1 Introduction to the New Zealand economy

INTRODUCTION

New Zealand is a small open economy with an income level that places it among the richest countries in the world. As an open economy, New Zealand has vital links with the rest of the world via trade, migration flows, historic, diplomatic, sporting and cultural affiliations, and market connections in products, components and financial flows. These connections have been developing since the late 18th century, when regular transport and communication links were established with other economies. And as a small economy, with a population of 4.5 million, New Zealand is strongly influenced by offshore market performance through such global ties.

Nevertheless, New Zealand's institutions and governments do influence its economic destiny. The strength of the global connections, in one sense, limits the country's freedom of action as compared to very large economies such as those of the United States, Japan, China and Germany. Yet, in another sense, New Zealand has greater freedom of action than these large countries. Decisions can be taken nimbly; our actions tend to have small effects internationally and are less likely to draw the attention of other countries.

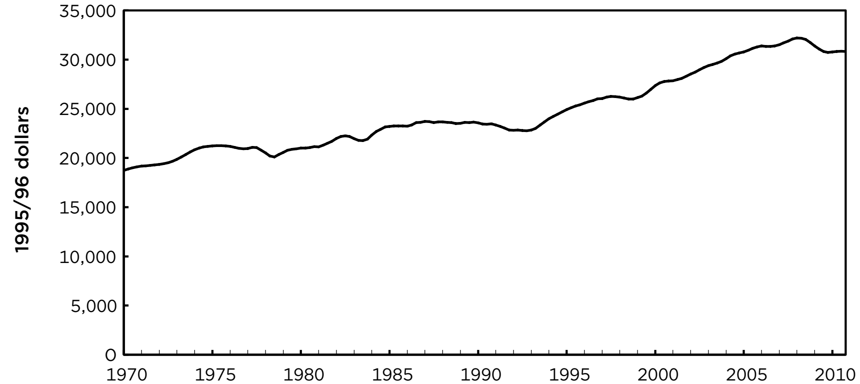
MEASURING THE ECONOMY

A convenient starting point from which to discuss the structure and performance of the New Zealand economy is with a key indicator of overall economic activity – gross domestic product (GDP). GDP is useful in explaining employment and inflation. It is also useful in comparing economic activity levels between countries because GDP numbers are prepared on a standardised basis according to United Nations guidelines.

This aggregate indicator provides us with a snapshot of various aspects of the economy, but it needs to be clearly understood. GDP is not a complete measure. It is an estimate of the total value of final goods and services produced in the New Zealand economy over a particular time period, say a year. However, GDP does not measure people's wellbeing, happiness or wealth. In economics, there are various measures of performance or economic welfare but they are beyond the scope of this introductory book. GDP is discussed here because it is a reasonably straightforward and widely available measure of economic activity. While it tends to capture broad trends in economic activity and consumer welfare, GDP is not a perfect indicator.

Graph 1.1 illustrates GDP in New Zealand since 1970 on a per person basis expressed in real terms – that is, with the rate of price inflation removed so that GDP is closer to 'concrete' changes in economic activity. Real GDP measures activity using the purchasing power of a base year. The vertical axis of the graph measures real GDP per capita in New Zealand dollars using 1995/96 prices in the calculation. In 1970, real GDP per capita was around $19,000, and in 2010 it was around $31,000 – an increase of 63 per cent over the period. This increase in real GDP per capita is caused by two factors: the increased production of goods and services (often via productivity improvements); and the availability of additional resources (human and physical). However, real GDP per capita has not increased smoothly. Analysis of the dips in the graph reveals much about New Zealand's economy, as these recessions often changed its path. We discuss the largest downturns below.

Graph 1.1 **Real gross domestic product per capita, quarterly, 1970–2010**



Source: Statistics NZ
Gross domestic product data is sourced from the following:
1934–1977: McDermott and Hall (2009)
1977–1987: Statistics NZ, SNBQ.S2SZT
1987–current: Statistics NZ, SNCQ.S1RB01S
Population data is derived from:
1934–1991: Statistics NZ, de facto population, DPEQ.SBEC
1991–current: Statistics NZ, resident population, DEPQ.SDAC

In 1973/74, the world price of oil rose from US$2 per barrel to US$10 per barrel when the Organization of Petroleum-Exporting Countries (OPEC) cartel forged a consensus that enabled them to restrict oil exports following the Arab–Israeli war. New Zealand imported most of its oil at this time and the 1970s oil price hikes caused New Zealanders' cost of living and business's production costs to increase rapidly. Real GDP per capita stopped rising.

