

To Whither or Wither ?



Observations on the State of the Economy Roderick Deane*

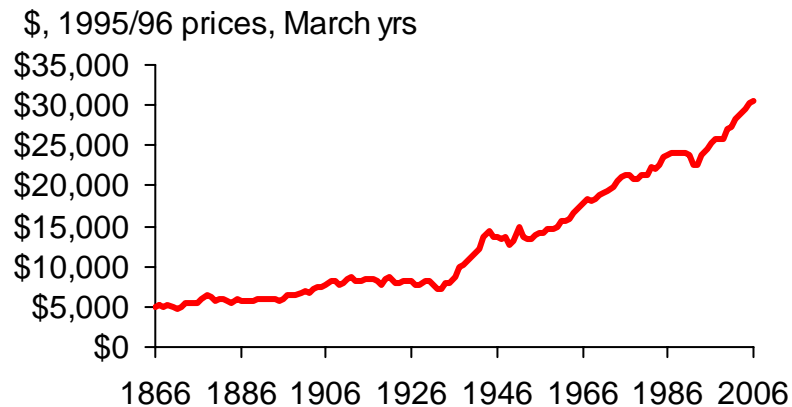
An address to the Treasury Group Lecture Series, Wellington
1 May 2007

*Dr Roderick Deane is Chairman of Fletcher Building Ltd and the NZ Seed Fund, and a Director of Woolworths Ltd in Sydney. He is also Patron and Chairman of the IHC Foundation. Until 30 June 2006 he was Chairman of ANZ National Bank, Telecom Corporation of NZ Ltd, Te Papa Tongarewa (The Museum of NZ), City Gallery Wellington Foundation, and a Director of the ANZ Banking Group Ltd in Melbourne.

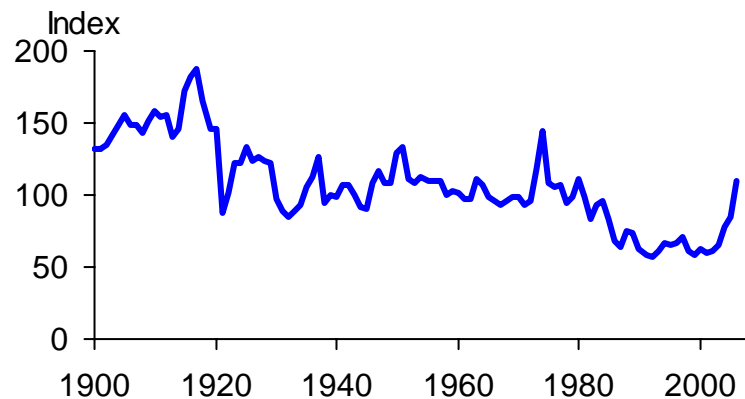
Dr Deane is very appreciative of the assistance he was given in preparing this material by the Economics Group of the ANZ National Bank and by Bryce Wilkinson and Roger Kerr.

A long-run perspective on New Zealand's economic growth

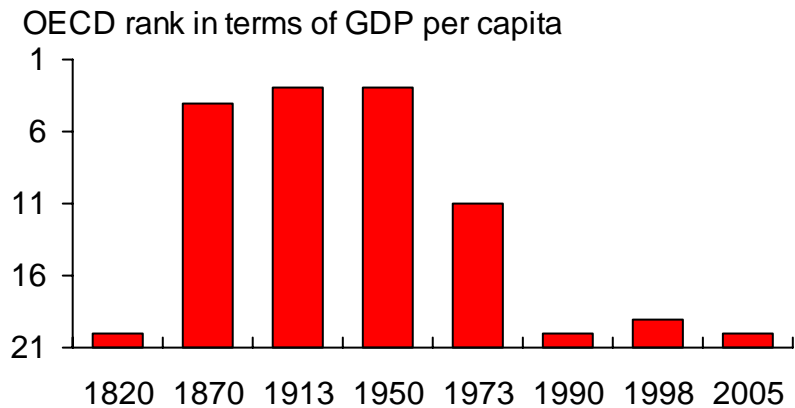
GDP per Capita (1866-2006)



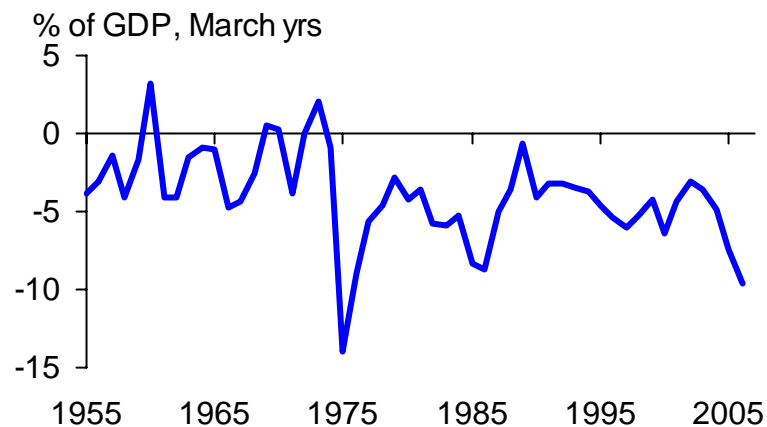
Real Commodity Prices (1900-2006)



The rise and fall of NZ's relative place in the world: (1820-2005)

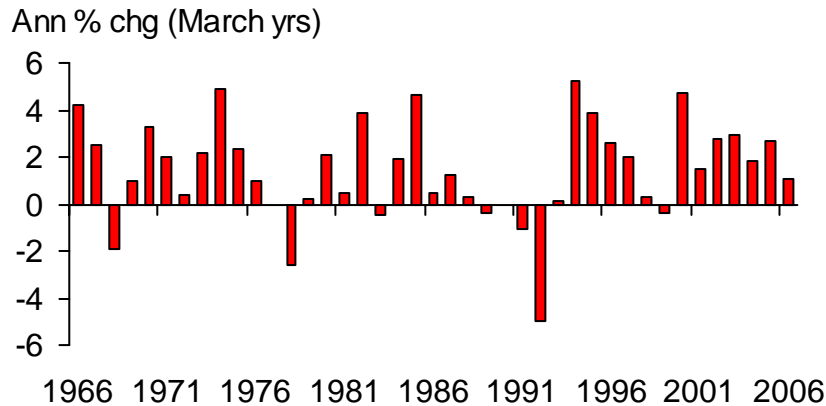


NZ's Current Account History (1955-2006)

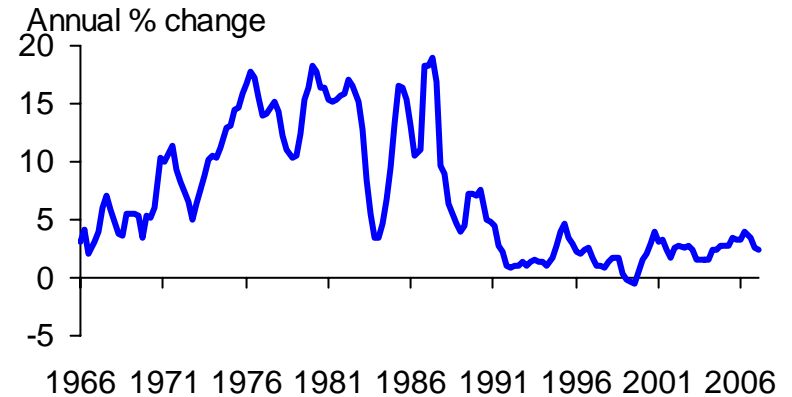


Current macroeconomic settings have improved significantly

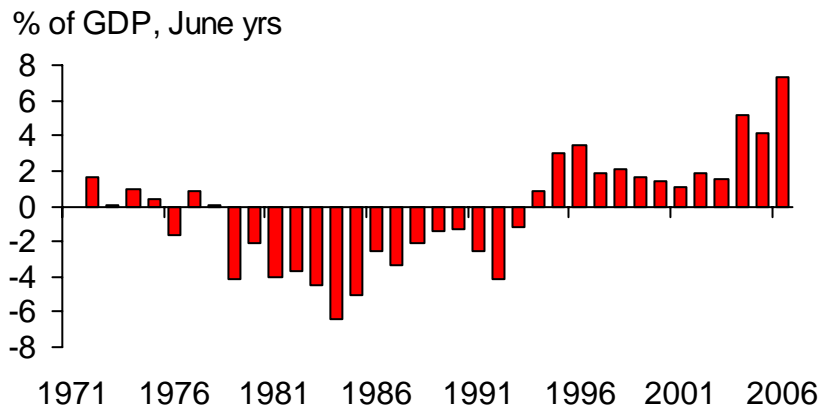
GDP Growth per Capita (1966-2006)



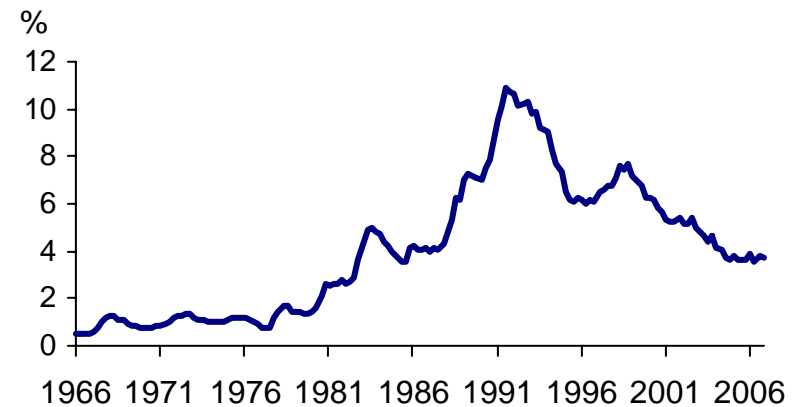
Consumer Price Inflation (1966-2007)



Fiscal Balance (1972-2006)

