Liberalising New Zealand's Economy: Rehabilitation and Recovery

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The economic reforms of the 1980s in New Zealand constitute one of the most far-reaching liberalisations in modern times. ***Grant Scobie****, Professor, and* ***John Janssen****, Lecturer, in the Department of Economics at the University of Waikato, review the outcomes of the reforms to date, and express cautious optimism about their sustained impact.*

A recent OECD report described New Zealand's post-war economic growth rate as 'subdued' (OECD, 1993:11). Such diplomatic courtesy obscures the facts. Between 1950 and 1985, growth in New Zealand was less than half the rate for the OECD as a whole. In an attempt to arrest this dismal performance, economic policy was revised dramatically in the mid-1980s. The subsequent reforms constituted one of the most comprehensive attempts to restructure an economy that has ever been undertaken in a modern democracy during peace-time.

As a consequence, New Zealand has become an international case study for countries undertaking liberalisation and structural adjustment. It has sparked interest among reformers in economies as diverse as those of Western Europe and Latin America, together with the states emerging from the disintegration of the Soviet sphere in Central and Eastern Europe. This interest centres on three questions: What was done? Did it work (or, perhaps more realistically, is it working)? Was it worth it? This article addresses each of these questions.

The Background

Unqualified statements about average rates of economic growth do not necessarily convey the real implications of laggardly performance. Had New Zealand managed to grow at the average OECD rate (2.9 per cent annually) instead of under half that rate (1.4 per cent), average incomes would have been 70 per cent higher by 1985 than they actually were. Part of that income could have been used to finance public-sector deficits, leaving still more for private investment and consumption. In other words, higher growth would have allowed higher living standards and provided more resources for environmental management and social-equity programs, all without the accumulation of an extraordinary level of public debt.

Instead, there was a long-term decline in international competitiveness, and a commensurate fall in living standards relative to other countries. Such growth as did occur was largely accounted for by more inputs: improved productivity accounted for less than a third of total growth from 1950 to 1985 (Smith & Grimes, 1990).

External forces invariably make convenient scapegoats. Falling terms of trade, Britain's entry into the European Community, and, more recently, the failure of the GATT rounds to deliver a more liberalised climate for international trade have all been blamed for New Zealand's economic misfortunes. In contrast, the starting point for the reforms was the recognition that poor economic performance was largely a consequence of domestic policies rather than of the vagaries of the international marketplace.

Why the Reforms?

For virtually 50 years, economic policy in New Zealand had been characterised by extensive state involvement in almost every aspect of economic and social life. As part of a long-standing concern for social welfare, the state made extensive transfer payments, assumed a key role in the provision of many goods and services, and increasingly intervened in markets for equity reasons. Long-term economic growth and employment generation were pursued by a virulent form of Latin American *cepalismo*, an inward-oriented strategy implemented through a battery of protective trade barriers. Interventions in the trade and macroeconomic policy areas were intended to act as substitutes for changes in the real exchange rate, which became increasingly overvalued, heavily taxing the exporting sectors.

Past interventions lead to a cancer of new interventions, many aimed at correcting the distortions created by other distortions. By the mid-1980s, the state apparatus was attempting to manage virtually every key economic variable. Interest rates, exchange rates, price levels, labour contracts, imports, transport, capital flows, energy supply, telecommunications, export marketing and investment in R&D were all determined by law, regulation or decree.

A mounting body of evidence shows that countries that adopt outward-oriented growth strategies have achieved superior economic growth, and displayed greater resilience to external shocks (World Bank, 1987). Both the long-term performance of many Asian economies and their rapid adjustment to the major international shocks in the 1970s stand in sharp contrast to much of Latin America (Sachs, 1985) and New Zealand.

Given the massive level of intervention that had been reached in New Zealand, it seemed reasonable to predict that any unshackling of the economy should be accompanied eventually by accelerated growth. Inefficient state enterprises would no longer be a fiscal drain, interest and exchange rates would now reflect the true value of foreign exchange and capital, and the state would no longer direct the course of economic development. Resources would be released from the many industries that survived only because of inordinate protection, and become available to industries that could compete internationally.