The government partially offset the effects of rising oil prices in the early 1970s by borrowing offshore. But it eventually exhausted its credit lines. Without this support, real GDP per capita eventually fell in 1978 and 1979. OPEC export quotas were tightened again in 1979, causing oil prices to surge and deepen New Zealand's economic problems. The decline in GDP from 1978 to 1979 is called a recession. The recession of the late 1970s caused downward pressure on living standards, employment, investment, the exchange rate and a range of other indicators that will be discussed in later sections of the book.

One of the most complex recessions was the stagnation in real GDP per capita from 1985 until the early 1990s. In 1984, the newly elected Labour government faced a foreign exchange crisis and chose to radically reform economic policy from a *command and control* economy towards a more *market-based* economy. This included withdrawing subsidies, floating the exchange rate and moving towards more flexible labour market policies. The policy changes caused a severe dislocation of economic activity as resources moved between sectors to accommodate the new market environment. Real GDP per capita only resumed growth in 1993.

In 1997, the Asian Financial Crisis adversely affected the economic performance of South Korea, Thailand, Taiwan, the Philippines and Indonesia. These are important markets for New Zealand exports and the crisis caused export demand to fall. Because export demand is an important component of total demand in New Zealand, the economy again went into recession.

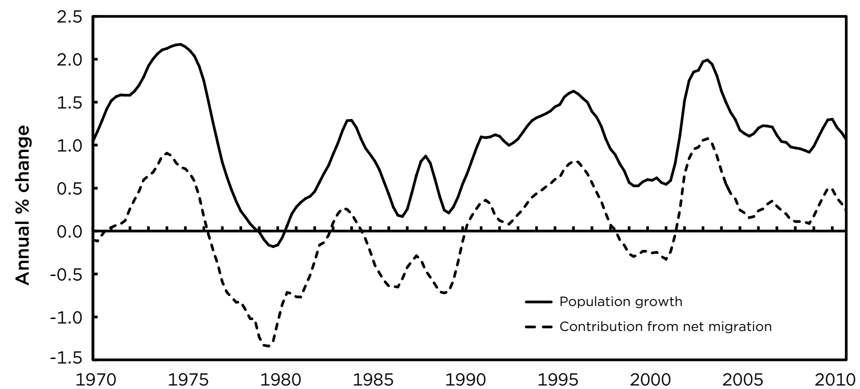
Over the summer of 2007/08, major dairy farming regions in New Zealand experienced a drought. This is an unusual event in the Waikato and Bay of Plenty. Dairy production and exports fell, along with farmer expenditure on inputs. The drought coincided with the Global Financial Crisis (GFC). During the GFC there was a partial breakdown in trust between major global banks, which threatened the world's payments systems. Investors' appetite for financial risk was severely reduced. The crisis was initially felt in housing markets around the world, which had become increasingly unaffordable. The northern hemisphere GFC and significant interest rate increases by the Reserve Bank of New Zealand (RBNZ) provided the triggers for adjustments in the New Zealand housing market and household consumption. Housing construction declined from late 2007 through to late 2009 and property prices fell by 7 per cent over the same period. Household consumption slowed through 2008 and early 2009. These influences show up in the fall in real GDP per capita in 2008. Much of the world economy (including New Zealand) is still dealing with this correction in house and property prices and the aftermath of the financial crisis. The effects on New Zealand are further discussed in Chapter 7.

There appear to be two distinct phases in real GDP per capita growth over the period 1970–2010: slower economic growth (shallow upward trend) from 1970 to the early 1990s; and faster growth (steeper upward trend) from the early 1990s to 2010. Part of this improving growth rate may be due to the package of economic reforms that was initiated in 1984. However, changes in the market environment caused by globalisation and the rise of the Asian economies, discussed in Chapter 3, probably also had a significant effect on the growth rate of real GDP per capita. Significant increases in household debt funded by the savings of foreigners, discussed in Chapter 6, are also likely to have played a part.

KEY GDP DRIVERS

The brief discussion above suggests a number of key drivers that influence real GDP. The first driver is population. The working population contributes directly to national output through employment and the total population also influences the final demand for goods and services in the economy. The natural increase in the population is usually smooth but net migration is quite variable, Graph 1.2.

