Thinking Big:
And drifting slowly ever further behind

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It has been said that a definition of insanity is doing the same thing over and over again and expecting a different result. That's my story about New Zealand policymakers, dating back many decades.

I'll come back to that in a minute. I want to use most of my time this morning to reframe how people are thinking about New Zealand's longer-term economic performance.

But first, where are we right now? There are numerous bank economists and other forecasters out there commenting on the immediate flow of data. I probably can't add much to what you'll have heard and read from them.

We have an economy that isn't doing particularly well - headline GDP numbers look okay, but per capita growth has been pretty feeble. Inflation has been persistently undershooting the Reserve Bank's target range - which matters because it means many people have been left unnecessarily unemployed.. The Reserve Bank has been only slowly waking up to its own past mistakes - they've been cutting the OCR for 9 months now, but are still behind where they need to be. Real interest rates are still too high, and as a result the exchange rate is also too high. Some bits of the economy are doing quite well - after a terrible decade, tourism and low-level export education have had a good year. But there is little reason to be optimistic about what is coming. It is slowly dawning on people that dairy prices aren't rebounding materially any time soon, the impetus (boost to demand) from the Christchurch repair process has passed, and whatever you think of the economics or politics of the immigration surge (we'll come back to that) it isn't likely to get any bigger than it is now.

And it isn't as if the rest of the world is going to be much help either. Global growth forecasts are being revised steadily lower. If a lower oil price is a boon, it is really no more than a small offset in a world of weakening offshore demand. Of the three main economic areas, at best the US is limping along, with no sign of any growth acceleration, a collapse in investment in the oil and gas sector, and troubled politics that are only likely to intensify uncertainty. None of the stresses in the euro area has gone away, and within the wider EU they are getting worse each day as Europe struggles to cope with the flood of refugees and illegal migrants. Parties opposed to the Brussels consensus seem to gain ground whenever voters get a say, and the rising prospect of the UK leaving the EU could yet be one of the straws that triggers the eventual dissolution of the euro and EU. Both those could be good outcomes in the longer-term, but in the shorter-term they could be immensely economically disruptive. And then there is China - a behemoth struggling to cope with (or, worse, avoid facing) the after-effects of one of the biggest, least-disciplined, credit and investment booms in history. A nasty correction in China's GDP would matter to the rest of the world, in a way that (say) the collapse of the Soviet Union's GDP didn't. Recall that most of the rest of the world has very little policy "ammunition" left in response - interest rates are near zero, confidence in central banks meeting their inflation targets is falling, and for all the talk of a case for more fiscal stimulus, most countries already have an uncomfortably large level of government debt.

Against that bleak backdrop, New Zealand has a few advantages. If our OCR should probably already be at 1.5 per cent, at least that is better than zero. Our government accounts are no longer in great shape, but they aren't bad by global standards. We have a flexible exchange rate, and should we ever need to markedly further cut the OCR our exchange rate would be likely to fall sharply (think of where it was in 2000). And notwithstanding the obscene level of Auckland house prices, and the overhang of dairy debt, New Zealand as a whole has not been on some credit-fuelled rampant boom. If we take the country as a whole, our dependence on foreign capital (the NIIP position as a share of GDP) has largely gone sideways for the last 25 years. Perhaps ideally it would have shrunk a bit, but this is no Greece, Spain, Ireland, or Iceland. Or even the US - with all that government sponsored or promoted poor quality housing lending. Risks of a domestic financial crisis should rate very low on your list of concerns.

The real challenges for New Zealand are more about our long-term continued underperformance - over the last 100 years or so only the likes of Argentina and Uruguay have done relatively worse than us. Even in the years since 2007/08 we haven't done particularly well. We've done only a little better than the typical advanced economy, and - for all the talk otherwise - we've done worse than Australia.

Just before World War One the best international estimates suggest we had the highest per capita incomes in the world. We had a few people in a moderately abundant land, brought closer to major markets by falling transport costs and refrigeration. In 1950 we were still one of the handful of countries with the highest incomes. But no longer.