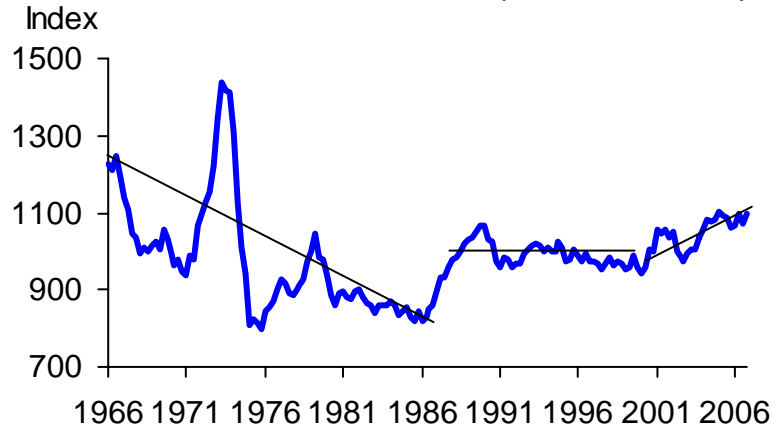


Unemployment Rate (1966-2006)

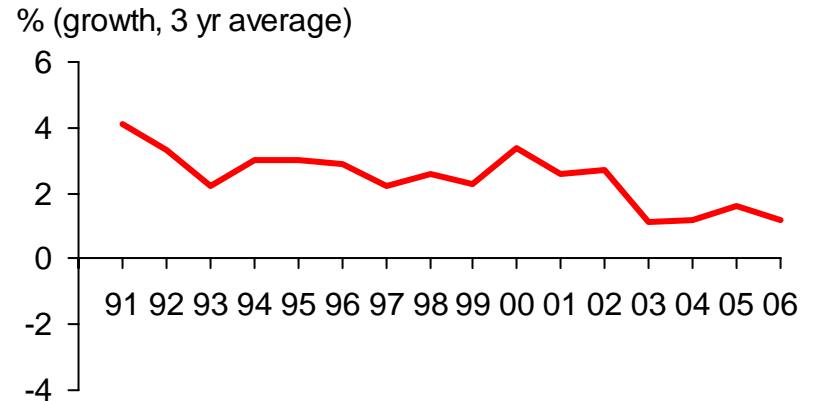


Terms of trade, productivity

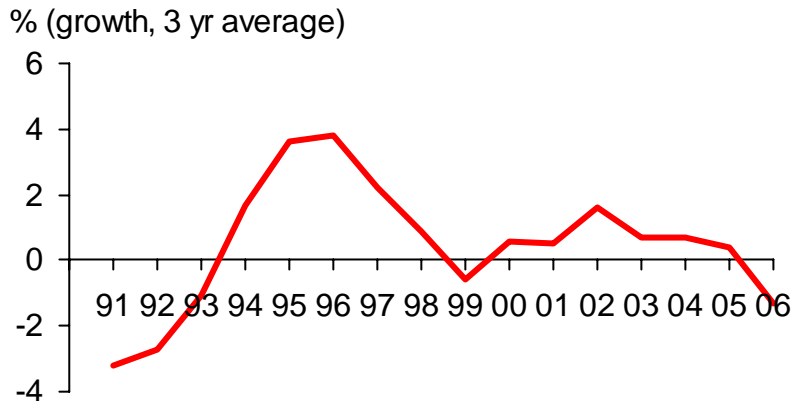
Terms of Trade (1966-2006)



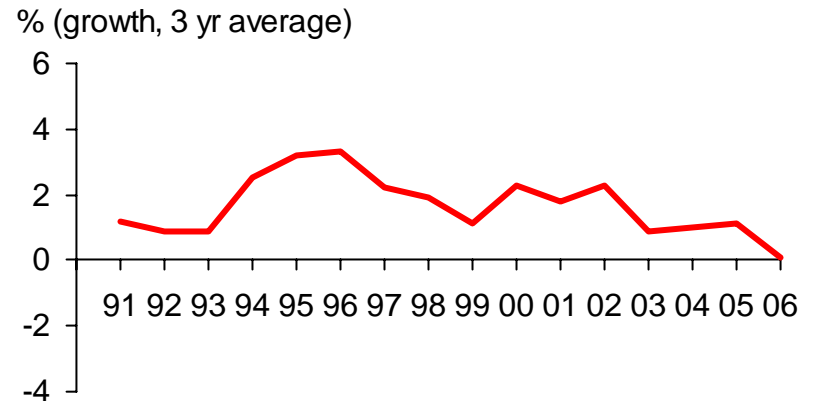
Productivity – Labour (1991-2006 March yrs)



Productivity – Capital (1991-2006 March yrs)

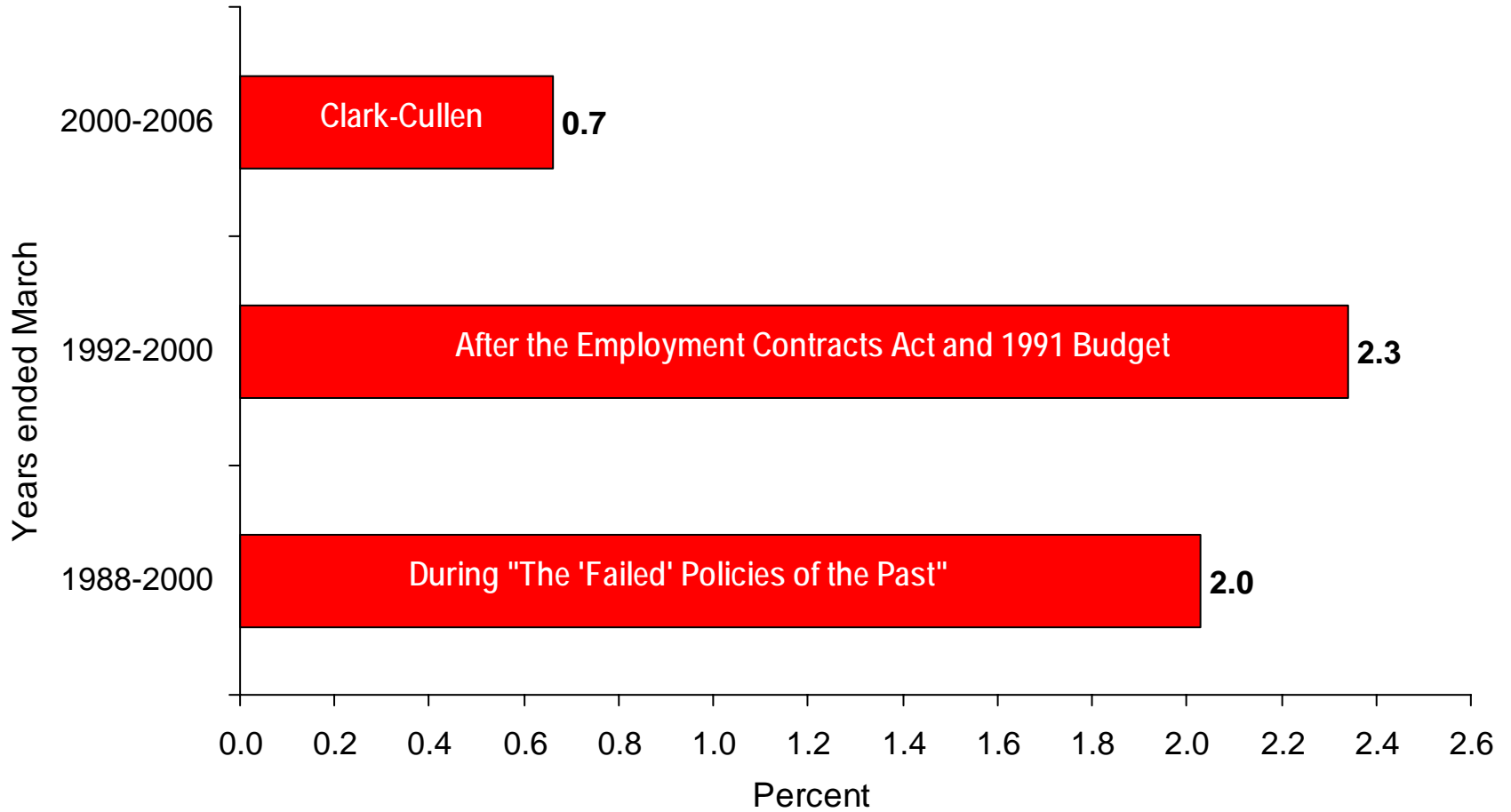


Productivity – Multifactor (1991-2006 March yrs)