The vision was for a liberated economy, free of the strictures of bureaucratic management, with barriers to efficiency removed, where the price system could again assume its role in transmitting clear signals to economic actors, and where individual energy and creativity would not be sapped by welfare payments or diverted to unproductive schemes to beat the system.

Liberalisation really started with the general election of June 1984. An electorate weary of ad hoc economic management by fiat turned to the Labour Party. The ensuing Lange-Douglas administration proceeded as if it had a mandate for massive reform, though only a hint of what was to follow had been debated during the campaign.

A wide range of economic remedies was applied, many carrying the seal of good housekeeping from the International Monetary Fund and the World Bank. Interest and exchange rates became set by the market, subsidies were removed, monetary policy focused on long-term price stability, state enterprises were put on a commercial footing (often as a prelude to sale), financial markets were reformed, capital markets were opened, and tax incentives removed. Deregulation, to a varying extent, touched every area of business, industry, social service and the labour market. Given the apparently comprehensive treatment, reasonably rapid recovery was expected.

What Did Happen?

The first full year following the reforms saw an unprecedented jump in growth to 5.1 per cent. This was an aberration, reflecting expansionary policies prior to the 1984 election. Real economic growth from 1986 through 1993 will average 0.5 per cent annually, or about one third of the rate from 1950 to 1985. In three of the years since the reforms began, real output fell. The prima facie evidence, now being increasingly cited by opponents of reform, is that this is a clear-cut case of 'from bad to worse'.

Adding to these growing concerns is the level of unemployment. In the early post-war period, New Zealand had managed its labour markets in such a way that measured unemployment was negligible. Even until the mid-1980s, unemployment was under 4 per cent. Today it is hovers above 10 per cent. It is very doubtful that the framers of the reforms would have expected unemployment to exceed 10 per cent some nine years after the start of the restructuring.

In the first four years of the reforms, unemployment averaged about 4 per cent (see Figure 1). In 1988-90 this rose to 7 per cent as the effect of restructuring was felt, particularly in the manufacturing and public sectors. From late 1990 to late 1992, unemployment averaged almost 10 per cent.

The three percentage points that have been added to total unemployment in the recession of 1991/92 is expected to be reabsorbed by 1997 (NZIER, 1993:62). If the natural rate of unemployment for an economy such as New Zealand's is taken to be 5.5 per cent, then we still face chronic unemployment of between 1 and 2 per cent. A significant portion of this group is made up of unskilled early school-leavers with no further training. For many of these, the former government departments of forestry, postal services, mining and railways had provided sheltered workplaces: sheltered in the sense that their employers had no incentives to concern themselves with the staffing levels or financial outcomes of the operations, since subsidies had always sustained them. This effect, together with some feather-bedding in the major unionised sectors of the economy, has suppressed unemployment below its natural rate prior to the liberalisation (see Figure 1).

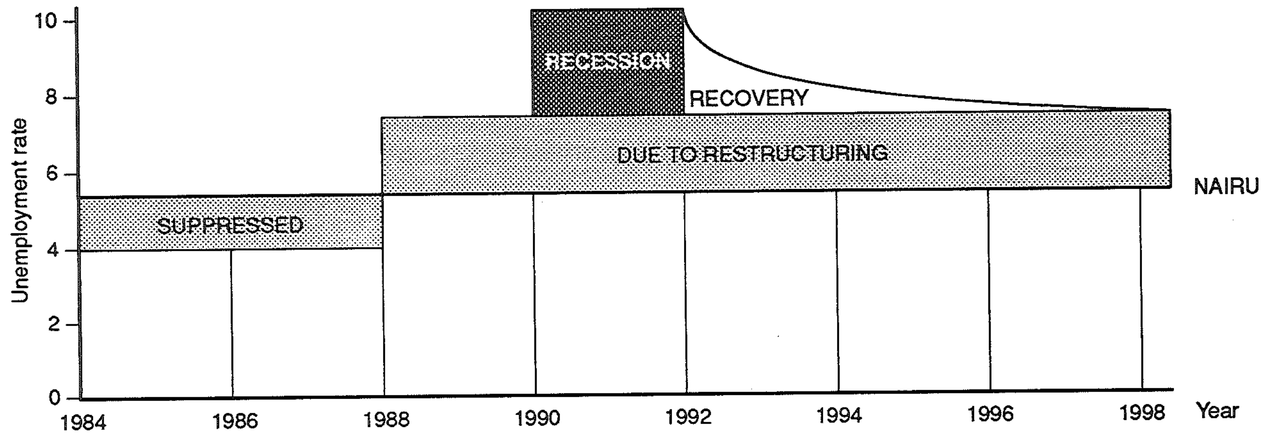
It could be argued that this portion of the increase in unemployment was a direct consequence of the liberalisation. Undoubtedly, the human costs of this structural upheaval have been heavy. However, the evaluation of any particular policy is fraught with the problem of the counterfactual: what would have happened had the liberalisation not taken place? It is altogether too naive to assume that the old order would have simply continued.