Graph 1.2 **Population growth and net migration contribution, 1970–2010**

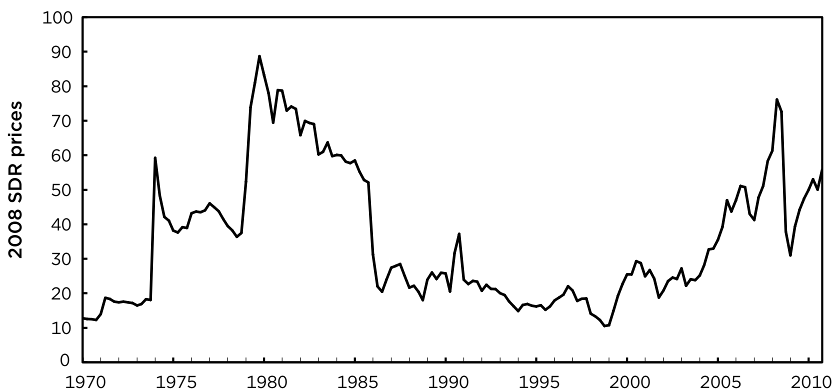


Source: Statistics NZ
Population data as per Graph 1.1
Net migration data: Statistics NZ, ITMQ.SPZNA

The New Zealand population growth rate has averaged 1.4 per cent per annum since 1950. The natural increase in population (births less deaths) is fairly stable. However, migration causes considerable variation in population growth over time. In 2001, population growth was just below 1 per cent and net migration was minus 10,000 persons per year. In the following year, net migration rose to 40,000, boosting the population growth rate to 2 per cent. This led to a significant increase in household spending on goods and services and a construction boom. Real GDP per capita rose steeply over this period.

World prices of New Zealand exports and imports also affect GDP growth. As discussed earlier, oil prices and other import price rises cause GDP per capita to grow more slowly or even decrease. In contrast, rising world prices for New Zealand exports tend to increase real GDP per capita.

Graph 1.3 **Real oil price, 2008 SDR prices, 1970–2010**



Source: DataStream
UK US$ Brent crude oil price: DataStream, UKI76AAZA
US CPI: DataStream, USCONPRCE
USD to SDR: DataStream, USI.SA

The world oil price has been quite volatile on occasions since 1970, as can be seen in Graph 1.3. The international price of oil is expressed in real Special Drawing Rights (SDRs) in this graph. SDRs are calculated by the International Monetary Fund (IMF) and are comprised of a market basket of major currencies – US dollars, euro, yen, pounds, etc. This currency index removes potential distortions from any one currency's relative strength or weakness in a particular period.

The import and export price effects are combined in a single indicator called the terms of trade, Graph 1.4. The terms of trade measures the ratio of New Zealand export prices to import prices. Let's take an example from the early 1970s. Over the period 1971–73, the prices for New Zealand exports, particularly meat, rose sharply. The terms of trade rose to record-high levels. Real GDP per capita also rose sharply, reflecting this rise in export prices and the terms of trade, Graph 1.1.

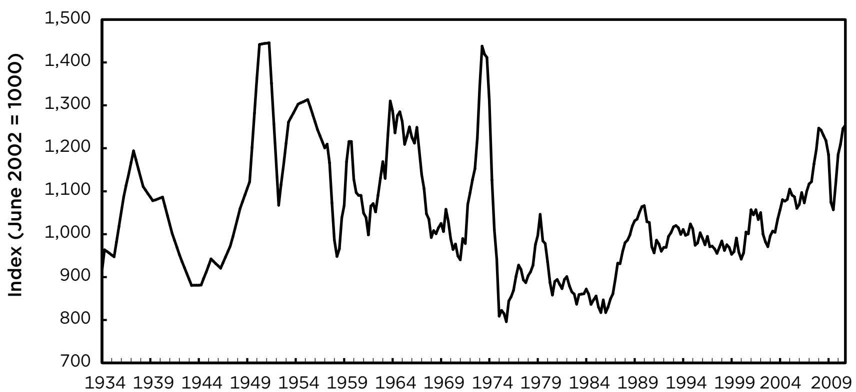
This rise in the prices for meat and other agricultural commodities in the early 1970s was caused by the conjunction of a number of weather, market and policy factors. Meat prices rose, mainly because of a shortage of animal feed. An El Niño weather pattern caused anchovies to drift away from the Peruvian coast, which in turn caused a shortage of fishmeal for animal feed. Droughts in the USSR, North America and Australia further compounded the feed shortage. In the policy sphere, the Soviet government decided to maintain their cattle numbers by importing animal feedstuffs (rather than adopt their usual drought policy of slaughtering cattle, which would have dampened prices). Given the size of its cattle industry, Soviet grain imports rose very significantly from the West. The result of all these factors was a temporary 'world food crisis'.