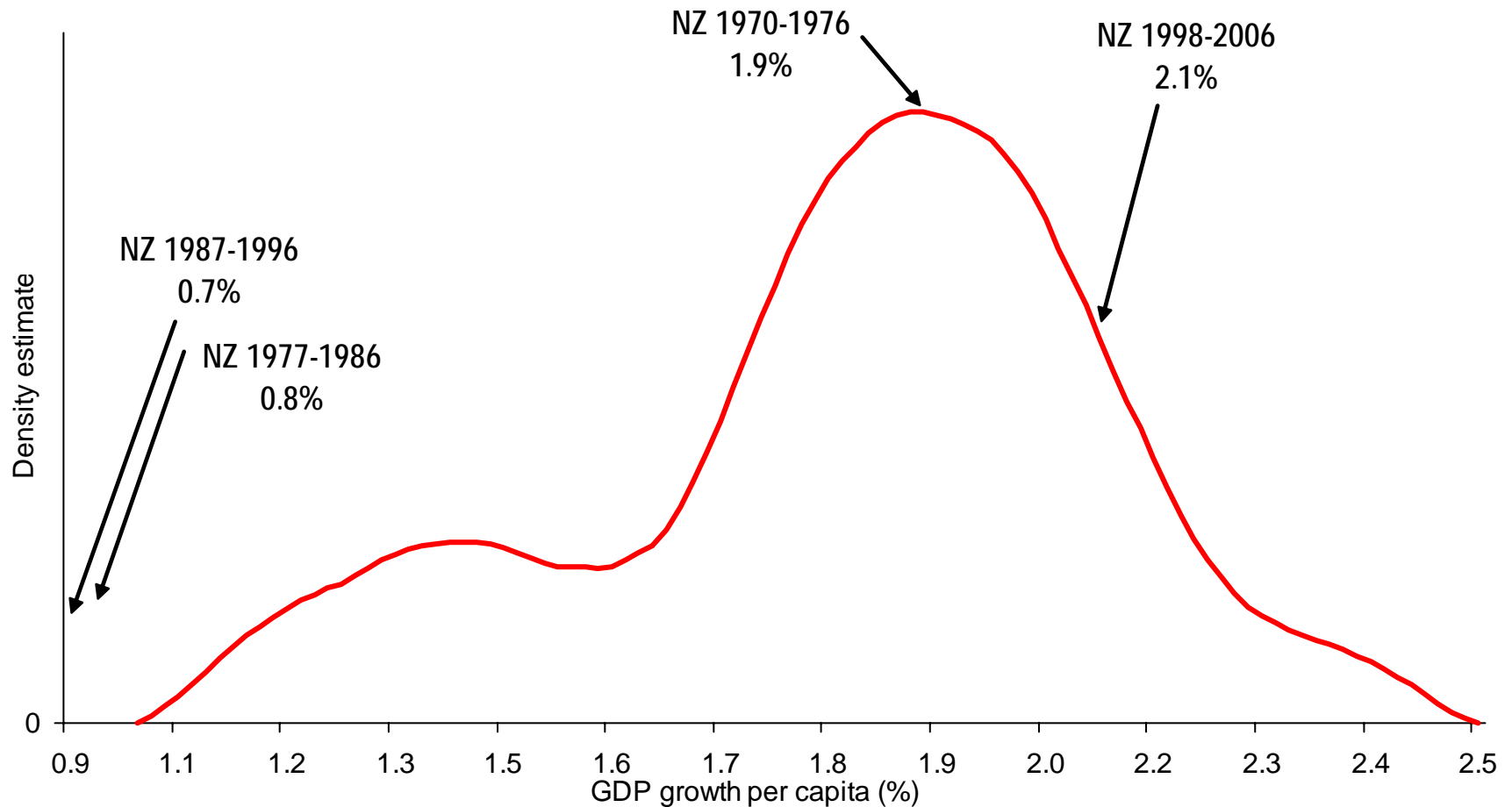
Multifactor Productivity

Trend Average Annual Growth Rate



Consequently, NZ has transformed itself from a below average performer to an above average performer