By 1984, there were serious imbalances in the economy. Subsidies were claiming an ever-growing share of public expenditure, fiscal deficits were running at almost 10 per cent of GDP, the current-account deficit passed 10 per cent of GDP in 1986, and foreign-debt levels were rising. By mid-1984, foreign-exchange reserves were virtually exhausted. It is therefore very difficult to argue that the existing policies were sustainable. If deliberate actions had not been taken, involuntary adjustments would have been forced on the country.

Critics of the reforms argue that the costs have fallen unduly on the low-income groups. It is true that between mid-1984 and mid-1992, the real disposable income of the lowest quintile of full-time wage and salary earners fell by 5 per cent, while that of the highest quintile rose by 2.5 per cent. However, the relevant issue is what would have happened in the absence of the reforms.

It is not at all clear that high fiscal deficits financed by inflationary taxation lessen the burden on lower-income households. Rather, the social costs of heavily

Figure 1
A stylised view of unemployment in New Zealand



Note: NAIRU = Non-accelerating inflation rate of unemployment

regulated markets and high inflation rates tend to fall disproportionately on part-time workers, women, and those on fixed incomes. Some gain protection, but often at the expense of others who may be even poorer.

Close to a decade of economic stagnation and high unemployment is giving reforms a bad press. However, one area of early success is price stability: New Zealand has the lowest rate of inflation in the world. In the five years preceding the reforms, annual inflation averaged nearly 11 per cent. For the year ending December 1992, it was 1.3 per cent. Achieving low inflation was seen as a necessary condition for restoring international competitiveness. The passage of the Reserve Bank Act 1989 freed monetary policy from a broad mandate of economic objectives, and required it to focus on achieving 'price stability' defined as an annual inflation rate in the range 0–2 per cent (RBNZ, 1990).

It would be all too easy to view the liberalisation and restructuring as an unmitigated disaster for the New Zealand economy. After all, real output of the economy was no higher in the last quarter of 1992 as it had been in late 1985. This period of economic stagnation is equivalent to the length, although n ot the severity, of the Great Depression: hardly a return to sustained growth. As well, unemployment has reached levels that were unthinkable a decade ago. Furthermore, deregulation of the labour market has allowed greater 'wage flexibility', a euphemism, as the critics of the Employment Contracts Act point out, for reducing wages. Real wages at the end of 1992 were lower than those in 1985, in every sector of the economy. The real disposable incomes of households of full-time wage and salary earners have fallen in every one of the last eleven quarters. The liberated economy responded by shedding excess labour, raising labour productivity significantly, and letting labour-market pressures adjust real wages downwards.

Why the Prolonged Stagnation?

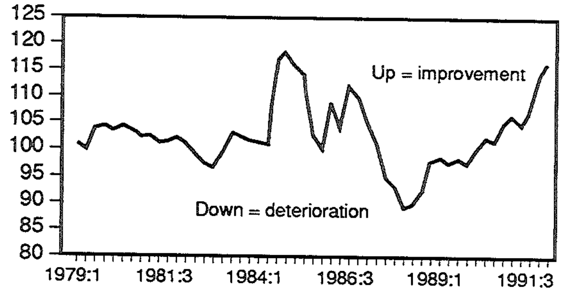
Given the nature of the reforms, it might have been reasonable to expect a return to sustained economic growth much sooner. Different explanations suggest themselves, including poor trading conditions, the nature and sequencing of the reforms, and the influence of macroeconomic policies. We examine each in turn.