Read back through New Zealand economic history and you find serious commentators worrying about underperformance even by 1960. In a way it wasn't surprising - we had hobbled ourselves and built a large and inefficient manufacturing sector here. We eventually undid all that protection - and did a bunch of other worthwhile reforms - and conventional wisdom was that we'd done enough to put ourselves back on the right path, and converge back to the incomes of other better-performing OECD countries. I treasure a *Herald* photo from 1989, in which the Minister of Finance David Caygill is shown pointing to a graphic illustrating exactly the convergence he expected. He wasn't alone. As a young government economist it was certainly my view.

But in the subsequent decades we have slipped further behind. Oh, the fall hasn't been as rapid as it was in the 1970s and 1980s, but it has been real and material nonetheless. For a few years at a time the terms of trade (outside our control) sometimes help us out. And we work long hours per capita, to make up to some extent for the low output per hour. But none of it masks the continued underlying decline - not just against Australia, or Singapore, but against almost every OECD country. The decline is there is the labour productivity data, and in measures of overall (multi-factor) productivity.

And despite all this disappointment, we've had consistently the highest real interest rates in the OECD, and a real exchange rate that has never sustainably fallen even as we've slipped ever further behind our peers. High interest rates can be sign of an economy doing very well, with abundant investment opportunities. A high and rising average real exchange rate is what you expect in an economy with rapid productivity growth, that is catching up to the rest of the world. That isn't the New Zealand story. In our case, they've been symptoms of something that has gone seriously, but quietly, wrong - squeezing out business investment (ours has been among the lowest in the OECD) and especially that in the tradables sector, where firms have to compete internationally.

At an individual level, for decades many New Zealanders have recognised that things here haven't been that good. In huge numbers they have been leaving New Zealand for better opportunities abroad (especially in Australia, with the massive mining developments over recent decades). In a standard, uncontroversial, economic model that should have helped those of us who stayed behind. Outflows of people put downward pressure on our interest rates. And it should have put downward pressure on the real exchange rate. Together those adjustments would have helped - a lot. More firms with smart ideas, products and export opportunities would have been viable, and we might even have been running current account surpluses not deficits.

But successive governments have simply stopped that adjustment from happening. Not by administrative fiat - governments don't directly control real interest and exchange rate. Instead, they've done it through a large scale government intervention called a skills-based immigration programme. Our governments aim to bring in 45000 to 50000 non New Zealanders as new residents each year. That is around one per cent of the population - one of the largest active immigration programmes in the world. We can lose sight of how unusual it is – I'm aware of few if any other modern governments that have ever turned to large scale immigration when their own national productivity and incomes have been drifting further behind those abroad. Emigration was a more common approach (see the exodus from Italy or Eastern Europe at the turn of the last century).

The logic of the programme is supposed to be that we capture some of the cream of the global crop, and in the process boost the productivity and economic performance of all New Zealanders.

Unfortunately, there is not the slightest evidence that the New Zealand strategy has worked. The formal evidence base around the economic impact of immigration to New Zealand is unfortunately still quite limited, and we never quite know what would have happened without the immigration. But it was never a strategy that was likely to succeed. For one thing, New Zealand is small, remote and (by advanced country standards) relatively poor - not exactly first choice for the hard-driving and ambitious best and brightest. Our universities are middling at best, so we can't attract many potential stars that way. As Hayden Glass and Julie Fry reportedly point out in their new book, our skills-based programme has been attracting less skilled people, on average, than the Australian or Canadian programmes.

Perhaps more importantly, no one seemed to stop to think about the nature of the New Zealand economy. It is small and remote, in an age where personal connections and agglomeration benefits seem to have become more important not less so. New Zealand might have plenty of smart people and low regulatory barriers to starting businesses but it seems to be a pretty poor place to base global business. That seems to be our experience. But look around the world, and you simply don't find many such businesses on remote islands.

Modern New Zealand has always been, and remains, a natural resource-based economy, and no one is making any more land, sea or other natural resources. We find new and smarter ways to maximise what we earn from the natural resources - productivity in agriculture in recent decades, for example, has been quite impressive - but that doesn't change the fact that we have a given stock of natural resources and a fairly rapidly growing number of people. For each new person we add there are simply fewer natural resources per capita. In a well-ordered society, abundant natural resources are a blessing not a curse, and there are plenty of opportunities for productivity gains in many of those industries. But the stock of resources isn't increasing, and the people are.

