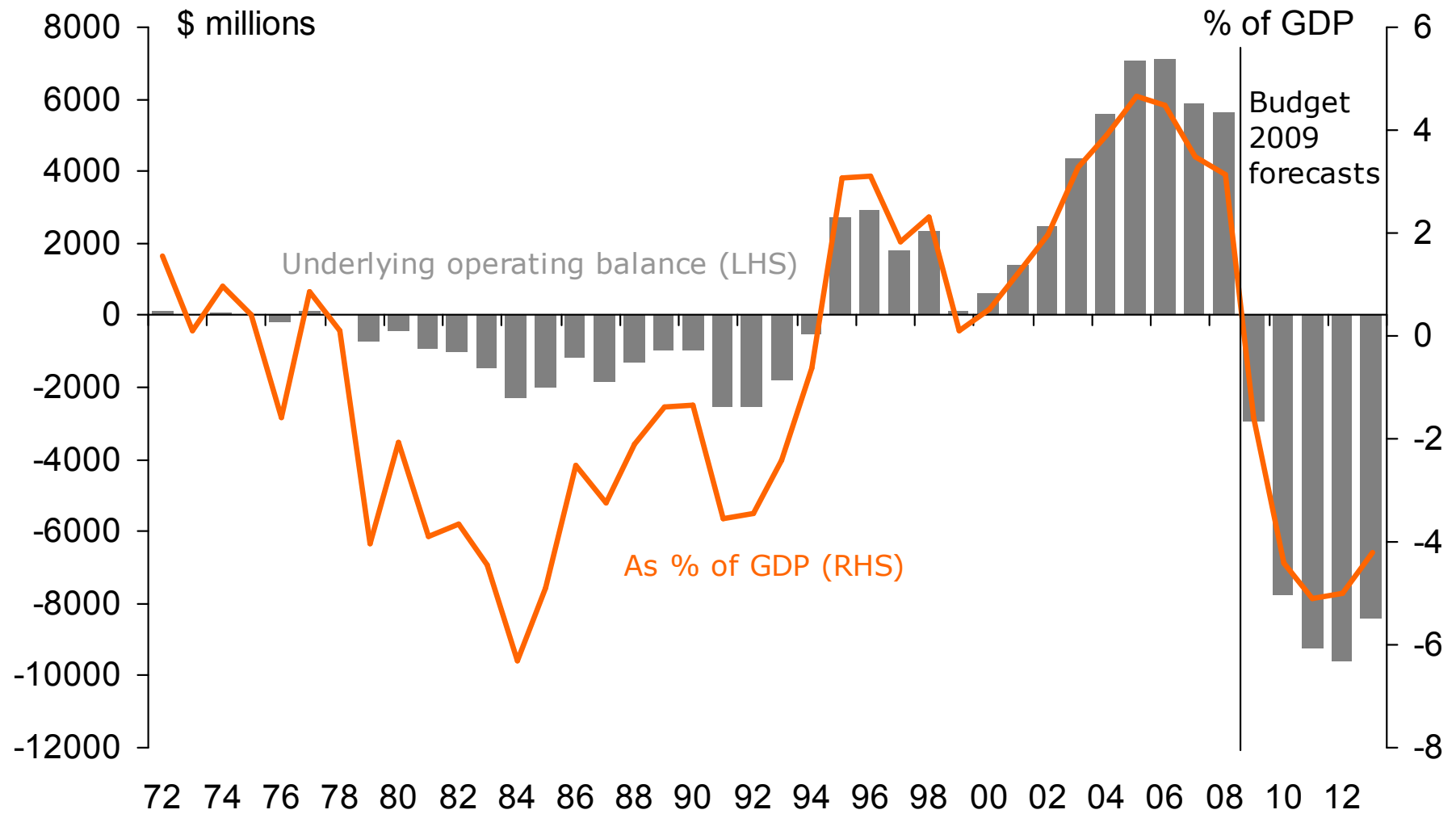
Central government spending : down then up



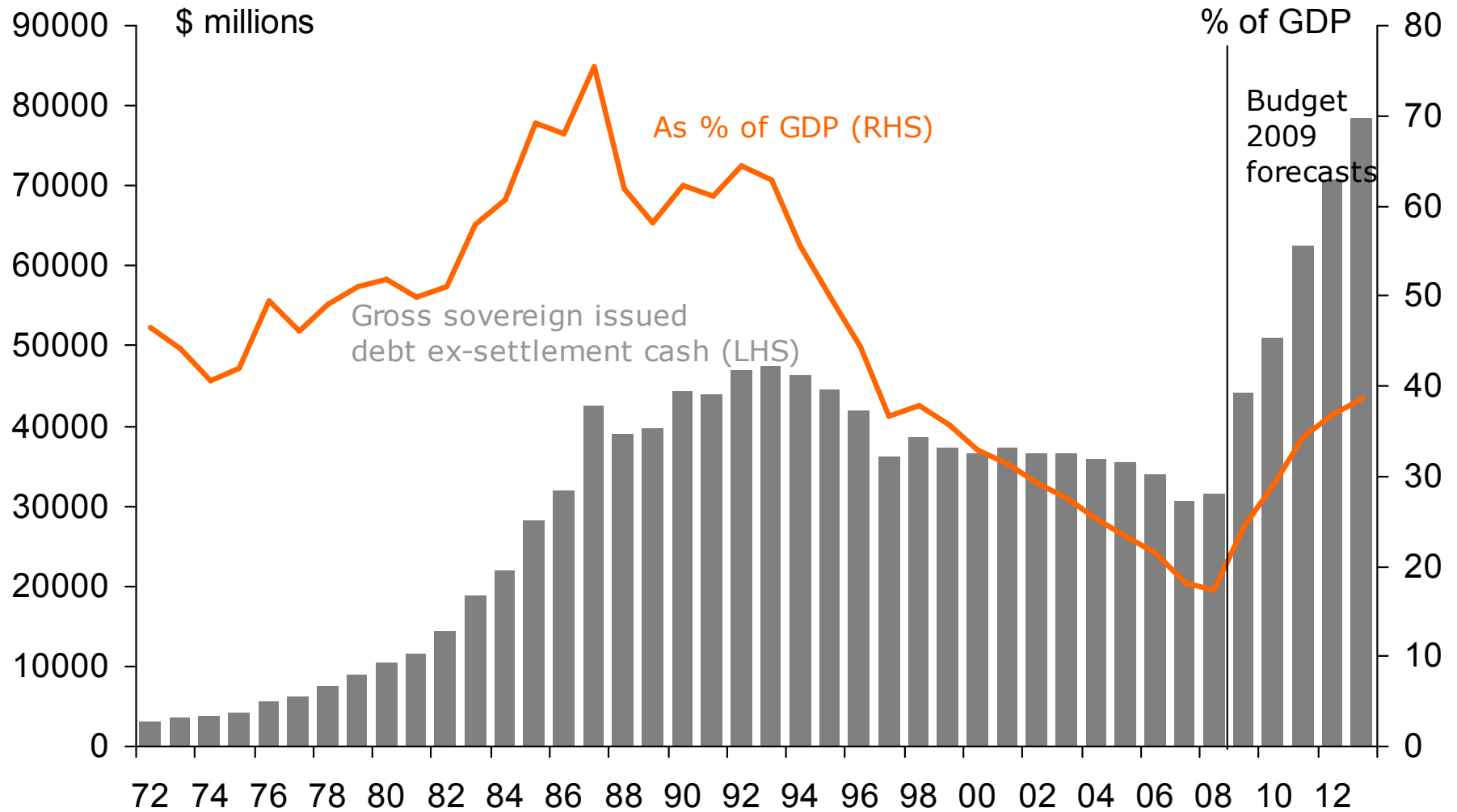
NZ's fiscal position coming from a better starting point (2008)



But NZ fiscal balance now deteriorating rapidly



NZ public debt forecast to rise rapidly



The Government sector is growing far too rapidly, squeezing out the private sector

Total Govt. gross debt forecast to increase from 18% to 41% of GDP from 2008 to 2013, or \$37b. to \$68b.

Investment in SOEs grew from 12% to 38% of GDP from 1999 to 2009, or \$13b. to \$68b.

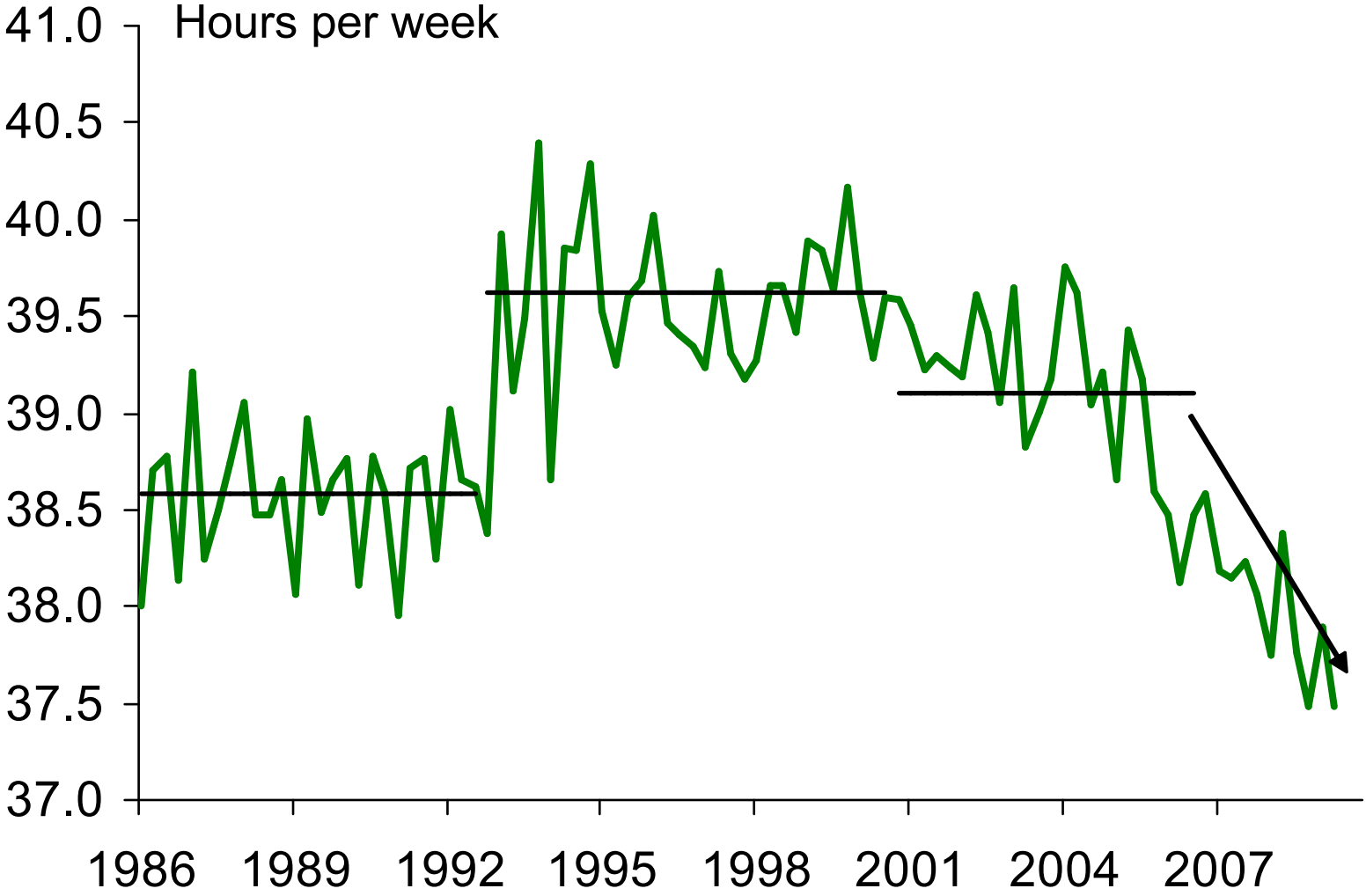
Total crown property assets grew from 40% to 60% of GDP from 1999 to 2009, or \$42b. to \$106b.

Total Crown expenses forecast to be 46% of GDP by 2012/13

Source: NZ Treasury Fiscal Strategy Report 2009

Working less but wanting more. Less hours per worker.

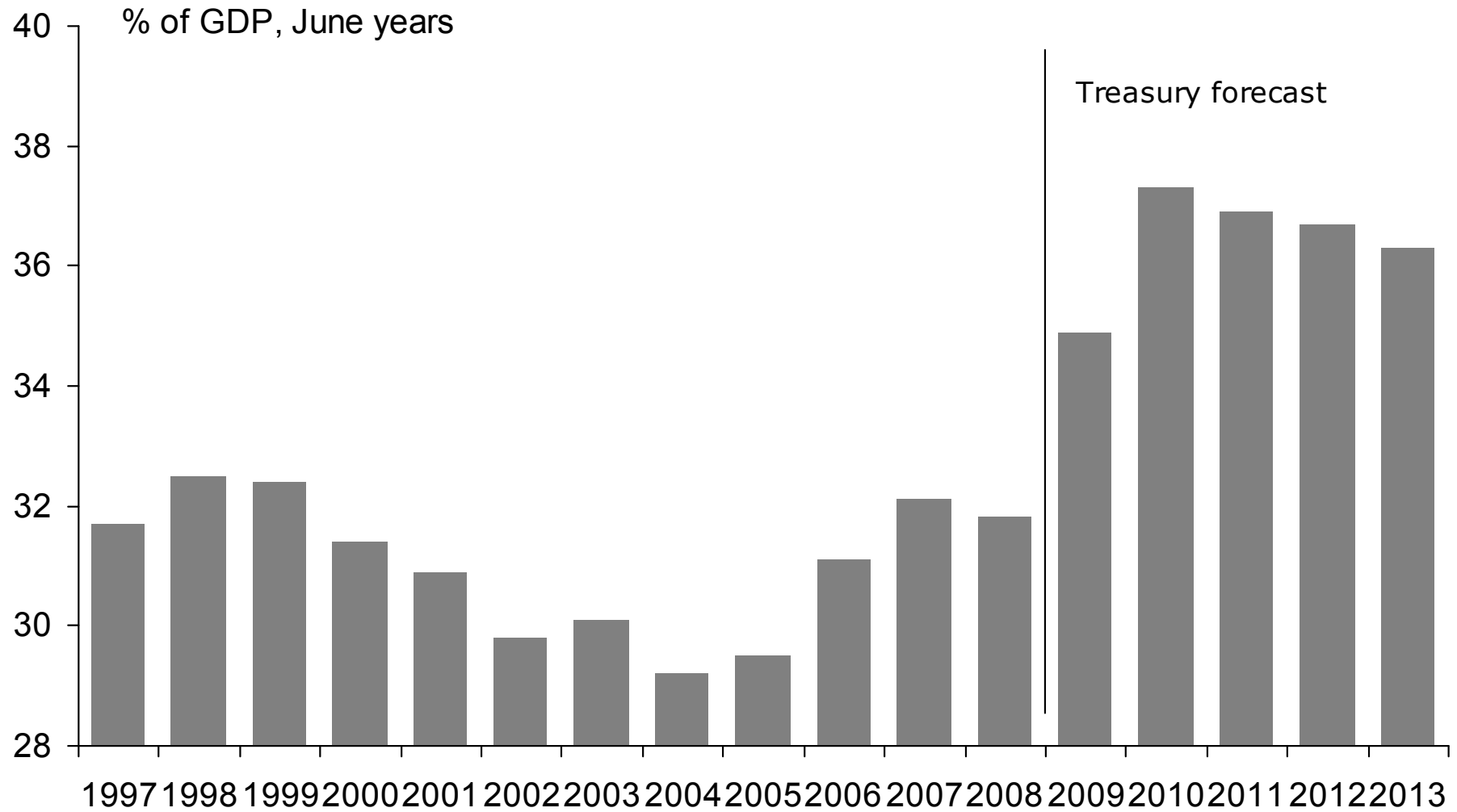
Hours per full-time equivalent (1986-2009)



Sources: Statistics NZ; ANZ National Bank.

