
STRATEGY FOR GROWTH

Economic Monitoring Group

New Zealand Planning Council Monitoring Report

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The Argument

In recent years we have failed to meet our economic objectives which include:

- a rising material standard of living
- high employment
- reasonable price stability
- a sustainable balance of payments situation
- fair distribution of income.

Instead of achieving a balance of these, we are experiencing persisting external deficits (financed by burdensome borrowing), public deficits whose financing has both aggravated inflation and crowded out private investment, high unemployment, static living standards, and an inflation rate higher than those of our trading partners until it was suppressed by widespread controls. While some of these problems have their origins in events overseas, our adjustment to events, whether through market-place actions or through deliberate policy response, has been inadequate.

Let us look ahead some five years or so and picture what a restructured economy able to meet our objectives would be. We live in an ever changing international and domestic economic climate and to get the best for ourselves and our children we need an economic structure capable of responding continuously to change. The key attribute of this sort of economic environment is adaptability. It will need to apply across all parts of economic life:

- the business world
- labour markets
- consumption levels and patterns
- government policy responses.

Inflexibility in one part of the economy merely transfers the burden of change to another part.

The main aspects of this requirement for adaptability will be as follows:

- (a) To ensure that the price signals received by businessmen (in particular) are those that reflect the situation in the real world. This will enable them to make more soundly based decisions in regard to investment, production and sales.
- (b) There will be a greater role for the exchange rate in relaying overseas realities into the New Zealand economy. This will call for greater flexibility in the use of the exchange rate as a tool of economic management and development.
- (c) Greater flexibility will be required in labour markets both in regard to mobility and

income levels. This will clearly have implications for the level and patterns of consumption.

It is the Government's responsibility to see that these things happen. The nature of the changes that will occur cannot be predicted by government with any useful degree of certainty. Consequently, detailed, specific government planning and regulation cannot contribute very much to the sort of economy we need. In fact, by trying to insure against unpredictable risks, government planning may impose a heavy cost of inflexibility and mistakes on the economy.

Thus we envisage an economy in which planning is undertaken principally at the level of the management of the firm, the farm and the enterprise, and with the risks and consequences of decisions taken in an uncertain world being borne by that management. We see this as the natural evolution of what is now becoming a relatively mature economy with a reasonably balanced range of economic activities.

What to produce and where to sell it is thus primarily a matter for enterprise not government. The restructured economy would be a much more market-oriented economy, reflecting and responsive to overseas price signals. Economic activities in New Zealand would be valued at their international worth, either as exports competing on world markets, or as import competing industries. With the distortions due to discriminatory assistance and protection removed, enterprise and investors could choose the internationally most profitable activities in which to employ people.

This economy would probably have higher import prices on average than at present, with consequential incentives for employment promoting domestic industry. It would not have a large range of highly protected industries passing on their high costs to consumers and other firms. Almost certainly, exporting in general would be a more profitable activity, but there would be few specially encouraged activities. If the government attempts to go on encouraging particular industries we see a very real danger of the Government planning us into yet another impasse of the sort we described in our first report. We are not, however, ideological "free marketeers". Because of the relatively small size of the economy there remain several activities where a single national enterprise may be appropriate. What we must guard against, how-

ever, is the inflexibility of monopoly and the inefficiency of special privilege.

The more general market orientation we envisage applies to all markets:

- for goods and services
- for capital
- for foreign exchange
- for labour.

The more all these markets are flexible and price sensitive, the less does any one of the markets have to carry the burdens of change and adjustment. We envisage that two of the least flexible areas, those of foreign exchange and labour, which today produce the major adjustment costs (external borrowing and unemployment) would in the future show much greater flexibility, i.e. a less rigid exchange rate regime, and a labour market more adaptive to changing economic conditions.

An important ingredient in the changed economy would be a better relationship between domestic costs and those of our foreign competitors. To ensure growth in the whole economy, New Zealand goods need to be competitive with foreign produced goods, both in overseas markets and in the New Zealand market. There are three possible ways to achieve this end:

- (a) a general lowering of New Zealand money costs relative to international costs, e.g. by achieving a lower rate of inflation in New Zealand than exists in our trading partners
- (b) a change in the nominal exchange rate that is unmatched by corresponding changes in the level of New Zealand money costs
- (c) a relative improvement in the efficiency (productivity) with which resources are used in New Zealand.

There are a variety of policies which can be adopted to move along these ways. Some, like consensual incomes policy, have been tried in the past and failed. Some, like changing the nominal exchange rate, produce ephemeral benefits unless safeguards are also implemented. Some, like restrictive monetary and fiscal policy, can cause bankruptcy and unemployment. In the Monitoring Group's view, whatever policy or policies adopted require a market-oriented structure for there to be any successful passage to a soundly based economy. Whatever package of policies may be adopted will run high risks of failure and undesirable cost unless they take place in a market-oriented environment in which prices are responsive to change and people are responsive to price changes.

In moving towards the sort of economy we are talking about, it is important that there should be an "announcement effect". That is, all firms

and individuals need to be clearly informed that enterprise is to be exposed to foreign and domestic competition and that that will be the rule of the game in the future. This is the most important and basic reform. The next step is to move towards a domestic cost level sufficient to secure full employment and growth in living standards.

This will involve the removal of production and export subsidies and protective devices such as import licensing to expose both exporters and domestic manufacturers to foreign competition. It will also involve the removal of domestic controls on enterprise to encourage production at lowest possible cost. The exchange rate regime will also need to be such as will lead to a much lower level of unemployment.

Lax control of the money supply and an associated large public deficit are a threat to the efficient working of any economic structure. The measures we propose will go part of the way to reducing the present alarming public deficit, while the return to higher levels of employment will help to reduce the deficit to manageable proportions. Reducing the size of the public deficit will reduce pressure on the capital market and allow the real interest rate to fall. We would rely on firm monetary policy and the exchange rate to maintain the continued internal balance (high employment and low inflation), and external balance in the face of changing world conditions. But a competitive economic structure remains the main mechanism by which monetary, fiscal and exchange rate policies are potent.

The early stages of the working-out of the policies we propose will result in the ceasing of production of some goods. There will, however, be new investment, new production and new employment. The radical revision of what is profitable and what is not will inevitably close up some of the lines of activity while opening up others. We expect that much of the change in activity will occur within firms. Nevertheless, there may be some industries where restructuring is more painful. These should not receive continued protection, but assistance with retraining and relocation of the labour force over a limited period might be appropriate. As we expect all of society to benefit eventually from the restructuring of the economy, so we expect all to share the costs. The sensible way to do this is not by avoiding change, but by assisting those displaced by change to find work in more useful activities. We recognise that the costs of such assistance will be a charge on the public budget during the period of adjustment.

In our first report we stressed that a devaluation, or a move to a flexible exchange rate regime which would permit a devaluation,

should be contemplated only if other policies could also be put in place with it. The Monitoring Group sees devaluation as part of a policy of development and restructuring. These intended real effects include not simply a reduction in the consumption of imports (which may well take place) but a more efficient use of the now higher priced imports through the development of new exporting and import competing activities. Domestic resources, including labour, of course, become relatively cheaper and more attractive to use. The main problem associated with a particularly large devaluation is its effect on the overall cost of the present basket of consumption goods and services because of a rise in the imported component. The fear is that these increases in the cost of living will lead to inflationary money income increases, and work to nullify the real effects of devaluation.

To prevent these employment promoting benefits of devaluation from being lost, the cost advantage to domestic production over imports must be retained. The maintenance of this cost advantage, and the avoidance of inflation, is the role of the other policies we propose:

- the creation of a competitive market environment which would prevent a return of a "cost-plus" mentality
- the maintenance of a firm mix of monetary and fiscal policies
- the achievement of a national consensus on the means and objectives of policies through adequate public information and discussion.

In the last resort, there will be little chance of meeting our objectives without a meeting of the minds.

Changing the Economic Structure

Traditionally economic management has aimed to achieve a range of objectives. These have usually included (not necessarily in order of priority):

- a rising material standard of living
- high employment
- relative price stability
- a sustainable balance of payments equilibrium
- a fair distribution of income

In recent years the New Zealand economy has not performed well in achieving many of these objectives: we have experienced stagnating living standards, unemployment, inflation, and increasing debt.

It is natural to regard the dismal experience of the 1970s as being largely due to external events. The oil crisis precipitated a decade of weakness in the world economy, and agricultural trade protectionism has discriminated against New Zealand's products. It is certainly true that the terms of trade — the average ratio between export prices and import prices and a key measure of the value of international trade — have been consistently lower than the average of the 1950s and 1960s. In these circumstances the appropriate course for the economy to take is one of structural adjustment, to reorganise so that the economy is better placed to grasp opportunities in a competitive and changing world economy. A decade has passed since the first "oil shock" and a return to international conditions and relationships such as existed before that is very unlikely. Unless this is accepted and an appropriate response made, an habitual lower standard of living in relation to other developed countries is inevitable.

The Monitoring Group believes that it is important to achieve a balance of objectives over the medium term, recognising the links between the various objectives. For example, it is much easier to address equity issues in a growing rather than a static environment. The total problem is a complex one, and to grapple with it, attention needs to be given to the structural adjustment processes, and by implication government policies, that would enable the economy to respond much more effectively to its opportunities. The lesson to be taken from our recent past is not so much that we are at the mercy of international events, but rather that

we have failed to adapt sufficiently or quickly enough to these events.

In a report published last year,¹ the Monitoring Group addressed the problems and consequences of slow export growth. It was also observed that because of the policies that have been pursued, particularly in response to the "oil shocks" of the 1970s, the burden of overseas debt has risen very sharply. These policies have been a mixture of seeking to facilitate the process of structural change, and of protecting and shielding industries that provide employment, income and exports. The attempt to diversify the economy through a widening of the export base was in fact well established by the late 1960s, so that the intensification of incentives designed to encourage manufacturers and others to expand into international markets was not a new strategy. The development of large scale energy intensive industries, certainly on the scale that has occurred since the late 1970s, has been a new phenomenon. It is evident, however, that these changes have not been broadly enough based, and that more fundamental changes in policy are needed.

In the past the economic policy instruments used by governments have included import control, farm income stabilisation, tax incentives for exporters, monetary and fiscal policies to iron out fluctuations, overseas borrowing, a reserve ratio system with interest rate controls and lending guidelines in the financial sector. The system of wage determination has been largely centralised.

The focus of these policies has been a mixture of economic stabilisation and economic development, and the boundary between the two has not always been clear cut. Import control, for example was originally introduced mainly as a balance of payments control measure but it is now a principal means of supporting the existence of a substantial part of the manufacturing sector. It is thus now associated with employment and industrial development motives. Export incentives were originally seen as an inducement to producers in a small isolated economy to become more world oriented in their outlook whereas they are now largely justified in terms of compensation to exporters

1. Economic Monitoring Group, *Foreign Exchange Constraints, Export Growth and Overseas Debt*, New Zealand Planning Council, 1983

for the costs imposed on them by protection given to other industries. The stated concepts behind farm income stabilisation may not have changed very much but support to farming has now taken quite a different form and could prove dangerously addictive.

We have now come to the limit of any further advantage attached to a policy mix with these characteristics. The reason is that the side effects and indirect consequences of the panoply of selective measures far outweigh the direct benefits that accrue to those activities so selected. This report begins, therefore, with a brief outline of how the economy might feasibly work once a process of structural adjustment had occurred. It should be stressed that this does not entail forecasts or projections of the relative rates of growth of specific sectors, or occupations. Rather, it is an attempt to outline the overall environment in which investment decisions, in the public and private sectors, might be made for the best, and to indicate how the policies of government might appropriately foster this environment.