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



We benefited from the mid-80's to mid-90's reforms

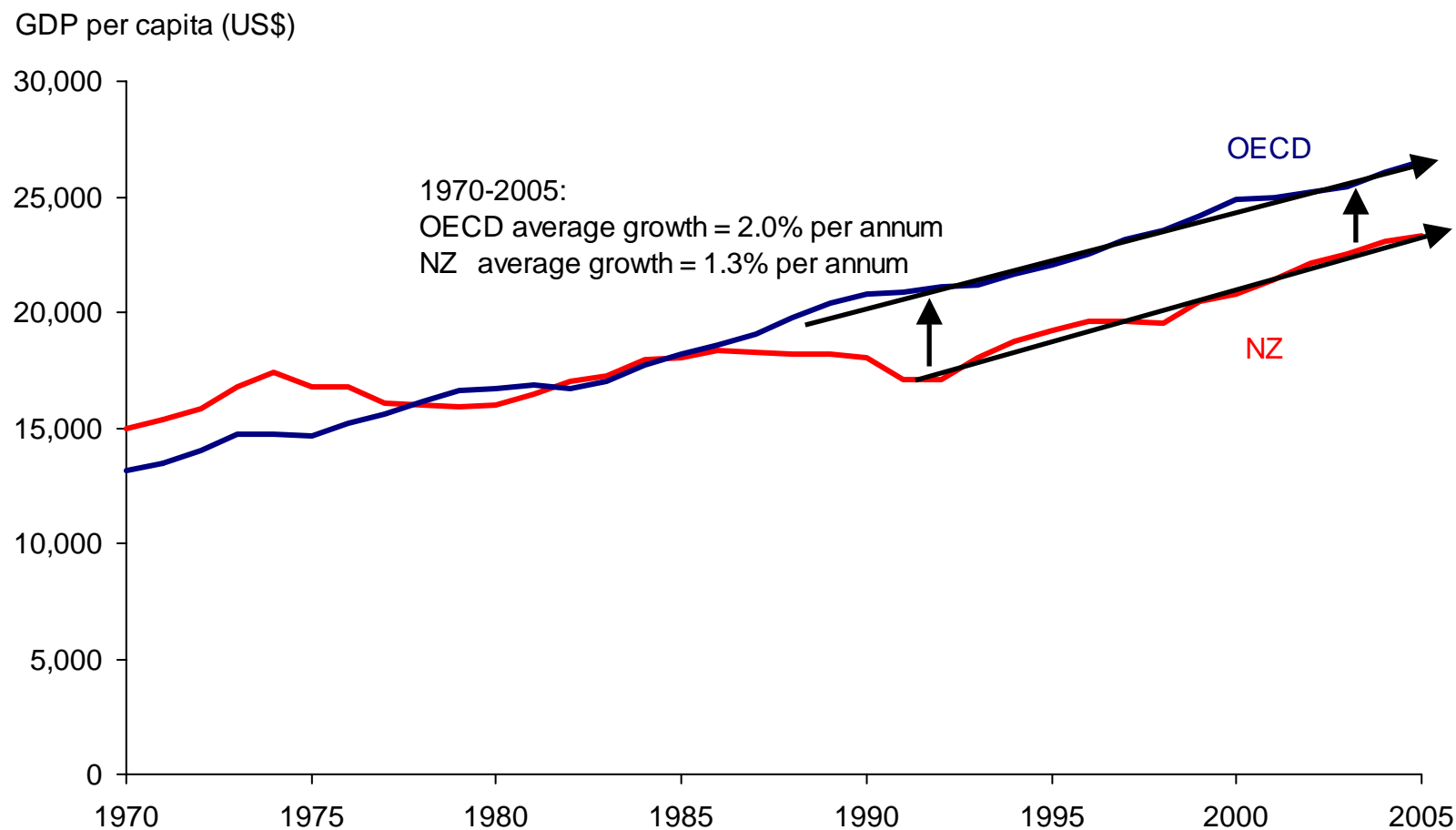
A reminder on the Reforms

- 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

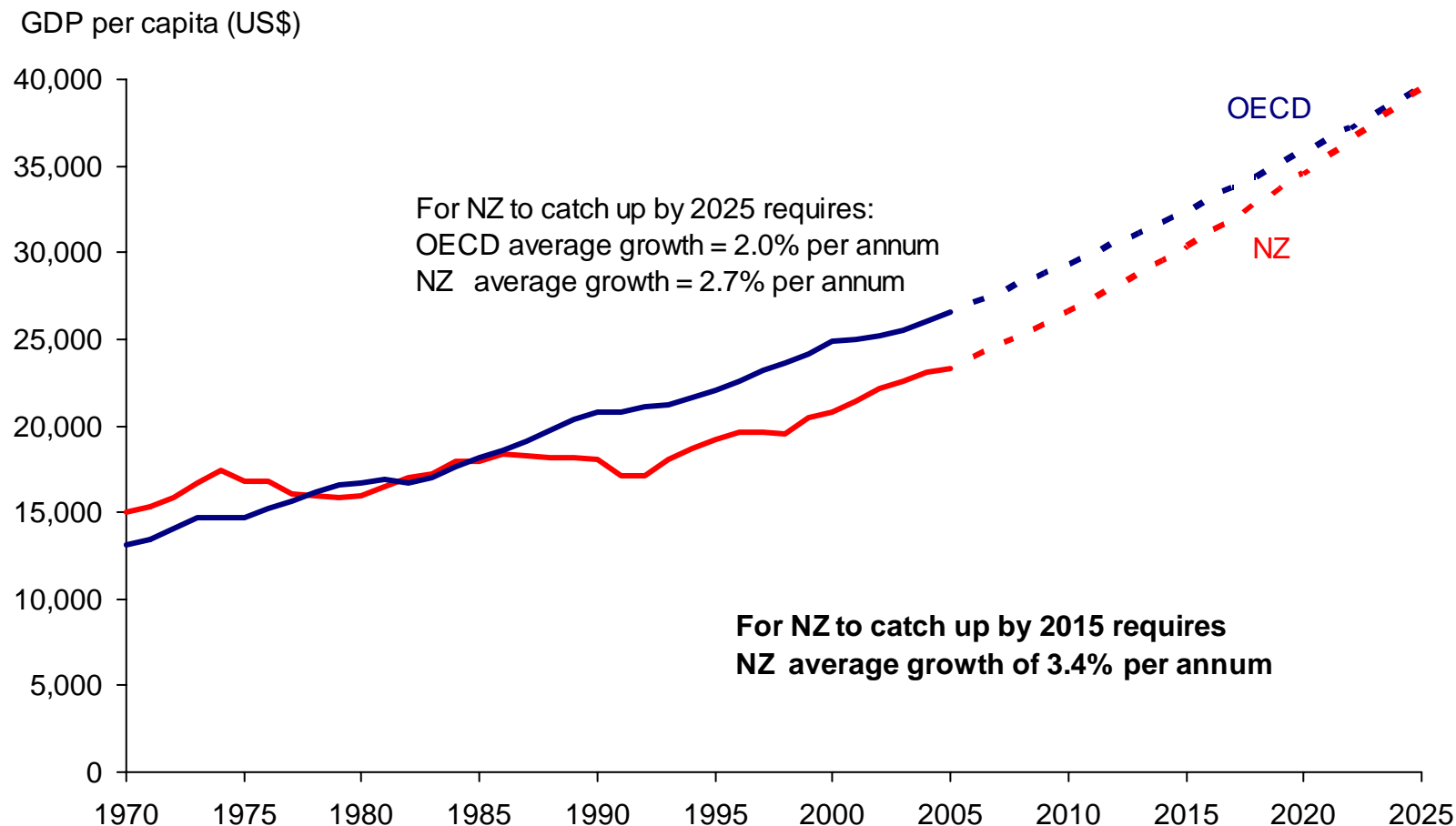
The decline has been arrested

GDP per capita



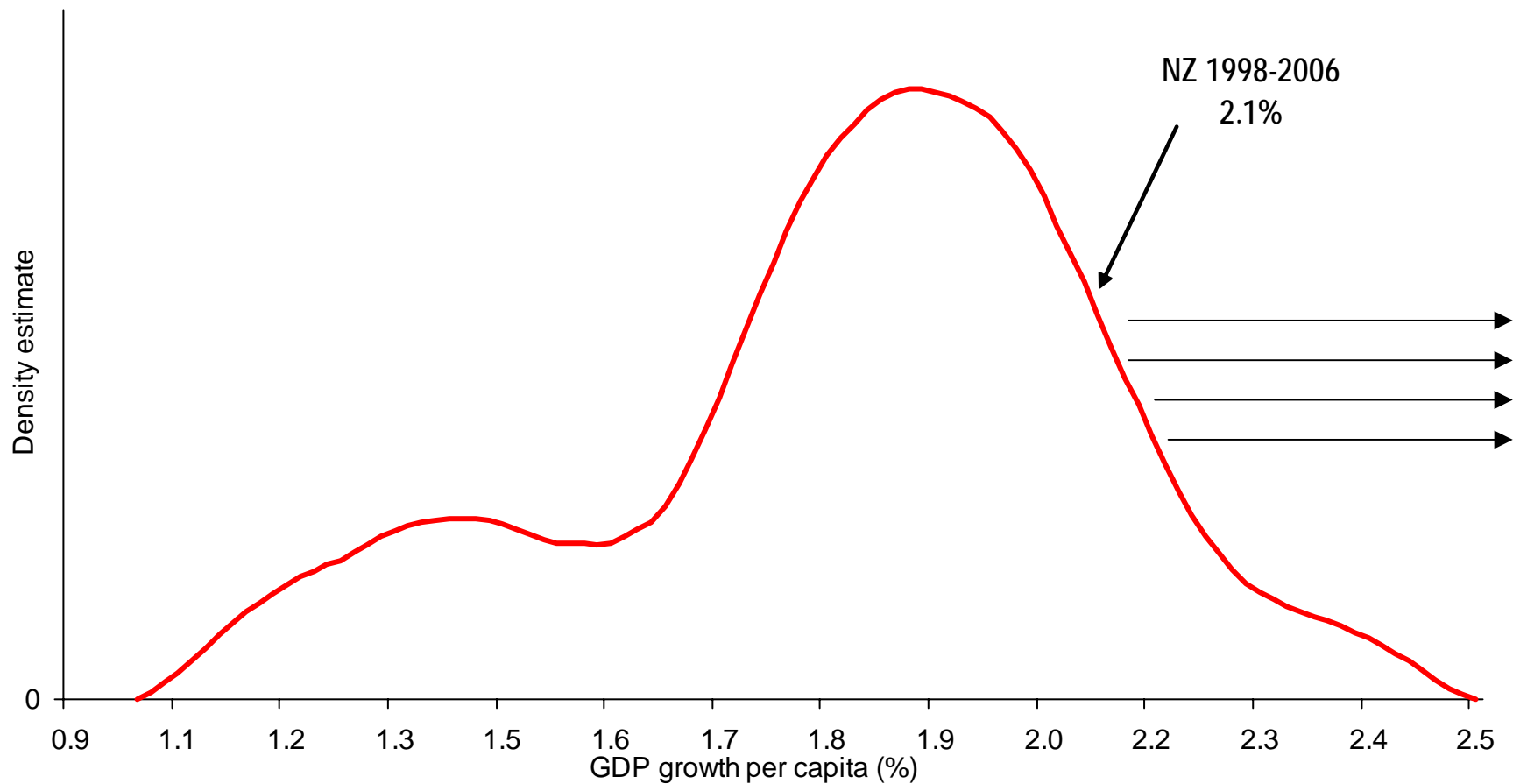
But closing the gap requires something a lot more

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 2.7 percent to close the gap by 2025

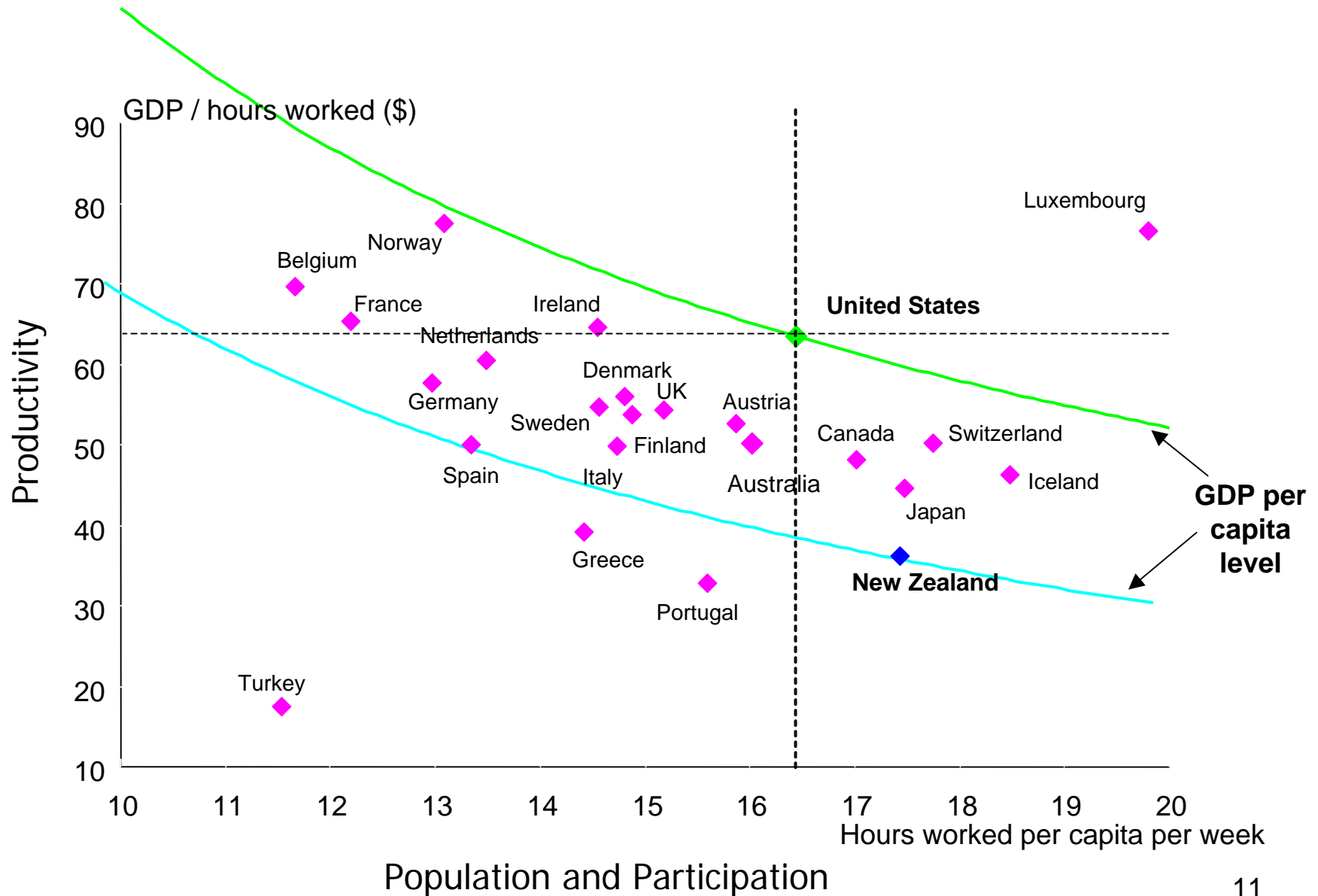


We are here, but we need to be there...

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



Work harder or work smarter



We continue to rank lowly in the OECD stakes

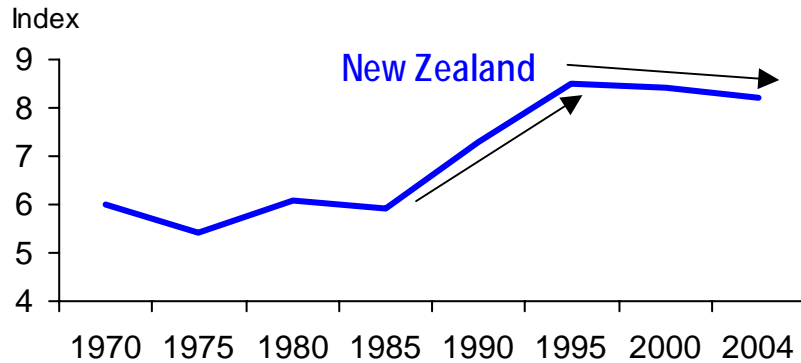
OECD Nation Rankings

Richest nation:	Luxembourg
High income:	Norway, USA, Ireland, Switzerland
Middle/high income:	14 nations including Australia, UK, Canada, France, Japan
Low/middle income:	New Zealand, Spain, Greece, Korea, Portugal
Lowest income:	Turkey

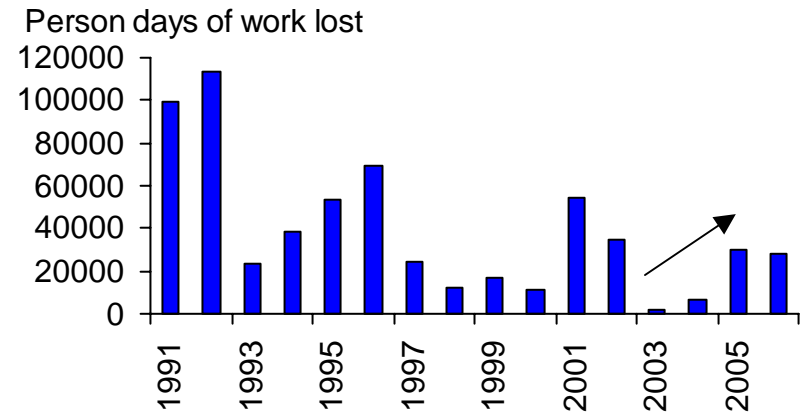
Rankings based on purchasing power, taking into account the cost of 3000 items, from a litre of milk to building a house

Are we in fact starting to go backwards?