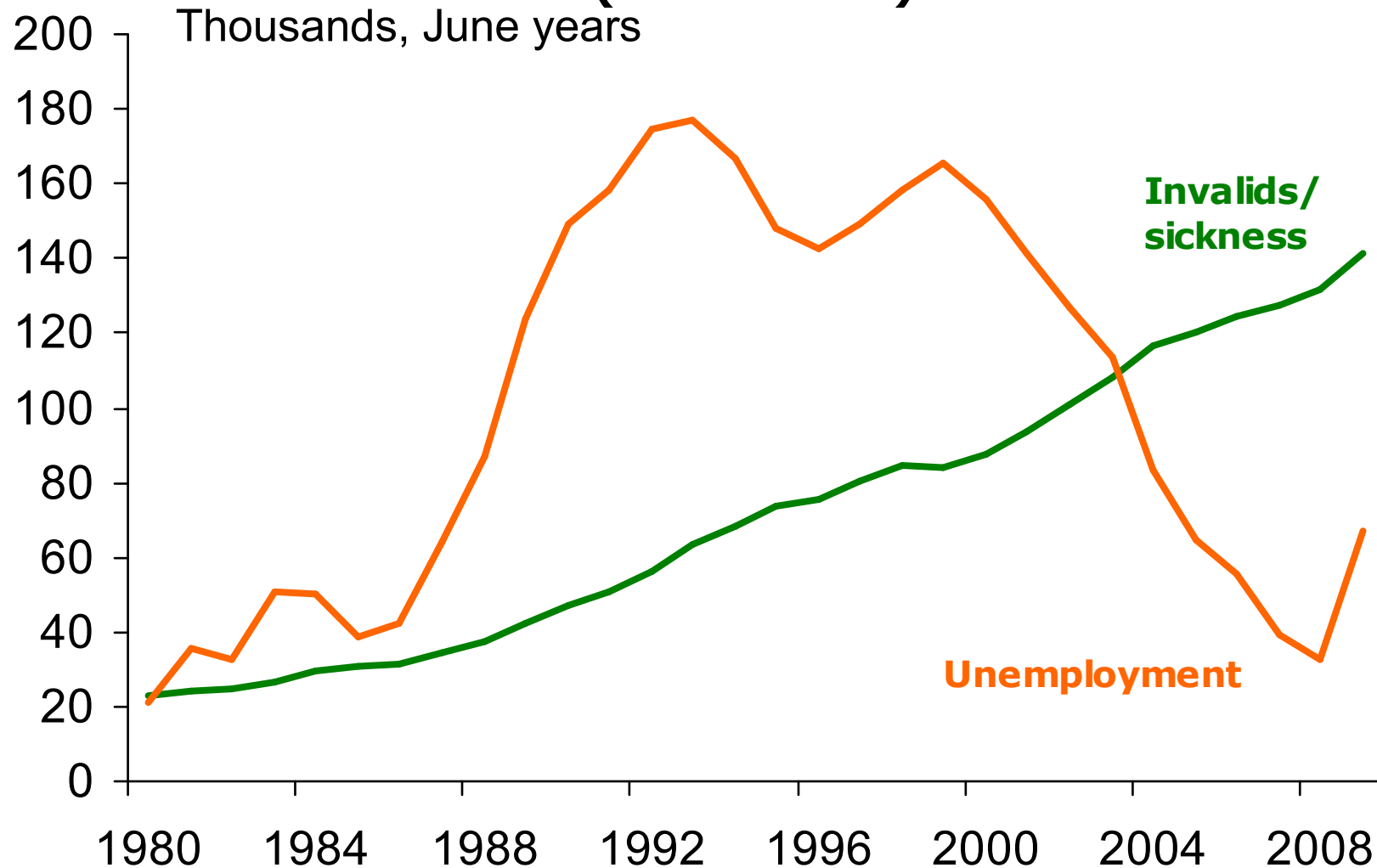
Increasing government spending

Core Crown spending (1997-2012)



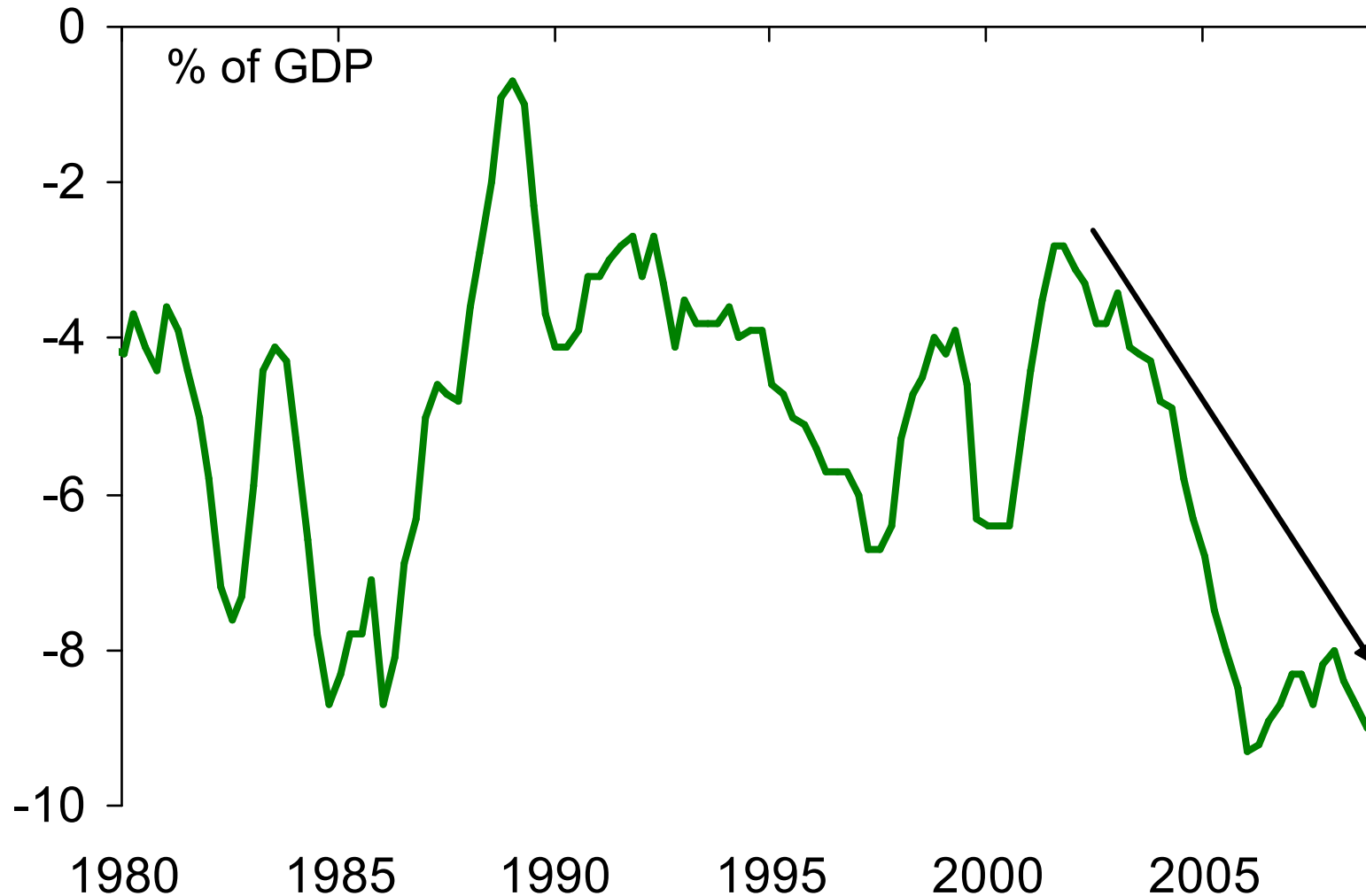
Is the NZ population getting more ill by choice?

Unemployment and invalids/sickness beneficiaries (1980-2009)



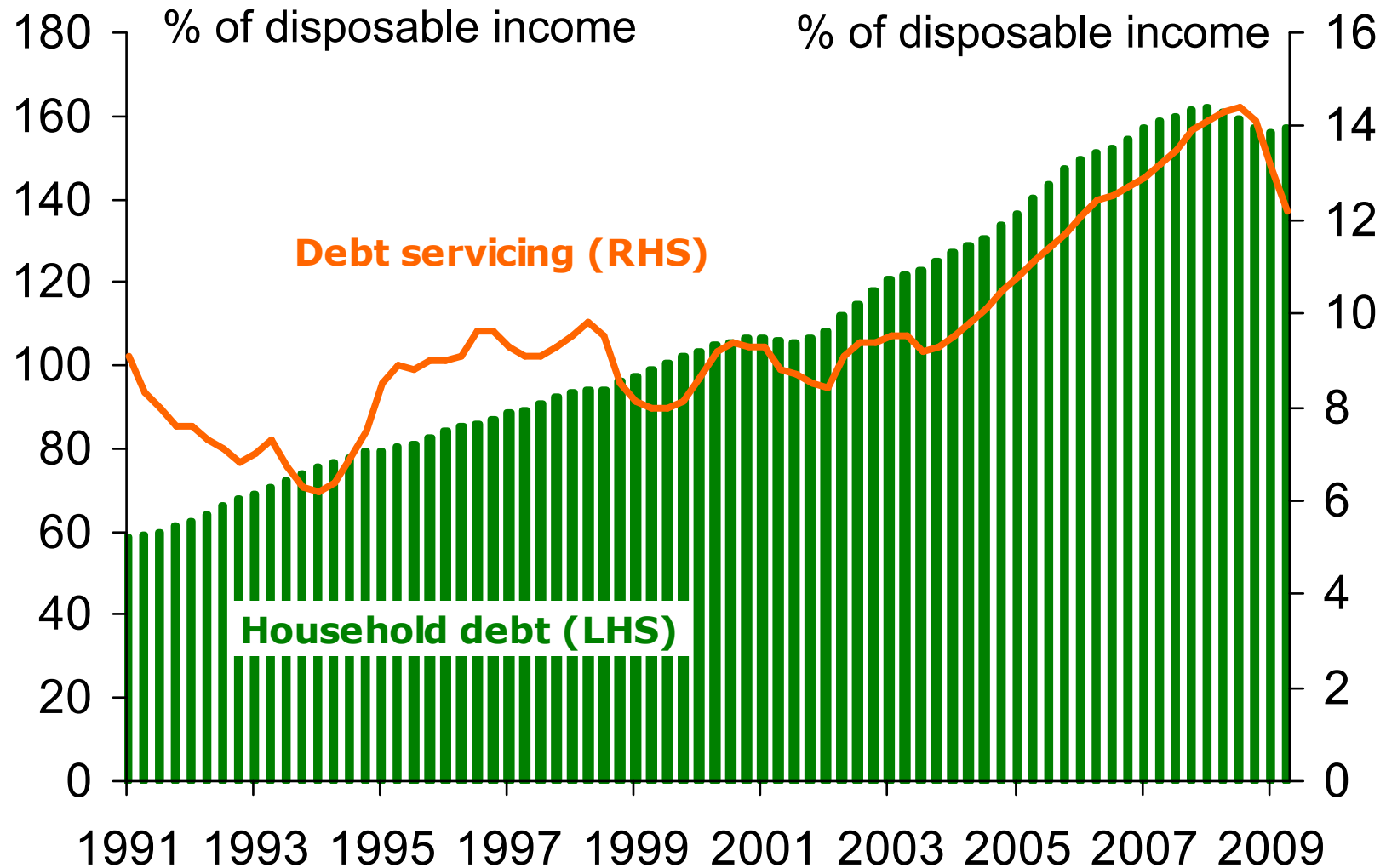
Borrowing more from offshore but are we investing it well?

Current account balance (1980-2009)



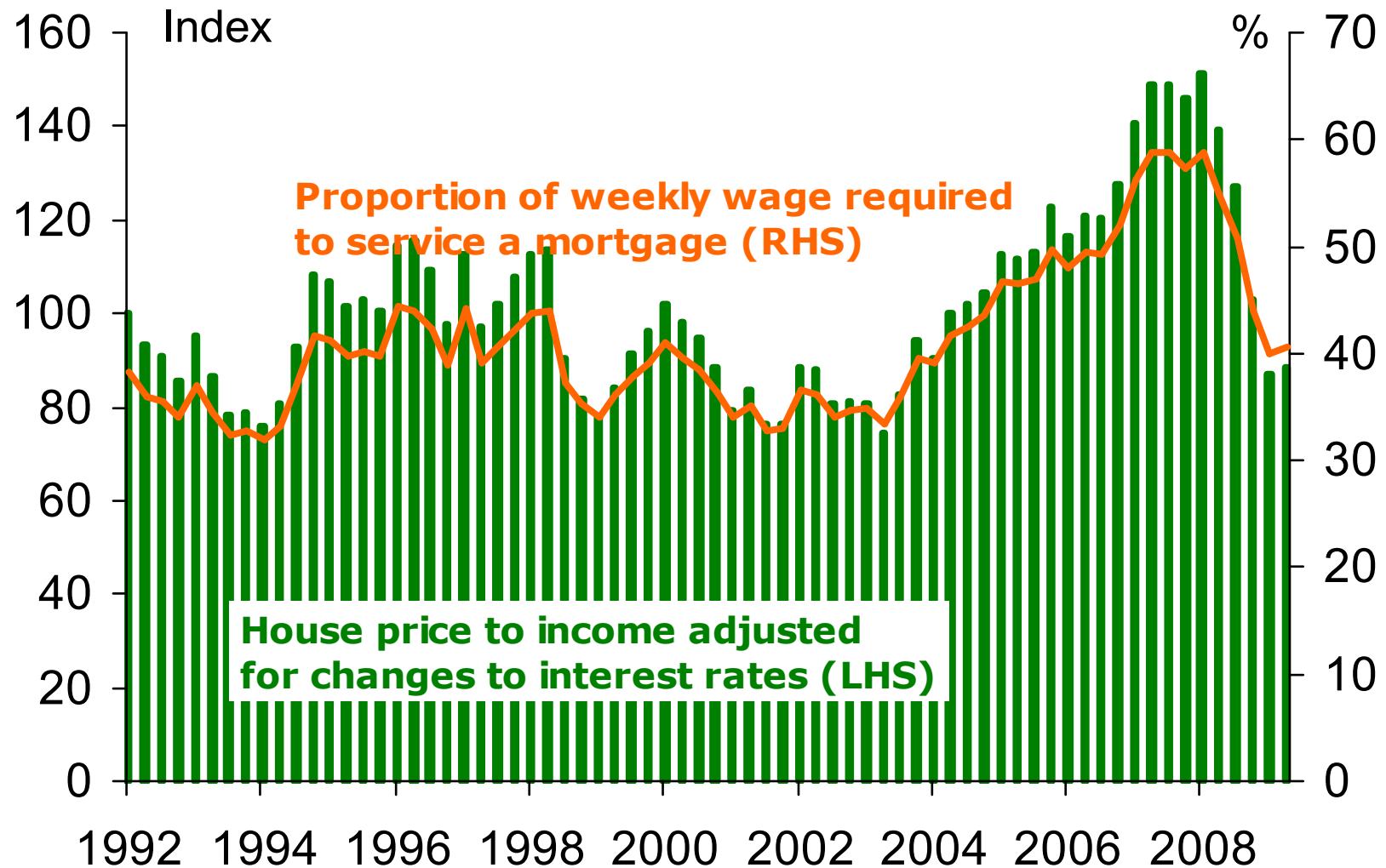
Households have been leveraging themselves up

Household debt and servicing (1991-2009)

