

Managing New Zealand's Economy in Times of Global Volatility

Address to the ANZSOG 4th China Advanced Leadership Programme
for National Governance System and Capacity Building

Michael Reddell
Reserve Bank of New Zealand
3 December 2014

Thank you

It is a pleasure to be here this afternoon. I follow in distinguished footsteps – I gather you had time with our Prime Minister this morning, and have also been addressed by the head of our public service, Iain Rennie.

My talk this afternoon is about New Zealand economic management. New Zealand is, and always will be, a fairly small country. Small countries rely on foreign trade for their prosperity – but demand for what we sell fluctuates. We are also a country that is, and has been, heavily reliant on foreign capital. Foreign capital creates opportunities - it opens up possibilities that were not otherwise there. But it also brings risk when things change in the outside world.

Those risks are something New Zealanders and their policymakers have long had to grapple with. I'm going to talk to you about how we manage the sort of volatility that the rest of the world throws at us. My focus will be on the system as it stands today, including how it coped with the financial crisis of 2008/09 and the uneasy global aftermath of those disruptions. But to help understand that system, and how it came to be, I want to step back, and present some of the economic history of New Zealand, through 3 phases:

- An era when few government institutions existed, and we just had to live with the volatility the world threw at us
- An era of “big government”, when we tried to limit our risk, by limiting our involvement with world markets
- And the current phase, in place now for 25-30 years, of opening to the world, with robust government institutions to balance prosperity and stability.

What I want to leave you with is a flavour of the institutions that we have put in place, and refined, to help limit the disruption to our economy, and the lives, of our people from the inevitable fluctuations in the world economy. We don't have all the answers, but through some combination of good luck and good management we emerged from the events of 2008/09 in better shape than many of our advanced country peers. But we don't take for granted our ability to do so in the future. A constant willingness to question ourselves, and let others question us, is one way that we help keep ourselves ready to cope with a changing world.

Early New Zealand - little or no “economic management”

As a political entity, New Zealand dates back to the time of the Treaty of Waitangi, signed between representatives of the British government and Maori chiefs in 1840. There was some small scale international trade - mostly with the new British settlements in Australia - prior to that, but no formal or central government.

The establishment of British colonial rule, and then self-government from the mid 1850s, provided a basis for a rapid expansion in the European population. Migrants were overwhelmingly of British descent, and the institutions put in place here (laws, Parliament, freedoms etc) were a small-scale or

cut down version of those in the United Kingdom. At the time, the UK was world's leading economy, towards the height of the Industrial Revolution.

Developing a new advanced economy, with a rapidly growing population, took money. As was the case across the colonies where Europeans were settling on a large scale - the US, Canada, Australia, Argentina, Chile, South Africa - the infrastructure needs of a new country were substantially financed using foreign capital. Both the public and private sectors borrowed extensively. That was easy, as the United Kingdom provided the deepest lending markets in the world, and as the 19th century proceeded it had an increasingly large amount of domestic savings, beyond the needs of its own economy, that were looking for investment opportunities around the world.

We didn't have a central bank, or our own currency, and governments provided little or no social safety net (no welfare benefits or social security systems - and many of the migrants had little family support). There wasn't much economic policy - beyond covering the government's spending with some mix of taxes and borrowing. Researchers tell us that by the end of the 19th century New Zealanders' had some of the highest living standards in the world. But we were totally exposed to the fluctuations in global markets (and indeed, to swings in domestic financial markets). We exported commodities - timber, then gold, then wool, and the increasingly - once refrigerated shipping was possible - meat and dairy products. But prices of commodities fluctuate - a lot. I said that New Zealanders borrowed a lot from lenders in Britain to finance its development. But sometimes those borrowing markets became very reluctant to lend - perhaps because of a crisis somewhere else in the world. One safety net was migration - people came here from Britain and Australia when times were buoyant, and when things turned down, they stopped coming, and many just went home.

This was, more or less, the story of New Zealand until the 1930s. At the peak of the Great Depression, government debt exceeded 200 per cent of GDP - around the same troubling level of debt the Japanese government has today. For a while, borrowing markets were closed to us, and many other borrowers. Sharp falls in commodity prices hit the country hard, and unemployment soared. The approach to economic management started to change.

Turning inwards

For the first time, an independent New Zealand currency developed - as distinct from the British pound. We had been part of a system based on the pound, but it had been managed, if at all, in Britain's interests not NZ's. The New Zealand currency was actively devalued by the government to improve returns to New Zealand firms (mostly farms) and to make it easier to service some of the huge debt burden. The Reserve Bank of New Zealand - our central bank, where I work - was set up in 1934, with the aim of providing more scope for policy to respond to New Zealand conditions. And policy began to turn considerably more inward-looking. After first a foreign exchange crisis in 1938, and then coming near to defaulting on the government's debt in 1939, extensive controls were put in place on imports, and on all uses of foreign exchange.