Adaptability

The economy would become much more adaptable across its whole extent. This increased sensitivity of response would be seen:

- in business
- in the labour market
- in incomes and consumption
- in government policy making

In order to work successfully the new economic structure would have the following main aspects:

(a) *Having the right price signals to respond to*

The Monitoring Group envisages that the prices and costs faced by business would be those that, by and large, reflect marketplace realities. Private and public sector decision-makers would be in a position to direct investment, production, administrative and sales effort on the basis of these signals. The importance of this arises because of the fundamental economic reality that unless New Zealand produces output that is in demand, and also produces it competitively, sustainable growth and other social objectives are not achievable. Any other approach to the management of the economy runs the risk of insulating major sectors from shifts in consumer tastes or from technological developments they would be wise to respond to. Even worse, there is a substantial risk of encouraging growth in activities that are quite out of place, and would be better phased down to provide resources for more efficient production.

(b) *Allowing the exchange rate to reflect price signals*

Because of the major role played by international trade (both exports and imports) in the New Zealand economy, overseas prices and costs would need to be appropriately represented throughout the internal economy. This would be needed in order that the various decision-makers could have signals to encourage more exports and import substitution if flows of foreign exchange were persistently in deficit. (It follows that if foreign exchange flows were instead in regular surplus, and there was also full employment, a higher consumption of imports could be sustained.) The exchange rate would be an important instrument through which this occurs. Inevitably, this means there would be much more flexibility of the exchange rate. One of the reasons for the massive increase in the overseas debt over the last decade is that there have not been sufficient possibilities for expanding exports, and it has been relatively attractive to purchase imports rather than to produce the equivalent goods locally or do without. Flexible exchange rates are not a universal answer to economic adjustment problems. The crawling peg system, for example, can end up being more or less a rubber stamping of the prevailing rate of inflation, and thus have little effect on the incentives within the economy to respond to fundamental imbalances in resource use, and in investment and consumption patterns. Nevertheless, rigid commitment to a particular exchange rate provides no basis for structural responses, and inevitably results in the introduction of surrogate taxes and subsidies which do not get to the crux of the problem. Along with a more flexible exchange rate regime, therefore, the Monitoring Group envisages that there would also be a package of internal policies that would enable reasonably free choices throughout the economy, especially between imports and locally produced substitutes. In this way competition would be the predominant element in the production pattern rather than various interventions which would almost certainly distort market realities. The overall impact would be to reduce significantly the barriers to the transmission of external price signals through to economic activity in New Zealand.

(c) *Greater flexibility in labour markets*

To accompany changes in the orientation of investment due to price signals it would be essential that the labour market adapts also. This would involve labour mobility, relative income relationships, and the acceptance by various occupations and the workforce as a whole of levels and types of consumption that can be sustained. There are really two distinct dimensions to this:

— Firstly, it would be necessary for the average real income level, which means the standards of consumption in the nation as a whole, to be closely related to the value of goods and services produced. Because of the importance of foreign trade influences in the economy, these real values are to a large extent determined in an international context. A consensual incomes policy, therefore, would have a potentially valuable part to play in achieving an appropriate rate of growth in real consumption, but this clearly should not be handled in such a way as to disguise the very important signals incorporated in exchange rate trends and other key prices. Moreover, it should not slow up necessary responses to price signals.

— Secondly, there would be ample scope in the system for varying rewards depending on industry or occupation. This is because industry and occupational mobility is clearly an important factor in structural change. As product markets become more flexible, it is a requirement that labour markets should also become correspondingly adaptive if the system is to work in a socially acceptable way.

In indicating that the market should play a greater part in determining economic outcomes, the Monitoring Group is not suggesting that the government should withdraw from any significant role in the economy. The government would certainly have an important role, albeit at a much less detailed level than has been the case.

It is government's main responsibility to manage the overall economic environment in such a way that the market signals coming through to investors are reasonably accurate ones, not distorted by the expectations inherent in excessive rates of inflation, featuring an exchange rate which sensibly reflects relative costs between New Zealand and the outside world, and an interest rate structure which imposes on investors the necessary discipline to ensure a satisfactory return for the consumption sacrifices entailed, but not artificially boosted by large government debt financing.

The Speed of Adjustment

If it is accepted that the New Zealand economy should have the characteristics indicated above, a judgement is needed about how fast the process of change should be. The speed with which the policy environment is changed is essentially a political decision and will have important implications for existing activity and employment. However it would be prudent for investors to formulate their plans on the basis that

policy will take the general direction outlined above. Major new investment which is undertaken on the assumption of continuing specific protection or assistance through *selective* government measures, even ones which have been part of the framework for some considerable time, would be most unwise.

A recognisable component of economic policy already includes measures of the kind that are required. Most significant in this respect is probably the deregulation of the transport sector, and the recent announcement of the phase-out of import licensing according to a managed timetable. The CER agreement with Australia also signifies a general freeing up tendency in economic policy. As indicated in our earlier report, however, the changes have been rather slow to emerge.

In many respects, the economy is not well structured which means that many activities might find their existence jeopardised if exposed to increased competition, even with a radically different exchange rate. More importantly, many sections of the economy do not appear to be very adaptable or flexible which means they would have some difficulty in adjusting to the proposed environment. The inflexibility is to some extent synonymous with controls and selective assistance and might be expected to decrease substantially with deregulation. However, attitudinal, educational and probably institutional changes are also required before the suggested changes become fully effective. Nevertheless, there are some indications that many sections of the economy are in a position to prosper if the policy environment was to be changed in the direction we suggest. On balance the Monitoring Group feels that a quite rapid transition is desirable and that the disadvantages would be relatively short term.

It is necessary to recognise, however, that labour force adjustment is different in character to other economic mechanisms, and that the existence of unemployment is socially damaging. Therefore the solution to the unemployment problem is more likely to flow from growth arising out of investments producing a higher national return, whereas continuing on the present path offers little hope. In response to the suggestion that protection from import competition should be used to maintain employment, it is to be stressed that "protection" can relatively easily be given through judicious use of the exchange rate for the vast bulk of industries, including farming, which are currently in receipt of direct fiscal assistance. Activities which are assisted excessively would clearly be more difficult to sustain, and it is in these areas that it would be unwise to expect economic conditions to remain supportive un-

less cost structures alter radically. Such changes can be made only by organisational or other improvements which raise productivity, or, failing this, trimming the incomes the activity provides. In a flexible economy activities unable to survive other than by squeezing incomes would seek alternative, more productive, uses for their resources. The protection of grossly inefficient industries does not enhance this adjustment. In fact it significantly slows it up and cannot in the end protect any jobs.

In its most recent report² the Economic Monitoring Group examined the implications of the public sector deficit. It was concluded that the deficit will take some years to substantially reduce, even if this is systematically pursued by the Government.

This will mean, among other things, a tendency to high real interest rates as the public sector attracts savings from the non-bank private sector to finance the expenditures of the former. One consequence of this situation is that it will be even more necessary than usual for highly profitable opportunities to be available for investors if there is to be a resurgence of economic growth during this period of adjustment. The basis of the economic environment which is being advocated is that the efficiencies inherent in a more open system would present such opportunities much more readily than has happened over the last decade or so as we have searched for a suitable way of dealing with the oil crisis and subsequent world economic changes. It is also worth emphasising that, particularly in the area of export assistance, the strategy of targeted fiscal assistance to various industries is a significant element in the public deficit. A strong feature of the policy approach described is the removal of this component of the government deficit.

The argument of the previous paragraphs is based on key relationships between real incomes and relative costs, particularly as they

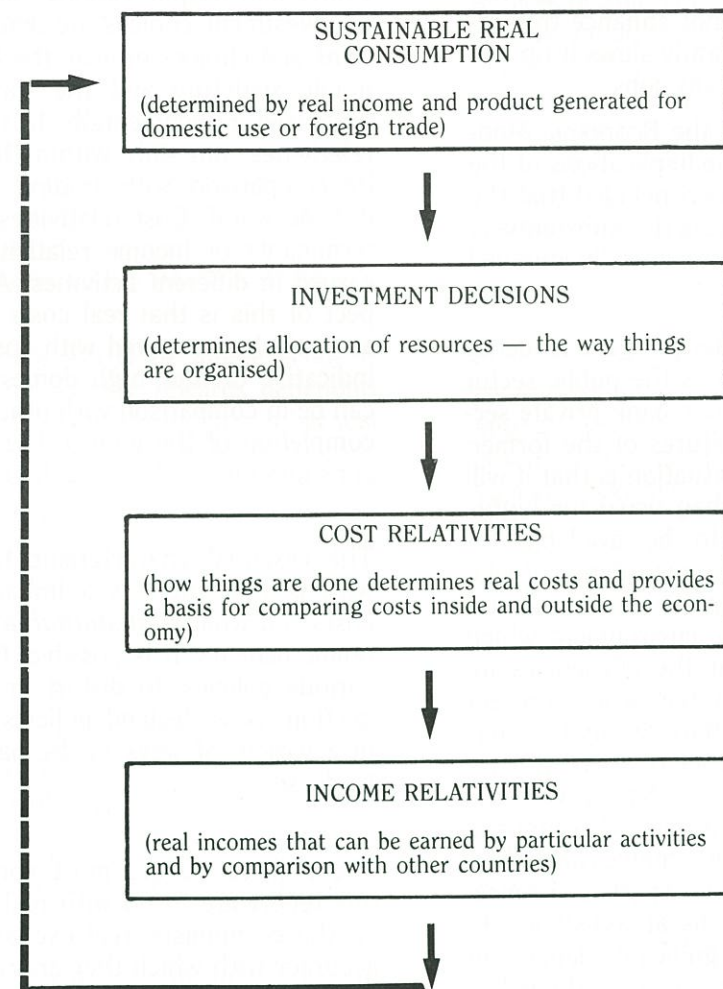
2. Economic Monitoring Group, *The Government Deficit and the Economy*, New Zealand Planning Council, 1984

interact in an economy which is involved in international trade. Figure 1 represents the chain of causation in a simple way. The sustainable real consumption standard in the economy is, in a very general sense, determined by the real income or product which is generated in the economy. At the interface between incomes and output various allocative decisions or investment choices are made. These allocations and choices provide the basis of the economic structure and the way resources are organised. Fundamentally, this determines cost relativities, not only within the economy, but by comparison with trading partners in the outside world. Cost relativities in turn are determinants of income relativities that can be earned in different activities. An important aspect of this is that real costs in New Zealand as a whole, compared with costs overseas, are indicative of how high domestic real incomes can be in comparison with other countries. The completion of the loop to the sustainable real consumption level is thus logically achieved.

The essential characteristic to be concerned with is that there is a linkage between real costs and what is *sustainable* in terms of economic benefits. It is possible, by the pursuit of various policies, to distort or cloud this connection. New Zealand policies have done that in a variety of ways in the past and continue to do so.

The policies we are most concerned with in this report are to do with real cost relativities — the economists' real exchange rate — the accuracy with which they are reflected, and the manner in which they affect real income growth. Because costs are not reflected accurately we have tended to be misled about what is really achievable in real income terms with the present economic structure. Massive overseas borrowing has masked the extent to which our real incomes are out of line with our relative real costs (or relative productivity). The only acceptable course is to change our ways.

FIGURE 1:
SCHEMATIC REPRESENTATION OF LINKS BETWEEN RELATIVE COSTS AND RELATIVE REAL INCOMES



Relationships Between Macro-Markets

The essence of changing economic structure, of altering the way resources are organised, can be explained in terms of responses to relative prices. In a money system the values society accepts for particular activities, processes, commodities, or services is represented by the money price tags that are attached. The notion of relative prices is particularly important in relation to priorities for investment and consumption decisions made throughout the system. Moreover, the system of relative prices is seldom static because of changing technology, changing tastes, and changing patterns in the concentration of economic power. Economic performance depends critically on the responses made by industries, firms and people to evolving circumstances.

