The New Zealand Economy and the Growth Debate

February 2003

Growth outlook: back to 'slow speed' after exceptional year

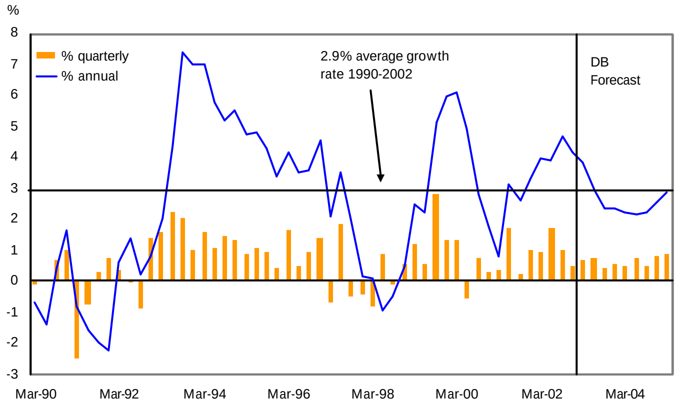
- Despite a continued difficult global economic backdrop the New Zealand economy grew by more than 4% in 2002, making it a top performer within the OECD.
- The strong performance, however, was not based on an improvement in the rate of trend growth. Instead, exceptional circumstances - largely out of New Zealand's control - provided a temporary boost:
  - high world prices for agricultural commodity exports led to record growth in farm incomes;
  - the NZ dollar was significantly undervalued, making exporters highly price competitive;
  - a strong increase in net inward migration led to a lift in population growth from around ½% to 2% p.a. (It should be noted here that growth generated by adding to the population does not directly lift per capita incomes and average standards of living.)
- The first two of the growth supporting factors have already reversed, causing a contraction in export sector incomes.

Deutsche Bank forecasts: New Zealand

	2002	2003F	2004F	2005F
GDP growth (%)	4.2	2.4	2.5	3.0
CPI inflation (%)	2.7	1.5	1.6	2.2
Current account (%of GDP)	-3.7	-5.6	-4.9	- 4.7
Unemployment rate (%)	4.9	5.5	5.7	5.4

Source: DB Global Markets Research

GDP growth



Source: DB Global Markets Research, Statistics NZ

- Furthermore, migration figures have reached a plateau and are widely expected to trend lower towards a more sustainable level over the course of this year.
- As a result of these factors, Deutsche Bank is forecasting annual growth to fall back to around 2% later this year. Once the global economy improves, a gradual recovery to 2¾-3% is expected – close to the average recorded over the past decade. The challenge for the business community and policy-makers is to lift the growth rate in a way that makes last year's 4% the norm rather than the exception.

Taking stock: the economy's strengths and weaknesses

- The recent *'Global Competitiveness Report'* by the World Economic Forum (November 2002) provided a useful snapshot of New Zealand's economic strengths and weaknesses.
- In the category of *'microeconomic competitiveness'*, which assesses current performance, New Zealand's ranking has worsened continuously since 1998, reflecting – among other factors - shortcomings in the quality and availability of skilled management, access to capital, the overall level of risk-bearing and

entrepreneurship in the economy, the regulatory environment, the level and quality of infrastructure, as well as the availability of labour.

Global Competitiveness Ratings in 2002
(rankings for 2001 in brackets)

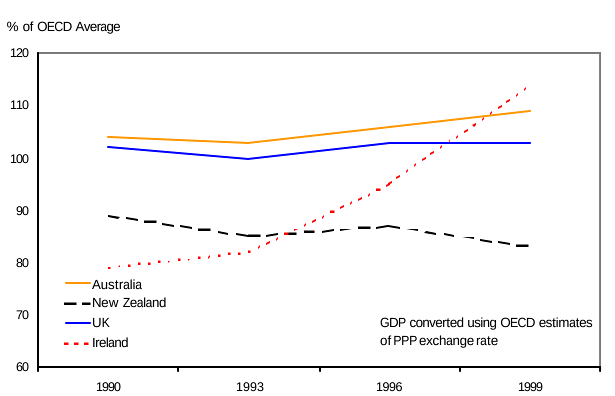
Rank	Microeconomic Competitiveness	Rank	Growth Competitiveness
1 (2)	United States	1 (2)	United States
2 (1)	Finland	2 (1)	Finland
3 (7)	United Kingdom	3 (7)	Taiwan
4 (4)	Germany	4 (4)	Singapore
5 (5)	Switzerland	5 (9)	Sweden
:		:	Switzerland
14 (14)	Australia	7 (5)	Australia
:		:	
20 (22)	Ireland	13 (21)	Japan
21 (19)	Norway	14 (17)	Germany
22 (20)	**New Zealand**	15 (8)	Netherlands
23 (26)	Korea	**16 (10)**	**New Zealand**
24 (23)	Italy	17 (13)	Hong Kong
25 (24)	Spain	18 (18)	Austria