Over the subsequent 40 years controls were tightened and loosened and tightened again. But a heavy reliance of direct controls, across an increasingly large part of the economy, was the dominant story. There was increasing unease about the world, and its risks - perhaps understandably after the trauma of the Great Depression. It wasn't a totally unusual approach for advanced economies at the time - the Depression and World War 2 shaped and changed economic thinking in many countries. But we took the controls considerably further than most, and left them in place for a lot longer than most. Part of the system involved actively encouraging foreign direct investment, especially in the manufacturing sector. Many policymakers wanted to reduce our dependence on commodities by reducing our need to export at all. For example, controls were used to developing small home markets for all sorts of products, whether or not it was efficient to do so. We assembled TVs and cars in New Zealand, for the tiny domestic markets.

A case could perhaps be made that this approach to economic management wasn't so bad. We largely avoided serious economic crises. Borrowing abroad was difficult and was actively discouraged, so our

exposure to disruptions in foreign funding markets fell right away - as the foreign debt itself fell towards zero. And there wasn't much domestic lending - that too was quite tightly controlled, so there were no domestic financial crises. Of course, recessions still happened, and the terms of trade still fluctuated. Foreign trade became less important as a share of GDP than it had been in the previous 100 years.

But it was not a sustainable model, for at least two reasons.

First, was the prospect threat that our overwhelmingly major export market - the United Kingdom - would enter (what would become) the EU, threatening to close off access to our meat and dairy exports. At the time, for dairy products in particular, there were no other major possible importing markets.

Second, and in long-term more important, the price we paid for the system was relative economic stagnation. The extensive controls, reaching into almost every sector of the economy, and the inward-looking focus they encouraged, made it very hard to achieve productivity growth of the sort that would sustain top tier living standards for a rapidly growing population. As late as 1960, perhaps only 5 or 6 countries had a higher level of productivity than New Zealand. The cost of bad policies doesn't always show up quickly, especially if prices are high for the things one does sell. However, the 1960s and 1970s were disastrous decades for New Zealand - by 1980, in an economy still subject to extensive controls, productivity levels were better than only about half a dozen of the then advanced countries. And even relatively stability that we had maintained was breaking down - public debt was rising, inflation had become a serious problem. Immigration had become a safety valve again - from the mid 1970s large numbers of New Zealanders started leaving for the increasingly better living standards in Australia.

During this period, economic policy decisions were centralised in the hands of ministers. Many choices were taken out of the hands of the private sector, and even within government official agencies - the Reserve Bank and Treasury - acted as advisers, competing to be heard. There was high emphasis on official secrecy, and only a limited amount of information or official analysis was made public, in a way that could have encouraged rigorous scrutiny of policies, or serious accountability for choices governments were making. Our experience is that politicians aren't good at making decisions on what industries are likely to flourish - but they often faced few consequences for supporting their favoured industries,

Opening up to the world

Some liberalisation had been occurring over the years. Decision-makers weren't blind to what was going on, but there was disagreement on the best way forward, and in any case it was always easier, in the short term, to postpone adjustment than to confront the issues.

But the reforms prior to the mid 1980s had been fairly limited. By contrast, the whole way of looking at policy - and economic management - was really totally upended by two reforming governments that held office from 1984 until the middle of the 1990s. Instead of trying to protect our people by shutting ourselves off, we turned outwards and once again embraced the world. Instead of governments protecting or favouring individual industries - rewarding people who built good connections with government ministers - we set out, as far as possible, to expose New Zealand firms to the opportunities and prospective returns, the wider world had to offer. The test was to be a market test, not a political test.

Change came on multiple fronts. A simple list of measures can't adequately capture the nature and scale of the change, but as just some examples:

- Removal of export subsidies, import quotas, and most tariffs

- Freeing up the labour market - to provide more choice for workers, and more flexibility for both parties
- Removal of controls on interest rates and “guidance” on sectors to be given priority in lending
- Reforming state-owned business enterprises - in many cases, privatised them, but when not we ensured that businesses were run commercially with no involvement of government ministers.
- Removing controls on, eg, petrol and electricity prices
- We reformed the tax system, to raise taxes efficiently, without favouring some activities/firms over others,
- We opened up the capital account of the balance of payments - allowing money to flow in and out, in the form of debt or equity
- We cut government spending and raised taxes, to balance the budget.
- Monetary policy was focused on getting inflation under control, and in the process the Reserve Bank was given real operational independence to keep inflation low and stable.

Much more emphasis was put on the different arms and agencies of government operating at arms-length from each other, each concentrating on the area it was particularly responsible for - be it taking decisions or providing advice - and being accountable for that activity. This wasn't just about accountability within government, but about opening up the whole system of government to much more outside scrutiny. One important aspect of the reforms had been our Official Information Act - which established a presumption that government information should be available to the public. There are exceptions to that - but they are tested by an independent agency, and finally by the independent courts. The whole focus of this sort of new approach was on building resilience into the system - by avoiding too much reliance on any one aspect of government, or indeed on government at all.

One particular example is around economic management. Prior to the reforms, most decisions had been made by elected Ministers - in particular a very dominant Prime Minister who was also Minister of Finance - behind closed doors. A key element of the reforms was to open up the system - in our idiom, to let the sunshine in - so that as far as possible, people could understand the reasons for policy decisions, and that possible tensions between different arms of policy could be resolved more openly. More information was provided – to the public, to financial markets, and to Parliament itself. A change in the electoral system in the mid 1990s also tended to strengthen the leverage of members of Parliament.