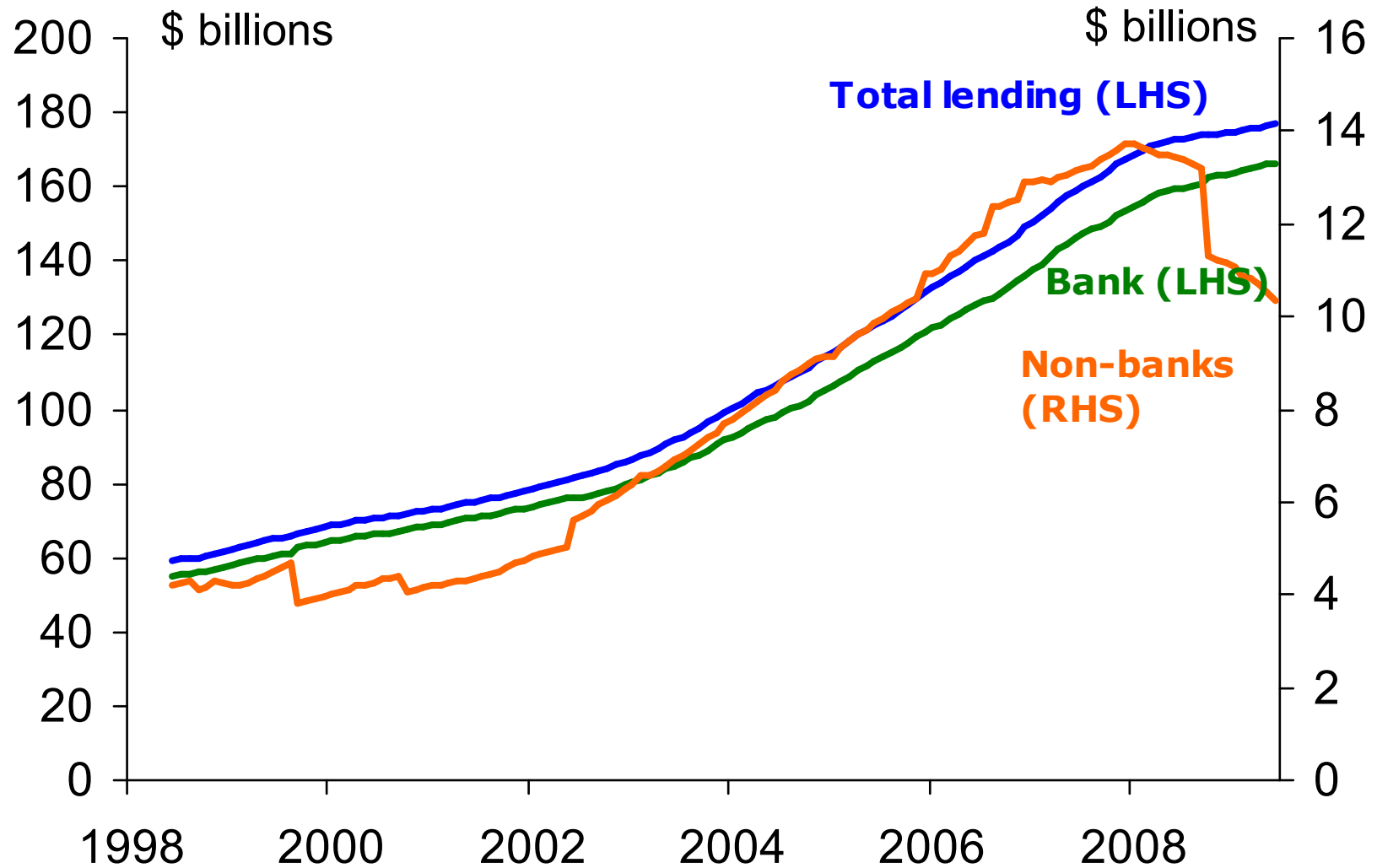


Housing valuation got stretched but is correcting now

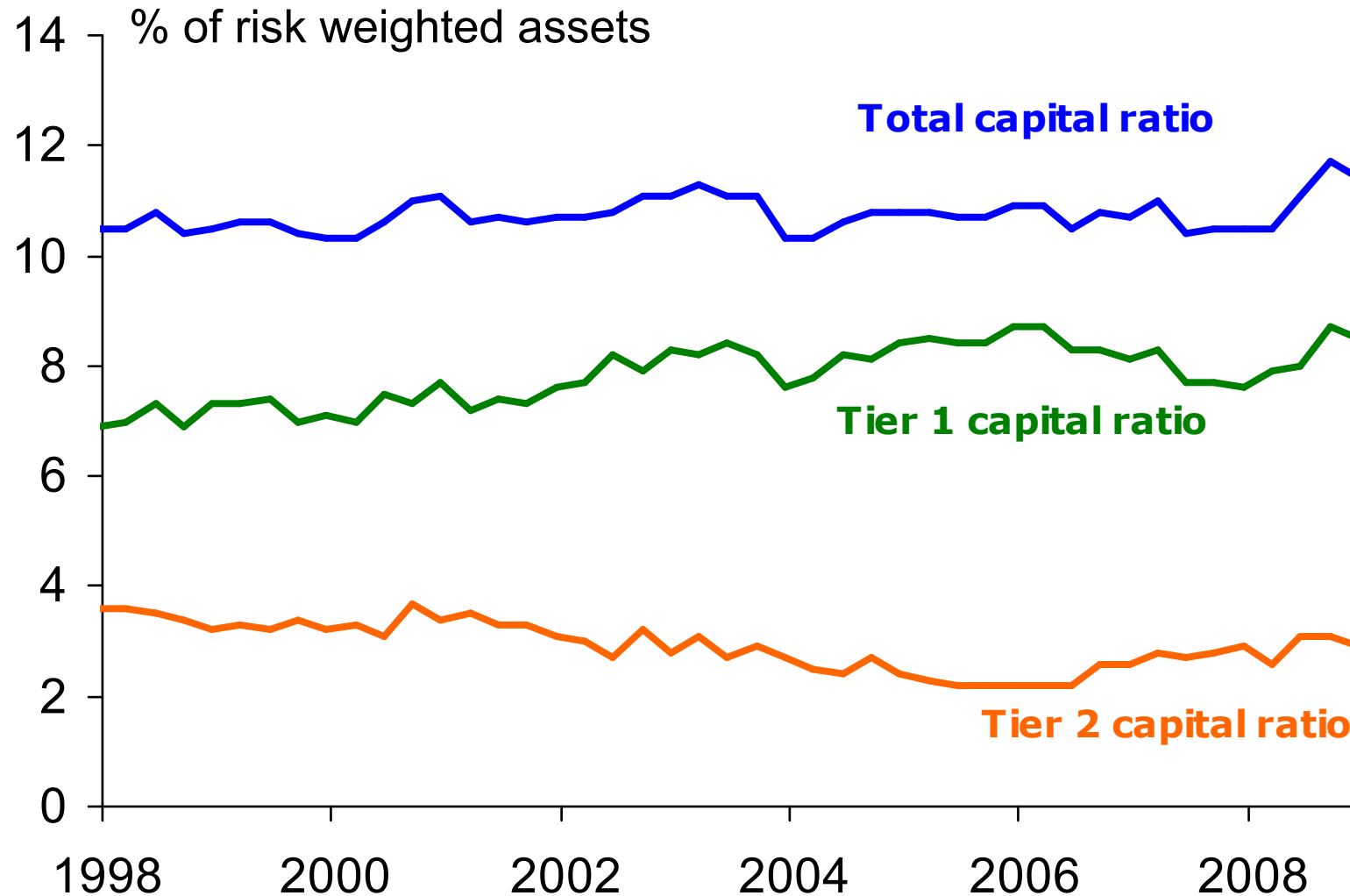
Housing affordability (1992-2009)



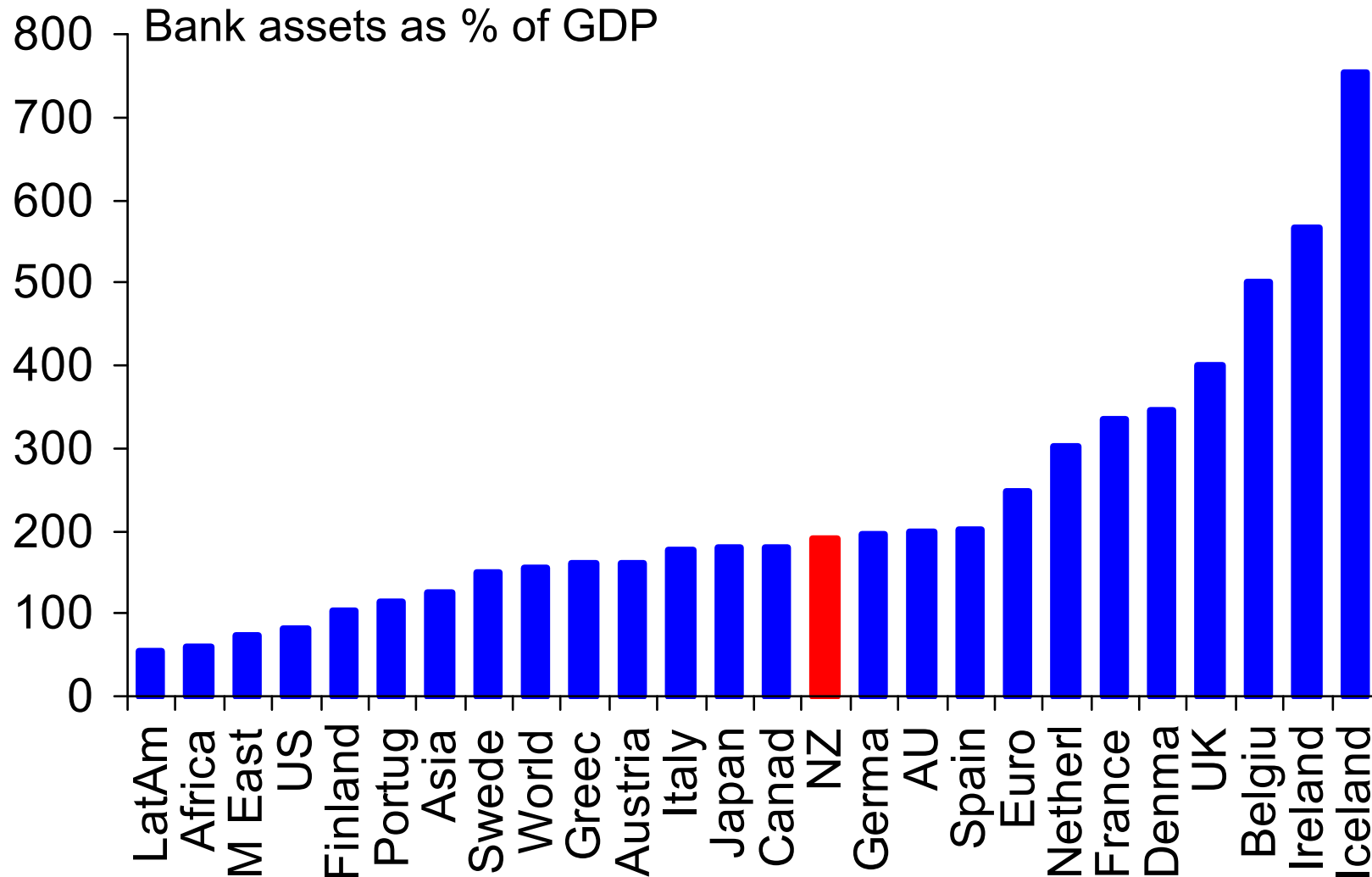
Bank and non-bank lending to households



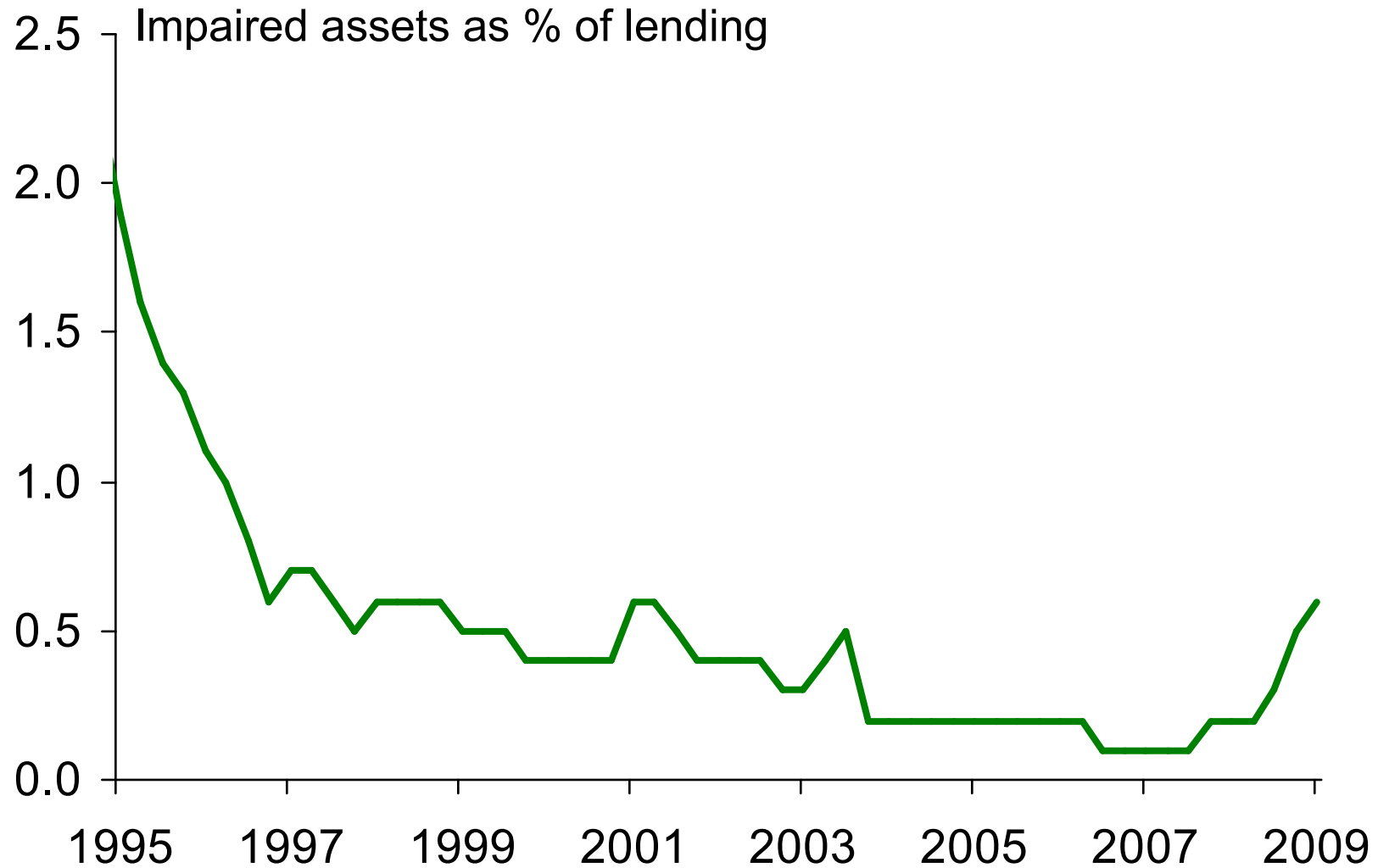
NZ's financial system is better placed than most. NZ banks are well capitalised...



... and not as highly leveraged...



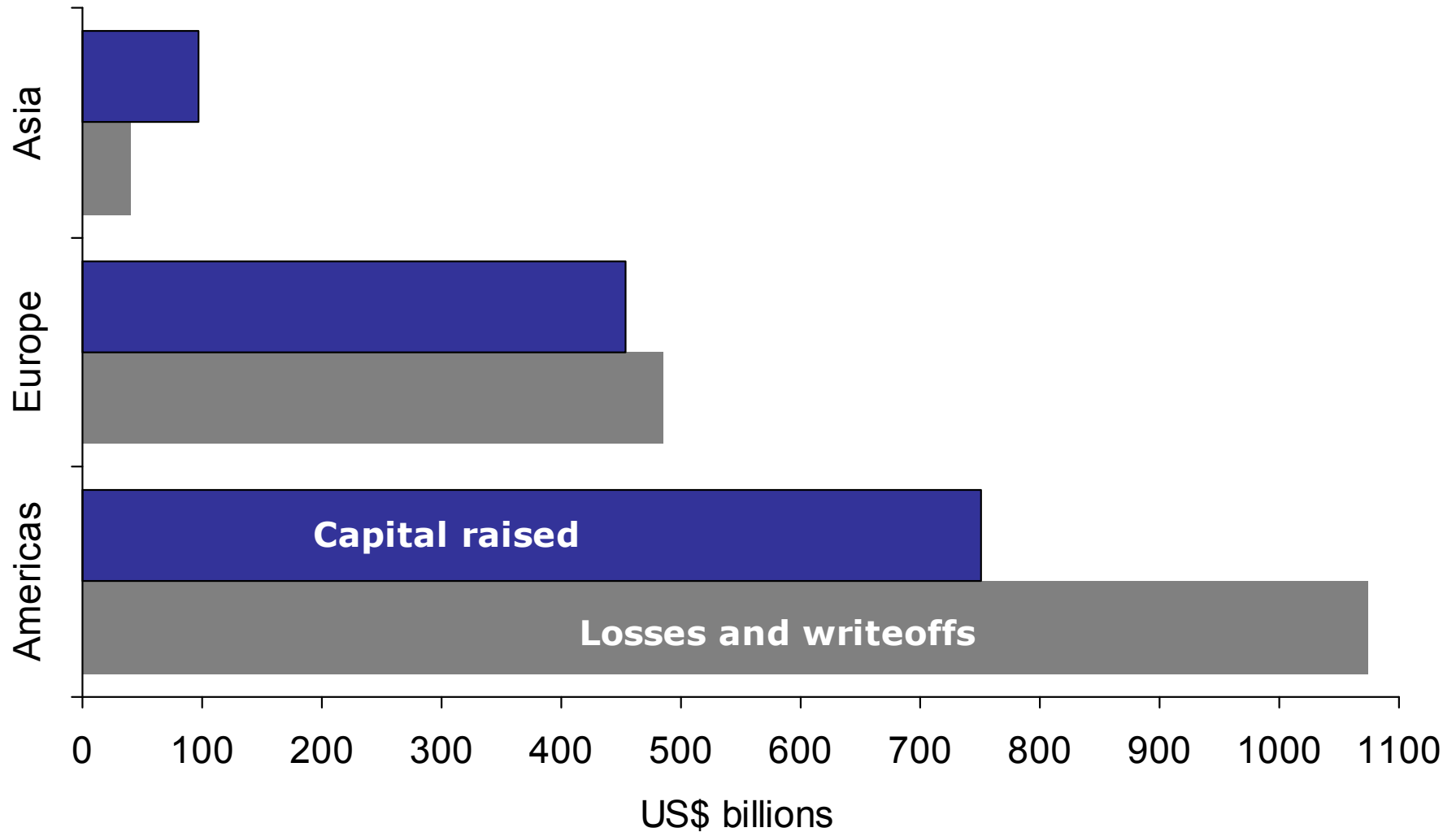
... banks have relatively low levels of credit losses...



