Looking at the numbers

A view of New Zealand's economic history

Chapter : Government

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Preface

The New Zealand Institute of Economic Research (NZIER) was founded in 1958 as a non-profit making trust to provide economic research and consultancy services. The institute is probably best known for its long-established *Quarterly Survey of Business Opinion* and *Quarterly Predictions.* The institute also undertakes a wide range of consultancy activities for government and private organisations.

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Government

The scope of government activity

Let's start this section by listing some of the roles government can play in the economy:

Making and enforcing laws and regulations

- Setting taxation levels
- Regulating the conduct of business (for example, via the Commerce Act)
- Setting labour market law and regulations
- Border control (migration, duties, tariffs)
- Monetary policy.

Spending

- Consumption and investment spending on:
  - Administration (including defence)
  - Health
  - Education
  - Housing
  - Infrastructure (transport, communications, utilities)
- Support of industry (grants, loans, etc)
- Ownership of businesses (state-owned enterprises and crown entities)
- Transfer payments to households (subsidies and welfare benefits).

We won't look at all of these activities in detail. From what we have seen so far, it has become clear that the performance of the external sector—our trade with the rest of the world—looms large as an issue in New Zealand's economic history. We will therefore have a brief look at trade policy. Other issues that we will look at are:

- Transfer payments to households and their impact on government spending and taxation.

- The emergence of monetary policy as a way of influencing the short-run performance of the economy.

Trade policy

Some of the ways that a government has of implementing trade policy are:

- *Customs duties and tariffs:* these are taxes levied on imports when they arrive in the country. 'The tariff' was originally the name of the list that set out the rate of duty that was to apply to each type of import.
- *Quotas:* a quota sets the maximum amount of an item that may be brought in from a particular country.
- *Export and import licensing:* a system whereby exporters need a licence from the government in order to export particular items, and importers need a licence to bring in certain items. In essence, the government decides, for particular products, who has the right to trade.
- *Trade treaties or agreements:* a treaty is an agreement between governments. It sets the conditions under which trade will occur between the countries that are treaty partners, that is, it sets the levels of tariffs, etc. A treaty can be bilateral, applying to only two countries, or multilateral, applying to three or more countries.
- *Export subsidies:* these can be direct payments, or tax exemptions, for exporters. Subsidies may not always be linked directly to exports but instead to specific types of production, such as agricultural activity. Production subsidies tend to be a form of import protection.
- *Controls on foreign exchange transactions:* governments can influence trading activity by setting the conditions under which traders have access to foreign exchange. In a modern context, the most likely form of government action is in changing the level of the exchange rate. There are now no direct controls on the exchange rate in New Zealand, although the Reserve Bank, which is semi-independent of government, can influence the exchange rate with its monetary policy settings.

Perhaps the simplest way of looking at trade issues in a New Zealand context is to look at a timeline of policy changes. We will see from this that the initial thrust of government policy in New Zealand was protectionist. This generally lasted through until the election of the National government in 1950. For the next 30 years or so, we see a struggle between those wanting trade liberalisation and those wanting to re-impose some level of protection. It's fair to say that the pressures for trade liberalisation began to win out, and by the mid-1980s the move to liberalising trade, both within New Zealand and overseas, was at full momentum.

Table 1 Timeline of trade policy

1840	Initially the customs tariff of New South Wales applied to New Zealand imports. The country ceased to be part of NSW in May 1841, and specific customs duties were introduced shortly afterwards. These were the main source of revenue for government. The underlying rate of duty was set at 10% (NZOYB, 1990, p590).
1888	By the late 1880s, which, as we have seen, was a period of slow growth, pressure grew on the government to use tariffs to protect New Zealand industry. Proponents of tariffs saw their advantages as being higher employment, higher wages, and the development of local industry, as well as providing another source of revenue for a hard-pressed government (Stensen and Olssen, 1997, p247). A major tariff measure was introduced in 1888 that was designed to protect several industries: boot manufacturers, garment makers, machine makers, woollen millers and the metal working industry. The import duty was 20 percent (Sutch, 1969, p105).
1922	The meat export trade was placed under the control of a board. This was followed, in 1923, by the Dairy Produce Export Control Act, which set up the Dairy Board.
1932	In reaction to the depression, an Imperial Conference was held in Ottawa to discuss trade issues. The aim was to promote trade between British Empire countries. Under the Ottawa Agreement, New Zealand agreed to maintain a preferential tariff for British imports (that is, a tariff that was lower than for goods from other countries). In return, practically all of New Zealand's exports to Britain would have duty-free entry (NZOYB, 1970, p569). However, the Ottawa Agreement generally reflected Britain's retreat from free trade. Up until this point, New Zealand and other nations had faced few problems in getting their products into Britain.
1934	The Reserve Bank was established via an act of Parliament, but as a privately owned institution (NZOYB, 1970, p833).The Bank fixed the rate at which it would sell 100 pounds sterling at 125 pounds New Zealand. In 1936, after Labour was elected, the Bank became a state-owned institution.