The transition to the new system of economic management was not easy, or costless. And it was controversial in New Zealand - lots of people, including “vested interests”, but not just them, were worried about the direction and/or pace of change. Perhaps because we had left change too long, we went through a nasty financial crisis in the late 1980s and early 1990s. As happened in several other countries that liberalised at the same time - eg Australia and the Nordic countries - inexperienced lenders and over-exuberant borrowers combine to produce a credit boom, an asset boom, a construction boom, and then.....a very nasty bust. Lots of government money was used to prevent the failure of our largest bank.

The numbers of people unemployed also rose sharply for a time - in some ways an inevitable part of restructuring the economy, but very difficult for them and their families - made more so, by significant cuts in government welfare benefits.

How the system works now

By the mid 1990s we had pretty fully in place the system of economic management and economic institutions that stills prevails. Of course, there is new legislation every year - as there is everywhere - but the basic structures have not changed much over the intervening period. And they have proved pretty resilient.

Some things haven't changed. For example, most of New Zealand's exports are still commodity-based products. Commodity prices still fluctuate sharply, and droughts are an ever-present threat to our farmers, who mostly rely on abundant rainfall for water.

And once again we are heavily reliant on foreign capital has returned. 40 years ago total foreign debt and equity was about 10 per cent of New Zealand's GDP. Today that foreign borrowing is now around 70-80 per cent of GDP. But most of the debt now is borrowed by the private sector - in particular the banks operating in New Zealand. Lenders have to reach their own view on whether the banks will be able to pay them back.

Government agencies and private markets both have important roles to play. Sometimes the role of government will be more visible - simply because government is a series of large institutions, while private firms and markets are widely dispersed. The role of government tends to be particularly prominent in crisis conditions - but of course that isn't the normal state of the economy.

I'm going to focus now on three important elements of government management of the whole economy:

- Fiscal policy
- Monetary policy
- Prudential regulation and supervision of the financial system.

Fiscal policy is, largely, about government taxes, spending, and borrowing. In New Zealand - unlike China I think, and also unlike the US - almost all this spending etc is done by central government. Total government revenue is just over 40 per cent of GDP - and central government accounts for about 90 per cent of that. In New Zealand, local and regional government are small - they matter in some regulatory areas, but for overall economic management they aren't important.

That makes economic management easier. I should add that central government does not limit what local government can do - but in an open and democratic system, with a requirement to disclose what is going on, and to consult, the reluctance of local voters to pay the cost of too much debt generally seems to limit how much debt local governments are willing to take on.

So fiscal policy is mostly about central government. Successive governments have seen the role of fiscal policy as mostly about providing a stable backdrop. In other words, one wants governments to provide the services only they can effectively do, and taxes are needed to pay for those services. A good stable tax system provides predictable messages to firms and households making their choices about work and investment.

Of course, tax revenue goes up and down with the economy - buoyant when the economy is strong, and weak in recessions. But in general there isn't much role for changes in fiscal policy to influence the overall level of spending in the economy from year to year. We will come back to this a little later, and talk about why.

Two things have been important in our fiscal policy:

- keeping the overall level of debt low (as a share of GDP)
- avoiding rapidly increasing government spending in buoyant times (assuming the good times will last for ever).

Why do we want to keep debt low? Unlike the situation in China, or in much of east Asia, New Zealand businesses and families don't save very much. So financing the investment the economy needs has involved a high level of borrowing from abroad - using other people's savings. Credit rating agencies play an important role in a market economy. They look quite suspiciously at countries with a heavy burden of foreign debt, even if - as in NZ - it has been taken on by the private sector. A low level of government debt helps provide some comfort - to rating agencies and to lender - that the

government has the capacity to act if a crisis were to hit NZ. That can help to keep markets open in times of stress, and to keep down the cost of borrowing,

And if debt is going to be consistently kept low, and if fiscal policy is not to prove more disruptive than helpful, it is important that spending not increase sharply whenever times are good and tax revenue increases. Spain and Ireland failed to adequately deal with that temptation in the midst of their quite extreme booms in the last decade, which was a material part of the problems those countries ran into in the euro crisis of 2011. The last thing any country needs is for fiscal policy to be fuelling a boom, then having to slash and burn in bad times, making a downturn worse than it needs to be.

New Zealand doesn't do these things perfectly. But "perfect" isn't an appropriate standard for anything - there are no perfect markets, and no perfect governments. What we have done - as variety of other countries have, especially since the crisis - is to put in place some "institutions" - rules and practices - to help decision-makers make good choices, that will prove with time to have mostly been good decisions. The challenge is to strike the right balance. In a democratic society only elected politicians have what we might call "legitimacy" to make the big choices. But politicians own incentives aren't always to do what is best for the country, and no politician has all the wisdom about the best choices for the country.

Fiscal policy is made by elected Government, and the Parliament. Indeed in NZ to be able to form a government a party has to show the head of state that it will be to get its Budget passed by Parliament. Only elected members of Parliament should be able to authorise taxes or government spending. But the law now requires that the government must lay out its fiscal plans, for scrutiny by the public, the media, and markets. It isn't just a matter of this year's plans: they also have to lay out the objectives they are working towards over the medium to long term. Examples might include the target level of government debt, and what proportion of national income that the government will be aiming to take in tax. That openness provides material which outsiders can use to question, scrutinise, and challenge the government. The government can still make pretty much whatever choices it wants, but it faces the discipline of outside scrutiny, assisted by adequate public information.