- New Zealand scored a little better in the *'growth competitiveness'* category - which assesses the economy's potential going forward – but was held back by a weak result in the 'technology' sub-index. In that category New Zealand got good marks for the share of the population participating in tertiary education. However, it scores relatively poorly in the key areas of turning knowledge into innovation and of commercialising innovation.
- A key feature of New Zealand's overall assessment is the difference between its rankings with respect to microeconomic and growth competitiveness (22th versus 16th), which reflects the gap between the actual performance of the economy and what could be achieved over the next 5-8 years. The *Global Competitiveness Report* suggests that New Zealand has the potential to advance to an innovation-driven high income economy over the next decade.

Per capita incomes and productivity growth

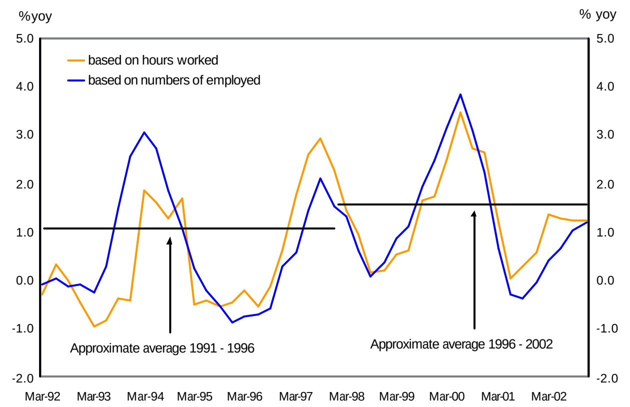
- Generating faster economic growth is a means to achieving higher per capita incomes and higher average standards of living. From the 1970s to the 1990s New Zealand's income per capita fell from 9th in the OECD to 20th. In absolute terms, New Zealand's standard of living, as measured by GDP per capita, barely improved at all. While New Zealand managed to achieve a sustained lift in average growth during the 1990s and per capita income rose by, on average, 2.2%, its relative position in the OECD rankings has not improved.

Real GDP per capita



Source: DB Global Markets Research, OECD

Productivity growth



Source: DB Global Markets Research, Statistics NZ

- Per capita income growth of almost 3% would have to be achieved for the next twenty years in order to close the gap that has developed between New Zealand's per capita GDP and the OECD average – assuming that the rest of the OECD grows at the same rate as in the last decade.
- Sustainable gains in GDP per capita depend on gains in labour productivity, defined as increased output per hour worked (as a result of improved skills or increased capital/technology intensity of the production). The table below, taken from the OECD 2002 Survey of New Zealand, illustrates productivity trends for NZ since 1984, together with a comparison with Australia, the US and the OECD as a whole.

Labour Productivity Growth (%,p.a.)

	New Zealand	Australia	United States	OECD
1981-84	1.3	1.6	1.3	1.9
1985-90	1.6	1.3	1.3	1.9
1991-97	0.5	1.6	1.3	1.7
1998-00	1.3	2.3	2.1	1.8

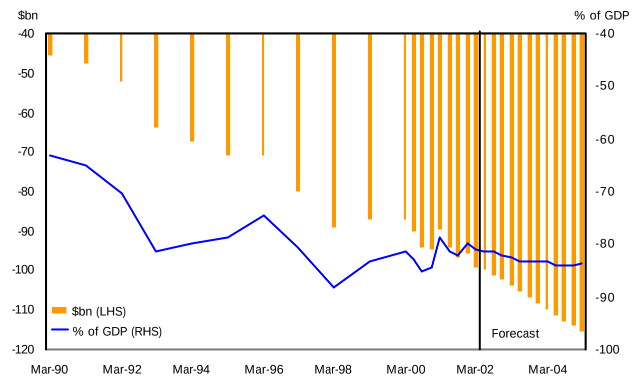
Source: DB Global Markets Research, OECD