1938 A consequence of the Reserve Bank setting the exchange rate was that it needed overseas reserves in order to buy foreign currencies. By 1938, with the New Zealand economy booming, the demand for foreign currency had reduced the Bank's levels of overseas reserves to low levels. In short, the country appeared to be facing a current account crisis. Labour's response was to introduce import and export licences. Regulations prohibited the import of goods except under a licence or exemption. Export licences were issued on the condition that the overseas exchange earned must be sold to a New Zealand bank for New Zealand currency. The use of import licensing, rather than tariffs, was a way of getting around the conditions of the Ottawa agreement, which required that preferential treatment be maintained for British goods.

1944 Walter Nash, finance minister, attended the conference at Bretton Woods, New Hampshire, which looked at economic development in the coming post-war period. As a result, the International Monetary Fund was formed and an international system of fixed exchange rates was set up. Exchange rates were based upon a par value system; member countries were required to constrain fluctuations in their exchange rates within a margin of plus or minus 1% of a par value expressed in terms of US dollars. These US dollars would in turn remain directly convertible into gold at a fixed rate, thereby maintaining some link to gold (Pearce, 1986, 212–213). In 1948 the New Zealand pound was revalued, with a par value equal to that of sterling.

1949 National elected; began to loosen import controls.

1951 Prolonged waterfront dispute resulted in emergency regulations being introduced.

1958 In response to a current account problem Labour restored import controls to most private imports. These controls were relaxed a bit in 1960, and relaxed further by National in 1961.

1965 The New Zealand Australia Free Trade Agreement (NAFTA) gave better access to the Australian market for New Zealand goods, and vice versa.

1971 Negotiation by Britain with members of the EEC (now the EU) secured New Zealand's butter and cheese exports to Britain.

1973 Britain joined the EEC.

1973 Oil price hike by OPEC hit the terms of trade. A second oil shock occurred in 1978 following the revolution in Iran. By 1980 government had embarked on 'Think Big' projects, largely in the petrochemicals sector, in order to reduce the country's dependence on foreign oil. Government also introduced export subsidies or what was termed a 'one-sided' devaluation.

1982 Closer Economic Relationship (CER) agreement, which further freed up trade between New Zealand and Australia, was signed.

1984	Labour elected. The NZ dollar was devalued by 20%. Export subsidies abolished. Government subsequently took the borrowing associated with the 'Think Big' projects onto its books, and began to sell the projects to the private sector.
1985	The NZ dollar was floated. Labour replaced import licensing with tariffs and committed itself to a phased lowering of tariffs.
1986	A goods and services tax (GST) was introduced. Exports were largely exempt.
1989	The Reserve Bank Act: the bank was charged with maintaining price stability.
1994	The Uruguay round of GATT, begun in 1986, was concluded. It brought agriculture and services under the ambit of the multilateral trading system. It also introduced further reductions of tariffs on goods.
	APEC committed itself to achieving free trade and investment by 2010 for developed economies and by 2020 for developing economies.
2001	A free trade agreement with Singapore was negotiated.
	Australia put limits on New Zealanders' eligibility for welfare benefits, affecting the free movement of labour across the Tasman.
	The New Zealand Dairy Board, the last of the major producer boards, was abolished and replaced by Fonterra, a co-operative company. Fonterra would lose its monopoly on dairy exports within a year.
2002	Australia and the US began negotiating an Australia-US free trade agreement.
2005	Closer economic partnership agreement between New Zealand and Thailand was entered into force
2006	Trans-Pacific Strategic Economic Partnership Agreement between New Zealand, Chile, Singapore and Brunei Darussalam entered into force
2008	A free trade agreement with China was agreed.
2015	Trans-Pacific Partnership, a free trade agreement between 12 Pacific-rim countries was signed.