That pressure might take the form of questions in Parliament, or newspaper editorials, or commentaries from the financial markets, or research reports from think tanks. At times those things can be quite inconvenient for governments - but successive governments have recognised that, inconvenient as it may be, the scrutiny and institutions work for the best interests of the country. And in our system, a party that is in government today knows that, almost certainly, in a few years time they will be in Opposition and wanting the same information and process of challenge and contestable advice that troubles them today in government. Phil Goff will be talking to you later - he has been a senior minister and a senior opposition figure, several times each.

New Zealand doesn't have a written constitution so any of these provisions could be repealed by Parliament very quickly. But established norms of behaviour - constitutional conventions we call some of them - help ensure that these provisions support better quality long-term decisions than we might otherwise have.

Another important aspect of the framework, which is a little different from many other advanced economies, including Australia's, is the way the economic forecasts the government uses are done. Lots of government spending and revenue decisions rely on forecasts - of, eg, how strong the economy will be, and how much revenue the tax system will bring in. In many countries, the published forecasts belong to the Minister of Finance, who has the final say on them. But in the New Zealand, the Minister of Finance makes the fiscal decisions, but the professional staff in the Treasury - our Ministry of Finance - generate the numbers. The (public servant) Secretary to the Treasury must attest, in public and in writing, that the forecasts represent his best professional judgement on the economic situation and the fiscal consequences of that situation. Ministers cannot shade forecasts up to suit themselves. They can, of course, spend more than might be wise, but have to be willing to

defend those choices, knowing that good quality information about the possible implications of those choices are open for all to see. Citizens and Parliament can debate what makes sense. No one is blessed with perfect insight as to what best policy might be at any time - in fact, the contest of ideas is an essential part of the system.

So that is fiscal policy

What about monetary policy? Monetary policy these days consists largely of the Reserve Bank's ability to alter the interest rate it pays banks on the money they leave with the Reserve Bank (our forecasts of what we might do in future do also matter). We used to use many more direct controls - akin to some of reserve ratio restrictions and lending guidance instruments in China today. But now we rely on this indirect instrument - this single interest rate - to influence conditions across the financial system and the economy.

Using this single instrument also means that we don't control the exchange rate. New Zealand has had a floating exchange rate since 1985 - which just means that the market sets it day by day. Floating exchange rates can be inconvenient. But they are usually better than the alternative, and especially in tough or volatile times. One big advantage is that uncertainty about the exchange rate encourages people borrowing to borrow in local currency, not in foreign currency. Sometimes foreign currency loans can have a lower interest rate, but the chance that the exchange rate can fall sharply represents a big risk. Sometimes foreign exchange markets do funny things, but generally we've found that markets seem to respond to things that it makes good sense for them to respond to.

Monetary policy decisions are made by the Governor of the Reserve Bank of New Zealand. He is an independent official - not a politician. He is appointed by the Minister of Finance, but the Minister can't appoint his own crony; he has to work from nominations provided by the directors of the Reserve Bank.

But the Governor isn't simply a free agent, able to do just whatever he wants. Instead, before being appointed someone being considered for the appointment must reach agreement with the Minister of Finance on a Policy Targets Agreement, which sets out practical targets that will guide the Reserve Bank in keeping inflation low and stable. Our Act requires us to achieve and maintain price stability. At present that involves keeping inflation in a 1 to 3 per cent range.

In normal times, in NZ and in most advanced/open economies, monetary policy is the main tool for stabilising fluctuations in the economy. Interest rates can be adjusted quickly, and have a pervasive effect across the economy - both directly by affecting returns to savers and costs to those considering investment projects, and indirectly through the effect on the market-determined ("floating") exchange rate. By contrast, fiscal measures (spending and taxes) can take considerable time. In most market economies there are few big projects just ready to go, and it is also generally regarded as undesirable for tax rates to be moved round a lot

So monetary policy plays a key role in stabilising the economy. But just like with fiscal policy, transparency is important:

- The Policy Targets Agreement itself is a public document
- The Reserve Bank publishes extensive quarterly economic forecasts, and discussion of the things shaping its view of appropriate policy
- The law requires that at least every 6 months the Bank explain how it is going to achieve its target, and account for its conduct of policy over the previous period.
- The Governor can be, and is, called to appear before a committee of Parliament to account for his policy choices.
- Markets use all this information each day in trading in bond and foreign exchange markets. Market prices, and analysts' reports, can provide valuable information back to us.
- And if everything goes badly, there are protections:

- the Governor can be removed from office if he hasn't been doing a good enough job in pursuit of the target
- and the government can, for a limited time, impose another goal on the Reserve Bank - but again it must do that in an open and transparent way

Fortunately, neither of these reserve powers has yet been used. But knowing they are there makes a difference. The whole system is designed so that it is clear that the prime responsibility for setting targets rests with the (elected) government, while the responsibility for carrying them out rests with the central bank Governor.