That wouldn't matter if we were rapidly growing industries that were taking on the world based largely on the skills and talents of our people. After all, there are no known bounds to human creativity and ingenuity. You could think of the US or the UK, or Belgium or Ireland. But we aren't.

What New Zealand exports has changed over 170 years – at one stage, gold was our largest export, perhaps whale products at one stage even earlier. Optimists like to point out the agricultural exports have diminished in relative significance. But if we look at all our exports, our natural resource based exports - agriculture, oil, fish, gold, (most) tourism, forestry, aluminium - make up probably 80 per cent of our total exports (good and services). That proportion isn't shrinking materially. There are some globally successful companies based here, who don't primarily draw on the natural resource base – Fisher and Paykel Healthcare might be the best known – but there aren't many, and there is simply no sign of the export base transforming. Exports of educational services have been in the headlines this year: they are a welcome boost, but we aren't exactly selling premium Ivy League type products.

Probably since the earliest European settlement, there has been a focus on growing the number of New Zealanders. There were a whole variety of reasons: some about national security, some about "filling the land", but in the last few decades the policy bias towards a larger population seems to have been driven by a view that if only we had a bigger population, and bigger cities, that might give us some chance of finally reversing the productivity decline (a decline matched, over 100 years, only by places like Argentina and Uruguay). And all without really stopping to think hard about the importance of location. Peripheral places only tend to support high incomes for small numbers of people. Our natural resources, combined with the skills and talents of our people, enable us - more or less the last bus stop before Antartica – to produce pretty reasonable living standards. It looks as though they'd produce really good living standards for small numbers of people - perhaps the 3 million we had in 1974 - but it doesn't look as though they do so for a fast-growing population now in excess of 4.5 million.

Long-term prosperity depends on being able to successfully sell stuff to the rest of the world. That, after all, is where the bulk of the markets are: the best opportunity for really smart companies, products, and management teams to make the most of what they have to offer. There is nothing very controversial in that proposition – countries that catch up mostly do so by trading more heavily with the rest of the world. You've seen it in central and eastern Europe in the 25 years since communist regimes gave up.

But how have we done? 100 years ago we had some of the highest per capita exports of any country. Now we languish way back, esepcially when compared to other small countries. More recently, in per capita terms, the volume of tradables sector production (exports and local producers competing with imports) in New Zealand is no higher than it was 15 years ago. Over that period we might have hoped for a 50 per cent increase (around 2.7% pa). No wonder our living standards are falling behind, and no wonder our relative productivity performance is dropping. And all that has happened over a period when New Zealand's terms of trade (the relative prices we face) have been averaging more favourably to New Zealand producers than they've been for 40 years.

Much New Zealand discussion has also focused on empowering and enabling Auckland. You all know the rhetoric - our one "real" city, our one global city, and so on. Population growth in Auckland has been very rapid. Since World War Two only one OECD country has a largest city that has grown faster than Auckland. Since 2000, Auckland has grown by 29 per cent and the rest of the country only by 13 per cent. That much larger population - and the growing diversity of the population - should, so it was argued, have markedly boosted our economic fortunes. It is successive immigration programmes that have supercharged this population growth in the last few decades - if anything New Zealanders have been leaving Auckland.

We know that within countries incomes tend to be higher in bigger cities. But that simple empirical insight has led to all sorts of wrongheaded policy thinking here. Instead of concluding that we should focus on getting the conditions right to grow the overall economy (productivity and per capita income), as a result of which activities would locate across different regions in whatever pattern worked best for each firm, there has been a belief that if only we build and promote a big city then growth will come. There is simply no good economic basis for that belief - world expert in this area, Ed Glaeser, said as much when he visited a couple of years ago. It is just old-fashioned boosterism dressed up in modern language - the Dunedin stadium debacle writ large.

Whatever the arguments, there is simply no evidence that the strategy has worked. Over the last 15 years, a period of no growth in per capita tradables sector production, we've also seen Auckland's average per capita incomes falling relative to those in the rest of the country. Fifteen years ago average Auckland incomes were 130 per cent of those of the median New Zealand region. Now it is more like 120 per cent. These aren't small changes. Sure there is lots of activity here, but much of it just support the needs- roads, schools, houses, shops, offices etc - of a very rapidly growing population. There is simply no sign of a fast-growing knowledge-based outward-oriented tradables sector, that would lead faster national growth in productivity and incomes, emerging here.