... and our banks are still profitable

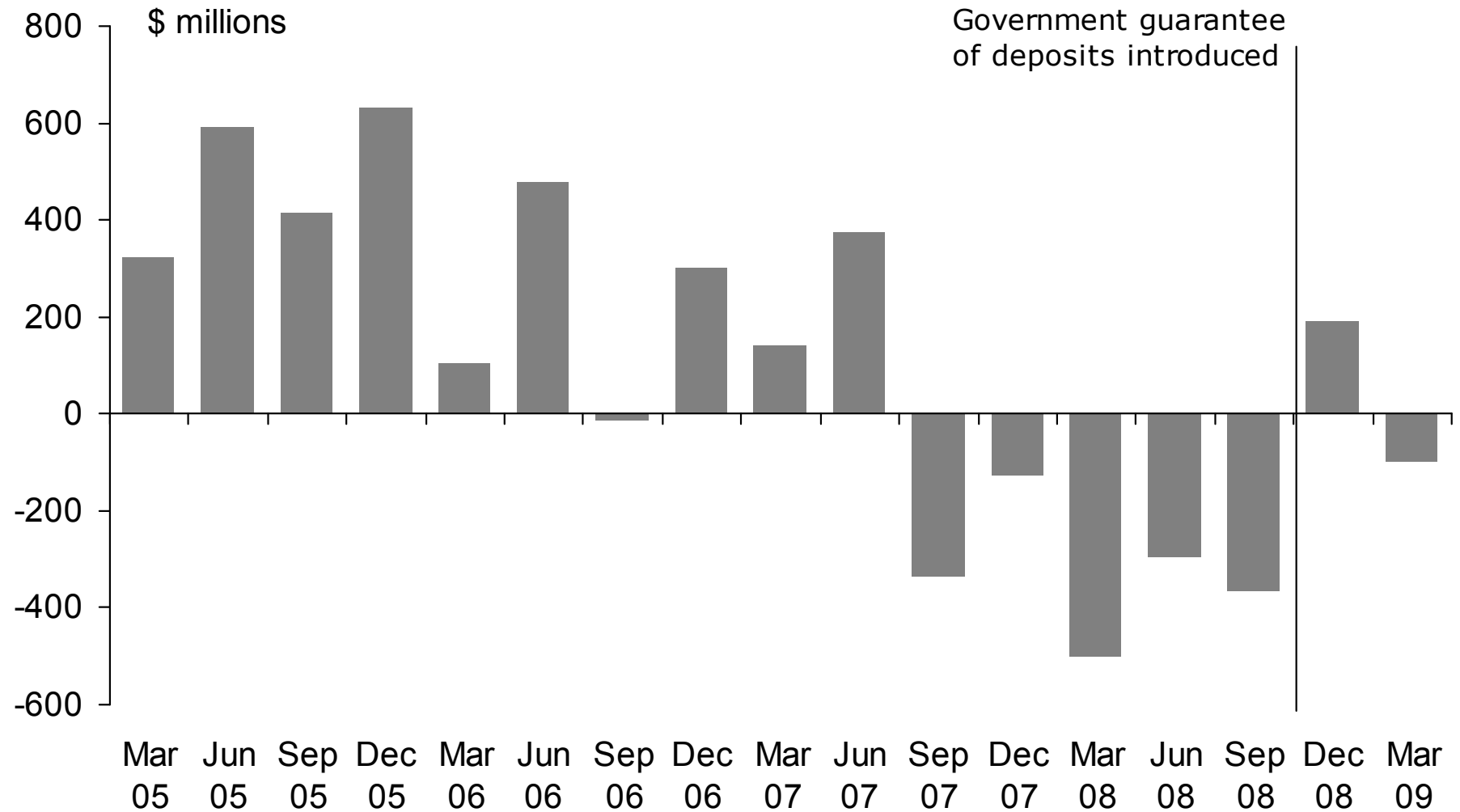


There have been huge worldwide financial institution losses and capital raised since credit crisis began



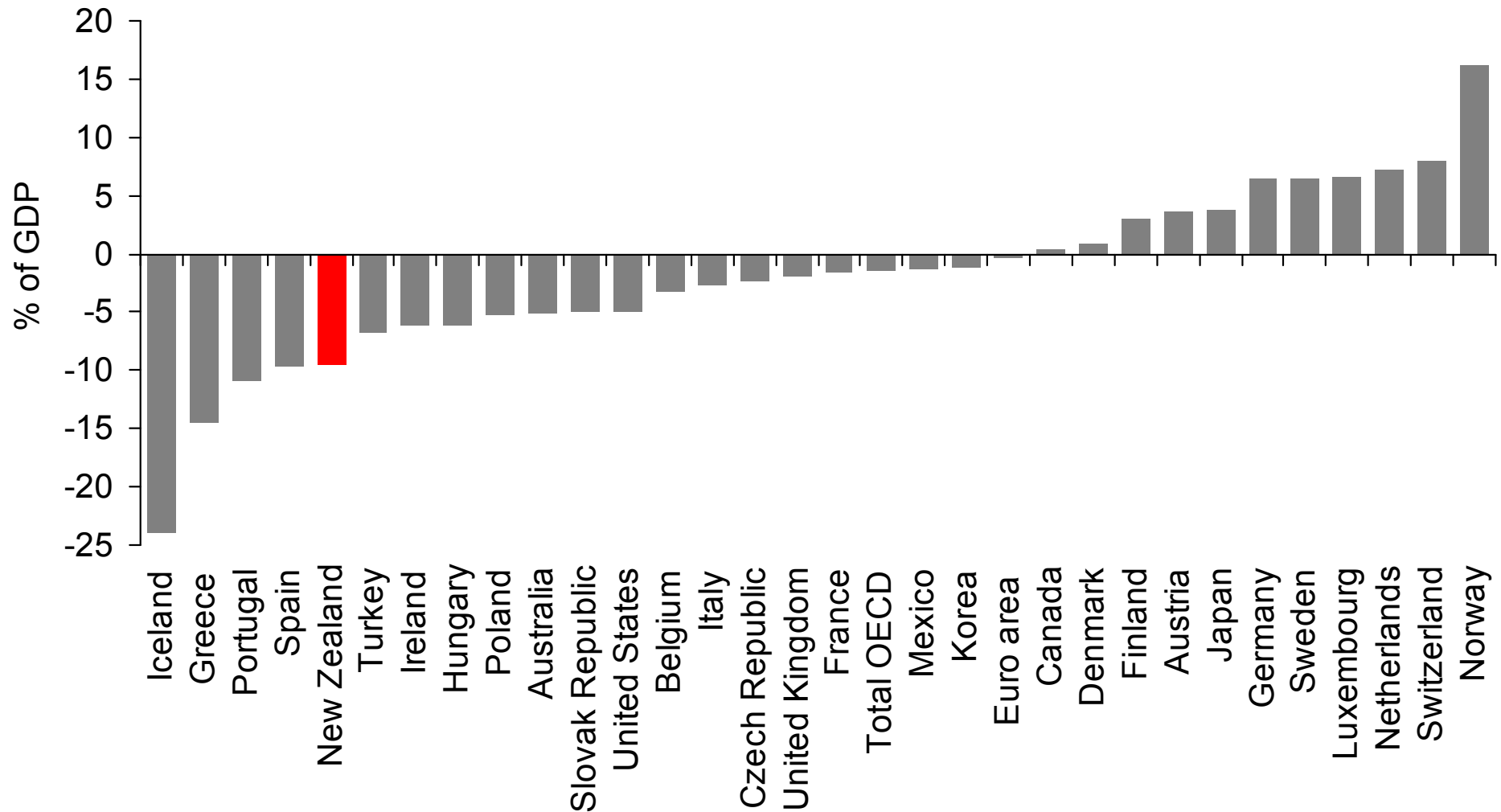
NZ deposit taking non-bank financial institutions

Change in total assets



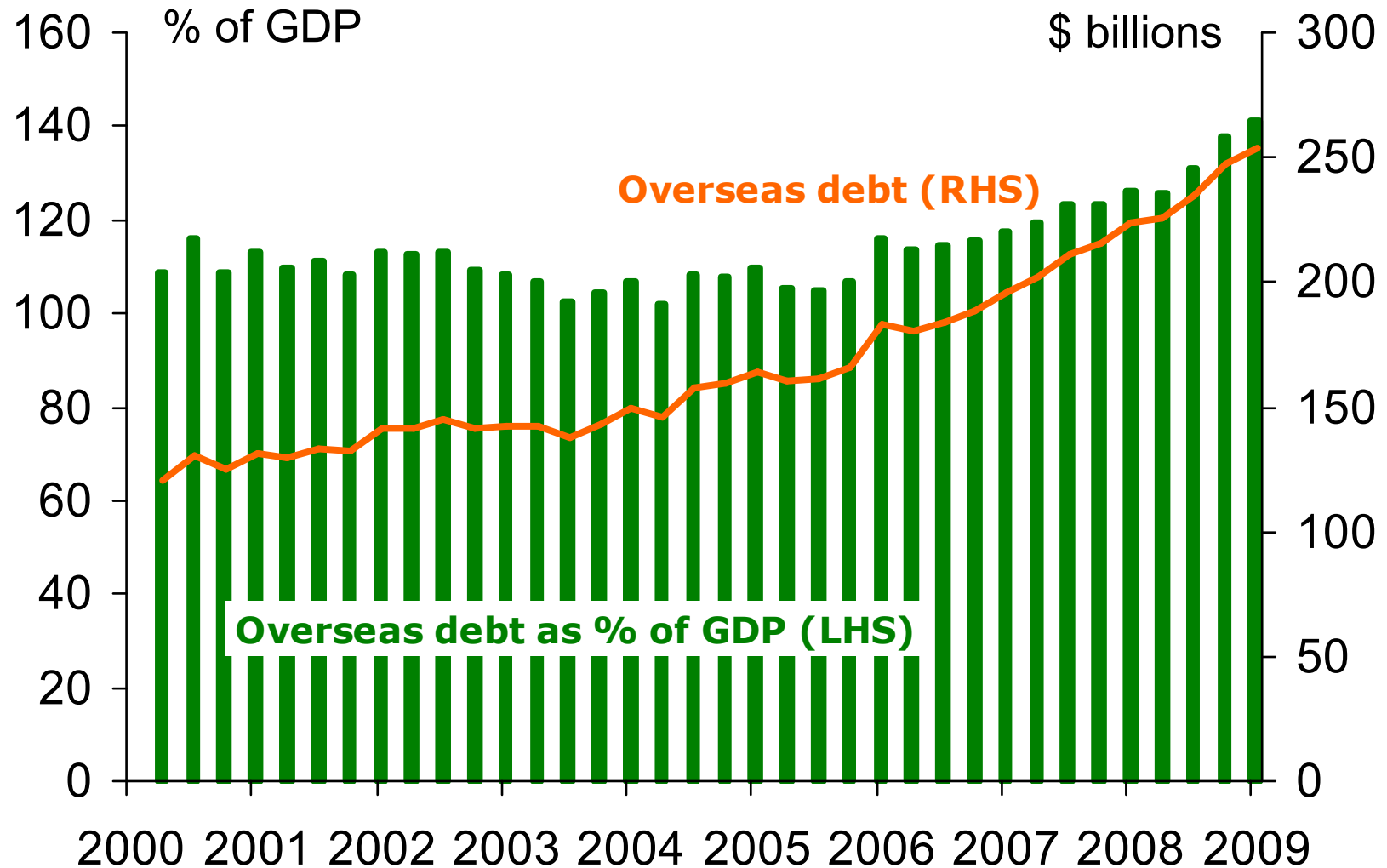
NZ's external current account deficit is unsustainable