In the first instance, it is necessary to be clear about which relative prices are important in policy terms. In a small internationally trading economy such as New Zealand the concern is with international competitiveness. If policies are used to insulate the existing order from changes in relative prices brought about by shifts in demand patterns or technology, and to dilute the incentive to reduce costs or modify output, they are wrongly conceived. They should instead aim to sharpen the motivation for resource reallocation to productive ends. A small economy such as New Zealand, experiencing difficulty in maintaining its share of world trade growth, is necessarily concerned about the competitiveness of its industries.

One way an uncompetitive situation can be rectified is by some form of general reduction in real incomes, which can be achieved through macroeconomic policy. As long as the rest of the world is not taking similar action this could be expected to result in a move towards external balance. However, a more positive result could be achieved by encouraging resource shifts into more productive areas. In order for this to happen, investors need to get signals from markets about the kinds of products which would provide higher incomes. In the end, growth cannot occur unless business is prepared to respond actively to the opportunities available. Government cannot guarantee this, but should see to it that its policies do not lead to false incentives or false expectations at crucial points of economic decision-making.

Thus there are two potential themes to policies of adjustment. On the one hand, some form of

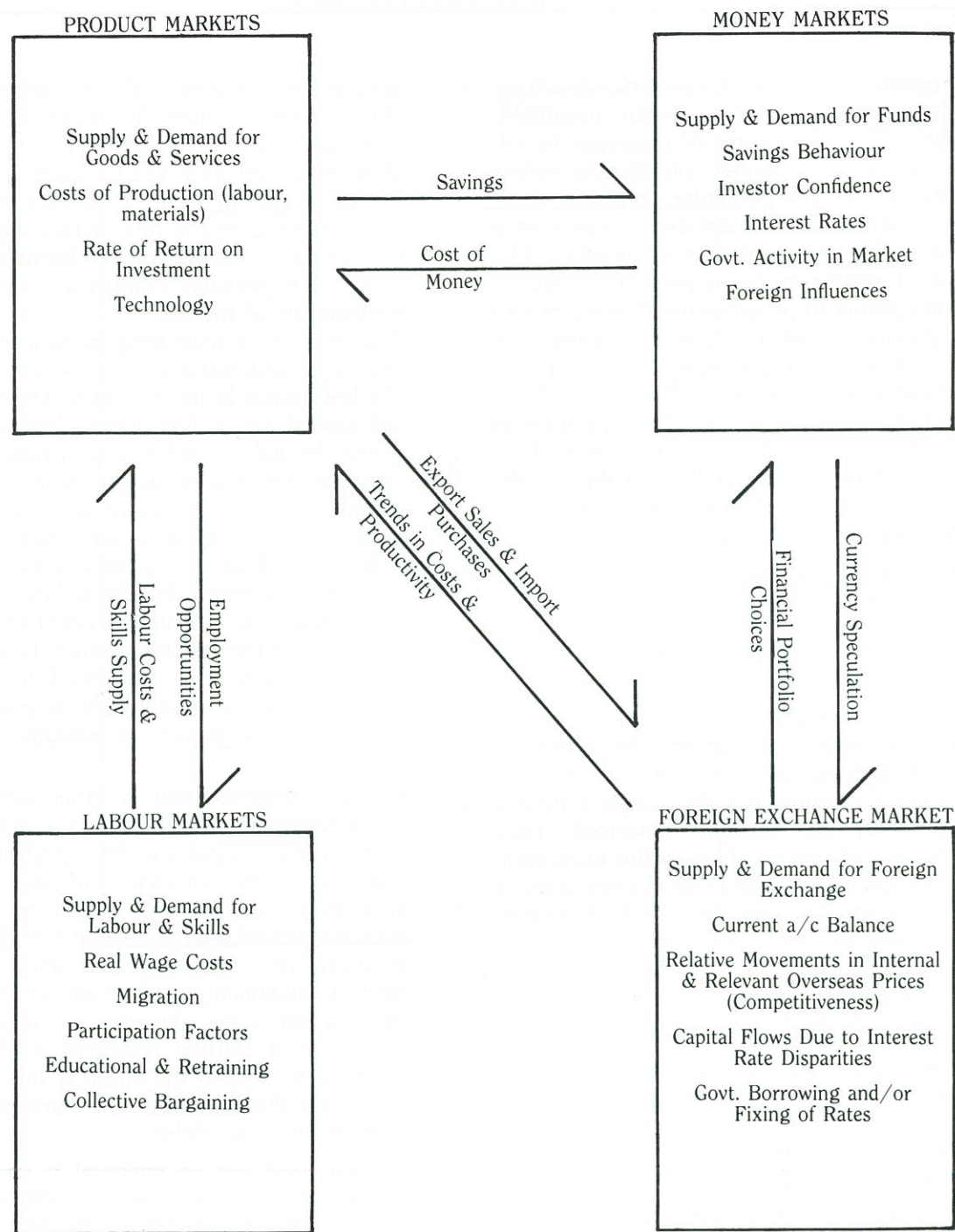
general retrenchment might be expected to restore competitiveness by lowering costs in existing industries. On the other hand, resource shifts might be expected to result in new activities which are able to sustain higher incomes coming to the fore. When the scale of the restructuring adjustment being sought is major, it is probably realistic to expect some combination of the two.

The task of restructuring in New Zealand is not to be underestimated as the experience of the last decade bears testimony. The long serving base of pastoral production has been under stress through a combination of reduced terms of trade and cost pressures arising in the internal economy. The sector at present is only competitive as a result of subsidisation. These industries will clearly still form a major part of our future economy, but the policies that have been used in an attempt to get them through the trough have obscured, rather than clarified, the adaptations that may need to be made through product development, marketing and production techniques to sustain long-term viability.

Similar comments apply to other sectors. The real concern is with relative prices and relative costs because these are the signals to which investors can be expected to respond. The relative prices experienced should promote resource shifts into activities that will contribute positively to overall economic objectives. The path of adjustment the economy actually takes may include some elements of retrenchment and some of shifting resources. Clearly it is desirable if most of the strain is taken by the latter, but this will require a marked increase in economic adaptability.

The economy may be regarded as having four major categories of markets, referred to as "macro-markets". These are product markets, financial markets, labour markets and foreign exchange markets. These market types justify the description "macro" because the price-quantity relationships they determine have a general or multi-sector character. Thus the structure of interest rates, which might be seen as the price outcome of the functioning of financial markets, is an economy-wide characteristic affecting all economic activity in which credit is a factor. Likewise, all sectors employ labour, so whatever influences combine to determine the *general* level of wages are important throughout the economy. Clearly

FIGURE 2: MACRO-MARKET LINKS



there are key linkages and interdependencies between these “macro” markets, and it will be useful to consider them more carefully. Figure 2 suggests how these broad markets interact.

The product markets generate the economy’s real output of goods and services. This is where resources — labour, capital and raw materials — for productive purposes are used. The composition of output is influenced by relative prices, tastes, technology, and the balance of economic power. Total product is a function of overall demand, resources available, and productivity.

Another general outcome of product markets is the determination of an overall price level. This is determined essentially by the stock of money available for economic transactions: the greater the supply of money available to finance the product markets’ activities, the higher will be the general price level. All these things heavily depend on and affect conditions in the other major markets. The level of activity influences both the demand for labour and the demand for capital (which in turn is one of the key influences affecting financial markets). On the other hand the real cost of labour and real interest rates, conditions effectively determined in labour and financial markets respectively, have major feedback effects on the way product markets can be expected to work.

Money markets are concerned with the supply and demand for financial resources. The supply of finance is very largely the result of financial deposits lodged with banks and other institutions. There are a variety of motives and effects interacting to determine this, coming under the general subject of savings behaviour. The demand for finance arises from the credit sought for investment and other purposes.

The situation is further complicated by the possibility of international financial flows. This means that conditions in money markets are more complex than a market adjustment process between society’s financial deposit-holding behaviour and the demands on financial resources coming through from product markets. Yet another dimension, important for understanding money markets, is the central government budget. This has been commented on in the recent Monitoring Group report.³

The foreign exchange market reacts to the supply and demand for foreign exchange. The supply of foreign exchange is determined by overseas sales of output from the product markets, inward capital flows from foreign investors, or overseas borrowing. The demand for foreign exchange is determined by the inflow of imports and capital outflows of various kinds,

including the repayment and servicing of debt. Clearly there are important interactions with both product and money markets due to conditions in the foreign exchange market.

The relationship with product markets occurs because of the extent to which goods and services are either sold in, or purchased from, international markets, and the exchange rate is the means by which the relevant costs and prices are reflected in domestic terms. The link with financial markets occurs because expectations about currency rates or international financial conditions may influence New Zealand currency asset and liability positions and, hence, internal monetary conditions.

The labour market is the term given to the mechanisms determining employment and wage rates. Labour supply is the term applied to those who wish to participate in paid employment (including self-employment). Labour demand depends on conditions in the product markets and the amount of paid employment available. Because, as has been pointed out elsewhere, “the labour market is the interface between the economic and the social system”⁴, the labour market has very limited scope to be used as an adjustment mechanism suitable for solving problems elsewhere. The labour market on its own cannot be expected to clear quickly when its supply and demand characteristics get out of balance. Some, who feel economic performance could be improved by concentrating policy on the factors that cause slow adjustment, see this slowness and reluctance to adjust in the labour market as a major cause of other pressure.

Macroeconomic policy is concerned with the various interactions in these macro-markets. Traditionally, government policy in New Zealand has included substantial elements of direct control in its approach to macro-policy. This naturally affects the way events in one macro-market are seen in others. For example, the exchange rate, that is the price of the New Zealand dollar in terms of foreign currencies, has mostly been fixed. This means that policy makers have been prepared to undertake their own foreign exchange borrowing or asset building activities (mostly the former) rather than allow the price to alter. They have tended to seek any adjustments which are necessary as a result of exchange market imbalance by measures affecting other macro-markets (usually product markets as explained in Chapter 3.) Likewise, there has tended to be a considerable element of control in both money and labour markets. Finally, governments have taken a major hand in influencing the way product markets work.

3. op.cit

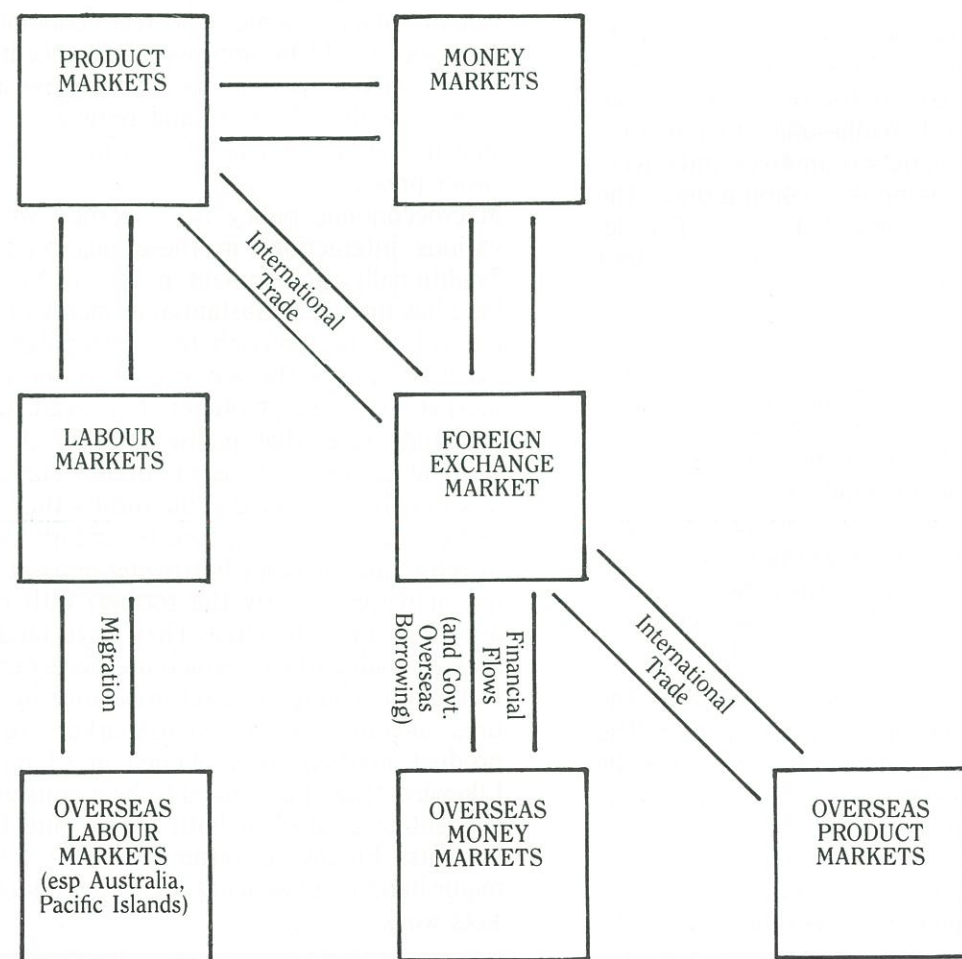
4. Easton, B., et. al., *Studies in the Labour Market*, New Zealand Institute of Economic Research, 1983, p4.