The 1971–73 agricultural commodity price boom did not last. Meat prices fell back to more normal levels, causing the terms of trade to fall in 1974. Coincidentally, OPEC raised oil prices in the same year and one of our major export markets, the United Kingdom, joined the protectionist European Economic Community (EEC). The combined effect of falling export prices and rising import prices caused a record fall in New Zealand's terms of trade – to its lowest level since the Great Depression.

However, real GDP per capita did not fall immediately after the fall in the terms of trade. In fact, it kept rising through 1975. This delayed reaction was caused by New Zealand government policy changes that increased foreign borrowing to buffer the terms of trade shock on GDP. Consequently, real GDP per capita did not fall in line with the 1974 terms of trade decline for some years – until the foreign borrowing limits were reached.

This lag raises another important feature of real GDP fluctuations. New Zealand policy actions are influenced by world market conditions and by domestic business cycles. World market conditions for trade and foreign borrowing set some boundaries for New Zealand economic performance, but domestic policy action can alter the timing of their effects on the domestic economy. Domestic policy can also make the impact of foreign market constraints on New Zealanders worse by dampening necessary market signals. Ultimately, though, a small open economy has to live within its means.

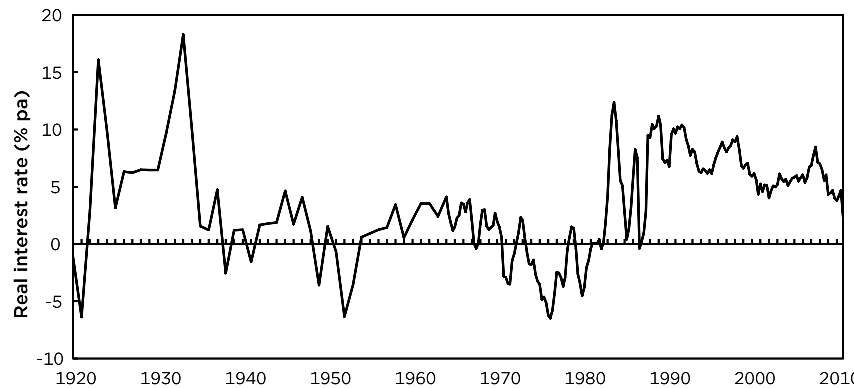
Graph 1.4 **Terms of trade, 1934–2010**



Source: Statistics NZ, RBNZ
1934–1957: Reddell and Sleeman (2008)
1957–current: Statistics NZ, OTPQ.STTZZ5

World capital markets are another important external influence on the New Zealand economy. Because New Zealand borrows foreign savings on a regular basis, interest rates prevailing in world financial markets set a floor (minimum) on interest rates in New Zealand. The effects of world financial market conditions can be gauged by examining real mortgage interest rates in New Zealand, Graph 1.5. The real interest rate is the nominal or actual rate paid by borrowers minus the inflation rate. Accordingly, the real interest rate is a better measure of the true cost of borrowing and the true return to savers.

Graph 1.5 **Real floating mortgage interest rates, 1920–2010**



Source: RBNZ, Statistics NZ
1920–1964: Real mortgage rate, Reddell and Sleeman (2008)
1964–current: Nominal mortgage rate, RBNZ, Table B3
1964–current: Consumer price inflation, Statistics NZ, CPIQ.SE9A

In 2010, real interest rates were at their lowest levels for 20 years, Graph 1.5. This was due mainly to the Global Financial Crisis. Central banks around the world slashed interest rates to offset the impact of the GFC on economic activity and jobs. In the United Kingdom and United States, central banks even resorted to 'quantitative easing' (printing money) to try to rescue their economies. Nominal interest rates in many large economies were near zero in 2010 and negative in real terms.

New Zealand interest rates also fell alongside global interest rates. First, the Reserve Bank lowered the Official Cash Rate (OCR) from 8 per cent to 2.5 per cent (around zero in real terms) to stimulate the economy against the recession. Secondly, because New Zealand banks borrow money in foreign money markets, New Zealand mortgage rates followed global interest rates downwards.