The system is design to ensure a high level of accountability, and to provide clarity about who is accountable for what - the Minister for the goal, and the Bank for achieving it. But all this separation of powers and roles doesn't mean that the fiscal and monetary authorities don't talk to each other. Doing so is made a little easier by our physical location - our central bank and finance ministry are across the street from each other, and both are across the street from the offices of the Minister, and of Parliament. But it is more than that. All parties recognise that choices each make can affect the other.

But we don't typically actively coordinate policy. Instead, the government makes choices about fiscal policy, conscious of what it might mean for monetary policy. For example, a large programme of public spending just before an election might look less appealing when it is clearly understood that launching such a programme will result in interest rates being raised quickly, and potentially by quite a lot. Those changes would quickly affect borrowers across the economy. Again, politicians have been able to recognise that although the constraint is inconvenient sometimes – but the inconvenience is part of what makes it good for our country over the longer-term. We don't want a system that makes it easy for governments to trick voters, or markets

I've stressed openness and accountability - the ability to contest and debate policy choices. But I don't want to mislead you. The goals are out in the open, but of course the deliberations of policymakers aren't. Cabinet still meets in private to decide on the Budget, and the staff of the Reserve Bank advise the Governor in private. But the outcomes of those processes, and a lot of the thinking that goes into them is later published. As another example, we publish, in full, the central bank balance sheet, but with a lag - for example, any foreign exchange intervention isn't apparent until data are published at the end of the following month. And after each government Budget a lot of the background papers are published. If the government doesn't publish them citizens can use the Official Information Act to request the material. Final decisions on those requests are also made independently.

Let's turn now to what might be called the third limb of macroeconomic management

In the decades when we had heavy controls on the economy and financial system, prudential regulation of banks and other financial institutions wasn't very important - or useful. There wasn't much lending taking place, and the rate of change in the economy - resources moving from one sector to another - was typically quite slow. The possibility of a major financial institution failing was pretty low. In New Zealand, as in most advanced economies, there were few serious financial stresses in the 30 years after World War 2.

But in an open and more liberal economy, all sorts of things are possible. In particular, lending booms and asset price booms become much more feasible, when there are no administrative limits control on how much can be lent to whom. Governments aren't very good and knowing who should, and should not, be borrowing, so that freedom is generally a good thing. And there are - or should be - important market forces limiting the scope for things to run to extreme. People don't want to buy shares in banks who consistently make loans that turn bad. But just as governments don't always get things right, neither do markets. What look like good and sensible loans can turn very bad when economic circumstances change. And financial crises, and bank failures, can be very be costly, not just for those directly involved, but for the wider economy. We've seen evidence of that in places as diverse as the US, Ireland, and Iceland in the last crisis, and in Indonesia and Thailand (for example) in the Asian crisis of the late 1990s.

So putting in place a good system of prudential regulation was an important element in a successful transition to an open market economy. The aim is not to control the individual transactions of banks but to reduce to a very low level the risk that a bank fails. Prudential regulation is mostly about ensuring that good buffers are in place to minimise the damage if, and when, things go wrong. And from time to time they will go wrong - since no one knows the future. Bank lending is partly about taking risk, and facilitating innovation and growth. So most banks will always have a spectrum of loans on their books - some rock solid, and perhaps quite small; others apparently - at least to a bureaucrat's eye - quite reckless, and many in the middle. Those loans in the middle will perform fine if the economy does reasonably well, but could do badly if economic conditions, or the value of the underlying collateral (eg land) turns nasty. It is also fair to add, that one of the risks prudential regulators have to be conscious of is the risk that governments will bail out big banks that get into trouble. Markets work well when those who take business risks bear the losses if things go wrong. They work less well if the losses can be passed off to the government. So prudential regulation is partly about minimising the consequences of (quite appropriate) government concern about what might happen if things go wrong in the financial sector.

In New Zealand, the Reserve Bank does prudential regulation as well as monetary policy. Our system has some advantages - it is easy to talk to people just along the corridor. But in other countries - for example, Australia - prudential regulation is sometimes done by a separate agency. Either approach can work. What matters is the ability of the regulators and their willingness to impose high standards. It is easy to let the buffers erode as a boom goes on and on - just as it can be easy for governments to go on a spending spree when boom time revenue is flowing in. People can forget the last recession, and assume that good conditions for the last decade will always be good. Resisting that temptation is what societies need prudential regulators for. It is one reason for putting some prudential powers in the hand of an independent agency. It is also why having good quality analysis of risks out in public is important - it supports ongoing debate and scrutiny of the judgements regulators are making.

In our system, powers are split between the Governor of the central bank and the Minister of Finance. But regulatory matters involving individual banks are done at arms-length from politicians. In our system it is important to minimise the opportunity for Ministers to favour their friends or cronies (or indeed, any one firm over another).

I've mentioned that in fiscal policy the government is required, by law, to set out its own goals, and in monetary policy the Policy Targets Agreement sets out the goal. There isn't an explicit quantifiable goal set down for prudential policy. When there is no clear goal that can give the regulators lots of power - perhaps too much. But all major prudential framework initiatives require consultation - not just with banks but with the public as a whole. Like other government agencies proposing regulatory actions, the Bank has to publish regulatory impact assessments of its proposals (including an analysis of the costs and benefits of the proposal). That helps outsiders to gauge the quality of the analysis that is behind the proposed policies. We are required to publish a six-monthly *Financial Stability Review*, which must contain the material necessary to allow Parliament and the public to hold the institution to account for the way it has exercised its powers. This scrutiny and accountability is particularly important in regulatory matters, since decisions made by officials and Ministers can bear directly on the value, or even the future, of citizens' private businesses.