Successive attempts to change behaviour in macro-markets with a series of specific interventions have not recognised the true nature of the broad interrelationships between macro-markets. Failure of these markets to interact so as to provide appropriate price signals is more likely to be the cause of the inability of the product markets to provide an appropriate proportion of exporting and import replacing industries. If this is so, it will prove extremely difficult for policy-makers to be able to isolate precisely what activities to assist. Moreover, as will be explained shortly, even if it does hit on exactly the right mix, it has virtually no ability to ensure that the most efficient cost structure is the outcome.

The brief review of macro-markets is completed by reference to linkages between New Zealand and world macro-markets (see Figure 3). The nominal exchange rate is a very important com-

ponent of the linkages because this is the principal window through which New Zealand industries can assess their competitiveness in relation to the world at large, by converting foreign prices into New Zealand dollars. The obvious role that the exchange rate plays in this respect should not be allowed to mask the fact that the really important things are product quality and real resource costs. In the long run it is the nature of commercial and investment responses to real international values which will determine the overall level of real incomes and the sectors through which they are delivered. The exchange rate itself does not bring about the reactions the policy-makers seek, and the whole approach to exchange rate policy must recognise this. This important area is pursued in Chapter 4 of this report, but in order to clarify the framework for this discussion it is necessary to consider more systematically the extent and effects of government intervention in the product markets.

FIGURE 3: LINKS WITH EXTERNAL MACRO-MARKETS



Government Intervention

In addition to affecting the interrelationships between macro-markets discussed in the previous chapter, governments also intervene at the level of sector, industry or even firm. These interventions take a number of forms such as: border protection, licensing and regulation of domestic industries, specific taxes and subsidies applied in the domestic economy, government ownership and management of parts of industry, and selective price controls. These policies by their very nature affect the pricing and availability of resources generally.

Whatever the justification for government policies to subsidise or protect industries in individual situations, the arguments carry very much less weight when intervention in markets becomes a general phenomenon. When that happens the overall impact of the policies becomes more important than the particular effect of each selective intervention. This observation leads the Monitoring Group to the view that a more efficient economic system would be achieved by cutting away these layers of selective intervention. Furthermore, selective government intervention which enables some sectors or industries to increase their profits often does so at the expense of economic efficiency. This happens in various ways, but mostly by a reduction in competition.

There are a number of cases, for example with production costs, where markets left to their own devices do not result in the most socially desirable allocation of resources. It should be acknowledged, however that these conditions are achieved less easily than is often claimed. When they are, intervention in the particular market to counteract the distortion may be warranted, but when interference with markets becomes widespread it is likely to be damaging to economic performance, because the indirect or macro influences are more important than the direct ones.

This chapter considers various policy approaches being used in New Zealand. Although there are gaps in research results which gauge the extent and effect of these policies, sufficient work has been done over the years to give an overall perspective.

Import Protection

A widely adopted approach to government intervention entails the protection of domestic industries from overseas competition. The most

common form of protection internationally comes in the form of import tariffs, taxes on goods that cross international boundaries. Another form, used extensively in New Zealand, is the physical control of import quantities. This is achieved by import licenses or quotas. Some items are prohibited altogether, while for others, stringent conditions are applied to either the value or the volume allowed entry. If the domestic demand is greater than the quota of imports allowed, this provides advantage to local producers in maintaining a market share over and above any they might have on the basis of costs of production alone. There is also an advantage to the holders of the import licenses as they can achieve a higher return than under competitive conditions.

Protection increases the prices at which import competition can outbid domestic production thus permitting production of higher priced domestic goods. An important side effect often overlooked is that it makes it more difficult for other industries to compete internationally. This depends on the wider effects this has on factor prices in the protected economy, and on the extent to which other sectors use protected products as inputs. In other words, it enables an industry to pay higher wages, or to achieve higher economic returns on existing and possibly outmoded capital equipment than it would in a competitive environment. Further, it might inflate the market value of domestic raw materials and assets (including possibly land).

The measurement of protection, through calculations of effective rates of protection, and its effects on other industries, is reasonably straightforward for tariffs, but poses special problems in the case of import licensing. It can be done through direct price and cost comparisons of specific commodities, or by the use of some technique which effectively captures the "rent" or surplus which importers are prepared to pay to retain licence privileges. Despite the difficulties, it is critical to attempt to do so if the actual impact of protection policies is to be understood. Appendix I reviews the various studies which have grappled with this issue. The present position is that we have some picture of the impact of protection in the mid-sixties, but only a very piecemeal indication of how things really stand today. Although there is little to suggest that our overall judgement that the general approach to policy through

selective protection is wrong, more research to improve our knowledge is clearly desirable.

The effective rate of protection is an estimate of the extent to which *value added* (i.e. not final product prices) can be increased in an industry as a result of protection: i.e.

$$ERP = \frac{\text{Value added at protected prices} - \text{Value added at world prices}}{\text{Value added at world prices}}$$

In other words it measures the extent to which either returns to investors or wages to employees (or some combination of the two) might be raised in an industry due to the restriction of competition. Clearly, if a large number of industries are protected, the impact on factor prices throughout the economy is likely to be considerable. The unevenness of protection is also important because it provides an arbitrary advantage to specific industries. This advantage may attract resources into industries which do not produce a high rate of return from a national point of view.

The estimates in Table 1 are reproduced from an article by Bushnell and Gibson.⁵ They have been drawn together from several sources and differences in timing, coverage and accuracy necessitate some degree of caution in inter-

5. Bushnell, P. and Gibson, B., *Calculating Assistance Costs*, published in *The Agricultural Economist*, Vol. 4 No. 4, 1983

preting them. Nevertheless, they represent probably the best overall view of the effect on relative prices of government intervention through import protection currently available. The averaged results for broad industry groupings is indicative of substantial variation in assistance to different sectors. It also suggests that assistance is quite high and widespread throughout manufacturing industries. The estimates for a handful of specific products show that, at least in some sectors, assistance is highly variable within as well as between sectors. Extremely wide ranges in effective protection are depicted for the various automotive components in the list. Reference to the source used by Bushnell and Gibson⁶ shows that this variation is linked to different countries of potential importation. In particular, rates of protection in relation to the United Kingdom are very low, whereas in relation to Japan they are quite high. It seems likely that this is due more to differences in relative efficiency between Japanese and United Kingdom suppliers than wide variations in efficiency for individual products within New Zealand. It is, nonetheless, indicative of highly protected production. The Industrial Development Commission in fact calculated even wider variations in effective protection in the motor vehicle assembly industry, contributing to the average rate of 544 percent. The reasons for the diversity were similar.

6. Industries Development Commission, *The N.Z. Motor Industry Development Plan*, Draft Report, 1982

Export Assistance

Assistance to exporting industries has now become a major feature of New Zealand policy.⁷ As a policy to help initiate economic diversification from a very small and uncertain base, and to try to ensure that, whatever form enterprises took, they developed the habit of marketing internationally and gained experience at the relevant skills, the original introduction of export incentives probably had much to recommend it. At the outset there was much effort involved in encouraging manufacturers, for example, in becoming committed to exporting, rather than regarding it as an outlet for spare capacity when the (usually protected)

domestic market was relatively depressed. There are reasons to believe that manufacturers now have a substantial investment oriented explicitly to exporting. Table 2 shows the proportion of manufacturing output which is in fact sold in international markets. While this is still quite low it is quite dramatically higher than it was when the incentives were first introduced.

To attribute any degree of success to export diversification policies is not necessarily to assert that this is the most effective way of encouraging exporting. Nor does it suggest that this is a worthwhile strategy to persist with in the future. The very fact of its apparent success is grounds to acknowledge that the initial breakthrough has been achieved and it is time to move to more general, less discriminatory approaches. Instead, however, export activity is being increasingly subsidised to the extent that even much of the traditional pastoral product base is also in receipt of direct assistance.

7. Reserve Bank of New Zealand, *External Structure and Policy*, 1981
Cullen, R. & Wooding, P., *Export Incentives in New Zealand, 1962-77*, Economics Discussion Papers No. 7803, University of Otago, 1978
Lloyd, P.J. et al., *New Zealand's Long Term Foreign Trade Problems and Structural Adjustment Policies*, New Zealand Planning Council, 1980

Table 1:
EFFECTIVE RATES OF PROTECTION IN MANUFACTURING

Industry/Product	Effective Rate(%)
a) Broad Industries	
Food, beverages, tobacco	9
Textiles, leather, apparel	223
Wood and wood products	
Paper, printing and publishing	45
Chemicals, petrol, plastic products	48
Non-metallic mineral products	17
Basic metal industries	4
Other manufacturing	76
Forestry and logging	12
b) Narrow product groups	
Kitchen Table Utensils	123
Plastic Floor Coverings	27
PVC Pipes	523
Plastic Apparel	
Motor Vehicle Assembly	
Automotive Batteries	0 to 320
Automotive Glass	24 to 250
Car Horn	57 to 380
Seat Belts	57 to 620

Table 2:
RELATIVE EXPORT EFFORT IN MANUFACTURING 1978/79

Industry	Percentage of Establishments Exporting	Percentage of Output Value	
		Exporters	All
Food	35.49	60.11	44.30
Beverages	33.33	1.66	1.13
Tobacco	100.00	4.70	4.70
Average	35.81	53.88	39.84
Textiles	48.91	0.49	0.34
Clothing	27.50	8.92	5.12
Leather	59.15	44.19	36.44
Footwear	38.10	5.10	2.81
Average	37.61	21.19	13.96
Wood & Wood Products	25.22	15.06	7.20
Furniture & Fixtures	32.72	12.96	7.51
Average	27.66	14.51	7.27
Paper & Paper Products	54.90	32.62	30.17
Newspapers etc.	22.76	4.85	2.49
Average	28.28	26.38	20.66
Industrial Chemicals	54.69	7.61	3.73
Other Chemicals	69.61	6.35	5.38
Petroleum Products	0.00	n.a.	0.00
Misc. Petrol & Coal	33.33	12.55	5.06
Rubber	44.12	4.45	3.02
Plastics n.e.c.	59.22	9.03	7.44
Average	57.59	6.99	4.56
Pottery, China, etc.	57.14	20.82	17.04
Glass	50.00	11.60	10.01
Other	15.79	3.09	1.29
Average	20.78	7.41	3.95
Iron & Steel	29.63	16.25	15.35
Non-Ferrous Metal	52.94	13.97	5.66
Average	42.62	15.66	11.03
Fabricated Metal Prds.	32.51	8.63	5.27
Machinery excl. Elect.	45.54	16.45	10.26
Elect. Industrial Mach.	51.81	13.06	10.42
Transport Equipment	32.48	12.89	5.52
Meas., Photo Eqpt.	78.26	18.05	15.84
Average	39.81	12.24	7.33
Miscellaneous	54.95	11.11	7.89
Total (excl. food & forestry processing)	37.52	12.16	7.50
Total MFG	37.50	28.57	19.20

Source: Department of Statistics

Table 3 gives some idea of the impact of pastoral assistance. These estimates take into account all forms of price and cost distortion present in the system including direct subsidies linked to output (e.g. SMPs), subsidies on inputs (e.g. fertiliser subsidies), cost excesses on inputs through indirect taxes or protection of other industries, and "assistance to value add-

Table 3
EFFECTIVE RATES OF ASSISTANCE IN AGRICULTURE (%)

	1981	1982	1983	1984
Sheepmeat	11	28	101	75
Wool	3	36	57	10
Sheep Grazing	6	33	72	34
Sheep & Beef Grazing	2	16	23	3
Manufactured Milk	14	8	7	9
Town Milk	26	24	36	45
Dairy	15	10	9	12
Pastoral	8	22	38	20

Source: Bushnell & Gibson, op. cit.