Trading conditions. Defenders of the reforms have turned once again to external shocks to explain why growth has been so elusive. However, despite some year-to-year variability, the external terms of trade cannot be blamed. In fact, in the eight years preceding the reforms, New Zealand's terms-of-trade index, measuring the prices received for exports relative to the prices paid for imports, averaged 1005 (June 1988/89 = 1000). During 1984-90, the index averaged 1044, rising to 1083 in 1991 and 1992. In short, liberalisation has coincided with an improvement in commodity prices in New Zealand's favour.

Likewise, the demand conditions in international markets were favourable, at least through 1990. Real growth in industrial countries averaged 2.2 per cent annually in the seven years before the reforms. This rose sharply to an annual average of 3.4 per cent during 1984-90. However, the global recession of 1991/92 saw real growth in the developed countries with which New Zealand trades fall to 1.5 per cent. This decline has been undoubtedly reflected in the recessionary state of the New Zealand economy and the rise in unemployment.

One of the striking features of the reform period has been the loss of international competitiveness and the resulting poor performance of the tradable goods sector. Between the end of 1985 and March 1991, 80 000 jobs were lost in this sector. This compares with losses in the home goods or non-tradable sector of 20 000 jobs. This is ironical. New Zealand had penal-

Figure 2
New Zealand's international competitiveness
(1979:1 = 100)



Source: *RBNZ Bulletin* (various issues)

ised much of its tradable sector for a long period. Removal of the distortions could have been expected to liberate the sector. In fact, the reforms resulted in a strong anti-trade bias, and were accompanied by an initial boom in the home-goods sector following the deregulation of the finance markets.

Between mid-1984 and late 1988, international competitiveness persistently declined, as measured by the nominal exchange rate adjusted for changes in consumer prices in New Zealand relative to major markets. Since late 1988, that measure has improved significantly (see Figure 2). It is in this latter period that export performance has improved dramatically. However, by early 1991, the index of competitiveness was still only at its level of the late 1970s, a level itself depressed by the chronic overvaluation.

Sequencing of reforms. Appreciation of the real exchange rate during a period of stabilisation and adjustment has been widely observed in other countries. It was foreshadowed explicitly by Krueger (1985) for the case of New Zealand. This 'overshooting' highlights the on-going debate about the sequencing of economic reforms. Different rules of thumb have been proposed. Typically, it is suggested that labour-market reform and fiscal stabilisation should be undertaken before floating the exchange rate and opening the capital account. Furthermore, trade liberalisation should be pursued before floating and financial liberalisation.

In order to be effective, an anti-inflationary monetary policy required a flexible exchange-rate regime. According to Margaritis, Hyslop and Rae (1992:29), the delays between the deregulation of interest rates in July 1984, the opening of the capital account in December 1984, and the floating of the exchange rate in March 1985 may have further prolonged the exchange-rate adjustment and lowered the effectiveness and credibility of monetary policy in the initial period of the disinflation process. The need for credibility early in the process is often viewed as critical in determining the success of a liberalisation. Establishing that credibility may have taken precedence over any sequencing considerations in the New Zealand case.

Macroeconomic policies. A real exchange-rate appreciation may not necessarily be the result of 'wrong' policies, but rather an unavoidable cost of reducing inflation. Furthermore, if temporary appreciation of the exchange rate is apparent to policymakers, then it should also be apparent to private agents, who would take it into account when making investment (Edwards, 1984). Management of the exchange rate during the reform period would have required the authorities to know more about short-term exchange-rate movements than private market players, coupled with a willingness and ability to support potentially costly interventions in the foreign-exchange market. But the experience of such interventions hardly engenders confidence in the ability of policymakers to 'outguess' the market.

Although the fiscal deficit of the public sector has been reduced, it remains substantial. It grew alarmingly with the recession in 1990 and 1991. Throughout the liberalisation, continued deficits led to a rise in the public-sector debt as a share of GDP. The ongoing debt servicing requirement puts added pressure on the government's budget. The deficit financing added to pressure on capital and exchange markets. Nor was the liberalisation a time of less government; government spending rose from 37 per cent of GDP in 1984 to 42 per cent in 1990, though falling somewhat more recently.