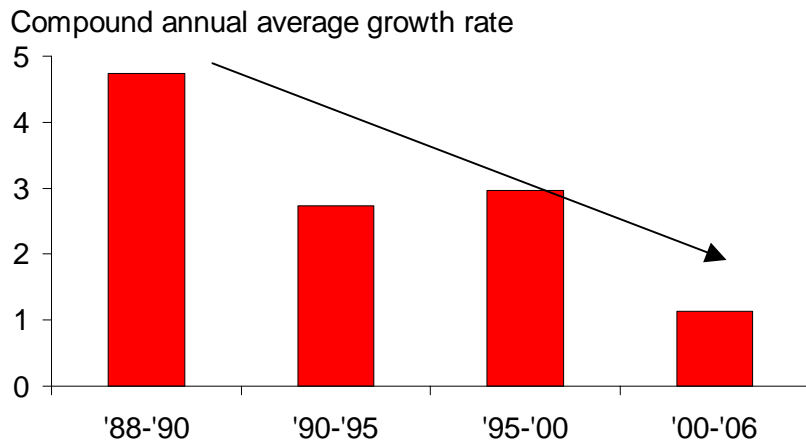
Economic Freedom Index (1970-2004)



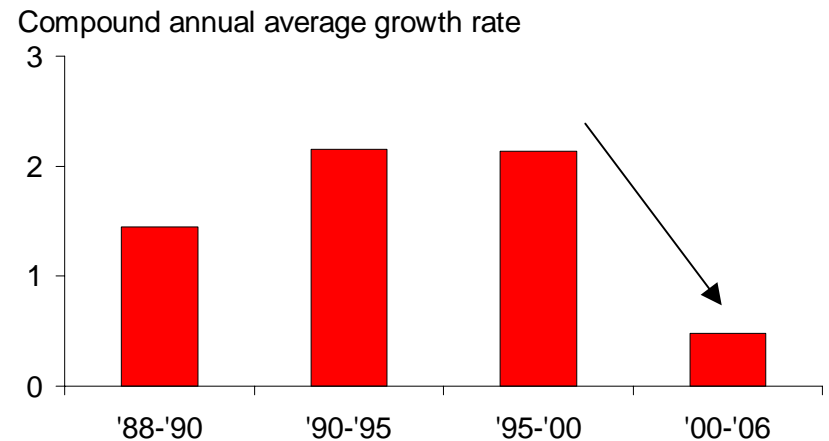
Work Stoppages (1991-2006)



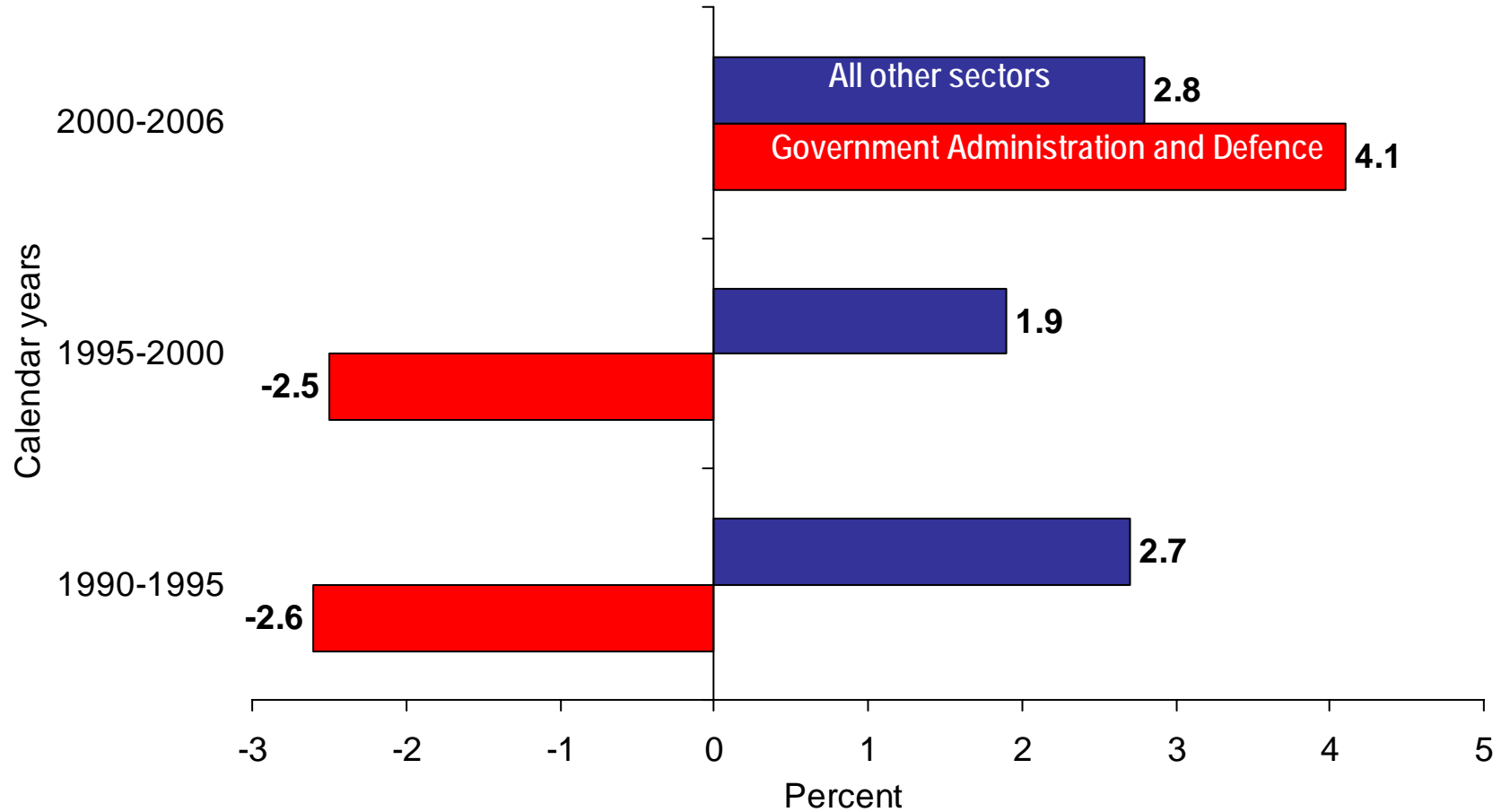
Labour Productivity



Multifactor Productivity

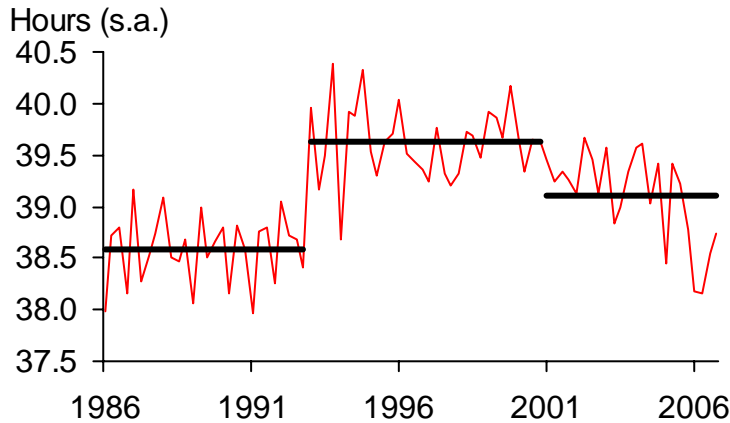


Core public service employment growth

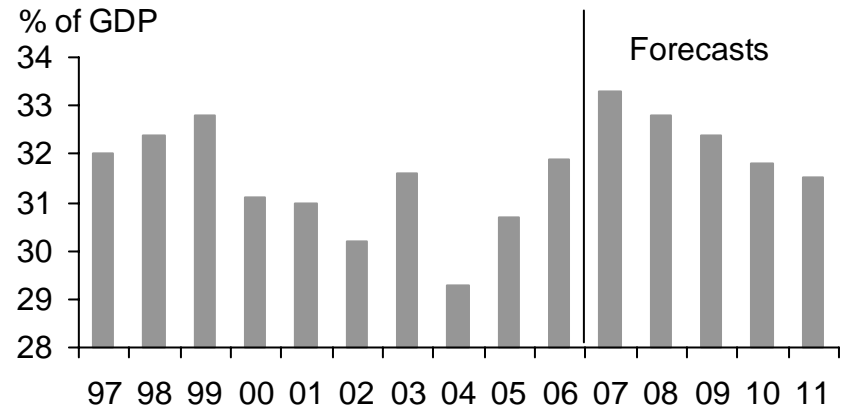


Working less but wanting more

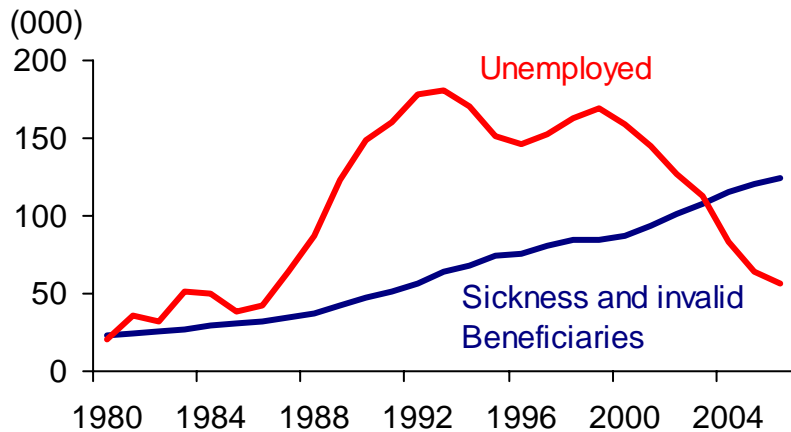
Hours worked per full time employee (1986-2006)



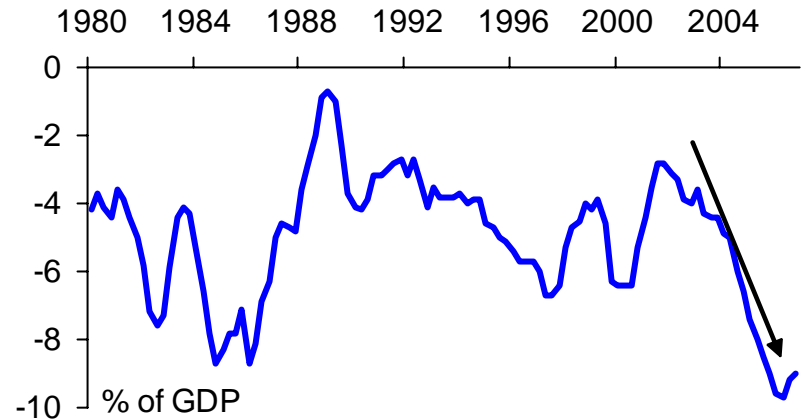
Core crown spending (1997-2011 June yrs)



