Hon Bill English

Minister of Finance

Speech to the Auckland Chamber of Commerce and Massey University

Building Our Economic Opportunity

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Good afternoon and thank you to the Auckland Chamber of Commerce and Massey University for inviting me back to speak to you this year.

A lot has happened since I was at this forum 12 months ago.

Throughout 2010, aftershocks from the global financial crisis continued to ripple around the world.

Today I'm going to talk about what we are doing to equip New Zealand for this changed world.

First, the end goal is one we can all agree on. We'd all like to see our economy growing at a strong, sustainable pace, creating new jobs, and supporting all the things Kiwis are good at.

Who's to say what we're actually capable of? The sky is the limit. But more objectively, we can set a minimum standard of what the economy ought to achieve simply by looking at what we've managed in the recent past.

Between 1989 and 2005, over a 17-year period, on average the New Zealand economy:

- Grew GDP by over 3 per cent per year
- Expanded export volumes by over 5 per cent a year
- And created 32,000 jobs a year

We did this despite one world recession, two Gulf wars, the Asian crisis, tech wreck and various other setbacks.

Government finances improved steadily through this period.

Why did we perform so well? Put simply, we did it because the economy was competitive. Previous economic reforms helped to get Government finances and the structure of our economy into shape.

But the years between 2005 and 2008 stand in sharp contrast. When the rest of the world was growing strongly, in New Zealand:

- A combination of poor policy and the recession meant that, in per capita terms, the economy shrank by 1.7 per cent over those years.
- Export growth slowed to a crawl.
- Job growth came from all the wrong places - domestic parts of the economy such as public administration, retailing, health and education. This was unsustainable.

The consequences of this decline are readily apparent. Had export growth continued at the previous trend rate, exports would today be almost $11 billion above today's level. This is an enormous lost opportunity.

Basically the economy is not growing as it should because it is not competitive enough.

So at one level the challenge we face is straightforward.

We need to get our labour force and our investment focused back on the areas where we are internationally competitive.

We need to get our exports growing again and bring what we're earning back in line with what we are consuming.

In theory, this is reasonably easy to understand. In practice, doing it is complex.

It means making sure the private sector gets the right signals about what it should be doing.

And it means the public sector delivering the necessary services without it being an undue burden on the rest of the economy.

The global environment

Let's start with some good news. 2011 is forecast to be a better year than 2010. The Treasury is predicting economic growth of more than 3 per cent this year, together with higher wages and falling unemployment.

Overall our trading partner growth remains strong. We have been well served by our strong ties with Australia, and our strong and growing links with Asia.

While growth in these areas could slow over the next year, they have been a major support through the downturn.

We are currently benefiting from strong world commodity prices, up 27 per cent over the past year according to the ANZ Commodity Price Index.

This trend may continue. New Zealand is one of the world's most efficient food producers. World demand for food is constantly rising.

We have genuine competitive advantages in agriculture and other primary industries. We are a great destination for tourists and we have world-class companies in high-tech manufacturing, education, software, film and other industries.

Our trade is moving quickly towards Asia. In the year 2000 the United States took 15 per cent of New Zealand's exports, and China 3 per cent. By 2015 it will be almost the other way round.

Exports to China have trebled since the free trade agreement was signed, with dairy and forest products to the fore.

This is the type of flexibility the economy needs to show. Historically, world trade has growth at two to three times the rate of GDP growth. Taking advantage of this, as we did in the 1990s, is the surest way to prosperity.

The Government's priorities to date

Most of you will well know the situation the incoming Government faced in late 2008.

This was mere months after Lehman and various other leading financial institutions had collapsed. At the time the risk of a return to the 1930s seemed all too real.

In our first year, we focused on helping New Zealanders get through the recession and preserving as many jobs as possible.

Budget 2009 limited the growth in debt to manageable levels and maintained the country's credit rating.

In hindsight, given the limited rise in unemployment and containment of Government debt, I feel we got the balance about right.

Last year's budget was about future growth. It included significant tax changes, which followed strong recommendations from the Tax Working Group. The upshot was strongly improved incentives to work, save and invest.

The tax changes were an example of pro-growth initiatives that can be achieved even in a tight fiscal situation.

Both the 2009 and 2010 tax packages were fiscally neutral. In fact they were marginally fiscally positive.

To permit reductions in tax rates across the board, the Government ended ineffective R&D tax credits, reduced KiwiSaver subsidies in a way that made no difference to the numbers joining, raised GST and tobacco excises, and lifted the effective tax rate on property and foreign owned investment.

I should mention that the tax changes were also broadly distributionally neutral. Once all tax package measures are allowed for, the impact on income distribution was essentially zero.