Other Policies

Intervention in the processes which allocate resources are not, of course confined to export or import substitute goods. It is apparent, that a large range of other interventions are made in the economy. It is difficult to draw a sensible boundary between legislation which might be deemed to have an essentially economic intention rather than being motivated by some other aspect of public policy. An extreme position would perhaps regard any form of law or curtailment of "freedom" a barrier to "market forces" but this would be conspicuously absurd. Very little research is available either documenting the extent of economic legislation or the nature of its effects. The following brief survey is not comprehensive, but it should indicate the scope of such policies in New Zealand. More detailed research is desirable.

A major form of government intervention in the economy occurs simply because government departments or agencies are the production unit. Usually there are strong barriers or straightout prohibition to privately-owned establishments operating in competition. A related, but slightly different, form is that of the government-owned corporation. Major examples of the former are the Forest Service (which through the management of state forests have a major influence on the supply of timber), State Mines, the Electricity Division of the Department of Energy, the Post Office, and, until it recently became a corporation, New Zealand Railways. The construction activities of the Ministry of Works and Development are yet another example.

ing factors" (the costs of advisory and research services, interest rate concessions, taxation concessions, etc.). The cost excesses due to other protection in the economy has been assumed arbitrarily at 20% and, as Table 4 shows, the estimates are sensitive to this assumption. More research is needed to achieve greater precision.

Table 4:
EFFECTIVE ASSISTANCE IN PASTORAL SECTOR AT ALTERNATIVE "COST EXCESS" RATES (%)

"Cost Excess"	1981	1982	1983	1984
10	16	32	52	30
20	8	22	38	20
30	2	14	28	12
40	-2	9	21	7

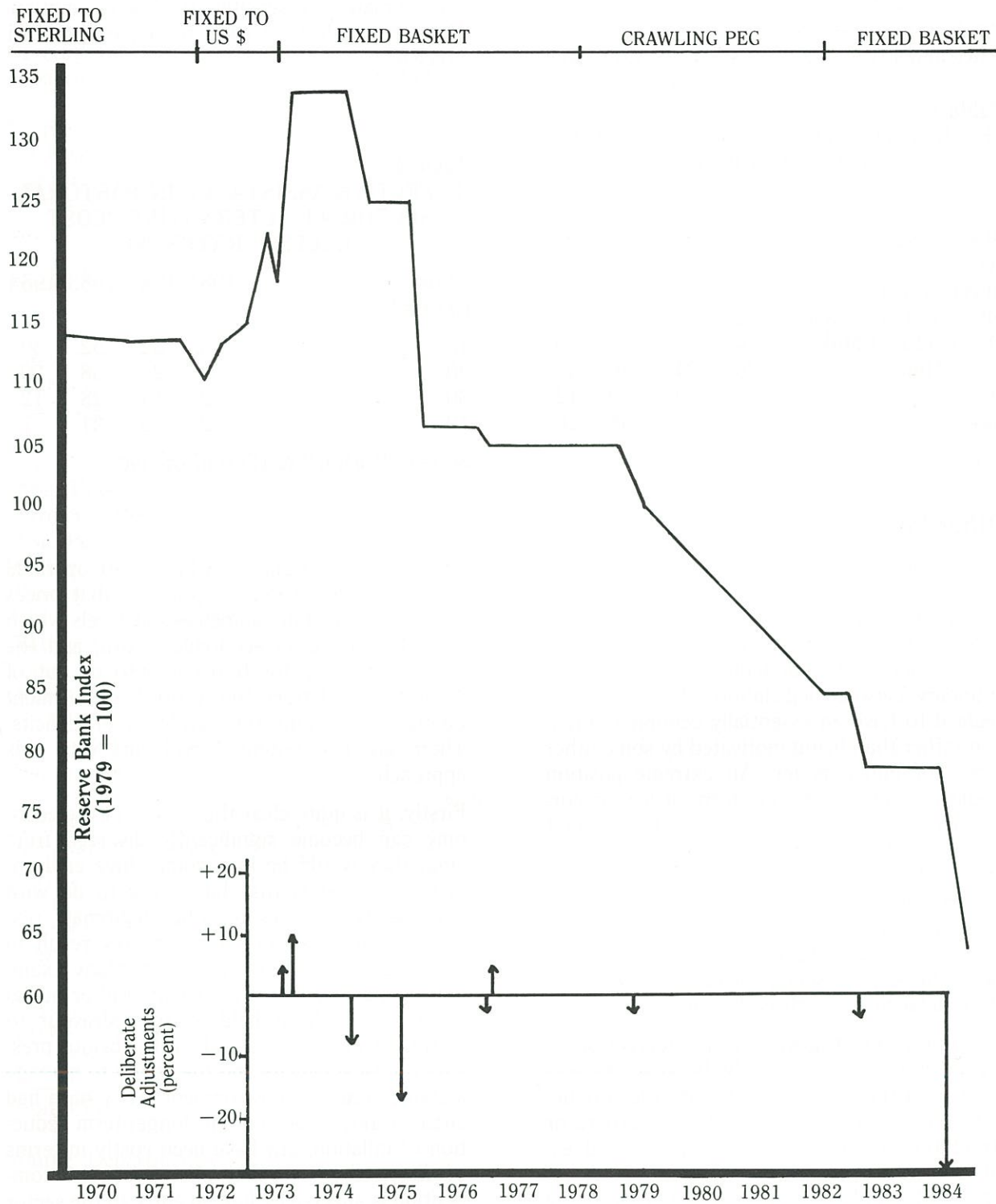
Source: Bushnell & Gibson, op. cit.

The essential means by which state-operated services influence relative prices is that prices are set by the state, sometimes at levels which do not produce an economic return, and the possibility arises for transfers into or out of (usually the latter) the central government budget to account for surpluses or deficits. There are two potential problems with this approach.

Firstly, it is quite clear that prices in the economy can become significantly divorced from what they would be in a competitive environment for reasons that have little to do with genuine externalities or other legitimate reasons for intervention. This can only result in resource misallocation. There are many examples in the past where electricity, rail or postal charges have been held in an endeavour to restrain general price spirals, with obvious pressure on fiscal deficits and the ability to manage a stable monetary environment. They have had virtually no impact on the longer-term reduction of inflation, but have been costly in terms of distorted price relativities. Secondly, competition is affected by limited entry to the sector and by the ease with which losses can be subsidised. Such be an environment is not well suited to the encouragement of efficiency and productivity growth.

Examples of the government-owned corporation are: the Bank of New Zealand, the New Zealand Shipping Corporation, Air New Zealand, the Development Finance Corporation, the Tourist Hotel Corporation, the Natural Gas

FIGURE 4: EXCHANGE RATE TRENDS



Corporation, and Petrocorp. The difference with the trading government department is mainly that the latter has a much greater degree of ministerial control over their operations.

The licensing and regulation of a wide range of economic activity is another, and in New Zealand widespread, form of intervention which affects the conditions under which the private sector is able to function. This clearly affects prices and profitability associated with economic activity. The licensing of the road transport industry, and the historical limitation on the distance that it has been permissible to carry goods in competition to rail, are clear examples of this. Licensing of trading banks has also limited the number of participants in the market, as have other aspects of regulation in the financial sector. The existence of legislation affecting a wide variety of matters regarding land use can also be regarded as a form of public intervention in the use of economic resources. These range from such things as the allocation of water rights to aspects of local body zoning, building regulations and things of that nature.

Direct price controls are another way in which governments have influenced relative prices. The motivation for this varies from overall price stabilisation (similar to restraints on government charges) to attempts to limit the impact of monopolistic structures in some industries. Price controls (usually with accompanying subsidies) on staple food items have been used as a form of family and low-income support but this is limited in scope today.

Conclusions

There are few aspects of economic activity that do not involve legal sanction of one form or another. In an orderly society the rule of law is an essential underpinning of the conditions which allow economic transactions to be undertaken with confidence. Property rights, the rules of contract, banking and currency laws, have to be enforced to ensure this. Another class of intervention seeks to improve competition, or to facilitate bargaining between groups with conflicting interests. Much commercial practice and industrial legislation has these objectives in mind. Apart from this, the concerns of public health and safety, the security of the state, and numerous other requirements justify a government influence over the things we do.

However, when governments intervene because it is assumed that particular industries should be supported and protected they are on much more shaky ground. The intricate web of import protection and export assistance constitute a clumsy and ineffective weapon to tackle what is a structural problem in the New Zealand economy. Because the parts of the economy are interrelated, assistance to one sector constitutes the imposition of costs on others — by bidding up input and labour costs. The real problem arises because there is no way of knowing whether disadvantaged industries are more worthy, in the sense that they would produce greater economic benefits for the resources used. Such is the nature of selective industry support in New Zealand. The idea that the dominant influences on relative prices should be communicated throughout the economy by more general policy instruments is therefore a compelling one.

Doing the Things We Are Best At

It is apparent from the discussion of selective policies that they do not provide a satisfactory environment in which to generate the sort of economic responses that are necessary. The reason is that, although the direct effect of the policies may be to increase relative prices in industries which trade internationally, and thus encourage their growth, they do so at the expense of competition and efficiency. In this situation, a more general policy framework is required which will allow the resource shifts that lead to better economic performance to take place. Within this general framework, individual enterprises directly involved in particular product markets, and disciplined by competition, will determine their own fates on the basis of their own performance. But at least the signals they receive in this sort of environment will tend to point them in the direction which also maximises national advantage.

A key ingredient in this policy framework is to ensure that the relationship between the New Zealand price level and the foreign price level is such as to encourage the growth of internationally competitive activities. Apart from some possible impact on overseas prices arising out of economic diplomacy, New Zealand initiatives can really only affect the price level in New Zealand. Thus if the relationship between New Zealand and overseas prices is out of kilter, the adjustment must be made at the New Zealand end or in the exchange rate.⁸

The fact that New Zealand has run substantial current account deficits for the last decade, and has now accumulated an unhealthy stock of foreign debt is evidence that the New Zealand price level is too high in relation to the foreign price level. That is, the present level of consumption is not sustainable in relation to our ability to pay our way in the world. This arises because the real costs of much of our national output, and hence the real incomes derived from producing it, are fundamentally out of line with its real value in international terms.