Unemployed and beneficiary numbers (1980-2006 June yrs)

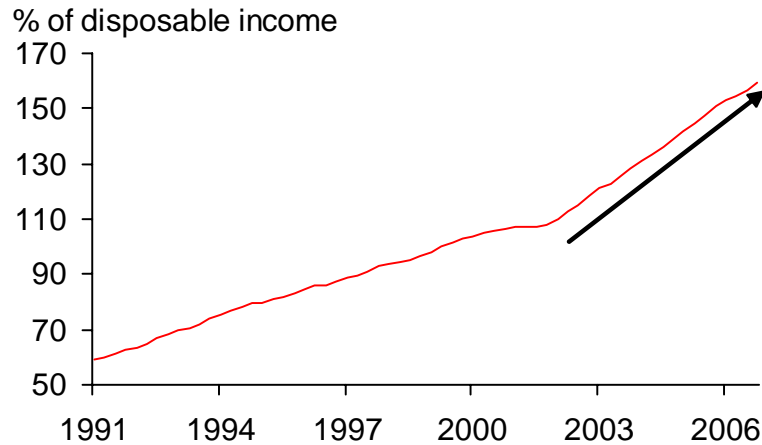


Current Account Deficit (1980-2006)

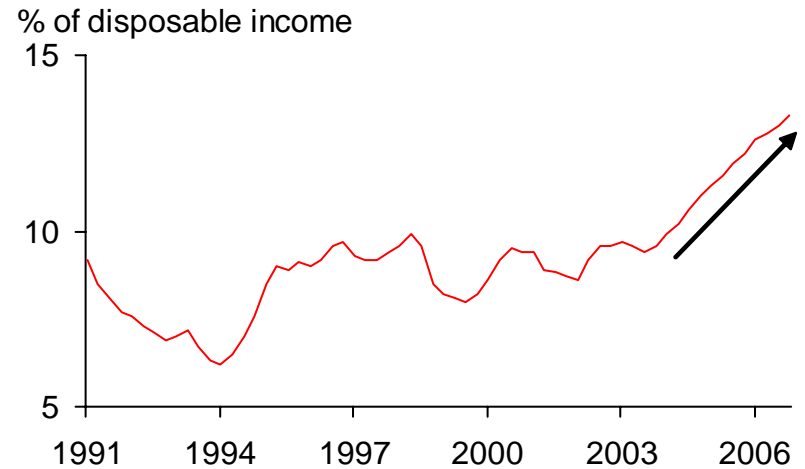


Household borrowing sky-rocketing

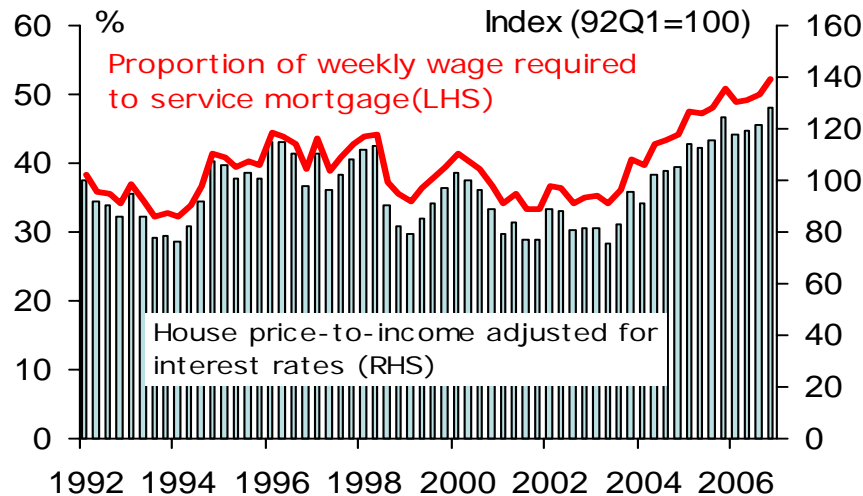
Household debt



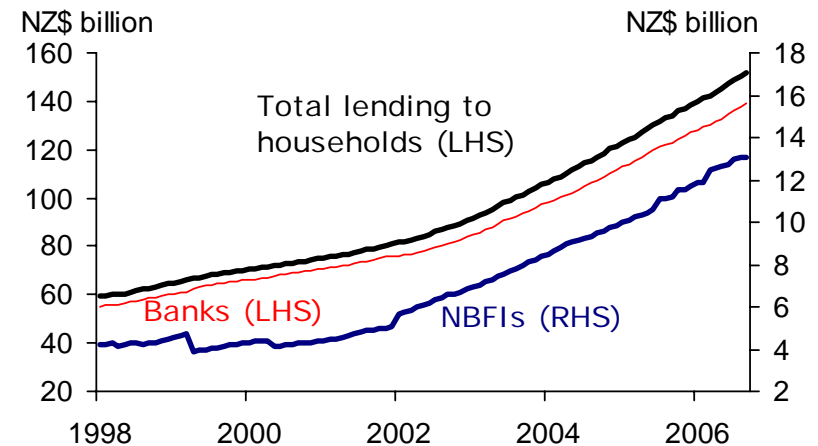
Interest servicing



Housing affordability

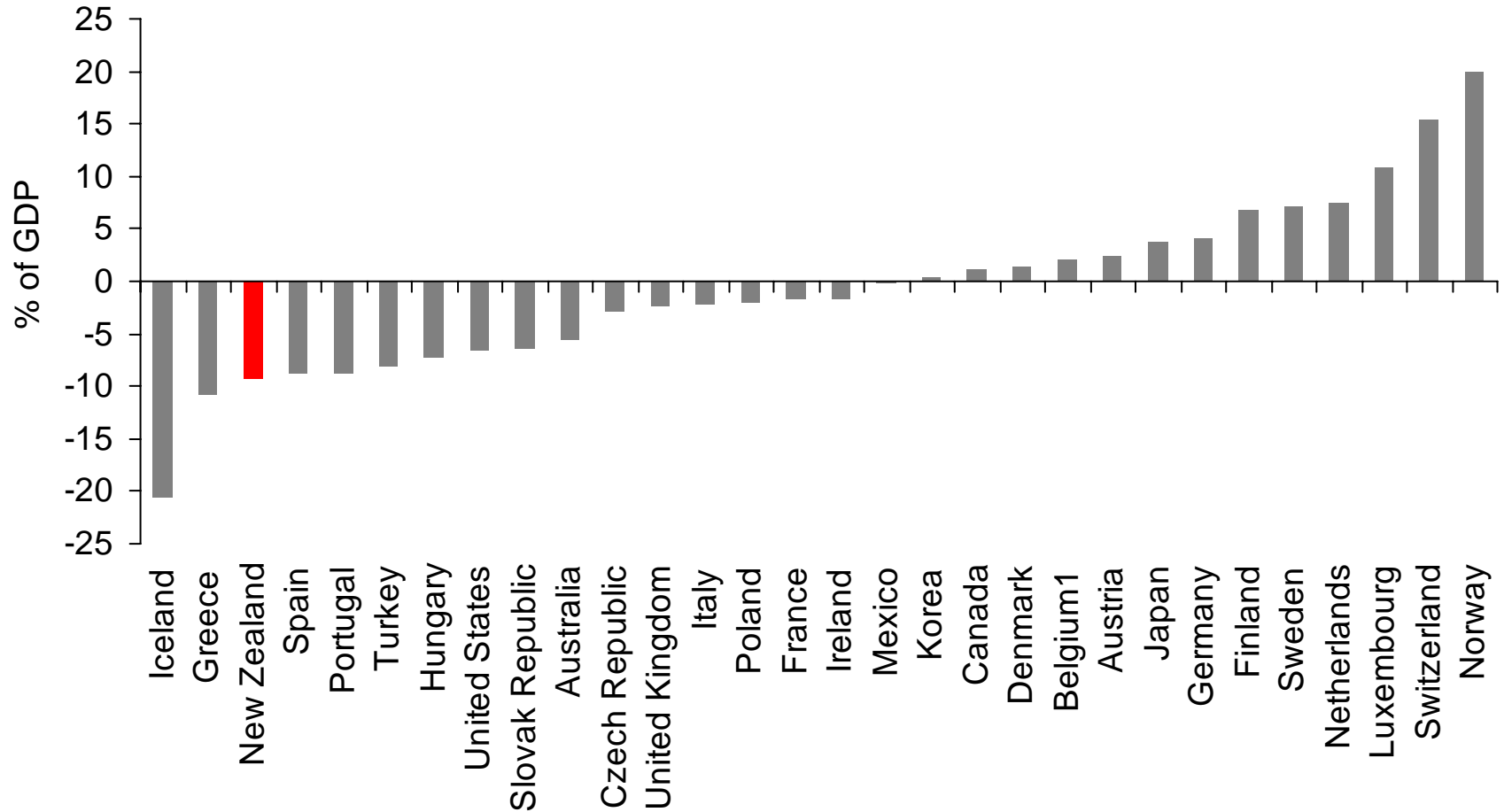


Bank & NBFi lending to households



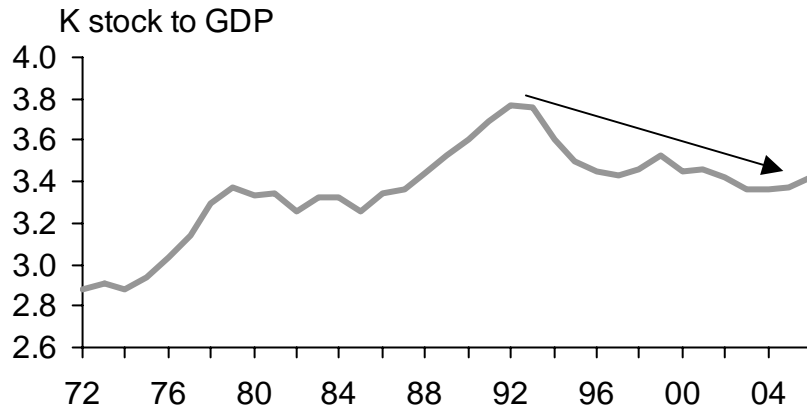
NZ's current account deficit is unsustainable