And nor would I expect it to: this is a natural resource based economy, and simply not a place where those knowledge-based industries would naturally locate in any number. Even if they started here, in many or most cases the owners could maximise value by relocating (or selling) abroad.

I can imagine you have lots of questions and challenges to this diagnosis. I can't deal with all of them in a short presentation, but perhaps the key one is "but isn't immigration generally beneficial?"

Well, yes, it generally benefits the immigrant. That is a real gain. But countries makes policy for their own people. Immigration programmes driven by economic considerations - as ours is (the govt tells us it is a “critical economic enabler” - should help the citizens of the recipient countries (and not just by boosting regulatory-restricted urban land prices). In fact, there is very little history of immigration boosting the incomes of the citizens of the recipient country anywhere, unless - and it is an important, but sobering, caveat - unless the immigrants bring with them a materially more economically successful culture and institutions, and swamp what was there before. Think of the fate of the indigenous populations of Australia, Canada, the United States, Chile, Argentina, and….New Zealand.

Immigrants typically flow from poorer countries to richer countries and in so doing tend to narrow the differences between incomes in the two. That is what the NZ/Australia flows should have done over the last few decades. Academic research is quite clear that it is how European migration to North America, Oceania and Latin American worked in the 19th century. Great opportunities in the US or NZ attracted lots of migrants - and in the process lowered wages a bit in the recipient countries and raised them a bit in the sending countries. The fabled gains to recipient populations typically do not exist. It is simply that really successful countries can “afford” to take lots of migrants if they choose. The US didn’t for 50 years after World War One, and then opened the doors wider again. But there was no discernible deterioration in US economic performance in the closed years.

So we come back to New Zealand. In their individual wisdom, knowing their own country, New Zealanders has been recognising that prospects for them and their families are better abroad than here. Even last year, more left than came back. And yet our governments - backed more or less by all political parties - have simply decided to bring in huge numbers of new people each year. It is an astonishing example of a central planner’s hubris - a whole new Think Big strategy in which governments, all with the best will in the world, mess up the stabilising adjustments that would otherwise have been underway.

Governments don’t help by messing up the housing market but, salient as that pressure is, especially here in Auckland, it isn’t the real issue. The real issue is simply that there are no new really good income earning prospects - new highly rewarding export industries - that the much higher population is enabling us to tap. We haven’t found new natural resources or ideas that need lots more people to take full advantage of them. Of course, we sustain reasonable total GDP growth building to support a rising population, but it does nothing to close our productivity deficits. And because people can’t be used for two things at once, the need to build to accommodate the ever-rising population crowds out some productive, internationally oriented, investment that would otherwise be profitable here. If we keep on with such a strategy we’ll keep on, little by little, drifting further behind the rest of the advanced world. We are simply in the wrong place to support very many people. No other remote island has anything like our population. Our own people have implicitly recognised the limits of New Zealand for decades. It is governments and their official advisers who seem blind to it.

So we have really do have major economic challenges after all. New Zealand will probably always support a nice lifestyle for the well-educated and talented - but then the beaches of Montevideo look pretty good too. We need to refocus our attention on stopping doing the stuff that just isn’t working, and which holds us back from closing much of the productivity and income gaps with the rest of the advanced world. Governments don't much us rich and prosperous, but they can certainly mess up our prospects.

Closing those gasps will take far more rigorous and robust analysis and advice from our key economic agencies, such as Treasury and MBIE, that looks hard at all the symptoms of our longer-term economic condition. But it will also take political will, drive and vision - and a willingness to put aside the implicit "big New Zealand" mentality that has shaped so much of our history - from Vogel to Seddon to Holland to Holyoake to Douglas, Birch, Clark and Key. There are plenty of nice, and - more importantly - successful small countries. And building a big city won't produce long-term prosperity, it will simply further unbalance what is essentially a natural resource based economy (and could be a very successful one for a modest population).

New Zealand isn't in short-term crisis, and for that we can be grateful. But our people - our kids and grandchildren - deserve more than leaders simply smoothing the pillow of continued relative decline, all the while pursuing a flawed "Thinking Big" more-people strategy that failed in the post-war decades, and has failed again in the last 25 years.