Sources: As stated above in the table. The history sections of official yearbooks have also been useful.

The rise (and slight fall) of government spending

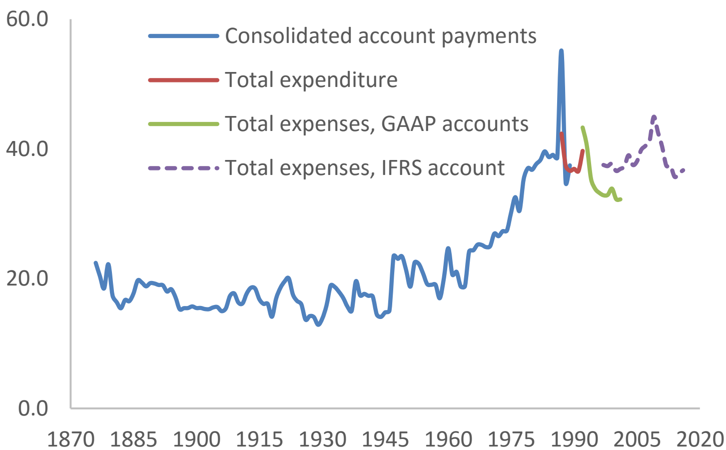
Figure 1 shows government expenditure as a percent of GDP. There are some discontinuities in the series. Figures produced on a GAAP (Generally Accepted Accounting Practice) basis are available only from 1994. Earlier figures are from Budget tables.

The feature that immediately jumps out from Figure 1 is the sharp jump in payments in 1987. This was caused by government taking on the debt from the 'Think Big' projects. But let's put that aside and focus on the long-term trends, which are reasonably clear:

- Government spending as a proportion of GDP stayed relatively constant over the forty years prior to the first world war.
- The ratio then began a 50 year rise and by 1966 was about double what it had been back in 1914.
- From 1966 to around 1980 the rise was steep, and the ratio exceeded 40 percent of GDP.
- Ignoring the 1987 spike, we can see that there was a gradual decline in expenditure as proportion of GDP from the 1980s, bringing it comfortably back below 40 percent of GDP.
- From 2003 there was a sharp increase in government spending bringing it back above 40 percent of GDP.

What caused the general rise in government expenditure, and the associated rise in taxation that was needed to fund this spending? The simple answer would be: governments. Both left and right governments presided over periods to 1980 when government expenditure was on the rise.

Figure 1 Government expenditure
Percent of GDP

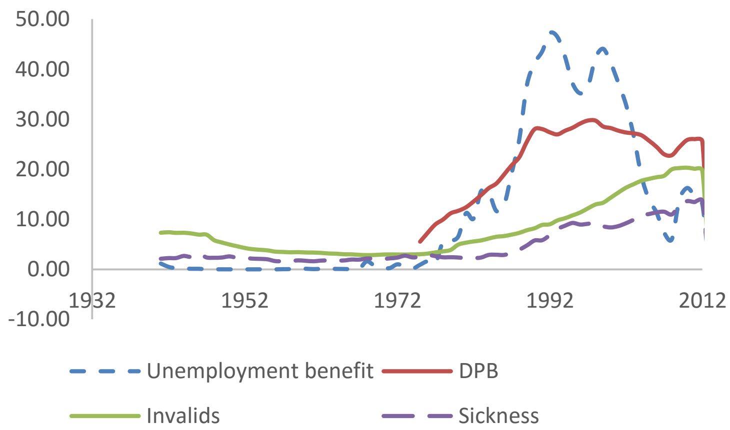


Sources: Government expenditure figures are from Bloomfield (1984) and Budget statements. For GDP sources see **Error! Reference source not found.**. The chart shows March years to 1989, then June years.