Current Account Balances of OECD nations

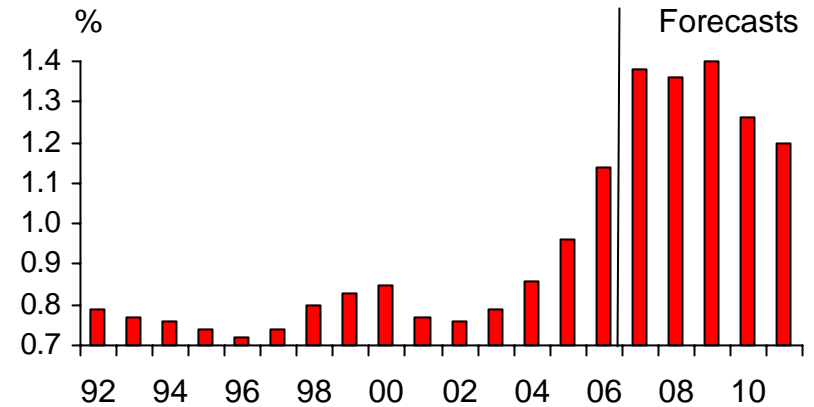


Infrastructure investment is a key issue

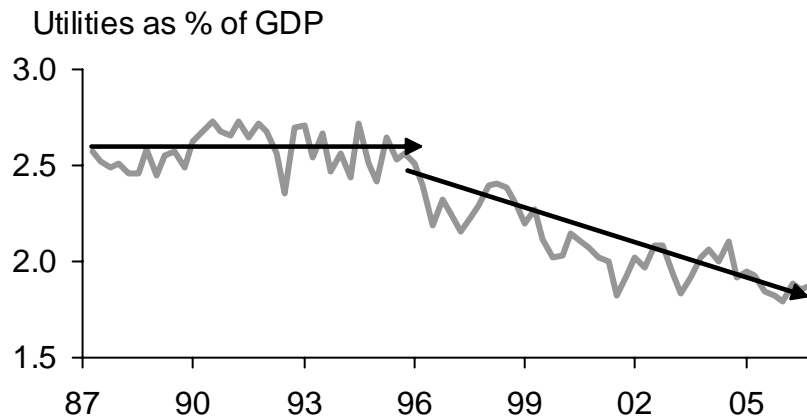
**Capital stock to GDP
(1972-2006 March yrs)**



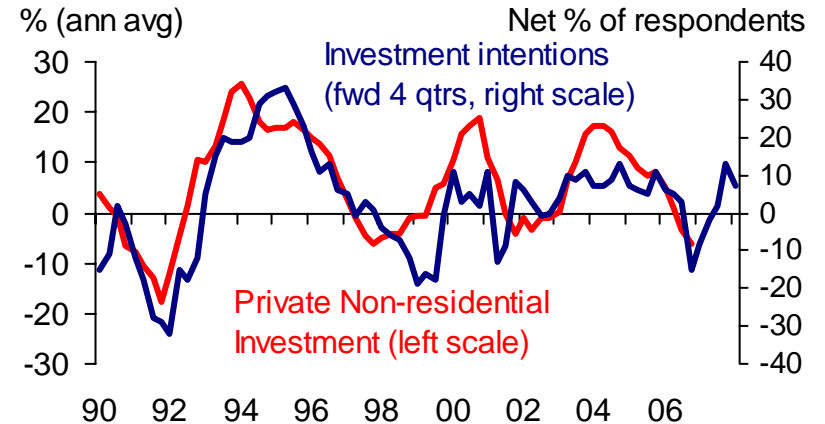
**Transport spending as % of GDP
(1992-2011 June yrs)**



**Utilities GDP vs economy-wide GDP
(1987-2006)**

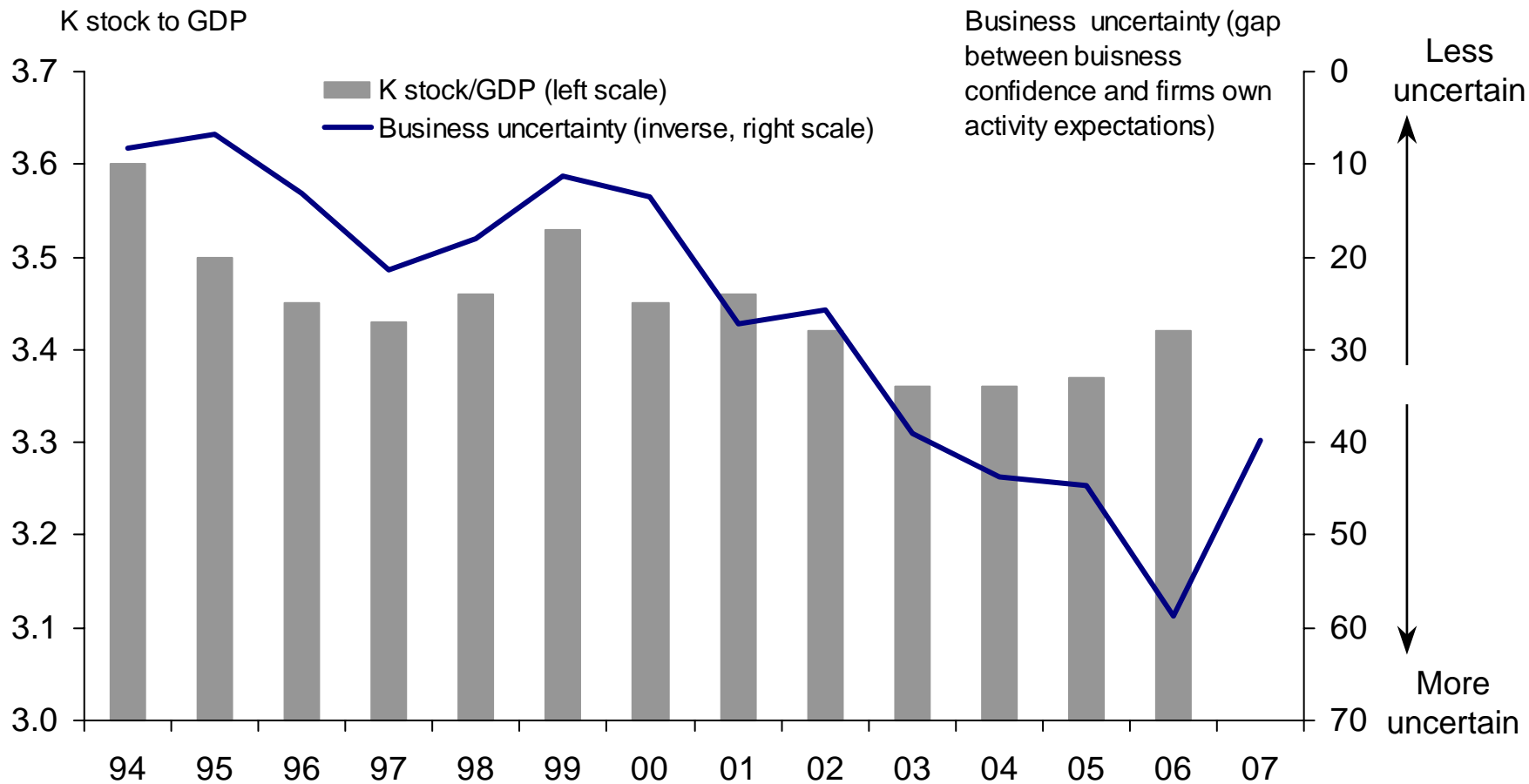


**Investment (ex-buildings) and QSBO
Investment Intentions (1990-2006)**



Uncertainty is impacting negatively on investment

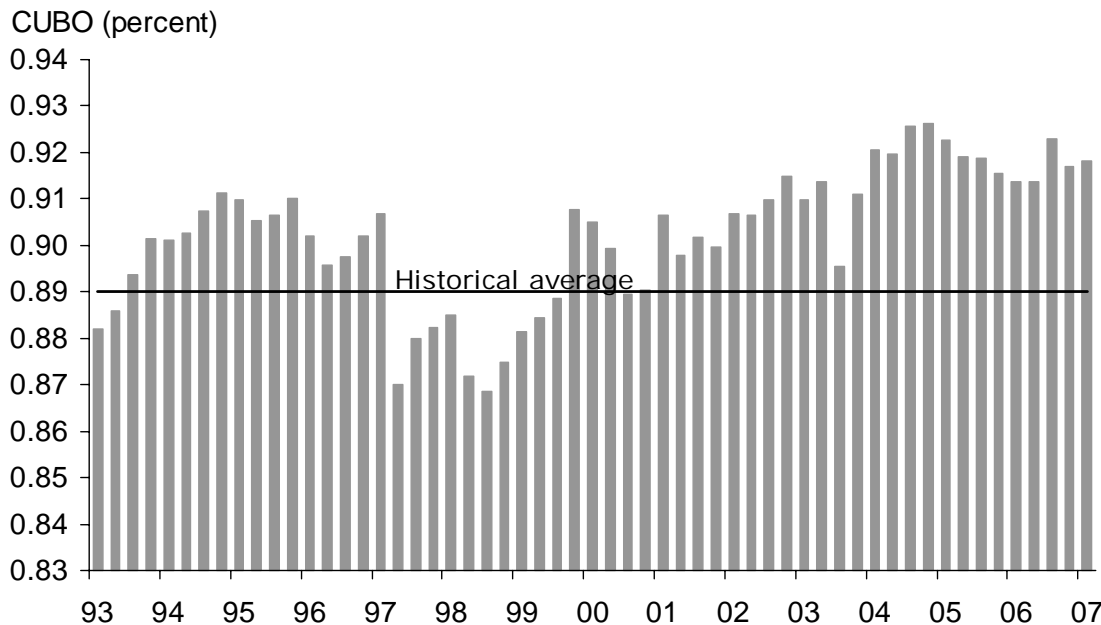
Capital stock to GDP and business uncertainty



At a time when more investment is needed because capacity utilisation is near historical high

Capacity Utilisation at near all time highs despite economic slowdown over past year