Past attempts to hasten structural change have centred on the use of various assistance policies to export sectors — some specifically selective

to activities or sectors such as pastoral farming, or fishing; some more general such as export incentives. There is some evidence that they have successfully diverted investment into exporting, but it has been associated with a substantial fiscal burden (the implications of which have been spelt out in some detail in Economic Monitoring Group Report No. 2) and it has done nothing to address more fundamental potential causes of the inability of New Zealand firms to expand exports. The idea is clear but in practical policy terms we are seeking:

- (a) areas of reform where there are major inefficiencies so that policy action is likely to result in major cost reductions and hence the possibility of significant growth through increased competitiveness
- (b) areas where the effects, whether direct or indirect, on export expansion can be expected as quickly as possible.

In this situation, what are the mechanisms available to reach the cost levels to enable us to pay our way?

- (1) Adjust the nominal exchange rate simultaneously with other measures that achieve reductions in real domestic incomes. The latter might be achieved with combinations of monetary and fiscal policy, and possibly also incomes and prices policies, that prevent or limit the transmission of overseas prices into the general price level. The effect of this is that New Zealand goods and services become cheaper in international terms and our industries become more competitive. The success of the policy on internal growth and employment depends critically on how the domestic economy responds — how prices are formed and the relevant supply and demand elasticities. It also depends on factor mobility. If internal prices and relative incomes are more or less fixed, or if resources are locked in specific activities, it may be difficult to achieve changes in the real exchange rate without substantial unemployment. Policies oriented to resource mobility may also be needed.

The nominal exchange rate has been adjusted from time to time, but in a cautious way, and without sufficient attention to the associated conditions necessary to ensure that the advantages arising from changes

in the nominal exchange rate are protected against inflationary erosion, or are unable to be realised because of resource bottlenecks and other rigidities of the economic system.

Since 1948, when the New Zealand currency was revalued to restore parity with sterling in the face of massive surpluses, high levels of overseas reserves and fears of inflation at home, the exchange rate was altered only once (in 1967, following a British devaluation) until the more inflationary and internationally fluid situation of the 1970s.

The exchange rate has tended to be used as a reactive, or defensive, economic policy instrument aimed at restoring or retaining some established relationship rather than as a positive measure aiming to lead the transmission of international effects to New Zealand traders and domestic producers. The exchange rate was still set formally in relation to sterling until the early seventies, when it became clear that the United States dollar was a more appropriate base. The exact formula has varied during the seventies but the widening base of New Zealand's trade is explicitly recognised in the formula. Nevertheless, despite the increased flexibility that has been built into exchange rate determination this is no more than the minimum that might have been expected in increasingly volatile international monetary conditions. The exchange rate does not appear to have been seen as an instrument of positive structural adjustment in New Zealand.

A very important note to this observation is that even if a much more flexible approach had been adopted with respect to exchange rate adjustment, it is doubtful whether the economic outcome would have been much different, and it may have been worse in terms of inflation and unemployment. Critical to this argument are the effects of protection on internal price levels and hence on relative prices.

In the past, when the export sector was almost entirely based on pastoral products, devaluation was a device to maintain farming incomes at an appropriate level. The situation is now quite different and there is a strong interrelationship between the relevance of the exchange rate as a tool of economic adjustment and the existence of industry protection and assistance. Firstly, the competitiveness of the export sector is no longer a matter of the farmers versus the rest, as is quite clear from an examination of the export structure. Farmers

clearly remain a group who stand to gain from devaluation but they are by no means the only one. Secondly the supply price of New Zealand exports matters. Our earlier observation of the agricultural trade, for example, suggests that the benefit of devaluation may only in part be as a device to transfer income to farmers. Part of its benefit may be an ability of the sector to price its products in world markets in such a way as to achieve a greater market share. Moreover, competitive pricing is clearly of relevance to exporters of manufactured goods. Thirdly, the incidence of selective assistance is now widespread. The inefficiency produced by assistance therefore takes on major significance.

- (2) The alternative to adjusting the exchange rate to alter relative costs between New Zealand and overseas is to reduce the rate of increase in costs in New Zealand below that of our trading partners. This could be done in a number of different ways.

(a) Reduce inflation by appropriate monetary and fiscal policies, supported by other forms of incomes policies. One of the reasons for the suspicion with which devaluation has been held as a valid policy option, and hence for the reluctance of governments to use it, is the possible inflationary consequences. It is regarded as a cause of inflation through the effect of costs of imported materials, and capital goods, the pressure on wages, and thence to a spiral of interacting increases. If devaluation is to work, the effect of rising import prices should be prevented from eroding the benefits to exporters and producers of goods competing with imports to the maximum extent possible. To minimise this, devaluation should be accompanied by tight monetary and fiscal restraints: the two approaches complement each other.

(b) More rapid technological development than in competing activities internationally can lead to lower relative costs. This could result in the New Zealand dollar value of exports being increased in international terms through quality changes recognised in domestic or world markets. Alternatively, New Zealand dollar cost reductions could result in lower pricing in world terms and expanded trade or import substitution possibilities. The success of the latter will depend on the demand elasticities, and the possibility for expanded production of the cheaper good. This scenario emphasises a theme common to all prescriptions of a "successful" real devaluation, that it is nec-

8. In economic jargon this relationship is referred to as the real exchange rate. This is formally defined as the relative price of tradable goods (i.e. goods with the potential to be exported and domestic production which competes with imports) to non-tradable goods. This concept is described more fully in Appendix II, but the main text does not use this terminology.

essary for producers of tradable goods to be in a position to expand production. This can only be done through increases in efficiency.

(c) The removal of protection as a means of altering real cost relativities has been alluded to above. The mechanism through which the costs change is through competition for resources, which is likely to mean a lowering of internal factor incomes committed to protected industries, unless they can continue to compete in a non-protected market, through productivity change, or shift into activities in which they can compete. In addition to border protection, internal economic regulation — as for example in transport or retail trade licensing — is very important.

Action which has been taken in the past has had a mixture of some of these elements at one time or another, although the idea of removing protection has not had high priority. Efficiency and productivity are the critical concepts because it does not become possible for producers of tradables to be able to make their supply prices more competitive without this. It is also evident that higher efficiency anywhere in the economy has the potential to translate into increased competitiveness of exporting and import competing industries. But to get to a viable set of policy options — specific measures which governments can justify to the electorate — it is necessary to do rather more than this.

The real question is not that greater efficiency is needed — but where and how the greatest gains in efficiency can be achieved for any given “cost” (whether that be in terms of reduced real incomes, unemployment, relocation of pop-

ulation, education, etc.). In other words, would an adjustment of the exchange rate under certain conditions so alter profitability of exports and import substitutes that restructuring would occur without prolonged unemployment and other adjustment difficulties? Or does concentration on inflation policy, the removal of protection, or some kind of technology support programme offer better “returns”? Would deregulation somewhere in the internal economy so reduce service costs (better transport, cheaper communications, better marketing or management consultancy) that competitiveness would improve?

The best approach is probably some combination of the above, but it is important that it is consistent, and that it moves towards the resource allocation environment one wishes to end up with.

The seriousness of the prevailing problems of deficit and external debt mean that any discussion of the exchange rate is considered only in terms of devaluation. The Monitoring Group wishes to emphasise that it is relative real costs which matter and that there may be several feasible approaches to altering these. An historical aversion to adjustment of the nominal exchange rate is a clear characteristic of New Zealand governments. This reluctance may well be related to the inflexible nature of the New Zealand economy. While the Monitoring Group would like to see the exchange rate used much more readily, devaluation on its own is no magic cure. The fundamental issues are ones of protection and their effect on resource efficiency and any policy strategy, which may include an exchange rate adjustment, should bear that in mind. A more detailed look at policy options is contained in the next chapter.

Chapter 5:

Policies For Economic Adjustment

The approach to policy in the 1970s has evolved in what was seen as a narrowly based economy regarded as having relatively few genuine production options, and where government could and should identify the main sectors for growth, providing specific incentives to achieve it.

It is increasingly clear this approach has already gone too far. The indirect consequences of selective and targeted assistance mean that for every niche of the economy which is in some way or other protected, some other activity is disadvantaged. The disadvantage is manifest in various ways in high costs and limited adjustment to external events.

This situation could be accepted if there was a strong case that those economic activities suppressed in this way would contribute no more to economic welfare than those which are supported. There is no reason to believe this. In fact, the situation is almost certainly quite the reverse. The most significant cost is likely to be paid not only by existing or *visible* enterprises, but by establishments and industries which are unable to contemplate starting up because of the costs with which they are faced. The time is ripe, therefore, for policy change of a more fundamental kind.

There is a dual problem. It is evident that, because of the persistent tendency for the demand for imports to exceed the value of exports, there is something wrong with the valuation of these types of economic activities in real New Zealand dollar terms and the impact this has on relative prices throughout the economy. The relative prices of exports and imports do not sufficiently encourage New Zealanders to economise on imports through the price mechanism, or to sell the output of the economy on world markets.

This final chapter to the report considers how new policies can be implemented. The critical outcome sought is economic responsiveness, or the ability of various sectors of the economy to adapt effectively and quickly. The New Zealand economy is not now sufficiently flexible. This means that many industries, including some elements that are traditionally thought of as being internationally competitive, may find adjustment difficult. If the policy environment is altered very rapidly a high rate of business failure and unemployment increase is a very real danger. Two things deserve emphasis in this respect.

Firstly, the essence of the move to economic flexibility is that it is intended to *create* more opportunities that it destroys. The essence of economic restructuring is that it is a process of winding down some activities and of winding up others. It is a basic assumption that new activities should produce greater economic benefits than those which are reduced.

Secondly, while a gradualist approach has certain appeal through recognition of possible adjustment costs, it is critical to recognise that the restructuring produces cost reductions arising from a more open economic climate. The one cannot be had without the other. To move too cautiously, therefore, may delay the reaping of the benefits of change and hence of returning to growth and full employment. There is a strong suggestion that caution and delay have been at the heart of the problems of the last decade.

The first principle to articulate concerning an economic strategy is that government policy should be restricted mostly to macroeconomic matters — the relationships between the key macro-markets described in Chapter 2 — and that detailed matters of investment choice and product mix be left largely to the marketplace.

Governments have available the following policy instruments:

- Exchange rate policy
- Budget policies
- Import licensing
- Tariffs
- Export assistance
- Financial market policies
- Internal regulation (or removal of rigidity)
- Financial market policies
- Incomes policies
- Price controls (including public sector pricing)

Exchange rate policy

The exchange rate and the methods which are used for determining it have had a prominent place throughout this report. It will by now be clear that the Monitoring Group believes the government should be prepared to use exchange rate policy as a lever for economic structural adjustment much more readily than has been its custom. Certainly an attempt to operate fixed exchange rates in the manner of the 1950s and 1960s is quite inappropriate. But beyond this there is a very large spectrum

of possibilities ranging from true floating (letting the foreign exchange market find its own price and relying on economic participants to make their own adjustments), through varying degrees of market determination with periodic buying and selling by the Reserve Bank in order to influence the rate, to some form of basket or trade weighted formula which fixes the value of the currency but allows it to alter quite frequently depending on movements in key world currencies or differing trends in average relative costs. The Monitoring Group is strongly in favour of an exchange rate regime which is much more flexible than has been used previously, even in the recent past. As the economy becomes more flexible the inflationary potential of moving the exchange rate would be less worrying. A sizeable shift of the exchange rate to move the economy in the direction it needs to go is also a possibility, but it is most important that considerable attention is devoted to achieving the conditions which will maximise the advantages of such a move.

