Herald 30 June '94

D-minus for varsity economic forecasts

By R. L. KERR, executive director, Business Roundtable

Three years ago 15 academics wrote a letter to the *Herald* attacking the Government's economic strategy. All were members of the economics department of Auckland University.

The academics wrote: "We wish to state in the strongest possible terms our view that in the present state of the economy, and in the midst of an international recession, the deficit-cutting strategy is fatally flawed. It can only depress the economy further and because of this it will be to a considerable extent self-defeating . . ."

Students at the university will soon be facing examinations. Three years to the month after the event, they may like to know whether their teachers deserve a pass mark for their predictions, which were described even at the time by the Minister of Finance, Ruth Richardson, as "shallow and unscholarly."

And taxpayers may wish to judge just how good the 15 academics they support are at their jobs.

By way of background, it may be recalled that on taking office in late 1990 the National Government was advised that a continuation of Palmer-Clark-Caygill policies would blow out the financial deficit from 3.3 per cent of GDP in 1989-90 to almost 5 per cent in 1991-92 and to 6.3 per cent by 1993-94.

The expenditure cuts, which the academics opposed, were directed at avoiding such a fiscal disaster.

The financial deficit was reduced to 2.3 per cent by 1992-93 as a result of the Government's decisions. A surplus equal to about 0.5 per cent of GDP is expected to be recorded in 1993-94 and increasing surpluses, boosted by a cyclical upturn, are now in prospect.

Was the economy further depressed as the academics predicted? Not at all. In fact economic activity stopped contracting soon after the letter was written, remained pretty flat through to September 1992 and then began to grow strongly.

The cumulative annual average rate of economic growth between the years to June 1992 and 1994 will be about 8 per cent. The level of economic activity in June 1994 is likely to be almost 11 per cent higher than when the letter was written.

Influences other than the deficit reduction contributed most to the low level of economic activity recorded in 1991 and 1992. External demand was particularly weak. Our terms of trade fell by 6.6 per cent and 1.3 per cent in the years to June 1991 and 1992 respectively.

New Zealand is now experiencing its most sustainable recovery for at least 20 years. Some 70,000 additional jobs

Mr Kerr

have been created since June 1991, investment is growing strongly, the balance of payments is in a sound position and business and consumer confidence is high.

By the end of June, 12 quarters will have passed since the economy stopped contracting. This is almost twice as long as the average length of all cycles at least since 1965 (6.4 quarters). There are no signs of pressures that would bring the expansion to a halt.

There are unambiguous signs that the economy is headed in the right direction. I would be the first to argue, however, that the job of reinvigorating the economy is unfinished, and that debt and Government spending are still too high.

The policy of deficit reduction has not proved to be "fatally flawed" as the academics asserted. Rather the Government has achieved its aim of balancing the budget within three years.

The academics' mistaken view reflected naive Keynesian thinking and failed to take into account the dampening effects on economic activity associated with high levels of debt and borrowing, high-risk premiums in interest rates, a crowding out of the private sector by the public sector, and continuing low levels of business and investor confidence.

By arguing that economic growth would correct the deficit, the academics did not appreciate that New Zealand had a structural deficit rather than a cyclical deficit.

A structural deficit cannot be corrected by a cyclical upturn. (Similarly those who incorrectly argue that the emerging surplus should be spent are confusing a cyclical and a structural surplus).

The alternative strategy followed by the Government counteracted the negative effects of the deficit cut on demand and increased the economy's international competitiveness.

The key elements were: greater consistency between monetary and fiscal policies. This was a direct result of the deficit and expenditure cuts. They took pressure off interest rates and the exchange rate; more competitive wage-fixing procedures under the Employment Contracts Act; and increased productivity arising from microeconomic reforms.

Most of the policies which have driven the recovery were consistently opposed by the Auckland University critics of the post-1984 strategy, and others such as Professor Bryan Philpott of Victoria University. Besides resisting a fiscal correction, they also favoured a currency devaluation. This was to be implemented at the expense of the Government's inflation target.

For their policy to be effective a real and not just a nominal exchange rate adjustment was necessary. Past devaluations had failed because employees in sectors protected from international competition were soon compensated for the reduction in their real incomes.

The resulting price pressures spread throughout the economy and quickly eroded the initial gains enjoyed by exporters and importers. The benefits of the 1984 devaluations, for example, were washed out within a couple of years.

The academics never adequately explained how a real depreciation would be achieved and subsequently sustained. They seldom acknowledged that devaluation is tantamount to a real wage cut.

The abandonment of inflation targets would have undermined confidence in monetary policy, raised inflation expectations and started a new round of price increases. Under those conditions any real exchange rate decline and upturn in activity would have been short-lived.