Current Account Balances of OECD nations



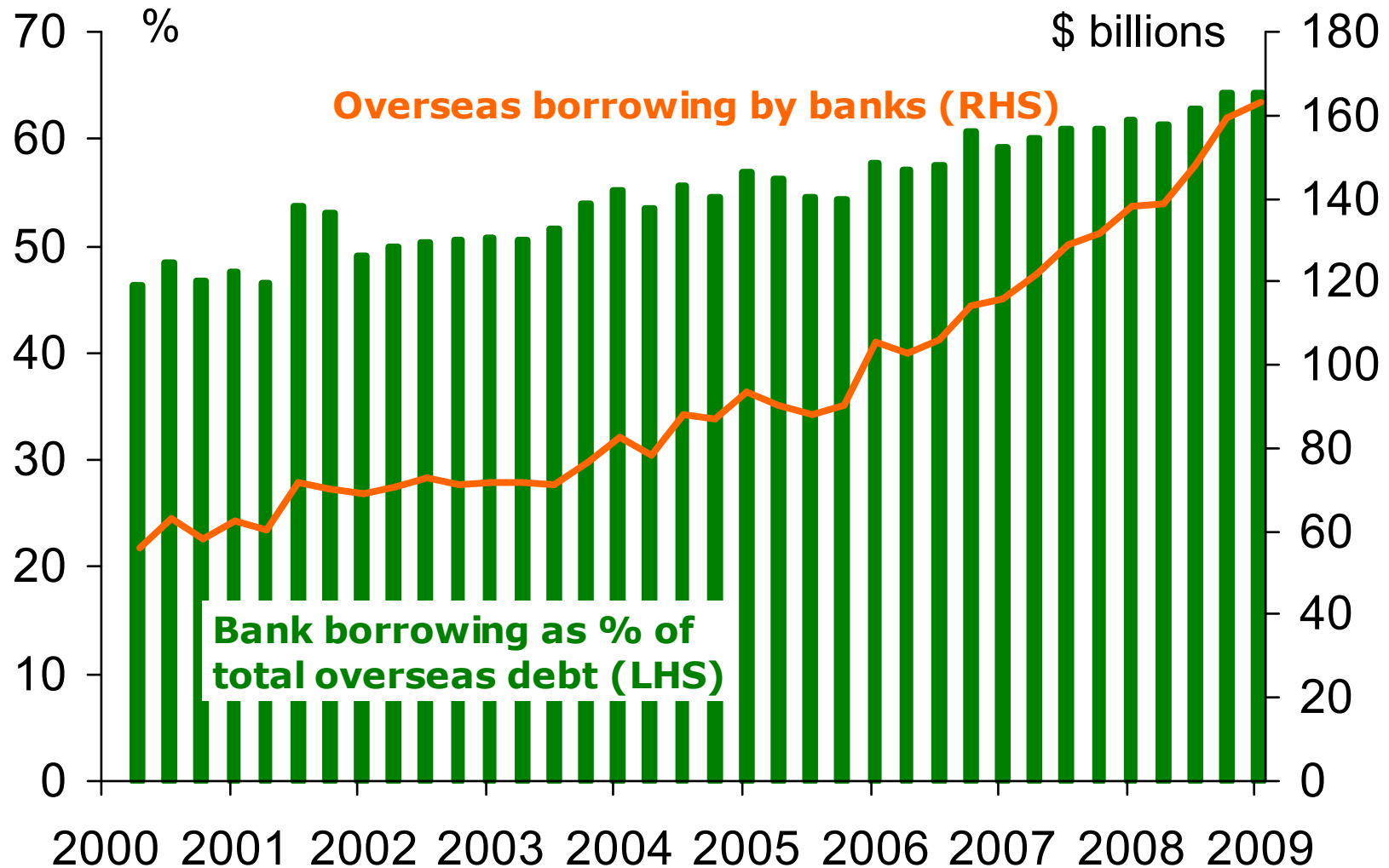
NZ overseas borrowing is very high

Overseas debt

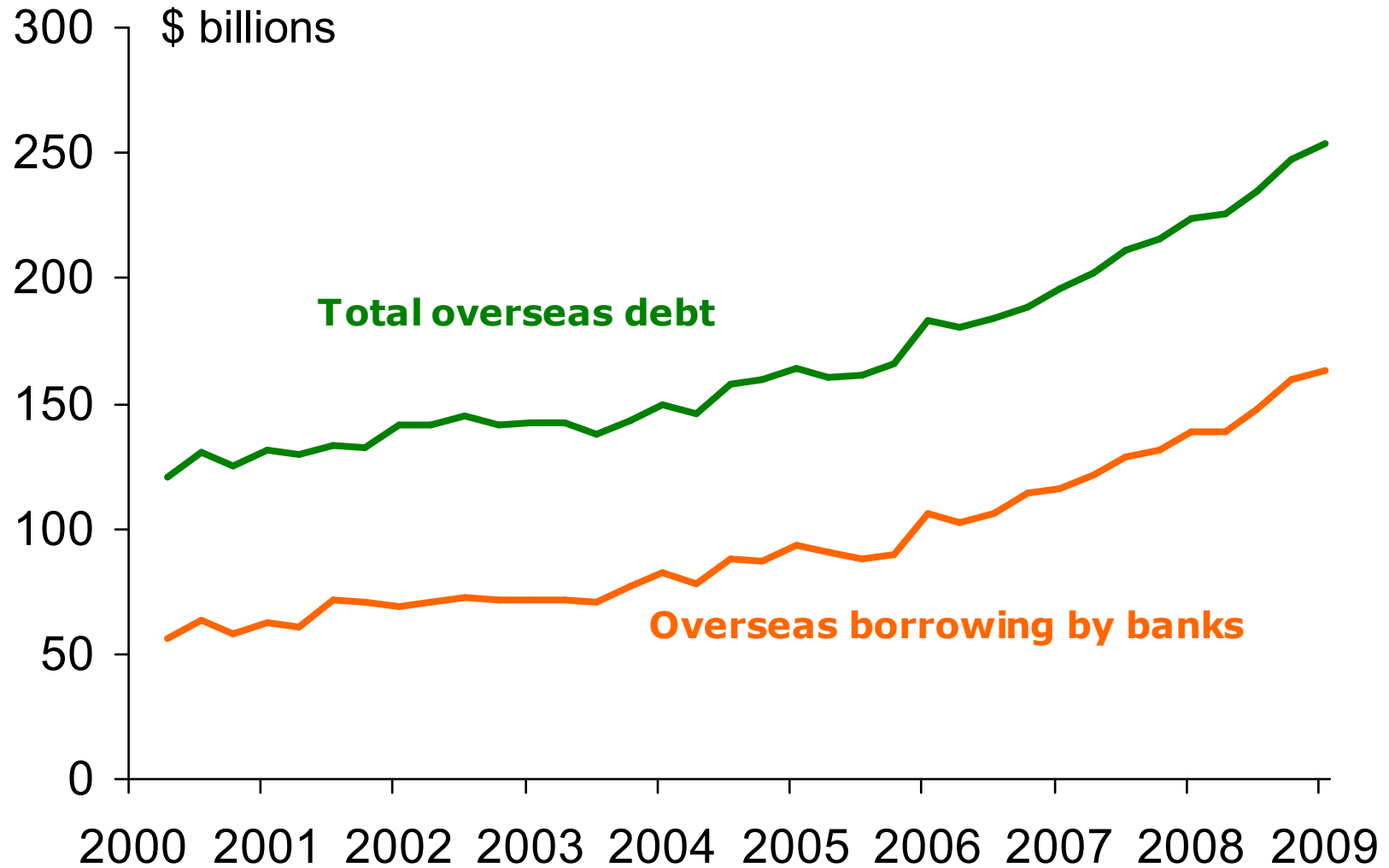


NZ overseas borrowing very high

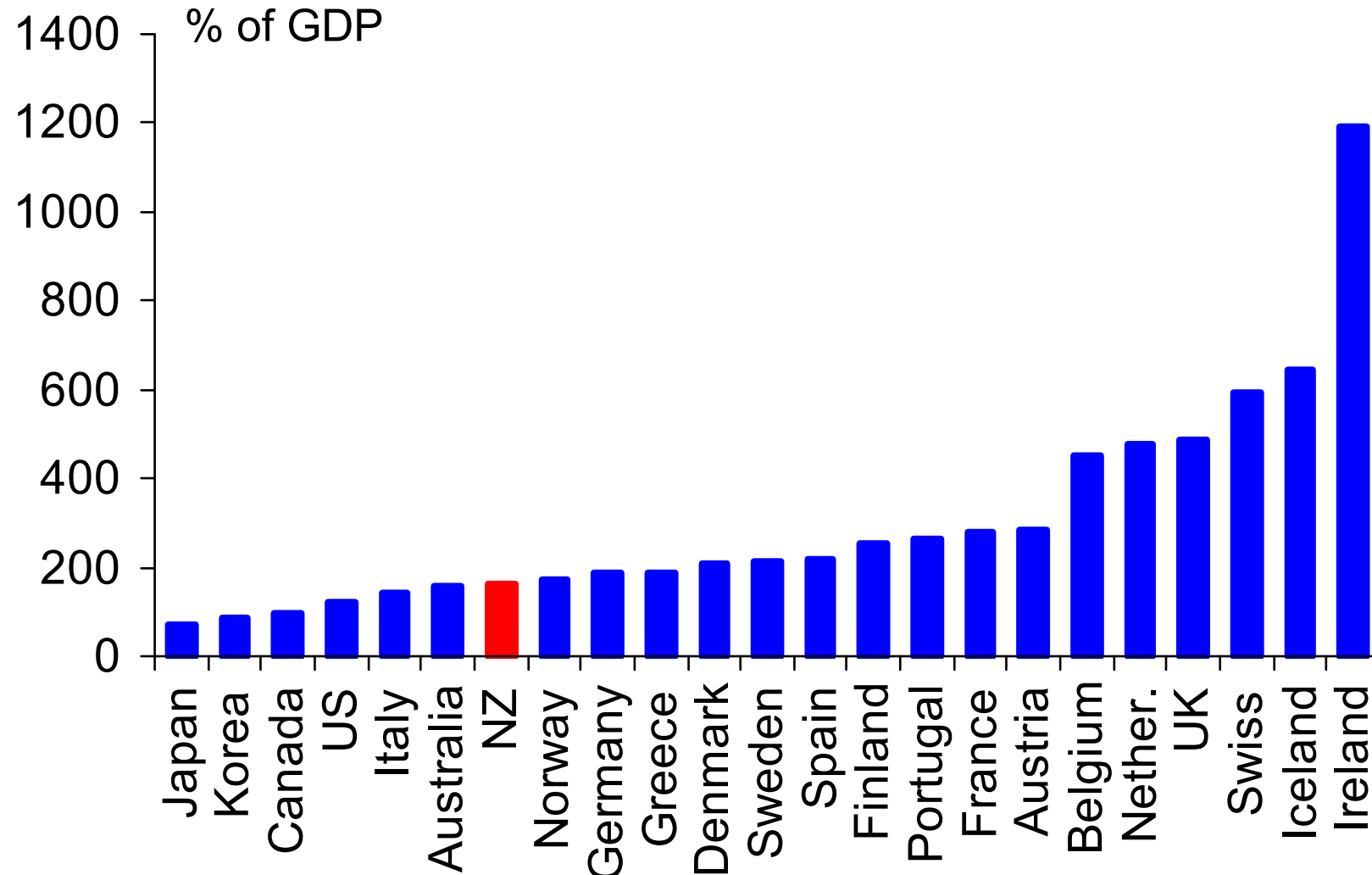
NZ banking sector share of overseas debt



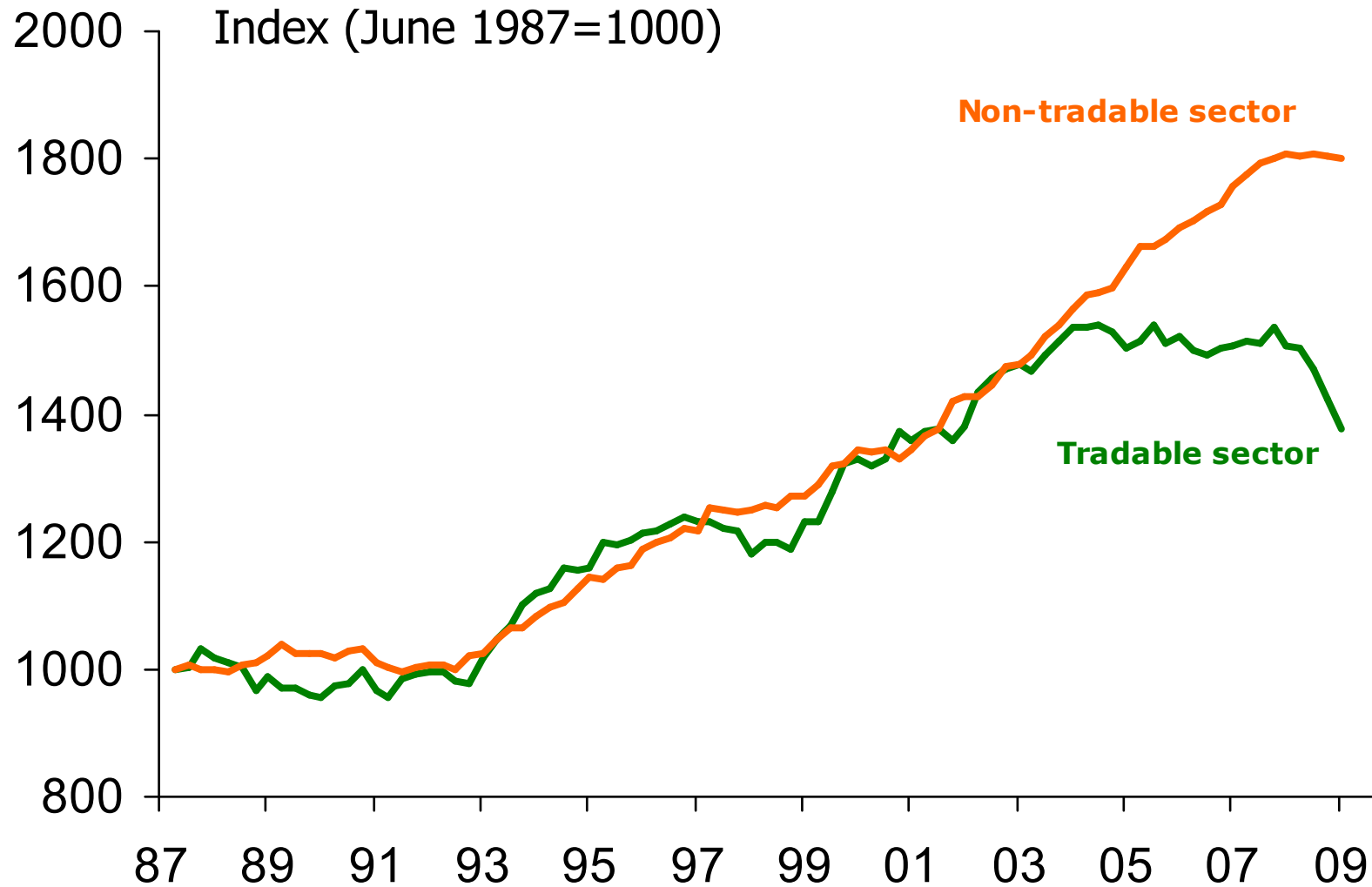
NZ overseas borrowing very high



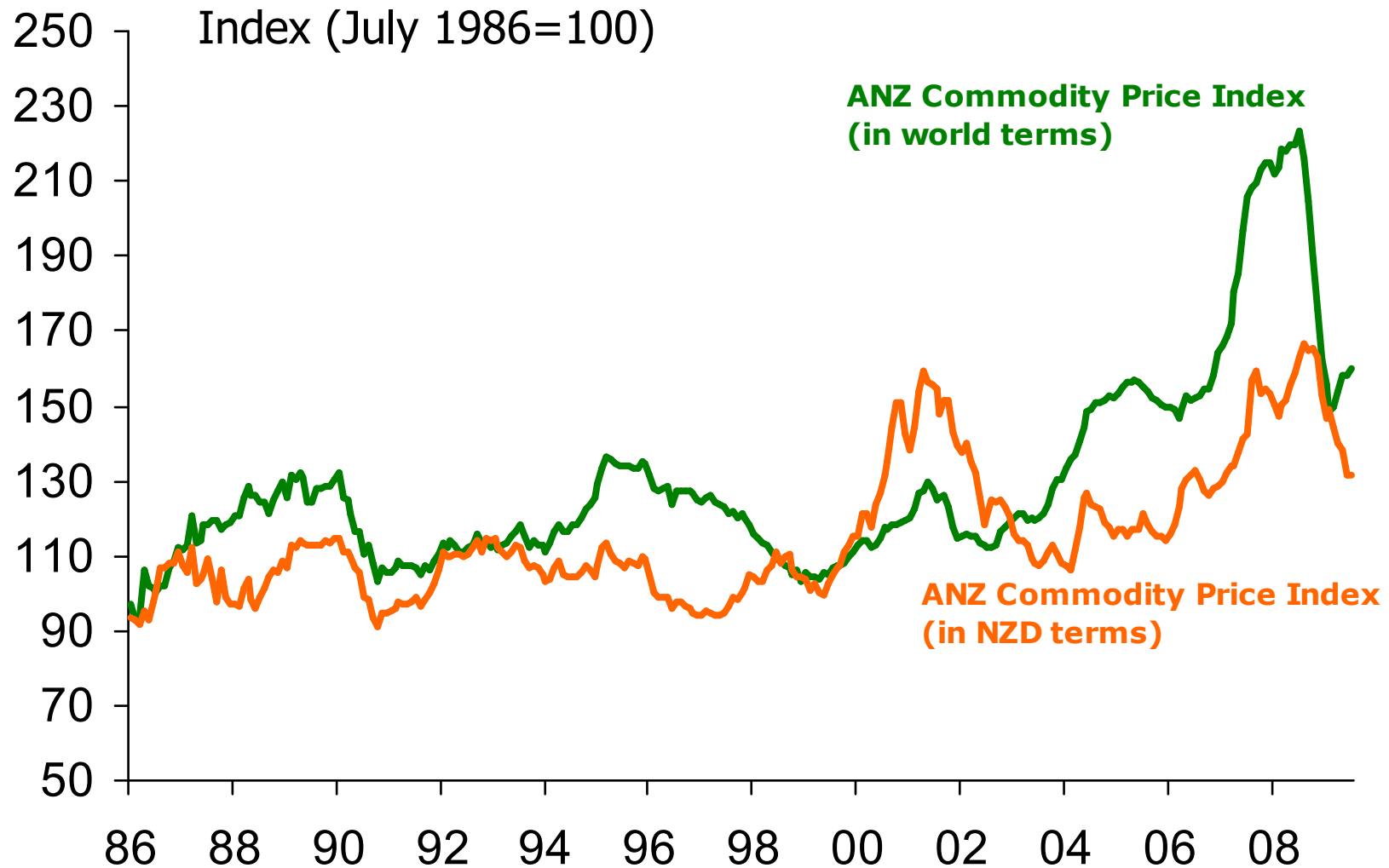
Comparison of gross foreign liabilities (2007)



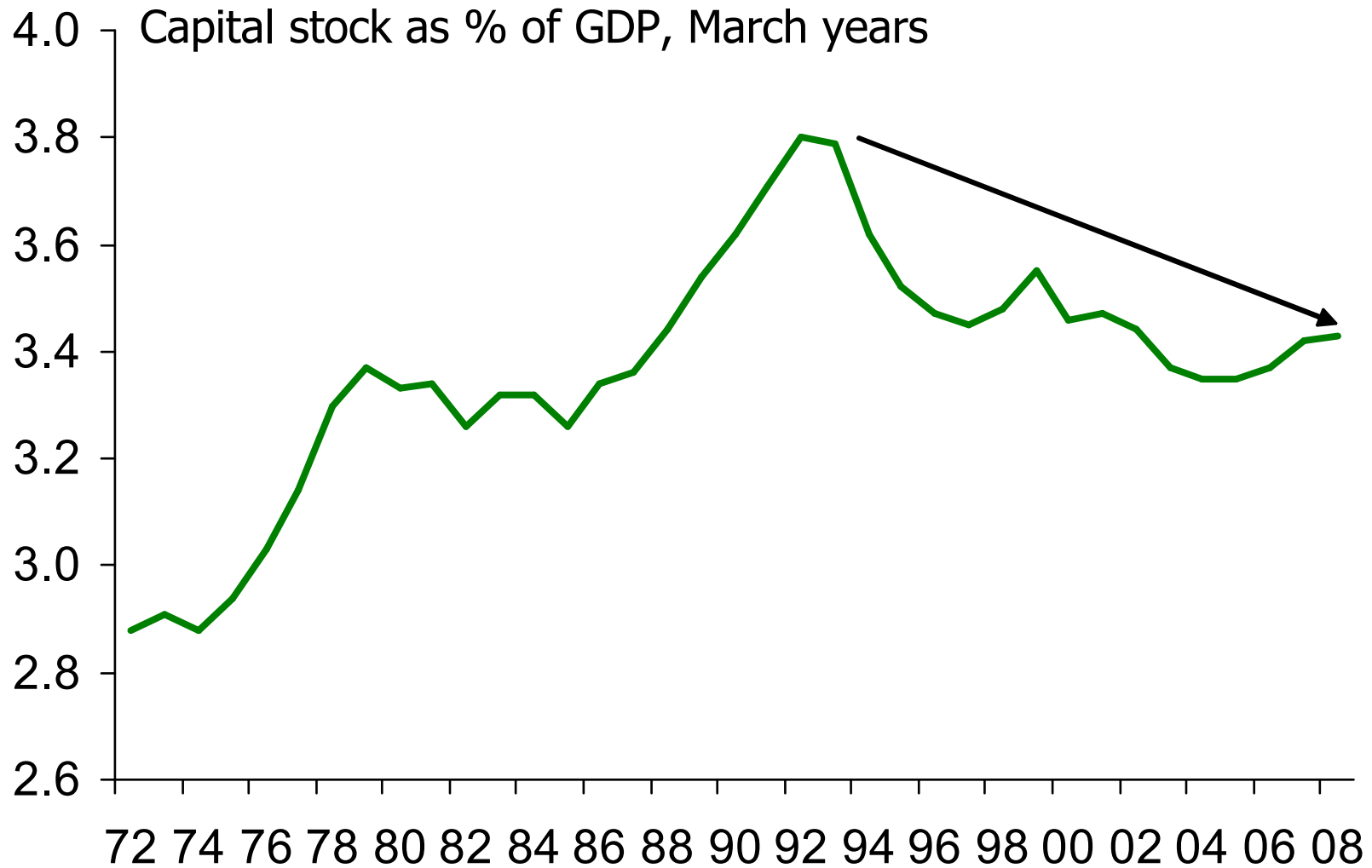
Poor tradeable sector value added performance