- Over each of the periods under consideration, New Zealand's labour productivity growth has lagged the OECD average.
- However, as the chart on the previous page shows (which includes latest data for New Zealand), there is some evidence to suggest that productivity growth in New Zealand has increased over recent years. In part, this probably reflects the increasing scarcity of labour, which has forced employers to seek to raise productivity to satisfy demand. An increase in growth in the business capital stock over recent years will also have played a role in boosting measured labour productivity. However, the improvement so far has not been sufficient to generate the conditions for stronger trend growth in GDP that would lift New Zealand back into the top half of the OECD - the stated goal of Government policy.

External imbalance reinforces need for strong export growth

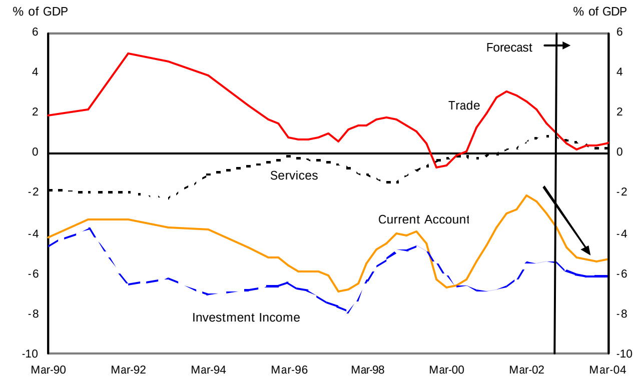
- In devising a growth strategy, the focus has to be on measures that improve New Zealand's export growth potential in particular in order to improve the economy's structural imbalance in the external accounts. New Zealand has the highest ratio of external liabilities to GDP in the OECD. As of September 2002, New Zealand's total net liabilities stood at NZD99.6bn or 80% of GDP.
- These foreign liabilities (including equity ownership by foreigners), which have been accumulated as a result of over 30 years of large current account deficits, are generally denominated in NZ dollars. They generate an outflow of payments to foreigners that exceeds the surplus of the combined trade and services balance.

Net external liabilities



Source: DB Global Markets Research, Statistics NZ

Current account balances



Source: DB Global Markets Research, Statistics NZ

- Strong export commodity prices and historic lows of the NZ dollar led to a reduction of the current account deficit to around 2% of GDP in early 2002. However, those favourable conditions have reversed and Deutsche Bank is forecasting the deficit to reach nearly 6% again later this year. Even with global growth improving, the deficit is unlikely to settle significantly below of 5% of GDP over the medium term, which implies a continued deterioration in New Zealand's external balance sheet over coming years.

- While foreign investment in New Zealand is high, much of the investment is either in the form of direct equity capital or long-term loans to New Zealand subsidiaries of overseas enterprises. There is no expectation that New Zealand is prone to capital flight if economic circumstances were to deteriorate, although the continued attraction of new capital at the prevailing exchange rate will depend on New Zealand's ability to improve its growth performance.

The growth debate: policies that lift economic performance

The following are some of the recurrent contributions from leading economists in the public and private sector to the debate about how New Zealand can improve its growth performance.

Improve public sector productivity.

With government spending currently comprising 40% of GDP, it is impossible for New Zealand to reach its growth targets without a world class public sector. While we do enjoy a skilled, non-corrupt public sector, hard issues need to be addressed as to the overall level, effectiveness and contestability of supply of key public goods and services (eg social welfare, education, health, compliance costs, research and development funding). Improved public sector productivity will enable us to keep pace with the global trend of lower taxes.

Increase in global connectedness

New Zealand's remote location is a disadvantage in many respects. Potential instruments to overcome this 'starting disadvantage' include aggressive export promotion, greater offshore representation, diaspora policy, targeted immigration, academic and research exchanges and collaboration, as well as attraction of FDI through investment agencies.

Improve infrastructure quality

The consequences of long term under-investment in the immobile factors of production is now becoming clear. A programme of both public and private sector provision needs to be accelerated to address current infrastructure issues in the transport, utilities and services areas.

Establish an overarching growth and enterprise policy framework

Too frequently Government policy seems at odds with a growth or enterprise mindset (eg anti stress labour reform, lack of progress on compliance costs). The Government can play a leadership role in this regard as it tests policies - both economic and in the wider social policy arena - against a growth and enterprise test.

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