Was It Worth It?

Evidence has now appeared indicating that the New Zealand economy has moved out of the recent recession, during which real output fell by 4 per cent between early 1990 and mid-1991. The economy bottomed out in the June quarter of 1991, and real GDP growth for the year ended March 1993 was 2.8 per cent. Real exports grew by 5.2 per cent in 1991/92, despite a recent downturn in the terms of trade, and falling foreign growth rates. The OECD notes that 'the reforms undertaken over the past decade are now being reflected in changed behaviour on a macroeconomic scale' (1993:116).

New Zealand now has low inflation, greater efficiency and accountability in ports, mines, railways, energy, postal and telecommunications services, and higher labour productivity. Labour and financial markets have been deregulated, and the tax system reformed. Many state assets have been sold, tariffs reduced and most subsidies eliminated. The management of the welfare system has lessened the disincentives to work.

Much unfinished business remains. The welfare system continues to distort incentives and discourages the creation of wealth; import tariffs still protect inefficient industries; subsidies prop up everything from the production of soap operas to R&D; the state owns vast slices of the productive estate; and the marketing of major agricultural commodities remains in a parastatal time warp of the 1930s. Incompleteness and hesitancy in the process of reform has undoubtedly led to loss of credibility and confidence, while reinforcing the traditional rent-seeking behaviour of supplicants to the fisc.

If sustainable economic growth was ever to be achieved, it was going to require a reorientation of the economy away from the inward-looking growth strategy that had held sway for 50 years. That reorientation has occurred. But was it worth it? If the situation in 1984 was indeed unsustainable, then changes had to occur. New Zealand chose to make those changes in a deliberate way. Certainly there have been substantial adjustment costs. But these would have had to be borne in some form; doing nothing was not an option. The loss of output in the nine years since 1984 cannot be entirely ascribed to the liberalisation. If the reforms have made it possible for the economy to sustain growth rates equal to the average OECD rate in the next three decades, instead of less than half that rate, then the payoff will be substantial. But the legacies of past policies will continue to limit future growth.

A mounting body of evidence shows that countries that adopt outward-oriented growth strategies have achieved superior economic growth, and displayed greater resilience to external shocks. Both the long-term performance of many Asian economies and their rapid adjustment to the major international shocks in the 1970s stand in sharp contrast to much of Latin America and New Zealand.

Total foreign-debt servicing now accounts for an estimated 53 cents out of every dollar of export income. Servicing the debt severely constrains the resources available for either increased consumption or investment and subsequent growth. It now appears that public-sector deficits will persist for at least another five years. Although a surplus has been achieved on the government's basic balance, the financial balance remains in deficit because of interest payments. Any faltering in real growth, with a concomitant fall in public-sector revenues, together with even modest rises in real interest rates, would mean further borrowing, just to maintain the current ratio of net public debt to GDP. In the absence of any serious cuts to public expenditures or increased tax rates, the fiscal outlook is fragile. The budget presented in July 1993 forecasts no significant reduction in the government's financial balance over the next three years. Net public debt will rise by a further 10 per cent by 1994/95. New Zealanders face another decade of restricted growth in both private and public consumption, relatively high unemployment and real interest rates, and only modest increases in real wages.

To attribute this outlook to the reforms themselves would be far too simple-minded. Half a century of protected industries, subsidised state enterprises, poor-quality public investment financed by overseas borrowing, and extensive welfare payments have left the country with a relatively poor stock of physical and human capital, together with a massive debt overhang. The present pain is as much the price of past inappropriate policies as of the reforms themselves. The reforms were inevitable; although their timing and shape are debatable, the previous policy mix had become unsustainable. Changes, whether deliberate or involuntary, had to occur.

These changes have dramatically restructured incentives throughout the economy, creating a climate for renewed and sustainable growth. There are now positive signs that the process is under way. But the recovery will be gradual. If real growth can be sustained at even a modest 3 per cent in each of the next three years, as the 1993 Budget forecasts, New Zealand will have achieved a period of growth unmatched in two decades.

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