A common view is that the rise in welfare spending has been behind the rise in government expenditure. Figure 2 and Figure 3 support this, with a large rise from 1975 to 1992 in the number of people receiving welfare benefits. There seems to have been a sea change in this area over the last 35 years. It might be best summed up by calling it the rise of the concept of 'economic rights'. The stigma that often went with accepting state aid seems to be dissipating. Instead, many citizens now view state aid as something that is theirs as of right. Alongside this has been the rise of beneficiaries' organisations, whose aims are to ensure that beneficiaries get what they are entitled to.

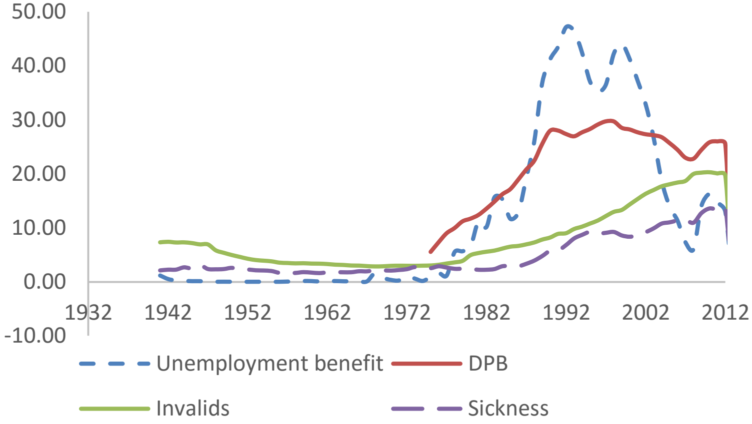
This phenomenon is in no way unique to New Zealand. Most other OECD countries have experienced similar rises in welfare spending since the 1970s (Thomson, 2000). And similarly, most countries have made determined efforts over the last decade or so to rein in government spending.

Figure 2 Persons on income tested benefits
Total



Sources: Official yearbooks, Ministry of Social Policy, Work and Income New Zealand. The chart shows totals as at March to 1989, then totals as at June.

Figure 3 Persons on other benefits
Total

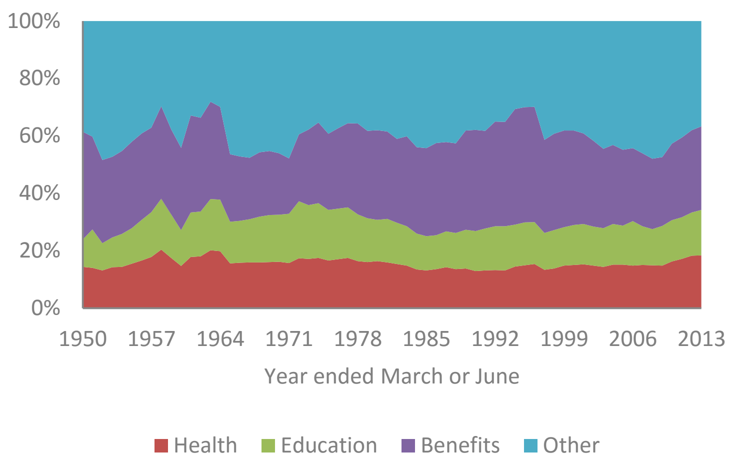


Sources: Official yearbooks, Ministry of Social Policy, Work and Income New Zealand. The major income tested benefits cover unemployment, domestic purposes, invalids, and sickness. The chart shows totals as at March to 1989, then totals as at June.

But spending on benefits hasn't been the only reason for the rise in government expenditure. Figure 56 shows that not only have benefits accounted for a larger proportion of government spending, but so have education and health spending.

Figure 4 Government expenditure by broad category

Percent of total expenditure



Sources: Dalziel and Lattimore (2001), Thorns and Sedgwick (1997). The chart shows March years to 1989, then June years.

Monetary policy

What is monetary policy?

> *Monetary policy is the setting of the money supply by policy makers in the central bank. Money supply is the quantity of money available in the economy.* (Mankiw, 1998, p598)

> *What causes inflation? In most cases of large or persistent inflation, the culprit turns out be the same—growth in the quantity of money.* (Mankiw, 1998, p12)

The main aim of monetary policy is to keep inflation under control, thereby protecting the value of the currency.