As for the devaluation of 18th July, 1984, this report has argued strongly for a more flexible use of the exchange rate as a means of ensuring that relative prices for activities within New Zealand reflect their international competitiveness. But it has also stressed that the impetus for growth will arise from reductions in government intervention, and a package of other policies designed to enhance the responsiveness of private investors to market opportunities. On the best information available, it seems clear that the speculative pressures on the currency accompanying the recent election made the devaluation inescapable. It is pertinent to observe that the fundamental underlying economic imbalances have been obvious for some time, and it is hardly surprising that the possibility of a change in administration had this effect. Recent announcements by the Government indicate a preparedness to put in place appropriate policies to accompany the devaluation. Obviously, the Monitoring Group would have preferred to see more action on these accompanying measures before any currency adjustment was considered, but in the particular circumstances this was not possible. The Monitoring Group would regard with alarm the translation of import price increases following devaluation into wage and other income rises.

Budget policies

These have been extensively dealt with in the Monitoring Groups's previous report. They concern the links which exist between government deficit financing, real interest rates, and expansion of the money supply. The most important characteristic for policy to achieve is consistency. The idea that aggregate demand manage-

ment policies are a useful means for fine-tuning the balance between inflation and unemployment is now regarded with considerable scepticism. Macro policies of this kind can certainly speed up real growth or restrain prices (enhance international competitiveness) in the short term but the malaise that has been identified in the economy is clearly of a long-term character. For this reason the Monitoring Group sees the control of monetary growth as an important precondition for non-inflationary expansion. There should be little, if any need, for official regulation of interest rates, as it is government's own deficit financing activities which are a major reason for their high level.

Import licensing

Direct import control now offers little benefit, short or long term, to the economy. In this respect therefore, a recent government announcement that import control is to be phased out over a five-year period is an important signal. Obviously, it would be desirable if licensing could be dispensed with earlier, but it has been an integral part of our system for so long that it is understandable that many affected interests have some difficulty in foreseeing how they would get on without it. Given the need to achieve sufficient consensus regarding the wisdom of dispensing completely with licensing, and the difficulties inherent in this, a five-year programme of liberalisation is probably appropriate. The announcement of such a programme backed by action that indicates it will be implemented, will probably mean that the process of adjustment will begin immediately and the economy will almost certainly be much more competitive and responsive long before the deadline is reached.

Tariffs

It is very important that selective protection to imports be reduced overall. The Monitoring Group sees the exchange rate coupled with suitable macroeconomic policies as being a much more desirable method of supporting import competing activities. Nevertheless it seems clear that a more immediate objective is to even out the discriminatory impact of present protection policies. Tariffs tend to be lower for raw materials and capital equipment, and higher on consumer goods, so that a policy of achieving an evening of effective protection could require an *increase* in some tariffs, even if the overall protective effect was to be lowered. Industries using a high proportion of low tariff inputs tend to have higher effective protection than many other industries with quite high nominal protection. Many, of course, get it both ways. Our aim should be an evening out of rates of protection followed by a reduction of the av-

erage level to the point where the exchange rate bears the burden of protection.

Export assistance

Assistance to exporters has steadily increased in incidence as erosion of the terms of trade, the high costs imposed by import protection, and the difficulties of diversifying a small and geographically remote economy have been more generally perceived. These policies are as potentially damaging to efficiency as hard core import protection, as they become imbedded in political processes and the general policy environment. This class of measures, therefore, has little to commend it in the medium term, and the economy would benefit from an early phasing out of these concessions. The problem in discarding export assistance, including subsidies to farmers, is that a large volume of clearly desirable economic activity is supported by it. The question arises, then, why discard it? The answer is simply that it does not provide with sufficient accuracy the signals which should come through from international markets regarding advisable changes in product mix, quality, and competitive pricing.

The answer to this dilemma lies in appropriate exchange rate policies. Investors require the confidence that they will be provided with an exchange rate which will fairly compensate them for any loss in competitiveness entailed in being asked to forego such things as export incentives and other fiscal supports. The requirement of the policy is to provide exporters with a "fair" exchange rate — that is, one which gives them an even chance of successful international competition provided they are sufficiently innovative and can achieve productivity growth in their businesses. Again this comes back to the responsiveness of the economy.

Financial market policies

The freeing up of financial markets which took place between 1976 and 1981 was beginning to produce capital markets much more suited to the type of economy New Zealand is becoming, and the Monitoring Group would wish to see a return to this structure as soon as possible. Without it, the pressures by innovative, but risky, new industries for direct government assistance will continue.

Internal Regulation

Internal economic regulation potentially entails barriers to resource transfer and efficient allocation of similar importance to trade policies. This is a large and little researched subject in this country.

The appropriate role for licensing and other such regulatory apparatus affecting the private

sector role can only really be judged on a case-by-case basis. Recent transport delicensing legislation (which has in effect increased competition between road operators and government-owned railways) is clearly desirable. There is no justification for persisting with arbitrary and inhibiting operating rules for those who might seek to exist in competition. If the outcome is a rejuvenated and competitive railways service more able to maintain or increase its market share, so much the better.

The need to hold a licence to operate, however, is not necessarily inappropriate. Licensing can provide a necessary overall vetting of the number of participants in areas where to do otherwise would lead to inefficiency. Clearly, however, the licensing route has been extensively over-used in the past and should be used only sparingly in the future.

Incomes policies

A vitally important question, about which little has been said in this paper, is how policies affecting the labour market should be approached. Success here is pivotal to the success of other structural adjustment policies, because labour costs are a significant element in total production costs in virtually every sector.

In principle, the concept of a consensual incomes policy is attractive, as an adjunct to the other structural policies suggested. In practice, it must be conceded that the track records of various "social contracts" around the world have been disappointing. It is dangerous to oversell the nature of the future benefits that might be achieved in return for "sacrifices now", which is inevitably the nature of any such approach. Inevitably there will be a degree of conflict of interest between employers who see benefits for competitiveness and expansion if labour costs are held, employees who are mistrustful that they are fully informed about enterprise viability, and governments. Despite these traps, the Monitoring Group favours incomes policies to assist adjustment provided too much is not expected of them, and provided they are not regarded as a substitute for effective monetary and fiscal policies. Attention could be drawn to the correlation between New Zealand's effective, if uneasy, consensus in the 1950s and 1960s and the low inflation rates of the period.⁹ However, care should be taken not to read too much into this, if for no other reason than that replication of the total political and social environment which existed then is not possible.

9. For example, see Monetary and Economic Council, *Inflation and the Labour Market*, Report No. 22, 1971.

Conclusion

There is no simple or straightforward answer to New Zealand's economic problems. There is no one statistical measure by which the economy's performance can be judged. The economy must be founded on activities which are internationally competitive, and investors must be given the framework of markets to identify these activities. The ultimate objective is sustainable growth of living standards at full employment of resources.

The thrust of the argument in this report is that government needs to concentrate on medium-term objectives, and to devise a strategy for achieving them. This strategy recognises the need for policy trade offs and tactical compromises in the short term. Thus exchange rate adjustment accompanied by suitable deregulation is important because of its impact on economic flexibility and efficiency despite some interim inflationary impact. Inflation in the longer run can be controlled with consistent budget policies, and perhaps an appropriate incomes policy to aid adjustment at critical points. The competition accompanying liberalisation will be a factor allowing overall demand management to be more effective.

Not all the successes will be achieved simul-

taneously, but past policies offer only continued stagnation and ultimate decay as inflexibility chokes off the changes that will enable the economy to adapt and profit from the changing international and domestic environment.

In conclusion, the Monitoring Group draws attention to its two previous reports dealing with the impact of the external and internal deficits. These deficits are both symptoms of our overall problems and constraints on solutions. The overseas deficit has resulted in an accumulation of external debt for which the servicing commitments are too high in relation to levels of export receipts. This situation has arisen because of the failure to initiate structural adjustment policies of the kind dealt with in this report. The government deficit is a major inflationary influence on the internal economy, and this makes it very difficult for the business sector to recognise changes in relative prices and profitability that will be needed to signal restructuring opportunities. The restoration of the health of the New Zealand economy by improving its competitiveness thus requires bold action on several fronts. However, reducing the budget deficit is a central theme in the medium-term strategy we are proposing.

APPENDIX

Appendix I:

The Measurement of Import Protection

Despite over 40 years of a strongly protectionist approach to economic management in New Zealand there is relatively little concentrated economic research on the subject. It is to be acknowledged that the empirical techniques suitable for examining protection have been developed relatively recently. After some early publications by Candler and Hampton (1,5), P.G.Elkan of the New Zealand Institute of Economic Research was very much a pioneer in the field during the 1960s, and during the 1970s the first comprehensive measures of effective protection were published (3). These remain the only original estimates of the price distortions effects of protection, although there have been some attempts at updating them using essentially "shortcut" statistical techniques (4,6). By the 1970s, especially following the work of Corden (2) and others in Australia, the theory and techniques of measuring effective protection have become better known. It should be noted that the use of import control as the principal protective policy instrument poses especially difficult research problems. Reliable estimates can be made only on the basis of exhaustive international commodity-by-commodity price comparisons. The recent introduction of tendering for import licenses in New Zealand opens an opportunity for using the market prices of licenses as a surrogate for the equivalent tariff, so this particular difficulty may lessen in the future.

The Project on Economic Planning at Victoria University has approached the long-term effects of protection within a general equilibrium modelling framework. As a result much useful data collection and analytical calculations regarding the effects of protection have become available (3,7). More recently the New Zealand Treasury commissioned and published a major study into the measurement and effects of industry assistance (8). This document contains a review of the techniques for measuring industry assistance, and enters some new territory with statistical estimates of the extent of assistance to the export sector. As yet, however, protection estimates available overall are

patchy as to detail and difficult to assess and compare chronologically.

The effective rate of protection measures the extent to which the value added in any industry (i.e. the amount which is available to pay incomes as profits or wages — including transfers for debt servicing and income tax) is raised above the value added that would be possible if all internal prices (exchange rate adjusted) were at world levels.

Of the several attempts to measure effective import protection in New Zealand, the study by Elkan is the outstanding landmark. However a careful reading of this painstakingly written and researched document only serves to emphasise the need for caution in interpreting any empirical measurement in this field. By drawing on various piecemeal sources Elkan was able to claim 300 valid commodity price comparisons for the period 1964-67. Although this number compares relatively favourably with the 500 or so (out of the literally thousands of commodity specifications possible) recommended by UNCTAD (9) as a sample to be taken as representative of world trade, the inevitably scratchy nature of data available meant that the selection of commodities was less than ideal. There must be some doubt, therefore, that the 300 constitute a realistic slice of New Zealand industry. Elkan was unable to repeat even this degree of measurement for any other period and, to estimate protection in the 1950s fell back on the assumption that, because of import delicensing carried out by the first National government, the bulk of protection could be estimated from the tariff with minor adjustments to account for residual quota protection. Other studies available, by and large, attempt to update Elkan's fundamental measurements for the 1964/67 period using relative movements in broad price indexes, in similar fashion to the way Elkan tracked back to 1957/58 in his own work. Whereas Elkan's justification for using this technique was perhaps, on balance, reasonably plausible, it becomes less so for projection into the future, especially as import control has remained an important, if not the

main, instrument of protection until the present time. The results from various studies, adjusted as far as possible to represent a similar sectoral classification, are compared in the following tables. They in fact suggest decline in average effective protection during the 1970s in a number of industries, but because of the method of calculation it must remain highly debateable whether anything meaningful can be taken from this. A freshly compiled set of comprehensive estimates is urgently required for policy analysis.

A second, but possibly less crucial point about all key studies measuring protection is that all

of them used unofficially adjusted input-output tables to compile estimates — a function of the availability of data at the time studies were done. With full sets of official input-output tables now available for 1959/60, 1965/66, 1971/72 and 1976/77 the possibility exists to rework each of the main studies with the official (and presumably better) numbers. However, the Monitoring Group suspects that the ability to depict accurately the nominal price effects of protection far and away dominates any errors in the estimates that have been made and would make any such updating a lower priority.