We have steadily unfolded our ongoing six-point economic plan covering broad economic policy. This has focused on boosting productive infrastructure; removing red tape and regulation; supporting business innovation and trade; improving education and skills and lifting public sector services and productivity.

The thrust of economic policy has now shifted from managing through the recession to making the economy more competitive. I'm here today to tell you that that pace is going to step up further.

Current situation

The economy is now part way through this adjustment. Private savings rates have lifted sharply and the appetite to incur additional debt has diminished.

In the short term, a higher savings rate limits consumption and retail spending. This was readily apparent through the second half of 2010.

In the longer term this is a necessary pre-requisite for faster and enduring growth.

I was pleased to see this neatly set out last week by Bank of New Zealand economists. They said gross household savings as a proportion of disposable income is on track to reach more than 5 per cent in the current March year – the best result since 1992.

As BNZ's economists noted, the process will be a bit painful in the short term, but it is laying the foundations for lasting, quality economic growth over the medium to long term.

Why this recovery is different from the past

In this regard, this recovery is fundamentally different to previous recoveries in New Zealand.

In previous recessions, at least since the currency floated in 1985, we've seen the New Zealand dollar drop and exporters – particularly in the provinces – benefit from both higher incomes and easier credit.

Typically this has in time flowed through to a sharp pick up in domestic spending – kicked along by credit expansion and a recovery in general asset prices.

This time, expansion has been more subdued. While corporate balance sheets are mostly in good shape, households are still paying down debt.

Consumers and businesses have little appetite for more debt and annual credit growth remains close to zero on most measures.

Two international complications are also shaping the adjustment.

First, world currency markets find themselves in an unusual situation.

Since Bretton Woods collapsed in the early 1970s, the system of floating exchange rates has worked tolerably well. Generally, deficit nations with weak growth and falling interest rates have depreciated, and vice versa.

The anomaly at present is that a block of nations with strong growth and apparently under-valued currencies, notably in Asia, have been reluctant to appreciate. Despite this, the currencies of major economies with weak growth, including both the US and UK, have depreciated, as is appropriate.

The upshot is that a number of smaller nations, including New Zealand, have experienced greater upwards pressure on their currencies than usual. While this is unlikely to be sustained, it is not helpful to the adjustment our economy needs to undertake.

Second, credit markets remain nervous. In the weaker European nations interest rate risk premiums rose steadily through 2010, and remain close to all time highs.

They remain far above, for example, the spikes reached when the Greek crisis broke last year. A renewed sovereign debt crisis cannot be ruled out.

The inevitable conclusion from all of this is that we must get our own house in order. The benefits of maintaining a competitive economy with sound finances are always high. At present the costs of not doing so may be very high.

Improving private sector savings and investment performance

The most important part of a competitive economy is a healthy private sector.

Of course, the Government does not control the business sector. Our task is to get the environment right so that you, the part of the economy that really creates jobs and wealth, can get on with your role.

One concerning aspect of the economy's performance over the past four decades has been its reliance on foreign capital. It is by no means obvious why this should be.

What is clear is that the rapid rise in net foreign liabilities is unsustainable. In part it reflects the binge in spending apparent in the middle part of last decade. This produced four successive years of current account deficits around 8 per cent of GDP - close to an all time OECD record.

Simply servicing the existing debt of almost $170 billion is a strain on the economy. These concerns are front of mind for credit rating agencies, and feature heavily in the discussions the Government has with them.

For these reasons, the Government last year established the Savings Working Group to review the evidence and policy options.

What quickly becomes apparent is that there is no one single policy change that will materially alter the position.

Alongside lifting national savings, we need to make the economy more competitive, so that our exporters fare better and the trade account improves as a result.

The Working Group presented some interesting ideas about how we might improve the tax system on savings; how we might make KiwiSaver more effective; and how the Government itself might play a bigger part in increasing national savings.

The Government has an open mind about those things. The only Working Group ideas we have ruled out at this stage are a further increase in GST and a new social security tax. And we have no plans to reintroduce interest on student loans.

It's important to remember that this is not solely about retirement savings or even private savings more generally. Our challenge is to increase national savings – right across households, business and the Government.

Part of the required change is cultural. New Zealanders have, to some degree, lost faith in their mainstream savings institutions.

This was emphasised by the Capital Market Development Taskforce. It was further emphasised, as if that were needed, by the multiple finance company failures of recent years. We are determined to change that.

Ministers will carefully consider savings and investment options over the next few months, with a view to including some measures in the May Budget.

Improving the operations of Government

Let me now turn to the Government's role in lifting national savings and making the economy competitive.

As the Prime Minister has confirmed, the Government will focus on two areas this year - on both the operating and the capital sides of its spending – to ensure it borrows less in future.