The central bank in New Zealand is the Reserve Bank. It can be thought of as the bank for banks. All registered banks have an account at the Reserve Bank. The Reserve Bank sets the terms under which these banks can obtain credit, thereby affecting the total amount of money that is available via the banking system.

Four monetary policy regimes since 1850

Quigley (1992) provides a useful summary of the history of monetary policy. He notes that since 1850 New Zealand has operated under four monetary policy regimes:

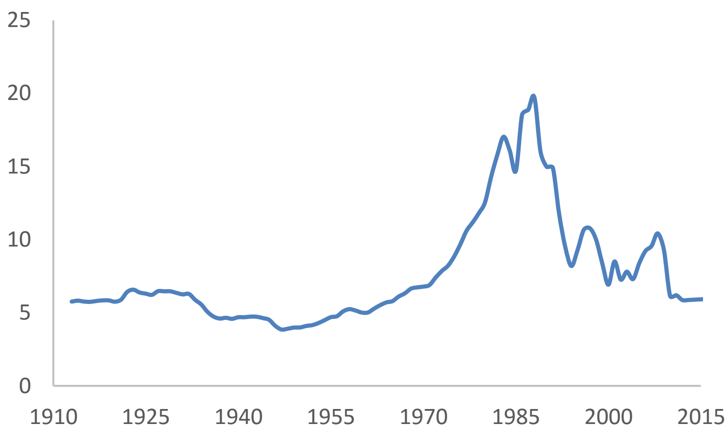
- The first, in place until 1914, linked New Zealand to the international gold standard. Trading banks issued paper money. This was convertible on demand into a legally defined amount of gold, but the banks faced few other legislative restrictions. This system, according to Quigley, was characterised by marked fluctuations in prices and growth. Also, direct government intervention was needed in order to stabilise the banking system in the early 1890s.
- In 1914 the gold standard was suspended, and with the decision not to return to a gold base along with Britain in the 1920s, a second monetary policy regime emerged. Overall, the aim seemed to be to maintain a 'sterling exchange system' with banks generally providing for convertibility of New Zealand pounds into sterling on demand. But as we saw earlier, in the external section, the New Zealand pound began to slip against sterling in the early 1930s, as the depression began to bite. Largely as a result of these 'unwanted' currency fluctuations, the Reserve Bank was established and by 1934 had begun operating.
- From the 1930s New Zealand adopted a third monetary policy regime. This was characterised by: the Reserve Bank buying and selling government securities, a fixed exchange rate, mandated low interest rates, management of the current account, and setting the levels of government securities that financial institutions had to hold. These policies appeared to be successful prior to the 1960s. But by then, mandated low interest coupled with expansionary fiscal policies were proving to be incompatible with maintaining stable prices. Also, it was argued that direct controls on financial institutions were inhibiting the development of New Zealand's financial markets.
- By the early 1980s the consensus of opinion was that the aims of monetary policy should be price stability and the efficient operation of the financial system. Also, these aims should be

achieved in a way that minimised distortion to the financial system and made maximum use of market forces in determining macroeconomic equilibrium. These views underpinned the emergence of the fourth monetary policy regime from mid-1984, when Labour was elected. This regime, which is still in operation, focuses on price stability, with policy operating within the context of deregulated financial markets.

The main feature of the fourth regime has been the use of interest rates to regulate the rate of economic growth and associated changes in prices. Figure 5 shows a long-run interest series—it is for average mortgage rates. We should bear in mind though that over the time period shown we had different monetary policy regimes in place, as outlined above. Only under the fourth regime has the interest rate been the prime means of implementing monetary policy. Note the low interest rates from the mid-1930s to the 1960s.

Figure 5 Average interest rates on house mortgages

Percent, average for year



Sources: Preston (1978), Reserve Bank of New Zealand

Monetary policy since the mid-1980s

Over the last 15 years or so, monetary policy has taken over from fiscal spending as the lever with which government seeks to fine-tune the economy. What's more, governments can do this at arm's length, by making it the responsibility of the head of the central bank to implement monetary policy. To a large extent this removes monetary policy from the political arena.