Most of our bigger banks are Australian-owned. Throughout New Zealand history, foreign-owned banks have played a significant role, but post-liberalisation became more important, and more concentrated on Australia. Foreign banks can be a source of strength or of weakness - depending on if things are going well in Australia or not. We regulate in the interests of New Zealand, and the Australian regulators regulate in the interests of Australia. In practice we work closely together, recognising that problems in NZ subsidiaries could undermine the Australian parent, and vice versa.

I've talked a lot about the role of government agencies. But in a market economy, market forces and market disciplines are play a vitally important role in getting the balance between stability and

prosperity. The best single test of a product is whether people keep on buying it. In the wider whole economy, when labour is in excess demand, wages tend to rise, and that limits how much more new investment might look attractive. Private lenders make choices about how much risk they will take on, and when they might need to pull back. As far as possible, if lenders and borrowers bear the consequences of their choices - if bad loans really lead to lenders and their financiers losing money, the fear of loss can be a powerful incentive. And market institutions - be it rating agencies, or the media, also contribute discipline, exposing those who are taking on too much risk, or sailing too close to the edge. Often enough markets get it right - the West didn't reach its current levels of prosperity through wise bureaucrats making choices about which industries look possible - but not always. Government officials and Ministers will also make a mix of decisions - some will prove to have been good, and others bad. Sometimes the choices of both groups can worsen situations, amplify crises, rather than ease them. At other times, both can act in ways that help stabilise the economy. Decentralised market economies have powerful self-stabilising forces, which governments can assist when policies are well-designed.

Dealing with the crisis of 2008/09

How did it all work in the great crisis of 2008/09?

In the years leading up to the US-centred financial crisis of 2008/09, New Zealand had had a rather mixed experience. There were very positive dimensions:

- we had an expansion that went on for longer than any of those in the post-World War 2 era
- we had sustained low unemployment
- commodity prices were rising
- low government debt, and continued fiscal surpluses.

But also some rather more troubling developments:

- a very rapid growth in house prices
- rapid growth in credit advanced by banks and non-banks
- very rapid growth in farm prices, and in lending to farmers
- a commercial building boom, often funded by rather speculative largely unregulated "finance companies" - borrowing from the public with little or no prudential regulation. By 2007, a number of them were failing, and others were looking under pressure.
- Generalised inflation pressures had been rising, threatening the top of our inflation target range.
- banks that had become increasingly reliant on very short-term wholesale foreign finance

And on the fiscal policy side, our institutions could do only so much to hold back a big fiscal expansion - Our last election before the crisis saw both sides of politics competed to use the large surpluses that had been built up. One side wanted tax cuts, and the other lots more spending. Both agreed that they didn't want the other side to get to spend (the public's) money.

Partly as a result of all these pressures, the Reserve Bank had raised the Official Cash Rate to 8.25 per cent, and the exchange rate was reaching record highs, making life pretty tough for non-commodity exporters.

Our government agencies (the Reserve Bank and the Treasury) had, for several years, expected some slowdown. We knew that asset and credit booms of these sorts could not go on for ever. And we were nervous about the risks associated with the high and rapidly rising level of debt.

But like most people we didn't foresee anything on the scale of the crisis that burst on the world in 2008. We had allowed for a couple of years of sub-par growth, not a 4% fall in the level of GDP. We certainly didn't expect that, 6 years on, GDP would still be perhaps 10% below the trend path it looked to be on before the crisis - with all that implied in terms of lost government revenue. And we hadn't allowed, at all, for foreign lending markets to simply seize up, making it all but impossible for NZ banks (or their parents) to borrow abroad for a time.

And, finally, although we knew that NZ was vulnerable to earthquakes and volcanoes, no one had any basis for expecting that the most costly earthquake in New Zealand's history would hit us just as we were beginning to emerge from the global crisis.

So how did the institutions hold up under these, pretty severe, stresses?

They worked well.

Let's look first at some of the things that did happen:

First, and not too surprisingly, when the world economy fell into a severe recession, New Zealand's international commodity export prices plummeted. Domestic incomes were severely hit by this fall in the terms of trade.

But in response, the exchange rate fell - and fell sharply. As I said earlier, in normal times exchange rate volatility can be annoying for many. But in the crisis, the exchange rate did exactly what was needed. That fall was uncomfortable for urban consumers - the books I buy on Amazon, or overseas holidays, suddenly became much more expensive - but in a sense that was the point. The lower exchange rate eased the pressure on (often highly indebted) farmers, and transferred some of the burden of adjustment onto the rest of the country. No official or Minister had to make this choice - it was done by the market.

Interest rates also fell. Official interest rates were cut dramatically - from 8.25% to 2.5% in little over 8 months. As I said earlier, monetary policy is supposed to bear the burden of stabilising the economy. It can never do so perfectly, but the ability and willingness of the Bank to act decisively meant the system worked as it was supposed to. No one worried that inflation was going to race away, or that decisions were being taken for political ends - public messages were constantly anchored back to the medium term inflation target.