NZ's capital stock growth lagging behind

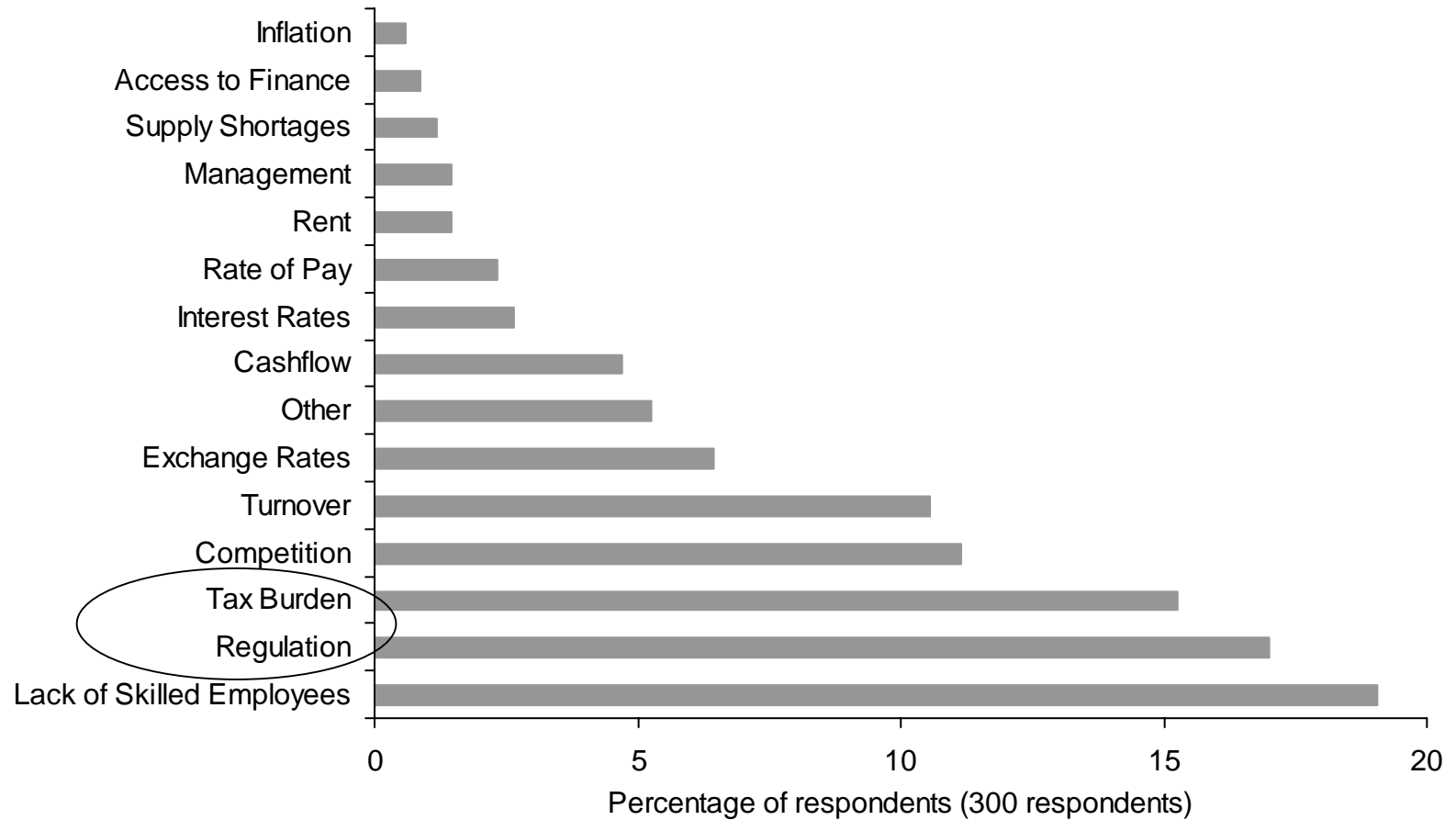


Annual average growth (%)

	1985-1994	1995-2004
NZ	2.7	3.8
Australia	3.2	4.1
OECD	4.0	3.9

The biggest problem facing small business...

Biggest problem facing small business (2005)



... and businesses in general

Main findings of Business New Zealand – KPMG Compliance Cost Survey: September 2006

- In 2006 compliance costs increased for four of the six company categories.
- Tax is still the top compliance concern, followed by employment law issues.
- Business people perceive compliance costs to have increased in all areas, especially regarding the Holidays Act.

Tax rates

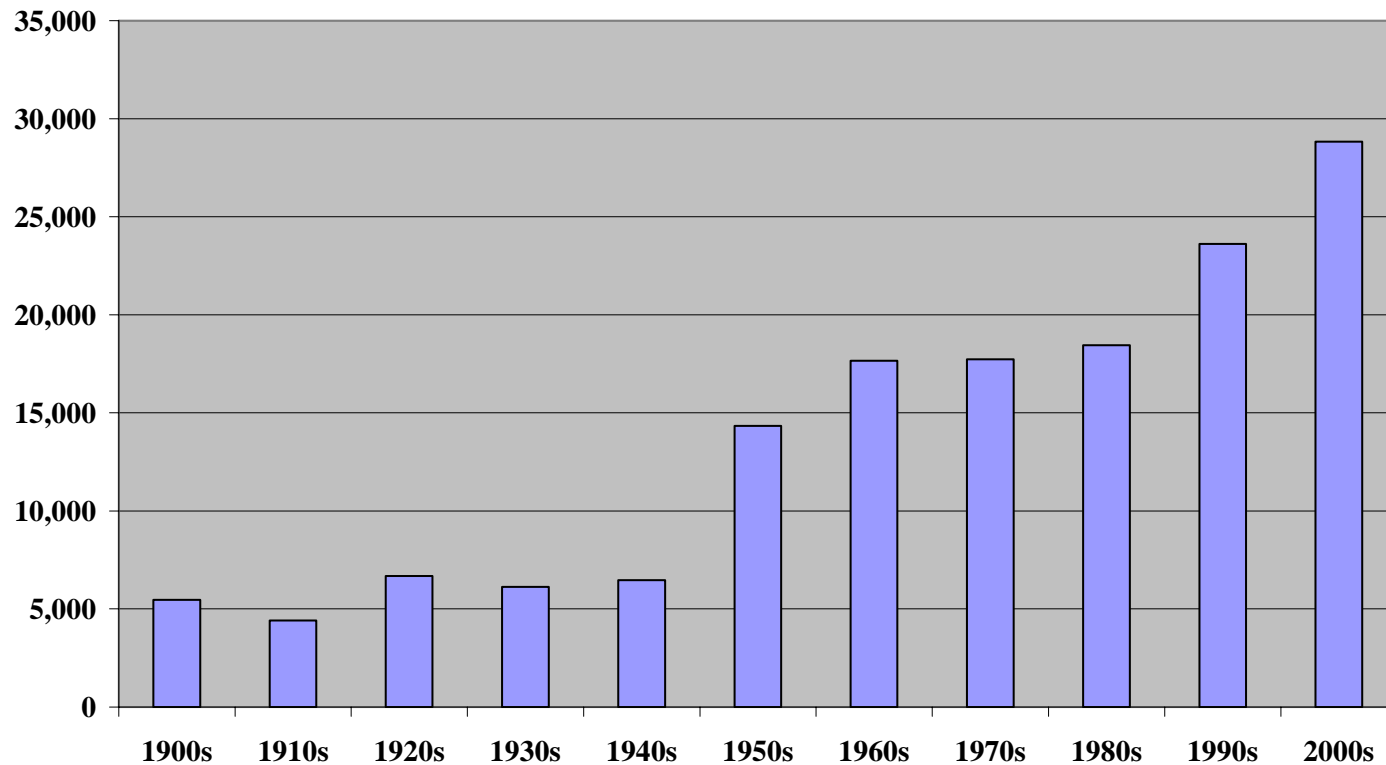


Tax rates



The regulatory creep

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



Of more recent years ...

Economic Negatives and Regulatory Interventions

- 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

Capital Markets

- Lack of depth & breadth says RBNZ Governor
- This limits economic growth
- Raises vulnerability to crises
- NZX small and declining in relative importance
- Agrees regulation needs improvement
- Private equity becoming dominant
- Yet all this pointed out to RBNZ & Government
- Ironically been huge increase in regulation and compliance costs in NZ capital markets

Employment Relations

- 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
- Days off in lieu at will
- Discretionary payments double dipping
- Workplace stress
- Inequality of power

Kyoto and All That

- Original estimate of **credits** \$300 million
- 2006 estimate \$609 **debits**
- Error \$900 million
- Treasury reported tax would be ineffective
- Carbon tax policy & NGA's abandoned
- 30 months of negotiations wasted
- Australia did not sign Kyoto but are further ahead than us
- Another new Government policy announced Dec 2006

Banking Regulation

- RBNZ requires “standalone capability”, particularly when under stress
- Major systems to be relocated to New Zealand
- Huge cost and inefficiency
- Harsh reactions to any reservations
- All third party contracts to be renegotiated/separated
- All direct reports to CEO require RBNZ approval
- No analysis that benefits of all this might exceed costs
- Individual director attestations
- Initial aim standalone capability under future stress situations
- Yet, RBNZ reiterates this is “light handed” regulation

Telecommunications

- Once the fastest growing industry
- Regulator over-ruled by Govt.
- 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
- Competitors predicting losses despite regulation
- Yellow Pages sale a short term palliative

Electricity Regulation

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

Research Study on Regulation

- ANZ Bank study December 2006 shows 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 is being rapidly 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

Scorecard

Positives

- Monetary policy (but softening eg inflation rising)
- Overall stance of fiscal policy
- Forex non-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 (cf, role of private equity)

In summary

- **Decade of good economic growth, but economy now slowing**
- **Given lags, this arose from**
 - World expansion
 - Commodity prices
 - Domestic productivity
- **Productivity growth based on**
 - 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, in recent years

- Increasing size of Government
- Extensive regulatory interventions
- Poor Government sector management
- Who believes health, education, or welfare are well managed ?
- Sharply slowing productivity growth
- Huge external imbalance
- Inflationary pressures re-emerging
- So where do NZ's comparative advantages now come from?

Some Solutions

- More respect for property rights
- Greater certainty in the application of the law
- More certainty in 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
- Smaller Government
- Lower taxes