Table Ia:
Estimated Nominal Price Margins over World Price Levels due to Import Protection in Manufacturing Industries

	1955/58	1964/67	1972/73	1978/79
	(percent)			
Beverages & Tobacco	120.0	133.6	64.2	12.8
Wool Textiles	29.0	37.1	32.0	21.3
Other Textiles	28.8	62.1	28.9	*
Footwear	35.7	58.8	43.2	35.7
Clothing	47.9	102.8	62.9	54.4
Furniture	44.3	67.9	27.7	21.0
Printed Products	20.8	29.8	0.0	0.0
Leather Goods	20.8	53.4	35.6	28.5
Rubber Goods	22.2	56.3	43.7	36.7
Chemical Fertilisers	0.0	0.0	0.0	9.3
Petroleum Products	17.1	3.4	-10.1	0.0
Other Chemicals	28.3	45.4	32.6	25.7
Non-metalic Mineral Products	4.0	23.0	19.0	12.7
Basic Metals	4.7	60.8	12.1	6.3
Metal Products	39.1	81.0	39.2	31.9
Machinery	45.9	59.0	33.2	36.0
Electrical Products	41.9	91.5	63.2	**
Vehicle Assembly	60.7	47.8	52.4	22.7
Other Transport Goods	35.0	35.0	45.4	***
Miscellaneous	34.4	73.6	44.5	36.9

* included in Wool Textiles

** included in Machinery

*** included in Vehicle Assembly

Table Ib:
Effective Rates of Assistance to Value Added due to Import Protection in Manufacturing Industries

	1955/58	1964/67	1972/73	1978/79
		(percent)		
Beverages & Tobacco	-31.3	-9.6	61.0	20.8
Wool Textiles	78.3	101.7	89.0	44.8
Other Textiles	41.1	195.5	67.1	*
Footwear	57.1	98.7	68.7	51.1
Clothing	124.4	1105.4	169.4	139.7
Furniture	91.9	200.0	41.3	-28.7
Printed Products	16.3	29.4	-19.2	-12.1
Leather Goods	37.4	192.9	112.1	84.0
Rubber Goods	21.8	90.6	111.1	67.5
Chemical Fertilisers	-23.8	-29.7	-1.5	8.9
Petroleum Products	42.8	-39.3	-65.9	-47.5
Other Chemicals	45.7	75.6	104.6	77.0
Non-metalic Mineral Products	-15.1	13.9	22.8	16.6
Basic Metals	-5.8	161.8	10.3	3.0
Metal Products	83.2	616.5	99.5	74.2
Machinery	135.9	99.2	57.0	81.1
Electrical Products	116.6	406.1	365.3	**
Vehicle Assembly	2428.3	101.5	-165.4	40.8
Other Transport Goods	38.5	32.8	49.8	***
Miscellaneous	69.0	186.4	92.8	77.1

* included in Wool Textiles
 ** included in Machinery
 *** included in Vehicle Assembly

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The Real Exchange Rate¹⁰

When international trade is important to the economic structure, questions of resource allocation, productivity and desired balances between macro-markets may be examined in terms of "the real exchange rate". It is important to distinguish the real exchange rate from the nominal exchange rate. The latter refers to rates at which currencies change hands in foreign exchange markets, and may for present purposes be thought of as the arithmetic converter that enables price level comparisons between countries. The real exchange rate is concerned with comparative real costs of production for competing activities, and is closely allied to the concept of "competitiveness". Quite clearly the nominal exchange rate, in combination with other prices in the system (nominal wages, prices of industry inputs, etc., plus all relevant overseas wages and prices) is important in being able to recognise the state of the real exchange rate. Ultimately, if the economy is to be able to expand, and to adjust in appropriate directions when subjected to changes in external circumstances, these international price and cost comparisons have to be reflected internally as price relativities which business managers can react to.

The real exchange rate is formally defined as the relative price of tradable to non-tradable goods. Tradables are exports of goods and services (exportables) together with domestically produced goods and services competing directly with imports (importables). It is convenient to think of tradables as the "goods" element in the familiar "goods and services" representation of economic output, although, strictly speaking many services can be traded internationally also, as our definition implies. Non-tradables, therefore, consist of all other production, and may be thought of broadly as the services sector.

If there is sufficient openness to external competition the prices of tradable goods are determined in international markets (allowing some margin for any "natural protection" due to transport and transactions costs). Thus export

production and sales, and production of import competing goods, are carried out in a context of world prices and competition from other world suppliers. Prices for non-tradable goods, because they are not subject to direct international competition, are largely determined in the domestic economy. The nature of internal competitive processes obviously dominates the way this happens. In aggregate, non-tradables prices are closely linked to domestic inflation and the rate of growth of the domestic money supply. Depending on attitudes and options of the policy-makers, the domestic economy may be stimulated to allow any increases in tradables prices (especially imports) to be passed into the general inflation rate. In other words non-tradables prices as a whole increase also.

The options referred to depend on the willingness of the policy-makers to maintain the prevailing import flow if import prices (or prices of other tradables) increase. The effects within the internal economy of taking measures to restrain the import flow can be expected to influence the relevant decisions. If foreign reserves are low and an increase in foreign debt is considered undesirable, increases in the demand for foreign exchange may not be viewed favourably. On the other hand, if the only measures available to restrain imports would cause a general economic contraction, the effects on employment and incomes may not be desired either. Clearly if there were options available which would lead to at least one of the following:

- an increase in export receipts through responses in export production, so that foreign exchange outflows can be maintained without adding to overseas debt;
- an increase in domestic production of import substitutes to replace previous imports;
- an increase in the demand for and production of non-tradables that *does not* also entail increased demand for imports;

then it might be possible for employment to be maintained without adding to the external deficit. The third case could happen only if consumer demand for services increased relative to goods. A perhaps unlikely, but graphic, example might be the employment of domestic servants for cleaning to replace vacuum cleaners. It seems plausible that there would only be an effective demand for this structural change

if the wages for servants were extremely low. In general it may be said that all of the above possibilities necessitate not only an ability within the economy to shift resources, but the willingness (or incentive) to do so. Even if the shifts occur, there is no way that average incomes can be maintained if there is not also an increase in productivity or efficiency. The policy questions hinge on the economic environment which would allow these responses. The question of devaluation should be addressed in this context.

New Zealand policy-makers have persistently been disposed to restrain the internal economy because of external current account deficits. This is a result of (and to some extent responsible for) the view that the economy has a foreign exchange constraint. It is common for commentators, observing greater demands for foreign exchange than supply, to say that the exchange rate is "overvalued". Implicit in this assertion is the assumption that higher import and export prices would result in some combination of the above three effects.

What is really meant by this is that there is something wrong with the real exchange rate, and that it is out of line with the nominal exchange rate. Internal prices of importables and exportables are low in relation to all other prices. Consequently there is not sufficient economic incentive to attract resources into enterprises with tradable output as opposed to non-tradable output. The result is that the economic structure leans in the direction of non-tradables production. Real demand is weighted therefore by the incomes earned in the non-tradables sector. Purchasers in the domestic economy have a tendency to obtain importables as imports rather than as domestic substitutes. Unless there is a shift in consumption towards non-tradables (which is unlikely because tradables are relatively cheaper) there is an external deficit. Producers are not sufficiently attracted to production of import substitutes or exports because the set of relative prices and costs they are faced with make non-tradables relatively more profitable.

Mere adjustment of the nominal exchange rate does not, on its own, offer any lasting solution to this problem. A devaluation of the nominal exchange rate that is not accompanied by a rise in the general price level (i.e. allows tradables prices to rise but not non-tradables prices) can, however, alter this relationship. This means that real income in the non-tradable sector must fall (and possibly also real income for certain factors — say labour — in the tradable sector). Effectively this means that competitiveness in the tradables sector is increased by a general reduction in real incomes. The eventual outcome in terms of growth and employment

is dependent on the ability of the tradables sector to increase its sales volume in these circumstances.

Alternatively, tradables producers who might have been competitive at the old exchange rate could decide to actually reduce nominal supply prices and increase profitability through larger production runs, or reduced overheads. The extent to which this would lead to growth depends on marketplace responses to lower prices. Clearly it is also necessary for internal costs to be contained following devaluation for advantages of this nature to be sustained.

Finally, it is necessary to emphasise the importance of efficiency in the use of economic resources. The competitiveness of tradables may well be enhanced by devaluation and policies which result in reduced real incomes. But any opportunity to lower costs through productivity gains modifies the extent to which real incomes need to be reduced to achieve the same outcome in competitive terms. The New Zealand economy has relatively poor productivity characteristics, a feature which has been linked to the uneven and high levels of sectoral protection and regulation in the main text of this report. Policies resulting in improved productivity would reduce the extent to which tough fiscal and monetary policies necessarily accompanying devaluation would lower real incomes on the one hand, or limit the extent to which the relative price effects of devaluation might be lost in inflation on the other.

Empirically the real exchange rate is not a precise concept. To begin with the distinction between tradable and non-tradable goods is ambiguous. A crude classification would suggest that commodities which are physically transportable, perhaps omitting a few where very high transport costs in relation to value, or storage problems, constitute effective "natural protection" (e.g. ready mixed concrete), are tradables, and services which usually are not transportable or storable are non-tradables. But this cannot in practice be done very easily. The nature of tourism, for example, indicates how arbitrary the distinction in fact is. Various retail and accommodation services purchased by visitors from abroad are clearly "tradable" in the sense that we are using the term but they do not lend themselves to this classification in the usual order of things.

Likewise, a large number of professional, financial, and consulting services can be performed for overseas residents. The nature of many activities within the building and construction sector, on the face of it a clear candidate for classification as "non-tradable", is yet another example. Overseas sales of prefabricated buildings, the commissioning of engineering and construction teams and equipment

10. This appendix deals with a technical concept widely used in economic literature to describe resource allocation and adjustment in open economies. It is provided largely as an extension to Chapter 4, but it is not part of the main flow of the argument. Readers wishing a more comprehensive explanation of the concept are referred to the following book, which also includes a useful list of references. Williamson, John, *The Open Economy and the World Economy*, Basic Books, New York, 1983, especially Chapter 8.

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from abroad, and the transshipment of "finished" construction products such as oil rigs, all indicate the presence of a "tradable" character in the industry. Electricity supply, water reticulation and other public utilities, government health and education services, possibly are as close as it is possible to get to genuine non-tradables.

Bearing these points in mind it would be extremely difficult to classify virtually any form of economic activity with certainty. In New Zealand, the matter is additionally complicated by the manner in which import licensing operates. Manufacturing enterprises producing import substitutes would normally be regarded as making tradable goods. But import licensing has tended to be operated in such a way that many commodities receive total protection. Direct import substitutes are effectively prohibited by licensing. This means, in effect, that those commodities are declared non-tradables through administrative regulation. Protection generally, even when it is not prohibitive, introduces a non-tradable element into what would normally

be clearly tradables production. The point is particularly important because it highlights the role that protection plays in eroding the competitiveness of non-protected tradable goods.

Thus any attempt to get a numerical measure of movements in the real exchange rate by weighting various price indexes together is likely to be inadequate. The surest measure that the real exchange rate has been unable to adjust to an appropriate level for balanced growth is the persistence of external current account deficits while the economy has had declining living standards and rising unemployment. The key issue in policy terms is recognising the problem as one of relative prices. Nominal exchange rate adjustment only produces satisfactory results if other conditions prevail. In practice this means an environment of low inflation where incomes are increased as a result of competitive efficiency rather than to maintain past consumption standards that cannot be sustained. This has implications for macroeconomic policies, for incomes policies, and for competition policies (protection).

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