Unemployment also rose sharply - but to 7 per cent, not the 27% they have seen in Spain. Open and competitive labour markets helped keep the basic level of unemployment low in normal times, and good but basic welfare system helps ensure that those who lose their jobs can get through the transition while remaining strongly motivated to find another job.

Perhaps most challenging was the threat to the financial system. As 2008 went on, more and more of the fringe lenders I referred to earlier collapsed. They were quite small relative to the banks, but the headlines were relentless. As the crisis built internationally, and as several other governments moved to guarantee their depositors, pressure built here and in Australia. We worried about the risk of runs, not just on finance companies but on banks themselves. Both governments decided to guarantee retail depositors - and they could do so in a credible way because they went into the crisis with very low levels of debt. On this side of the Tasman, it was a hugely unusual step to have taken - fear of contagion overwhelmed the normal determination to let those who take risks also take losses. This guarantee was also a good illustration of how our system could work quickly and effectively in a crisis, drawing together our Treasury, our Reserve Bank, and the government. The memories of finalising a guarantee scheme one Sunday afternoon will remain with me for a long time.

Not everything about that guarantee scheme worked smoothly. But the system itself did. The rules of the guarantee scheme were published openly, as were the subsequent losses. Independent inquiries were held later, and they reported openly - even when it was embarrassing for key government agencies. Debate has continued about whether, with hindsight the right decisions were made. But that debate - inside and outside government - is how we learn in case another crisis hits.

Retail depositors were a concern, but the wholesale funding market banks relied were much more concerning. Much of bank funding needed to be rolled over every 90 days. And international funding markets seized up in the middle of the global crisis. That wasn't because of specific concern about NZ

or Australian banks, but just because of global fears and extreme uncertainty. No one was confident that they knew the difference between good banks and bad banks. That posed risks of a severe credit crunch, as banks, uncertain about their ability to fund themselves, called in loans and cut off new funding. Again, the various government agencies were able to work together quickly and effectively in crisis conditions - with the Treasury and the government developing a guarantee which could be applied to new wholesale borrowing - at a cost to banks - and the Reserve Bank moving to make available term loans in the domestic market, to limit any domestic liquidity pressures. And all 3 agencies worked together to market the guarantee internationally, and ensure that the flow of foreign funding resumed as quickly as possible. We also knew that we had the option, in extreme circumstances of borrowing from the IMF. It is decades since we have done so, but international institutions are part of a system designed to have good buffers when bad things happen.

Despite all this one big thing did not happen during 2008/09. We did not have a serious domestic financial crisis. Asset prices (houses, farms, and commercial properties) fell quite substantially, and loan losses increased, but by international standards the increase in loan losses was quite modest, and they never remotely threatened the soundness of banks. Much the same thing happened in Australia, even though in both countries the increase in the ratio of credit to GDP over the previous few years was large - as big as those in countries which did have crises.

A variety of factors helped avoid a crisis. One was the relatively straightforward nature of the lending done by Australian and NZ banks - no complex derivatives of the sort that tripped up many in the United States. Market disciplines helped - bank shareholders expected to carry the cost if loans went bad. We also didn't have distortions like a fixed exchange rate, as they had in Spain and Ireland. Monetary policy had not by any means been perfect through the boom period, but interest rates had risen far enough early enough, and banks had been sufficiently disciplined themselves, to avoid any serious threat to the quality of assets on their balance sheets.

The large cuts in interest rates by the Reserve Bank, the sharp fall in the exchange rate brought about by the market, the quick deployment of guarantees and liquidity measures when required, and the reasonably well-capitalised position of the banks all combined to contain the consequences of the global crisis. China's big stimulus programme also helped, especially by boosting Australia's economy. In the biggest challenge in decades, the system worked, pretty much as it was supposed to have. Indeed, it worked sufficiently that we needed little or no discretionary fiscal stimulus through the crisis period. And our strong government finances meant that although the government deficit got quite large we didn't need any sudden or very dramatic cuts in spending (or tax increases). The Budget was returned towards surplus quite gradually.

The immediate crisis passed. But in 2010 and 2011 our second largest city was hit by a series of earthquakes. I know you've had some catastrophic earthquakes in China. Here, strong building standards meant that loss of life was limited (by international standards) but the economic destruction was huge. Current estimates are that repairing the damage and rebuilding the destroyed parts of the city will cost the equivalent of 20 per cent of GDP. In a small country damage to a single city can be a heavy burden.

I know that the government minister responsible for handling the earthquake aftermath is speaking to you tomorrow. I just want to touch on the economic dimensions. Again,, the institutions of an open market economy, with a reserve role for government, worked relatively well - recall my message that there are no perfect policies, or outcomes. Buildings were typically well insured, and the absence of regulatory restrictions helped ensure that the insurance companies themselves had off-laid most of the risk into international reinsurance markets. NZers had paid the insurance premia for decades, and now foreign investors shared the losses. And land - which generally can't be insured in the private market - had been insured by a government agency. That agency had itself tapped reinsurance markets, and the overall health of the government's finances meant that the insurance claims could be met without seriously disrupting the government's fiscal strategy. And rebuilding a major city takes real resources - capital and labour. The exchange rate has risen over the last couple of years, which has had the effect of freeing up some workers - instead of producing for exports they are in effect freed up for the huge construction work in Christchurch. No government edict did that.