Some of the critics of the strategy subsequently argued that monetary policy was eased in 1991 by the Reserve Bank to depreciate the currency as they had advocated, and that this explains subsequent growth. Their argument does not withstand scrutiny.

Monetary conditions eased during 1991 in response to lower inflation and inflationary expectations. The Reserve Bank was able to further ease monetary policy in September 1991 without putting in jeopardy its inflation goal.

This would not have been possible at a significantly earlier stage and without the complementary measures that the Government had adopted. The overall policy package was vastly different from that advocated by the critics.

The thrust of New Zealand's economic strategy commands widespread support among authoritative agencies such as the International Monetary Fund and the OECD, and internationally respected economists.

It has, however, been persistently opposed by numerous New Zealand academics who peddle outdated ideas that are not supported by mainstream economists.

The Minister of Finance's 1991 observation that open letters advocating an u-turn in Government economic policy had had a chequered history has proved to be prophetic.

She referred to a similar dire warning that 364 British economists sent to Mrs Thatcher in 1981. Their letter coincided with the start of the longest expansion that Britain had experienced since the war. This lesson apparently escaped our academics.

A fail grade is the only mark that could be fairly awarded for their dismal effort.

The 15 Auckland University department of economics staff who signed the original letter were: Conrad Blyth and Allan Catt, professors; Steve Jones, associate professor and head of department; Susan St John, Tony Endres, Keith Jones and Basil Sharp, senior lecturers; Robert Scollay, Anjum Siddiqui, Martin O'Connor, Keith Rankin and Grant Fleming, lecturers; John Horsman, Susan Laurenson and Gillis McLean, senior tutors.

THE UNIVERSITY OF AUCKLAND

PRIVATE BAG AUCKLAND NEW ZEALAND TELEPHONE 737-999

6 June 1991

The Editor,
The New Zealand Herald,
Auckland.

Dear Sir,

The debate over superannuation cuts must not obscure the more fundamental issue of whether the government is right to give over-riding priority to eliminating the budget deficit.

We wish to state in the strongest possible terms our view that in the present state of the economy, and in the midst of an international recession, the deficit-cutting strategy is fatally flawed. It can only depress the economy further and because of this it will be to a considerable extent self-defeating; a lower level of economic activity means less tax revenue for government and more demands for expenditure in areas such as unemployment relief. How long is it proposed to continue with this vicious circle?

The lower interest rates which are the intended reward of the deficit cutting exercise will give the necessary stimulation to the economy only if they lead to a revival within the country of investment, which has slumped to appallingly low levels in key sectors, with disturbing implications for our future productive efficiency. However it is elementary that businesses will only invest if they believe the investment will be profitable. It is difficult see this happening on the required scale as long as demand continues to be squeezed out of the economy, while our overvalued exchange rate penalises both exporters and those manufacturers who still try to compete against imports in our domestic market.

What is needed, as critics of the government's strategy have been advocating for some time, is to reinforce improving competitiveness with an adjustment to exchange rate policy, with the aim of enhancing the

profitability of exporters and import-competing manufacturers. If export-oriented investment and production, especially, can be sufficiently stimulated, only then can the economy be allowed to grow without the risks of dangerous additions to our external debt. In this scenario, the budget deficit-cutting exercise becomes redundant - the government's deficit cures itself as unemployment falls and as tax revenue rises with rising incomes.

On one point we agree with the government: the economy is in a precarious state. However the strategy being adopted will hinder rather than help economic recovery, while further blighting the lives of thousands of New Zealanders in the process. The instincts of victims of government cost-cutting are right - the government's deficit cutting not only threatens them as individuals but threatens as well the health of the entire economy. The sacrifices being demanded are at best unnecessary, and at worst will turn out to be counterproductive .

Yours faithfully,

Conrad Blyth (Professor)
Allan Catt (Professor)
Susan St John (Mrs - Senior Lecturer)
Keith Rankin (Mr - Lecturer)
Robert Scollay (Mr - Lecturer)
Tony Endres (Dr - Senior Lecturer)
Keith Jones (Dr - Senior Lecturer)
John Horsman (Mr - Senior Tutor)
Steve Jones (Associate Professor - and Head of Department)
Basil Sharp (Dr - Senior Lecturer)
Anjum Siddiqui (Dr - Lecturer)
Martin O'Connor (Mr - Lecturer)
Susan Laurenson (Mrs - Snr Tutor)
Gillis McLean (Mr - Senior Tutor)
Grant Fleming (Mr - Lecturer)

Economics Department
UNIVERSITY OF AUCKLAND.