This in turn leaves governments to focus on the medium-term implementation of fiscal policy, setting their priorities for, say, three to five years. There is no longer the necessity for government to try tuning the economy via its own spending, increasing its expenditure in economic downturns and cutting back during upturns. In reality the cutting back hardly ever occurred, because it was politically unpopular. This was a contributing factor to the long-term rise in government spending that occurred prior to the mid-1980s, and which we saw earlier in Figure 1.

Another advantage of fine-tuning the economy through monetary policy rather than fiscal policy is that there is less incentive for governments to boost spending before elections in order to gain favour with the electorate. The reason for this is that an over-zealous approach to increasing expenditure could result in a tightening of monetary policy by the central bank as it seeks to combat the inflationary effects of the extra spending.

The Reserve Bank Act, which gave the Bank responsibility for implementing monetary policy, was passed in 1989. Since then we have seen the Bank make slight changes to the way it implements policy. Overall though, the Bank has one aim: to contain inflation. It targets inflation directly, trying to keep inflation between 1 percent and 3 percent. It has one instrument with which to do this: the interest rate that it charges trading banks on the money that they borrow overnight from the Reserve Bank. However, in a relatively open economy like New Zealand, the exchange rate also plays a part in monetary policy settings. For example, a depreciation of the exchange rate pushes up the price of imports, which in turn affects inflation. Furthermore, movements in interest rates can produce movements in the exchange rate. The historically strong New Zealand dollar in 2006 – 2007 is primarily a result of an OCR, set 2 to 3 percent higher than most other OECD countries. So the setting of the official cash rate (OCR) by the Reserve Bank is a delicate game.

So far, so good. Over the 1990s inflation has been kept at low levels (see **Error! Reference source not found.** on page **Error! Bookmark not defined.**). There is however nothing new regarding the theory behind the present approach to monetary policy; the link between money supply growth and inflation has been known about for decades if not centuries. What is new is that modern societies now have the political will to control inflation. The 'great inflation' of the 1960s through to the 1980s showed the dangers of letting go of the money supply.

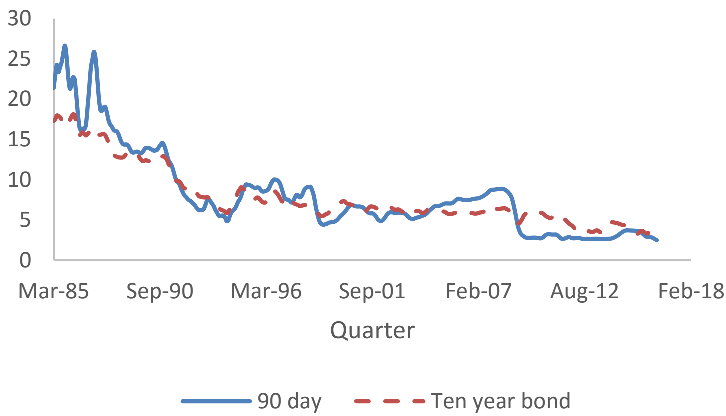
In a modern context, the tightness of money supply can be judged by the gap between the interest rate on 10-year government bonds and the interest rate on 90-day commercial bills. This difference is often called the yield gap. A positive yield gap indicates neutral or loose monetary policy. A negative gap—with interest rates on 90-day bills being higher than interest rates on 10-year bonds—implies tight monetary policy.

The rate on 10-year bonds to some extent reflects the market's expectations of long run inflation. The 90-day rate largely reflects the Reserve Bank's OCR, which has a major impact on the rates for 90-day commercial bills. The Reserve Bank has its own expectations of short-run inflation. If its forecasts show that inflation is rising, the Bank is likely to push up the OCR. If the Bank is confident that inflation is under control, it may cut the OCR.

Figure 6 shows short-term and long-term interest rates since 1989. Note the tight monetary policy in the 1980s and the mid-1990s, and through 2015.

Figure 6 Interest rates, long term and short term

Percent, average per quarter



Source: Reserve Bank of New Zealand

An exercise (in cynicism?)

Do governments really influence economic growth? Or is economic growth more the result of things like social trends, technological changes, random events, and global trading conditions?