One can think of the government as a bearer of residual risks that the market is not well-placed to cope with - society looking after its own. But if governments are to cope with those extreme events, it is all the more important that in normal times government debt levels are kept low. In NZ government debt has increased markedly through the recession and the earthquake, but even at peak net debt is around 30 per cent of GDP, and fiscal policy is now set – and agreed across the main political parties - with a goal of materially reducing that debt over the next few years.

Looking to tomorrow

Compared to the earlier periods I discussed at the start of this talk, New Zealand today is much better placed to both achieve sustainable growth in productivity and living standards, and maintain an economy that is reasonably resilient to the shocks a volatile world can throw at it. Downturns will never be averted but good policies and institutions can help limit the damage and cost.

If the product mix that we export has not materially diversified, our destination markets have. New Zealand is relatively unusual in not having a single country responsible for more than about a quarter of our trade. China is now a key market - second only to Australia in the last year or so. That share may fall back somewhat as China's domestic milk production expands, but a country the size of China - second largest in the world, depending on the measure you look at - will always be an important influence on the near-term fortunes of small trading nations.

We always face NZ specific risks:

- earthquakes/volcanoes/tsunamis
- animal disease, such as foot and mouth
- a substantial fall in house prices, that still appear high relative to incomes.

But global risks are equally important, probably more so in the next decade:

- many countries are still struggling to avoid deflation, and the risk of new recessions
- Agricultural commodity prices are still high. Optimists suggest that will last indefinitely. Many have borrowed on that basis. But what goes up, often comes a long way down later.
- overall debt levels are still very high in many countries. Including public debt, most debt to GDP ratios are still higher than they were before the last crisis
- stresses on the future of the euro don't seem to have dissipated (even if temporarily eased). Break-up remains a (hopefully remote) possibility
- China's own transition towards an open financial system poses risks; perhaps the more so on the back of the huge increase in credit over the last 5 years
- Australia has been a key beneficiary of the China-led resources boom of the last decade. Adjustment in our largest trade and investment partner remains a potential challenge

Our ability to get through the last crisis gives us some basis for confidence in our ability to cope - not for certainty, but until a system faces a severe test one never really knows.

We've learned from the experience of the last few years. Legislation now formally requires the Minister of Finance to take account of the impact on monetary policy of his fiscal decisions. Two recent reports have posed the question of whether a Fiscal Council would be a good thing - strengthening the independent monitoring of fiscal development.

And the soundness of our banking system has been strengthened further. Credit growth has been relatively modest, and under pressure from both regulators and from markets, capital banks have to hold have been increased. When banks tap wholesale funding markets they now have to do it for a longer term than previously. Real house prices remain uncomfortably high, but have not increased further since 2007. Banks and regulators are also much more conscious of the risks around short-term wholesale borrowing in international markets. And we and the government have worked together to increase our options, in a way that would allow a bank to fail - and those who took the risks to bear the losses - without the disruption that might otherwise arise. We can never know with certainty

where the next threat will come from. Big buffers, even if sometimes quite crude ones, go some way to protecting the economy, and our people, from the consequences if some nasty future shock does hit New Zealand.

Conclusion

Countries make their own prosperity. We didn't get to be a high income because of Britain. We won't get back to the top tier of advanced countries because of China or the US. Prosperity, and productivity, are mostly an outcome of the institutions and attitudes of people in each country.

But if long-term prosperity is largely in our own hands, in the short-term any economy can be buffeted - and potentially buffeted quite badly by developments in the wider world. There are a variety of connections - direct trade volumes (as China itself found in 2008), commodity prices, access to foreign finance, and so on. The risks can be reduced by closing your country off from markets, but when countries try to do that - as we did for several decades - it comes at a price: poorer long-term growth prospects.

In opening up to the world over recent decades, we have tried to build a set of institutions, involving markets and governments, that provides us a considerable amount of resilience. But the system of open markets and powerful government agencies is still relatively new – not just in NZ, but across the advanced world. Almost certainly there is much more to learn about how we structure economies to harness the strengths, and minimise the weaknesses, of governments and markets. It is about finding the right mix: creating freedoms so that citizens can pursue opportunities where they find them, but also building buffers so limit the damage if things go wrong.

We know we can't avoid recessions - sourced here, or from abroad. No one can. It might not even be a totally good thing if we could - occasionally all of us probably need salutary reminders, and correctives to over-optimism. But good institutions, and continual scrutiny of those institutions, by both insiders and outsiders, to avoid complacency or regulatory capture for example, can help ensure that we can "roll with the punches" – to absorb shocks, to banks, to government finances, to the labour market, and then to bounce back quite strongly. We are always conscious of the risks - central bankers are probably paid to worry - and we have learned lessons from the last crisis. But we think the regime has proved its worth, enabling NZ and New Zealanders to maximise their opportunities in the world economy, but with robust buffers and safety nets to limit the damage when new crises appear. Be sure, they will.

I'm now very happy to try to answer your questions - either about what I've talked about this afternoon, or other aspects of New Zealand's economy and its interactions with the world.