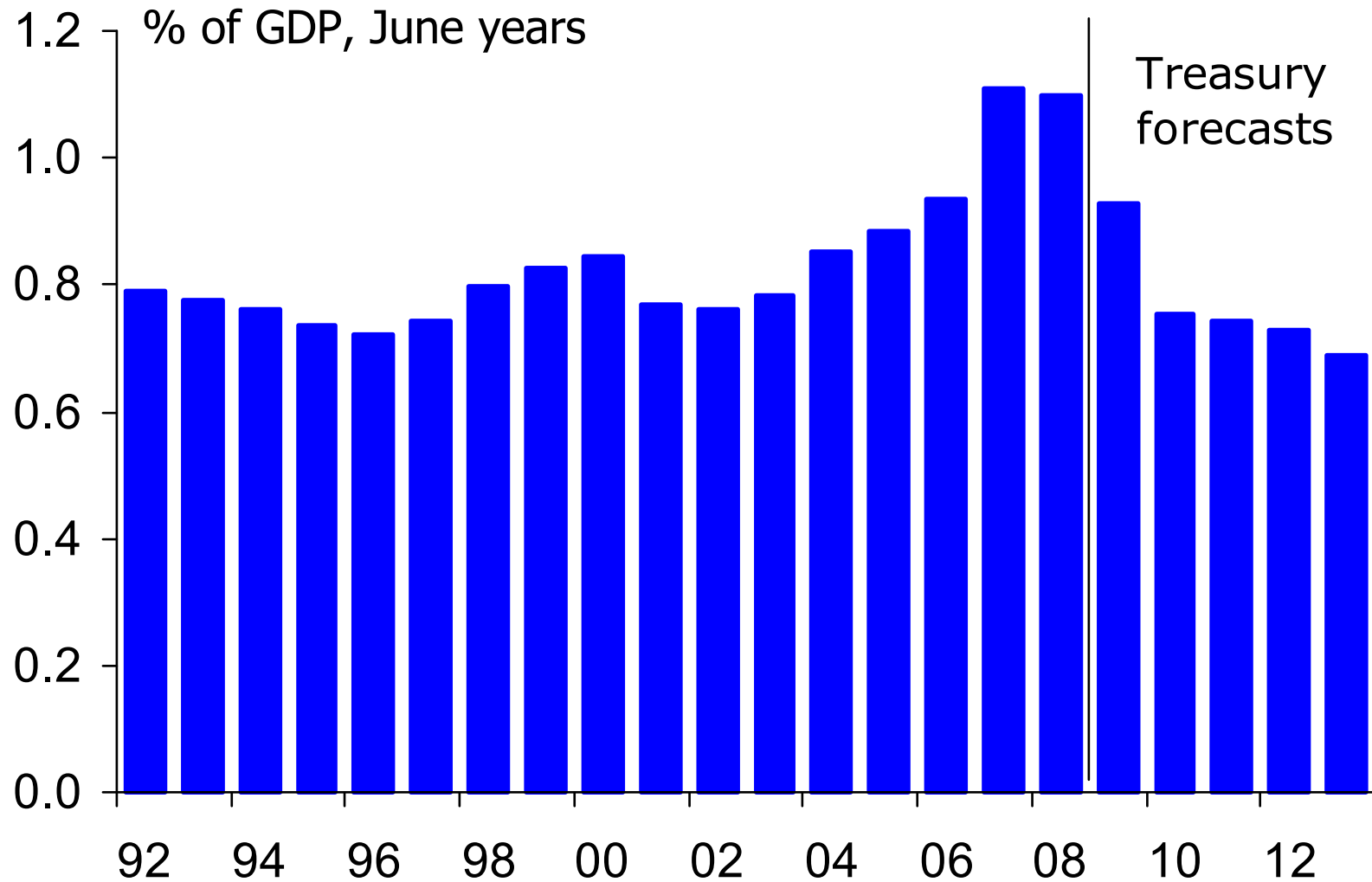
NZ's commodity price cycle is correcting down from unusually high levels



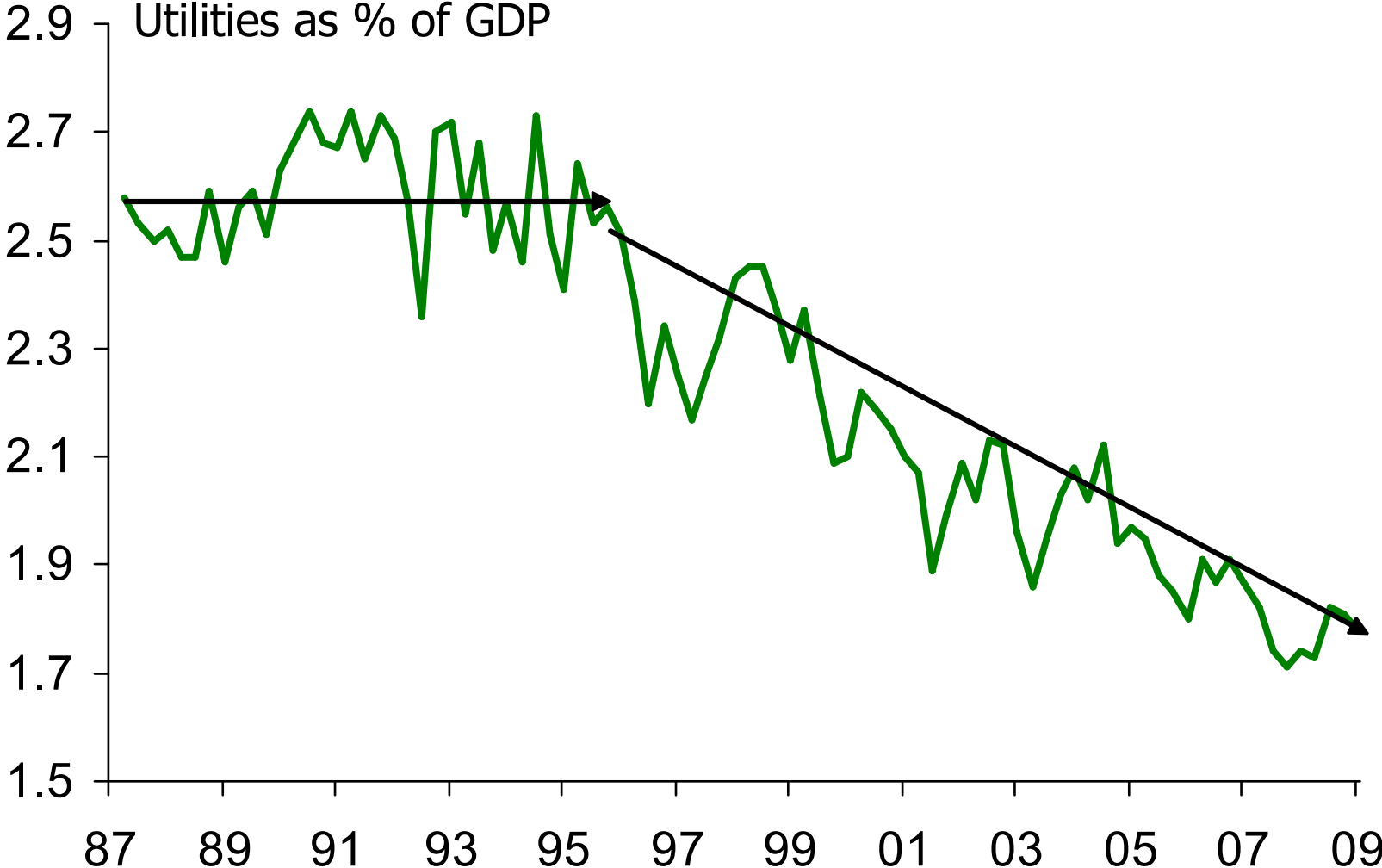
Infrastructure investment is a major worry zone



Transport spending as % of GDP forecast to decline

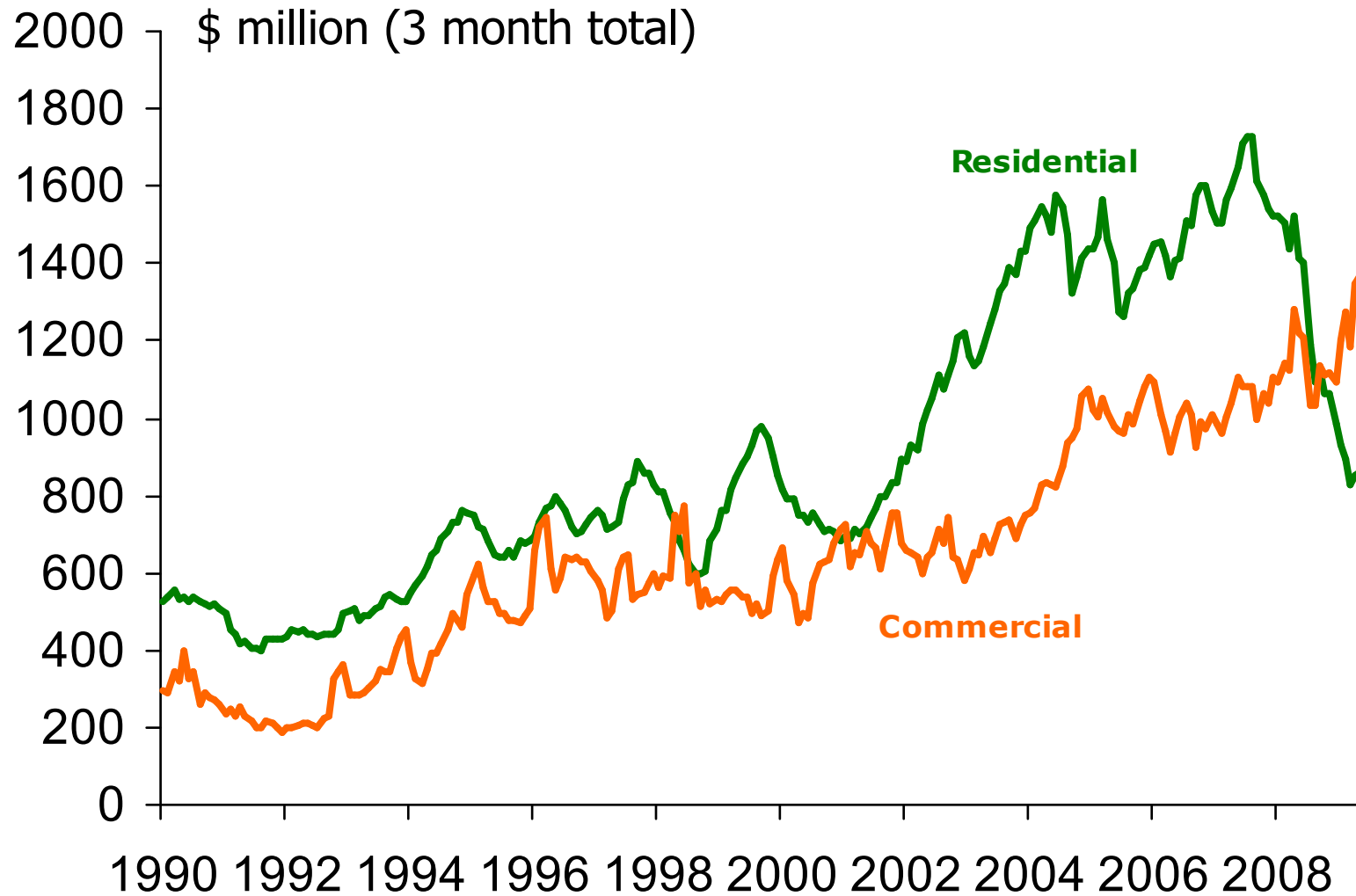


Value add contribution from NZ's utilities sector has been trending down over the past decade



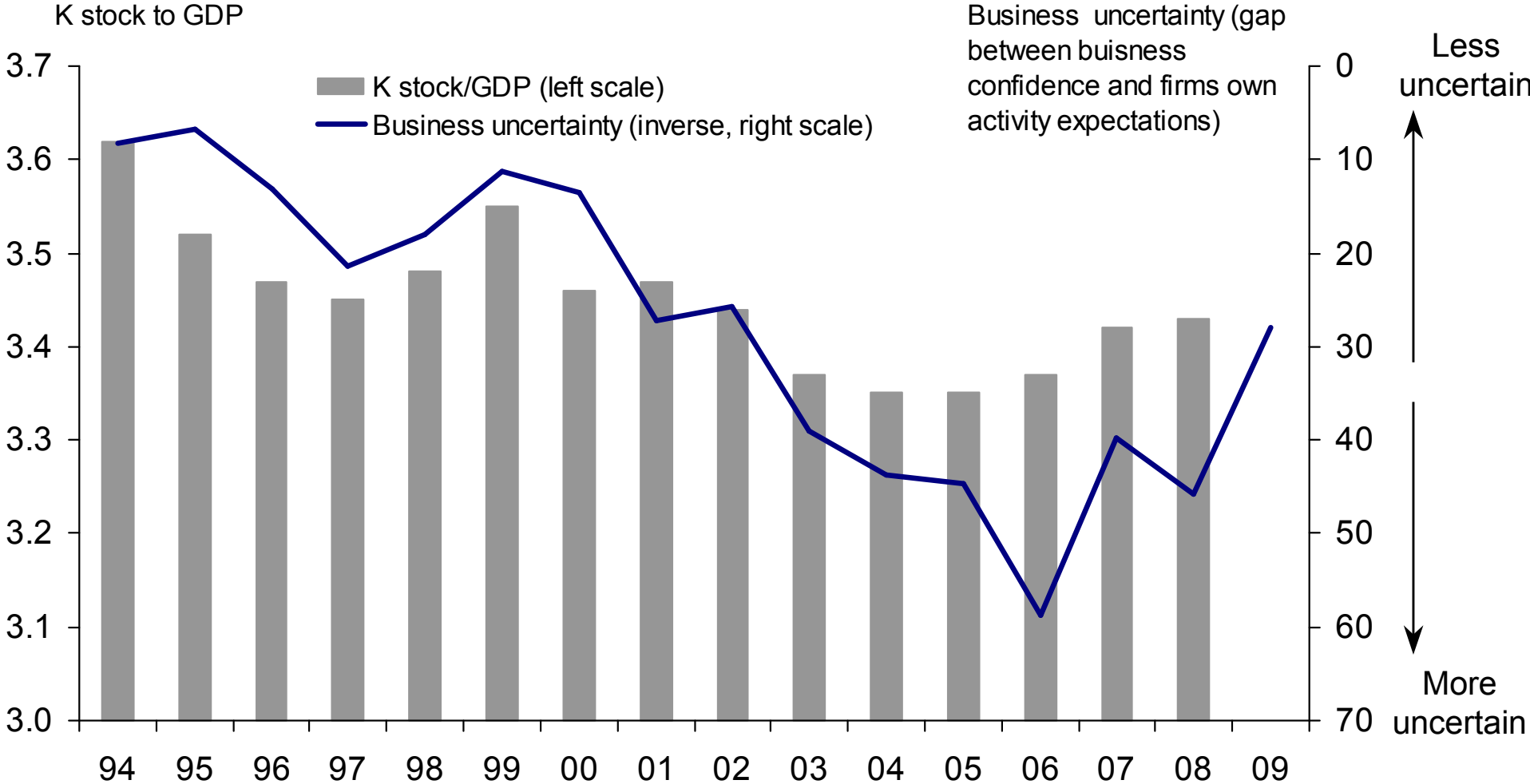
Sources: Statistics NZ; ANZ National Bank.

Residential and commercial building consents



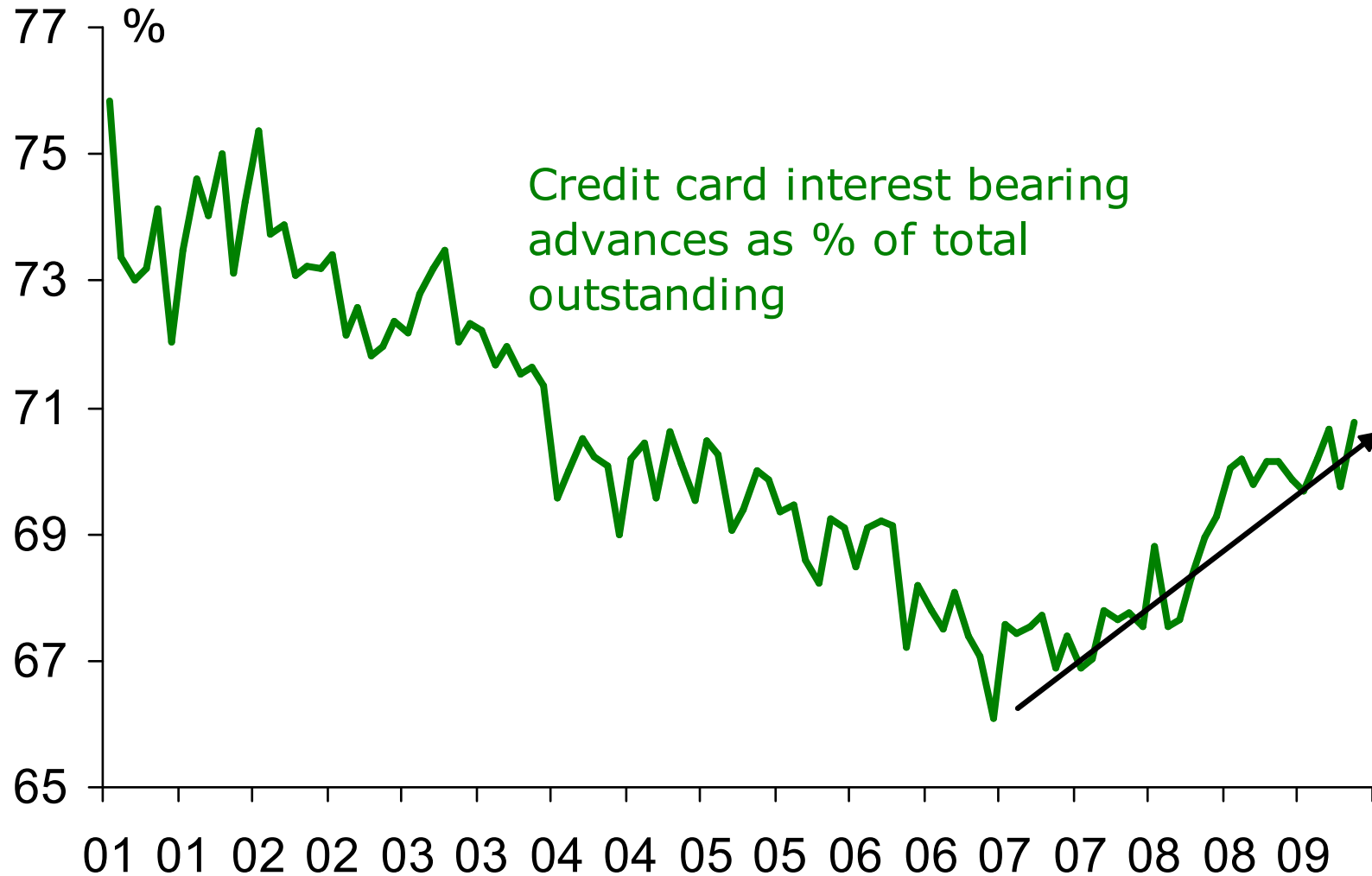
Uncertainty impacts negatively on investment

