What do we mean by "Good for the Economy"?

Keith Rankin, 31 March 2008

Helen Clark (eg TV1 News, morning of 31 March) says that the benefits of the forthcoming free trade agreement with China will be a $200m "injection".

Many will interpret this as meaning a $200m improvement in the balance of payments through increased exports. Others will interpret this as an injection of expenditure, which is the traditional cure for a recession. Another possible interpretation is that there will be efficiency gains of trade (arising from increased specialisation within New Zealand) amounting to $200m.

Let's examine these possibilities in reverse order, bearing in mind that New Zealand is currently experiencing full employment; at least "full employment" in the way economists generally use the term.

Chinese imports are subject to minimal trade restrictions at present, so there will be little impact on firms that produce goods in competition with Chinese imports. Hence, if there are efficiency gains, it will have to be as a result of firms moving resources out of the non-tradable sectors (construction, utilities, most services) and into exports. Unfortunately there are no market signals to move resources out of the non-tradable sectors that expanded so rapidly in recent years.

We have learned in recent years that exporting is not seen by our policymakers as important. We have sacrificed exporting at the margin while pursuing other policy objectives. The best we can conclude is that the government sees New Zealand as a specialist primary producer, and that long-run gain will come from reinforcing that specialisation at the expense of other tradable activities. Hence the commitment to a new research fund that targets only New Zealand's primary sector.

It is not however clear that the long-run marginal benefits of expanding, say, dairy output will exceed the long-run *marginal cost*. Additional production in this industry is expensive whether the expansion process is extensive (using more land for dairying that currently has other uses) or intensive (using more fertiliser and water and run-off per hectare of dairy land). And we should note that an expansion of dairy production is likely to be at the expense of other primary production, and not through drawing resources away from the non-tradable sectors.

The second possible interpretation is that an injection of additional expenditure from China will give the economy an expansionary boost through the "income-expenditure multiplier". This of course clashes with the fact that our monetary and fiscal policy settings have been quite contractionary since 2004. If our main macroeconomic policy aim is to dampen increased expenditure, then how can this stimulus be justified? Surely an injection of expenditure arising from more exports to China will be no less inflationary than an injection arising from tax cuts or reduced interest rates?

The argument for an expenditure injection may be sound, however, as a means to counter an *expected* recession. We may well be in need of a significant expenditure boost this time next year, and an increase in exports is not a bad solution to such a problem. Of course there are other ways to bring about an export-led recovery. A lower exchange rate would be useful, and it can be arranged by the government renegotiating its Policy Targets Agreement with the Reserve Bank.

The final possibility to consider – indeed the way most of TV1's viewers will have interpreted Helen Clark's words – is that the *balance of trade will improve* by $200m as a result of the free

trade deal with China. The problem with this interpretation, however, is that ever since 1985 our policymakers have been committed to the proposition that our balance of payments doesn't actually matter.

For much of our history, we like many other nations had a "mercantilist" mindset. China, more than any other country today, still has such a mindset. That's why China persists in using a fixed and undervalued exchange rate. China's policy is to run a current account surplus.

A mercantilist mindset is the belief that it is especially good for a country to earn more foreign currency than it spends; in other words, the balance of payments is seen as the nation's predominant economic performance indicator. It certainly was true of New Zealand during the Muldoon era, when "think big" projects aimed at saving and earning foreign exchange were the centrepiece of government policy. Today, Asian countries actually lend to countries like New Zealand the money to buy Asian-sourced goods.

Since 1985, New Zealand economic policymakers moved into an extreme anti-mercantilist phase. Only efficiency and inflation mattered. They thought it would be quite a good idea to build an economy based on activities like financial services, information, and construction. We would import most of those other mundane items that travel on ships. So long as we maintained a good relationship with our potential creditors, we could always borrow the funds required to pay for our imports. All we had to do was to offer to pay higher interest rates on the funds we borrowed than other more old-fashioned economies were willing to pay. Exports were OK, but they were no longer seen to be of special importance. It was creditors, not farmers nor manufacturers, who had to be pampered.

Does the current account of the balance of payments matter at all? Does it matter if foreigners accumulate claims on New Zealand's goods and services at a faster rate than the New Zealand economy grows? Most of them don't want our goods and services anyway. While gathering our generous offerings of interest, they just needed to be reassured that their claims on our economy would be saleable in the future.

If the balance of payments doesn't matter, then why bother having a tradable sector at all? We could completely specialise in non-tradable construction, utilities and services. We could buy all our goods on overseas-sourced credit.

Taking the anti-mercantilist position to that extreme is obviously ridiculous, especially if all countries were to attempt to do the same. Therefore we must conclude that maintaining a sustainable balance of payments is important, and that the free trade agreement (FTA) with China is intended, among other things, as an attempt to improve our current account deficit. Indeed, the extreme anti-mercantilism shown by Roger Douglas and Ruth Richardson is now generally rejected as political poison. John Key, for example, won't have a bar of it.

The China FTA however may prove to be futile as an attempt to improve our balance of payments. The basic mathematics underpinning balance of payments relationships is not well understood by some economists, and is certainly not appreciated by most politicians and journalists.

The most important relationship to note is that, for any country operating an unmanaged floating exchange rate, that country's official overseas reserves do not change. Hence, any net inflow of foreign money leads to an appreciation of the exchange rate and then to an adjustment of the current account to restore equilibrium in international monetary flows.

What this means is that *a net financial inflow* (loans and equities) that exceeds the country's interest bill (essentially interest payments and dividends) *causes* – through a rising exchange rate – *the balance of trade to go into deficit by the extent of that excess*. This has been the key dynamic of the New Zealand economy in recent years; a surplus on the financial account creating an equal deficit on the current account. The surplus on financial account has been caused, in the main, by high interest rates drawing debt into New Zealand. The New Zealand economy has no actual requirement for financial inflows on this scale.

A net financial inflow exactly equal to the net interest bill will lead to a stable currency and a zero trade balance. Such an "equilibrium" inflow will however lead to a current account deficit equal to the size of the large and growing interest bill.

The only way to get the balance of trade into surplus is to ensure that net financial inflows are less than our nation's annual interest bill. That will mean a falling exchange rate, more exports, and less imports than would otherwise be the case.

In the absence of a policy to manage annual inflows of debt at a level lower than our annual interest bill to the rest of the world, the gains arising from more exports to China will simply be nullified by less exports to other destinations.

Having made ourselves dependent on our international creditors, our main policy priority continues to be to convey the message to those creditors that all is very well in Aotearoa, even if all is not well when we dig a little deeper.

In the absence of a monetary policy that makes lending to New Zealand less attractive, the gains from such initiatives as the China FTA are illusory. New Zealand now needs a Policy Targets Agreement that falls sensibly between the extreme mercantilist position that the current account of the balance of payments is all that matters, and the extreme anti-mercantilist position that says the current account of the balance of payments does not matter at all.

The 1989 Reserve Bank Act was drawn up in the middle of the Douglas/Richardson era of economic policymaking. The Policy Targets Agreements continue to reflect an epoch of thinking that substantially came to an end in 1993. A that era, getting inflation down was represented as all that mattered. And only crude interest-hiking monetary policies were presented as an acceptable way of dealing with inflation.

We continue to sleep in the monetarist bed that we made 20 years ago. That is not by any reckoning "good for the economy".

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