7 June 1991

Simon Collins

In response to the letter to the Herald by the fifteen Auckland academics, the Minister of Finance sends the following comment:

I am surprised at the shallow and unscholarly nature of the letter circulated by the fifteen Auckland University academics.

It is quite wrong to assert that the government places overriding priority in eliminating the fiscal deficit. The government's strategy is above all one of balanced economic policy, in which a responsible fiscal policy, a commitment to stable prices, a liberalised labour market and strategies to encourage competition and enterprise are all key ingredients. Indeed the fact that the government has given itself three years to bring the fiscal deficit back into balance is itself evidence that we are not taking an unconsidered approach to our fiscal problem.

For their part, the academics' sole alternative policy prescription is "an adjustment to exchange rate policy, with the aim of enhancing the profitability of exporters and import-competing manufacturers". Such a statement is so vague as to be virtually meaningless. It says nothing about how such an adjustment is to be brought about and, even more importantly, how it can be sustained. If the academics wish to make a contribution to the economic debate, they must spell out their prescription better than that. Indeed the whole of the government's economic strategy is about achieving a permanent shift in resources to the traded goods sector, not by attempting to wave a magic wand, but by policies that prove sustainable because they tackle our underlying problems.

Having offered us their instant prescription, the academics go on to make the extraordinary statement that the deficit problem would then "cure itself". It is precisely this sort of wishful thinking that has led to decades of government overspending, and the huge build-up of debt that all of us now face.

Open letters from academics have a chequered history. Early in Margaret Thatcher's premiership, 364 prominent economists wrote a now notorious letter to the London Times urging the government to abandon its economic policy. No U-turn was forthcoming from the British government. Almost from that

moment the British economy began to recover. It went on to record its longest post-war expansion.

The contribution from the Auckland academics deserves no better a fate.

Martin Hames

New Zealand Herald 8 June 1991 p20

Economist group sees 'fatal flaws'

By SIMON COLLINS

Fifteen Auckland University economists have written an open letter warning that the Government's policy of cutting its budget deficit in the middle of a recession is "fatally flawed."

Their letter, sent to the *New Zealand Herald* and three other newspapers, says that spending cuts will be "self-defeating" because they will reduce economic activity and so cut the Government's tax revenue.

Their argument casts doubt on the basic economic justification for proposed cuts in the cost of pensions to be considered by the Government caucus next Friday, and for charging better-off New Zealanders for health care and education.

One of the group of economists, Mr Robert Scollay, said all but three of the university's economics department staff who were approached to sign the letter agreed to do so.

He said the public debate over pensions and user-pays seemed to assume that the Government had to cut the deficit between its spending and revenue.

The letter says:

"The debate over superannuation cuts must not obscure the more fundamental issue of whether the Government is right to give overriding priority to eliminating the budget deficit.

"We wish to state in the strongest possible terms our view that in the present state of the economy, and in the midst of an international recession, the deficit-cutting strategy is fatally flawed.

"It can only depress the economy further, and because of this it will be to a considerable extent self-defeating. A lower level of economic activity means less tax revenue for Government and more demands for expenditure in areas such as unemployment relief . . .

"The lower interest rates which are the intended reward of the deficit-cutting exercise will give the necessary stimulation to the economy only if they lead to a revival within the country of investment, which has slumped to appallingly low levels in key sectors . . .

"However, it is elementary that businesses will only invest if they believe the investment will be profitable.

"It is difficult to see this happening on the required scale as long as demand continues to be squeezed out of the economy, while our overvalued exchange rate penalises both exporters and those manufacturers who still try to compete against imports in our domestic market."

The letter says the answer is to stimulate export-oriented investment directly by bringing down the exchange rate.

"In this scenario the budget deficit-cutting exercise becomes redundant. The Government's deficit cures itself as unemployment falls and as tax revenue rises with rising incomes," it says.

The letter concludes by warning that the economy is in "a precarious state" but that the sacrifices being demanded by the Government "are at best unnecessary and at worst will turn out to be counter-productive."

The Minister of Finance, Ruth Richardson, last night slammed the letter as "shallow and unscholarly."

She denied that the Government was giving overriding priority to cutting the deficit, saying this was just part of a "balanced" economic policy.

● The economists' letter was signed by: Professors Conrad Blyth, Allan Catt and Steve Jones; Dr Tony Endres, Mr Grant Fleming, Mr John Horsman, Dr Keith Jones, Mrs Susan Laurenson, Mr Gillis McLean, Mr Martin O'Connor, Mr Keith Rankin, Mrs Susan St John, Mr Scollay, Dr Basil Sharp and Dr Anjum Siddiqui.