Capital stock to GDP and business uncertainty

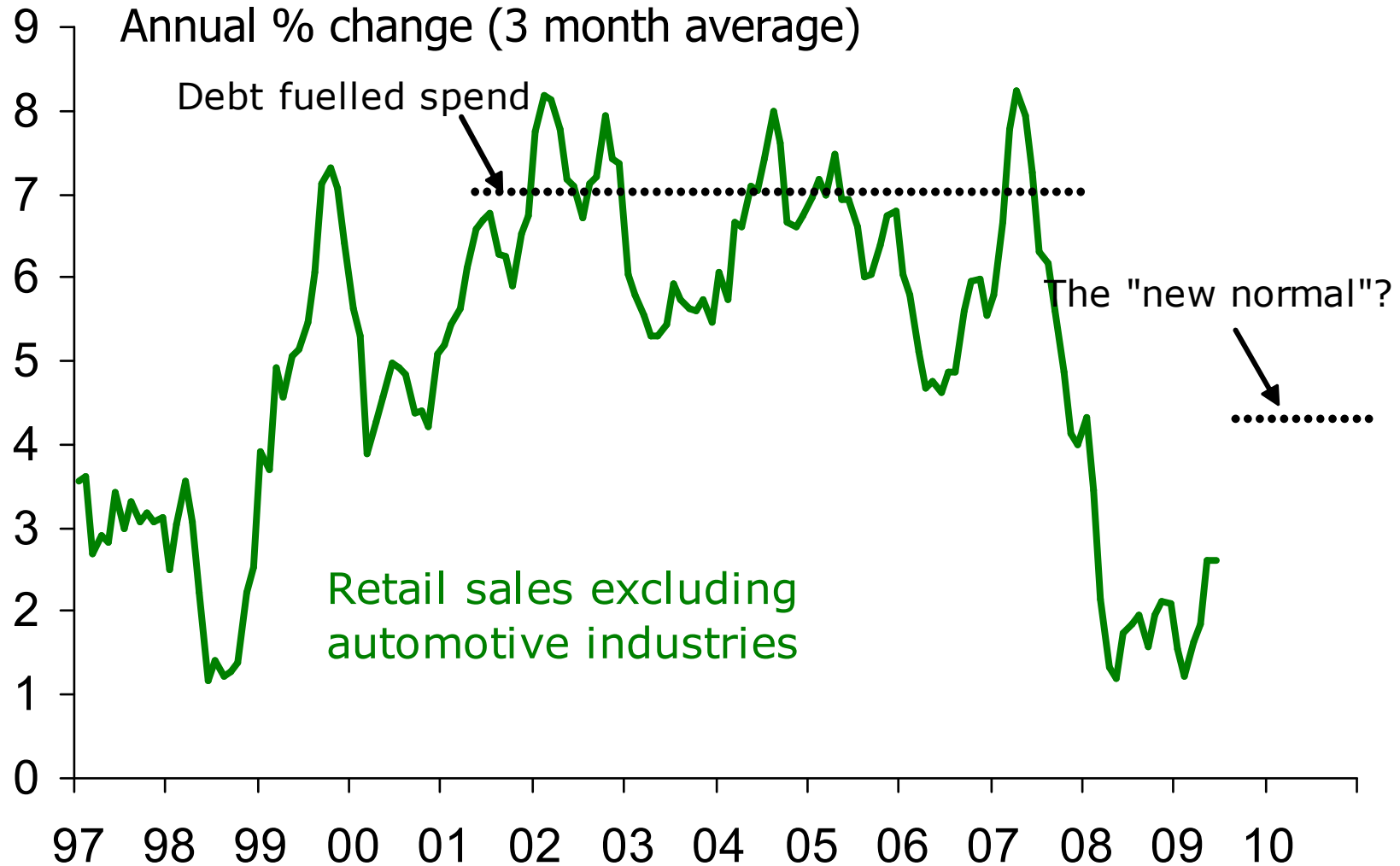


Sources: Statistics NZ; National Bank Business Outlook; ANZ National Bank.

Consumers “putting it on the card” but slow to pay it off, because they are finding it harder to do so

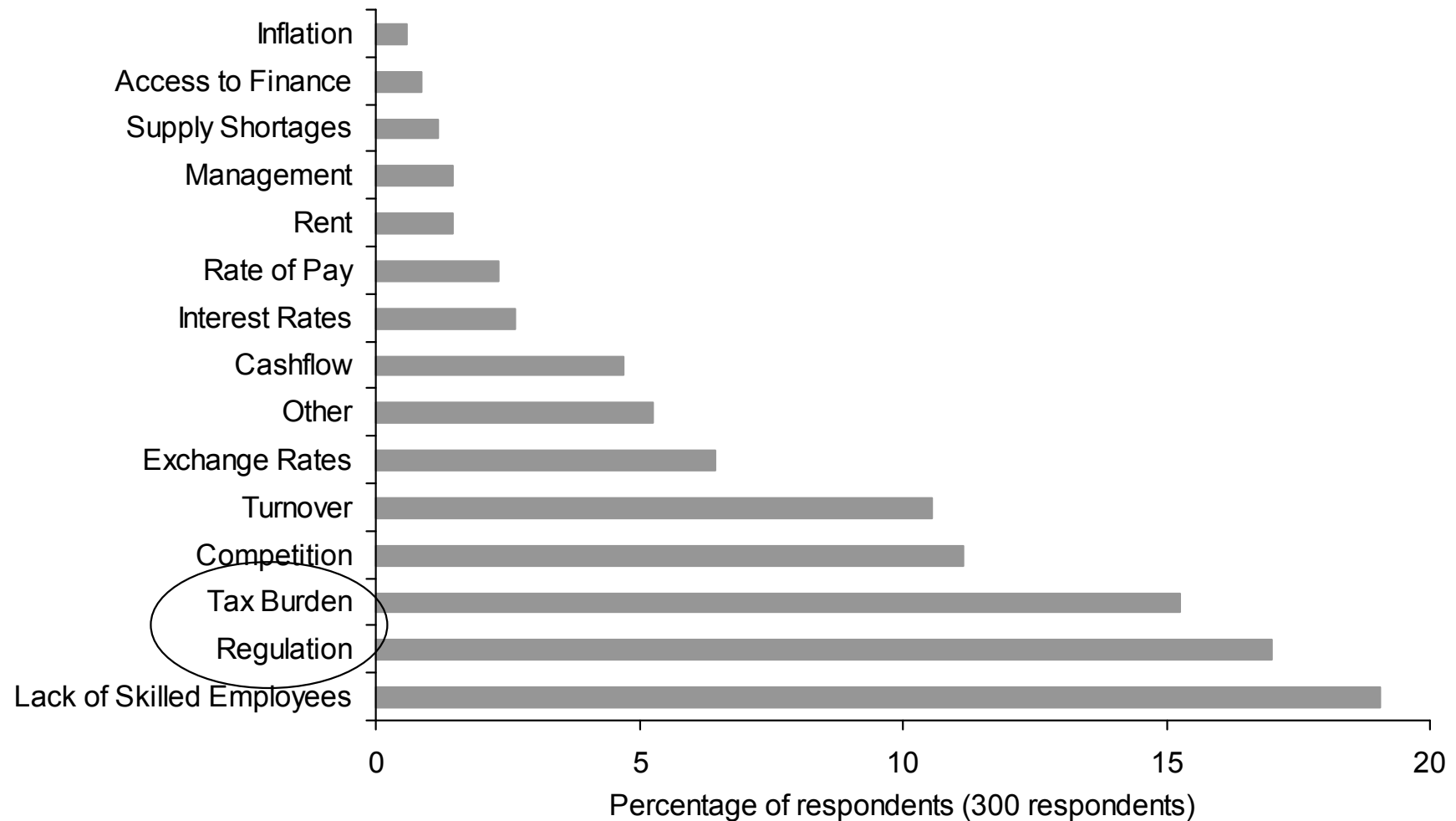


Retail sales growth to recover once the recession eases, but unlikely to return to previous growth rates



High taxes & excessive regulation are major problems facing small business...

Biggest problem facing small business (2005)

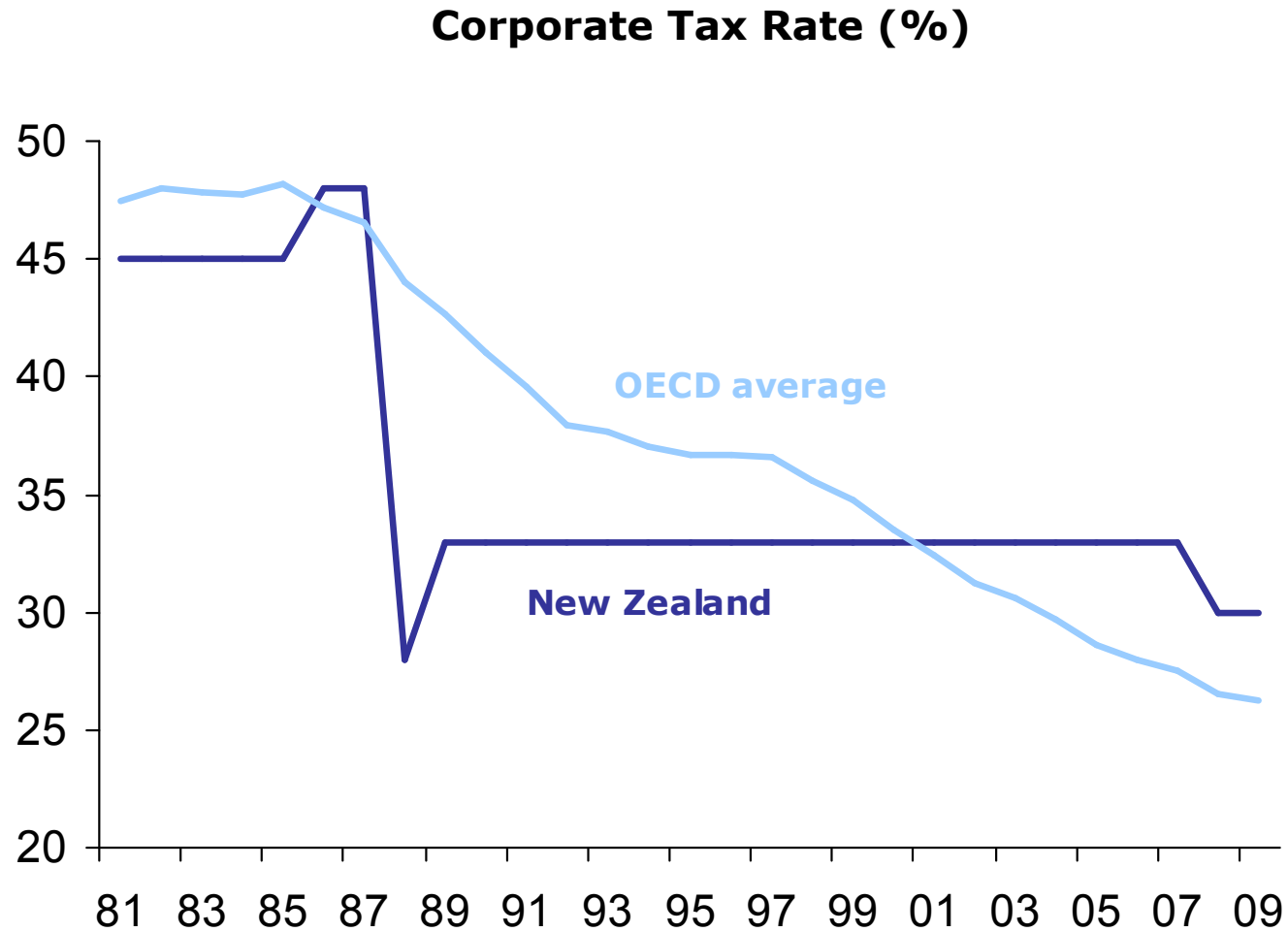


... and businesses in general

Main findings of Business New Zealand – KPMG Compliance Cost Survey: October 2008

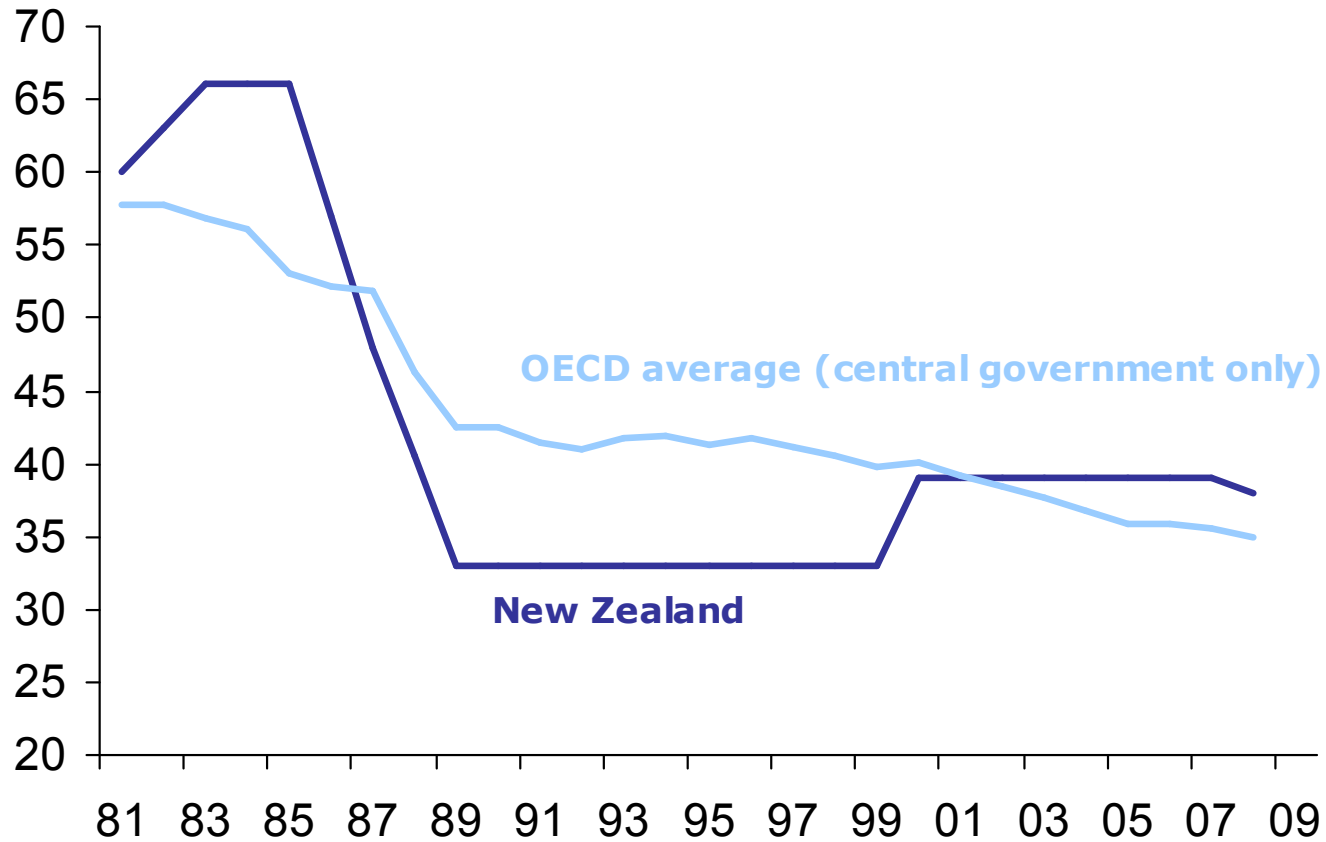
- Tax is still the dominant cost priority with 70% of respondents seeing it as a priority for change.
- Smaller firms continue to be harder hit by compliance costs than larger ones.
- Compliance costs have risen in all areas: IRD, ACC, ERA, KiwiSaver, OSH, Holidays Act, RMA, local body consultation, building regulations, et al

NZ's relative advantage on corporate tax rates has been severely eroded



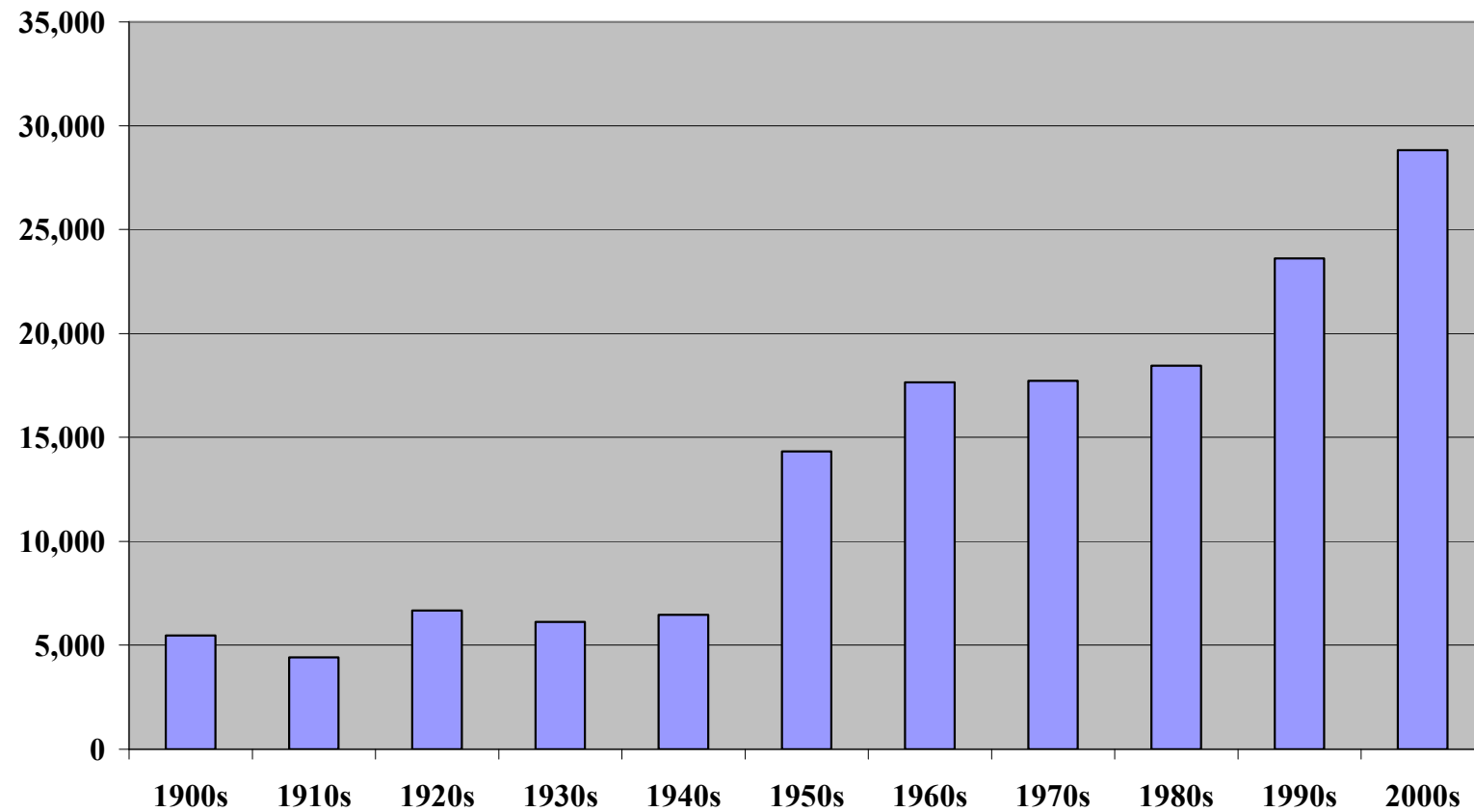
And the same applies to personal tax rates

Top Marginal Personal Tax Rate (%)



Regulatory creep has been an accumulating problem

**Number of Pages of New Primary Legislation by Decade
1900s to 2000s**



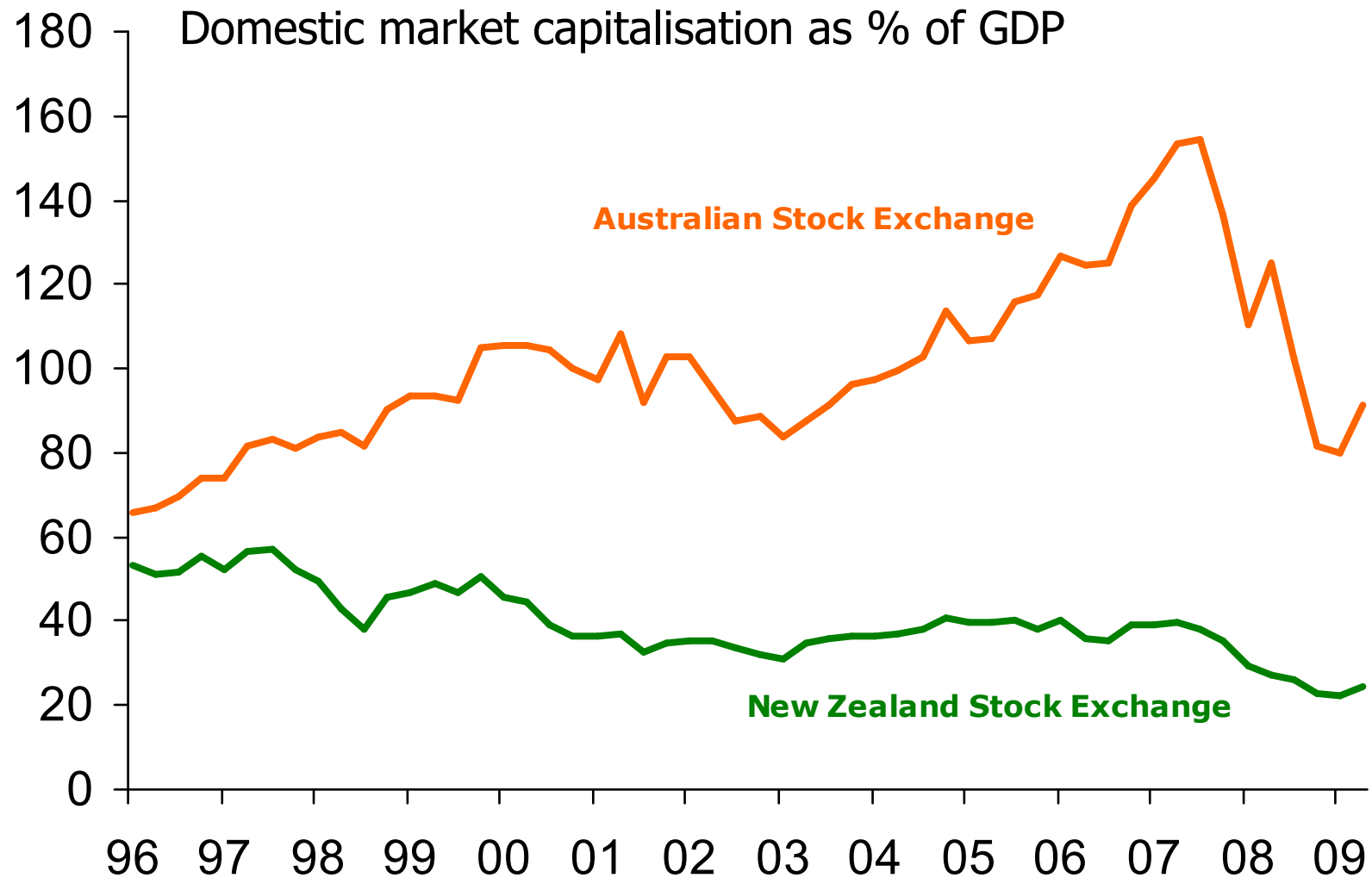
From 2000 to 2008 economic negatives and government interventions became prevalent

- Increase in top tax rate to 39c
- Restoration of ACC monopoly
- Employment Relations Act
- Tariff freeze
- Re-nationalisation of Air NZ, Kiwibank, rail
- Takeover regulation
- Commerce Act more restrictive
- Re-regulation of telecommunications
- Re-regulation of electricity
- Energy efficiency regulation
- More central control of health and education
- More lenient welfare rules
- Kyoto Protocol shambles
- Re-regulation of banking
- Privy Council appeals scrapped
- Resource Management Act
- Local authorities legislation
- Securities legislation
- Accounting standards
- Corporate governance

NZ has thin domestic capital markets

- Lack of depth & breadth (said RBNZ Governor and others)
- This constrains economic growth
- Raises vulnerability to crises
- NZX small and declining in relative importance
- Marked contrast to Australia
- Private equity became more important
- Pushes companies to offshore funding
- Pushes companies to offshore expansion
- Off market transactions predominate
- Huge increase in regulation and compliance costs in NZ capital markets
- Many parties now agree regulation needs improvement
- Major review now under way (Cameron task force)

Comparison of share market capitalisation



Labour market regulations constrain adaptability

- Numerous re-litigations of legislation
- Harassment cases a nightmare for employers
- Work/life balance imbalance
- Fixed term contracts
- Union meetings and site visits at will
- Holidays Act ... unintended consequences (review under way)
- Days off in lieu at will
- Discretionary payments double dipping
- Workplace stress
- Re-regulation of trading days
- Inequality of power
- Flexibility of labour markets eroded during 2000's

Kyoto and All That

- Original estimate of carbon **credits** \$300 million
- 2006 estimate over \$600 **debits**
- Officials error \$900 million
- Treasury reported carbon tax would be ineffective
- Carbon tax policy & NGA's abandoned
- 30 months of negotiations wasted
- Another new Government policy announced Dec 2006
- Emissions Trading Scheme (ETS) versus a carbon tax
- Huge disagreement over scale of problem
- Disagreement also over policy solutions
- All this has raised costs and uncertainty for business

Banking regulation intrusive

- RBNZ requires “standalone capability”, particularly when under stress
- Major systems were relocated to New Zealand
- Huge cost and inefficiency
- All third party contracts were renegotiated/separated
- All direct reports to CEO require RBNZ approval
- No analysis that benefits of all this might exceed costs
- Individual director attestations
- RBNZ claims this is “light handed” regulation
- Introduction of government guarantees for bank liabilities
- Guarantee applies also to non-banks
- Foreign funding is 42% of bank sector funding
- Australian and NZ banks came through international crisis as well as any banks and better than most

Telecommunications regulation destroys value

- Once the fastest growing industry in NZ
- Regulator over-ruled by Government (unbundling in 2006)
- Unbundling cost/benefit analysis ignored
- Regulation wiped \$3 billion off Telecom value
- No compensation for Telecom shareholders
- Regulation now all encompassing, even over Telecom organizational structure
- Following same route as failed electricity reforms
- Mobile termination rates now following same course
- No evidence of any gain to consumers from regulation
- This is despite the huge costs and great uncertainties of regulation
- Taxpayers now to invest \$1.5b. in broadband network
- Commercially odd joint venture, regional type model

Electricity regulation a mess

- Much regulation, numerous changes
- Industry largely Government owned
- Seriously conflicting numerous regulatory objectives
- Conflicting regulators (Govt. & CC & EC)
- Major transmission outages
- Lack of security of supply
- Uncertainty & underinvestment in some areas
- A disaster waiting to happen ?
- Review under way

Research Study on Regulation

- ANZ Bank study December 2006 showed poor regulation hinders economic performance
- Study found evidence of distortionary effects of regulation
- Recommended need for five policy changes
 1. Quantitative cost/benefit analysis
 2. Done by independent body
 3. Articulate goals better
 4. Ex post reviews essential
 5. Negative impact of uncertainty needs policymakers attention

Business adaptability has been severely eroded

Regulatory Dilemmas

- Regulation begets regulation
- Regulation overrides commercial solutions
- Regulation and changes induce uncertainty
- It imposes high transactions costs
- Diverts energy into rent seeking behaviour
- And away from focussing on winning in the market
- Regulation always has unintended consequences
- It concentrates on past issues rather than future growth
- Success ironically attracts regulation
- Regulation reduces flexibility
- It ultimately impedes the competition it pretends to promote
- Reduces attractiveness of New Zealand for foreign direct investment

Government reviews now underway

- 2025 Taskforce – chair Don Brash
- Regulatory Responsibility Taskforce – chair Graham Scott
- School Choice Working Group – chair Heather Roy
- Holidays Act Taskforce – chair Peter Kiely
- RMA Technical Advisory Group – chair Alan Dormer
- Land and Water Forum – chair Alister Bisley
- Hospitals Taskforce – chair Murray Horn
- Electricity Taskforce – chair Brent Layton
- Taskforce on the Maori Economy – chair Pita Sharples
- Capital Market Development Taskforce – chair Rob Cameron
- National Infrastructure Advisory Board – chair Rod Carr
- Tax Working Group – chair Bob Buckle
- Defence Review – leader John Mckinnon

Scorecard for past decade

Positives

- Relatively stable monetary policy
- Overall stance of fiscal policy (up until 2008)
- Minimal foreign exchange intervention (so far)
- Favourable terms of trade (thanks to global commodity boom)

Negatives

- Intrusive widespread re-regulation
- Growing size of Government (big spending increases)
- Higher taxes
- Infrastructure mess (roads, energy, telecommunications)
- Social policy (health, education, welfare)
- Constitutional issues (MMP, appeal rights)
- Shrinking domestic capital market
- Overseas deficit and overseas debt
- Prospective fiscal deficits and public debt increases
- Now rising unemployment

In summary

- **Decade of economic growth until 2007. This arose from:**
 - World expansion
 - Commodity prices
 - Domestic productivity

- **Productivity growth was based on initiatives from 84-90's**
 - Deregulation (promoted flexibility & competitiveness)
 - Stable macro policy (low inflation)
 - Reducing size of Government (since Government redistributes but does not itself generate growth)
 - Labour market conditions and the relative price of capital to labour

In summary (continued)

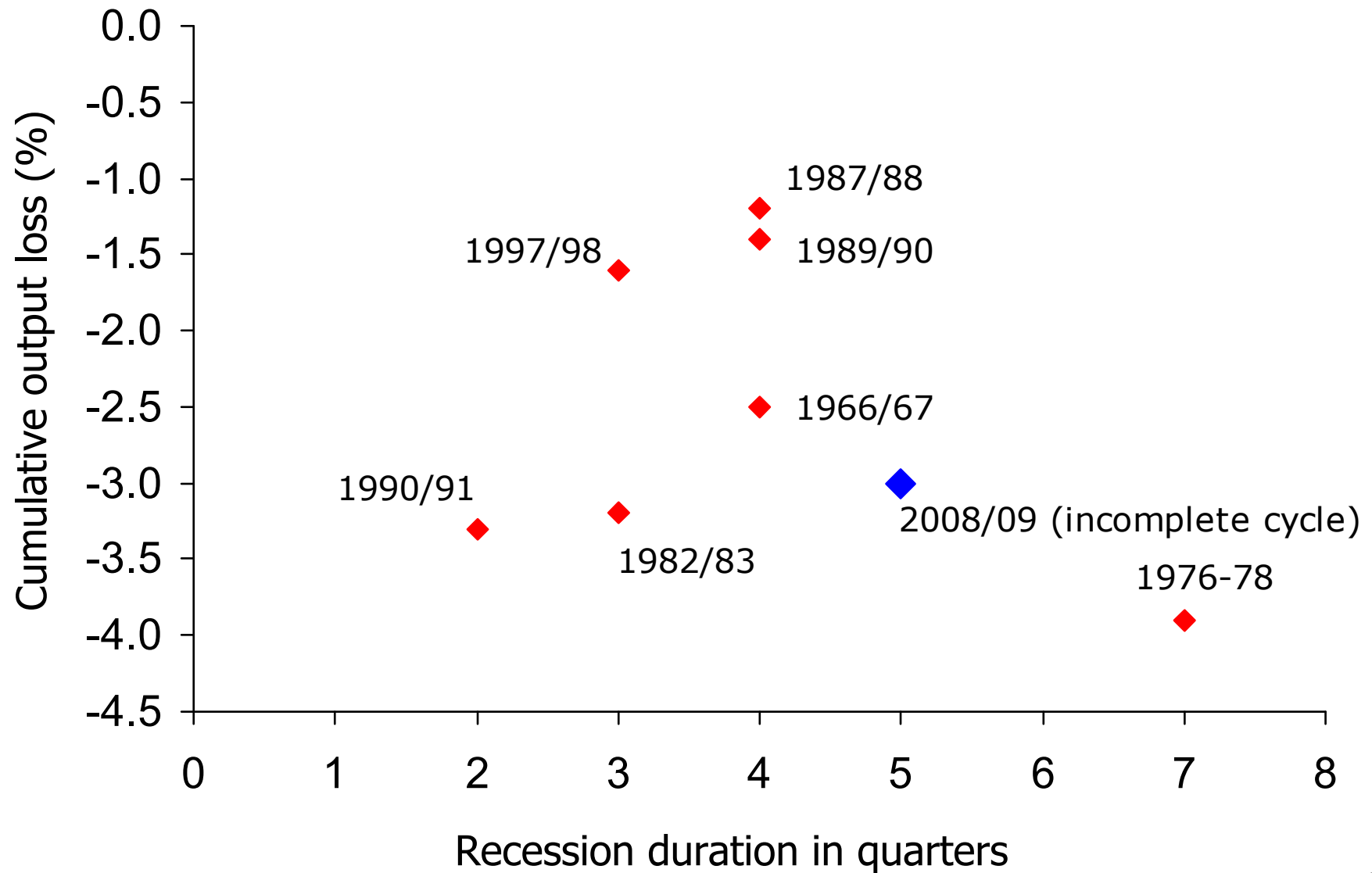
But, over recent years

- Increasing size of Government sector
- Fiscal deficits again and growing public debt
- Extensive regulatory interventions, some now under review
- Poor Government sector management
- Too many welfare benefits universal rather than needs based
- Erodes incentives for personal and family responsibility
- Who believes health, education, or welfare are well managed ?
- Sharply slowing productivity growth
- Rising unemployment (Treasury forecasts peak at 8%)
- Huge external imbalance & offshore debt (93% of GDP 2008)
- Bank offshore funding 67% of GDP in 2008
- Government now addressing issues but takes time
- So where do NZ's comparative advantages now come from?

Some Solutions

- More secure property rights
- Greater certainty in the application of the law
- Enforceability of contracts
- Less intrusive regulation and fewer changes in the rules
- Insist on cost/benefit analysis for new & old regulations
- Ex post reviews of regulations
- Open and competitive markets
- Review government guarantee on financial institutions deposits
- Smaller government, reduce public service bureaucracy
- Move benefit system to needs based rather than universality
- Tighten up on government expenditure
- Develop clearer price signals in public sector
- Lower taxes
- Ongoing stable monetary & fiscal policies

NZ recessions compared



Business cycles in industrial countries compared