The main control tool used in the Budget is the new spending allowance. This is currently set at $1.1 billion a year.

This figure has already been pruned from an average $2.8 billion a year in each of the previous Government's last five budgets.

That lack of discipline, which allowed total spending to increase by more than 50 per cent in six years, has damaged the economy. It sucked resources out of the efficient, export orientated side of the economy, and lowered our competitiveness.

We plan to reduce that new spending allowance in Budget 2011 to around $800 million to $900 million. I would like to think this is just a start and that at least some of this restraint could continue into future budgets.

We will continue to prioritise new spending in health and education – and initiatives that promote economic growth. And we will continue to reallocate existing spending into our priority areas.

Elsewhere there is still strong upward momentum in the system.

For example, over the next four years, New Zealand Superannuation costs will rise by almost half a billion dollars each year, driven by both indexation and higher numbers of retirees.

Other income support benefits are projected to rise by about $300 million a year, and finance costs by almost $550 million a year.

All these elements make the task of getting back to surplus harder. But despite this, the Treasury's current projections show that providing revenue remains on track, this tighter budget approach will allow us to return to meaningful surplus in 2014/15 – a year earlier than currently forecast.

Until we get back to surplus, we will allocate any positive revenue surprises to further reducing the deficit.

Looking at the mix of assets we own

The second area the Government will consider is capital spending – traditionally overlooked by successive governments.

Our first Investment Statement, published in December, shows that the Government, on behalf of taxpayers, owns $223 billion of assets.

This covers a vast array - everything from hospitals, roads, schools, police stations, conservation land, state houses, and military hardware, to the Super Fund, electricity companies and coal mining operations.

The Investment Statement reveals just how many calls on Crown capital there are.

By 2015 the Crown expects to acquire an additional $70 billion of assets, spread widely across its operations. This is more than the value of the entire New Zealand sharemarket.

Once depreciation and the run down of some temporary financial assets are allowed for, the net increase in assets to 2015 will be about $33 billion, taking total assets to some $256 billion.

This figure includes many high-priority areas, including new schools, hospital operating theatres, ultra-fast broadband and roads.

What the exercise highlights is the need to ensure that this capital is well used. It is a cost to the rest of the economy, and needs to be put to best use in each of the activities where Government engages.

Commercial assets

As the Prime Minister outlined, this reinforces the need for the Government to prioritise where its capital is used.

After all, that's what any business or household does all the time – they sell some things they own, they buy others, or they use the money to pay down debt.

The Crown has traditionally been poor at doing this. The usual response is simply to request more capital.

To give just one example, Housing New Zealand holds around $15 billion of assets, more than all the SOEs combined.

The managers of the corporation have pleaded for, and have now been granted, the ability to dispose of empty houses where there is no demand, reconfigure decaying or obsolete stock, and build the type of houses actually needed where they are needed.

There is little doubt that both tenants and taxpayers will be better off as a result. It's a change that should have happened long ago.

This same ability to shift our capital to where it can be best used needs to apply across the board.

At present, expanding funding sources for commercial assets presents the greatest scope to change the Government's asset mix.

This makes sense from all angles. It frees up Crown capital, provides the companies themselves with wider access to capital, and imposes greater transparency and commercial discipline.

At the same time, it allows the Government to retain control, and ensures permanent New Zealand majority ownership and domicile of the operations.

Air New Zealand has been a good example of the mixed-ownership model working well. I do not believe that Air New Zealand would have performed as well as it has, in a challenging operating environment, had it been a 100 per cent Government owned SOE.

The mixed-ownership model

At the same time, we want to provide Kiwi investors with opportunities to put their money in solid, New Zealand-controlled companies.

So we have asked Treasury for advice on the merits and viability of:

- Extending this mixed-ownership model to Mighty River Power, Meridian, Genesis and Solid Energy, with the Government retaining a majority stake in these companies.

- Reducing the Government's shareholding in Air New Zealand, again while maintaining a majority stake.

The Government will proceed with the extension of the mixed-ownership model only if the following tests are met:

- The Government would have to maintain a majority controlling stake by owning more than 50 per cent of the company.

- New Zealand investors would have to be at the front of the queue for shareholdings, and we would have to be confident of widespread and substantial New Zealand share ownership.

- The companies involved would have to present good opportunities for investors.

- The capital freed up would have to be used on behalf of taxpayers to fund new public assets and thereby reduce the pressure on the Government to borrow.

- The Government would have to be satisfied that industry-specific regulations adequately protected New Zealand consumers.

Ministers will consider Treasury's advice and make its position clear to New Zealanders well before the election in November.

Our opponents say we would be selling the family silver to foreigners.

They are wrong: For a start, they are ignoring the Kiwi ownership tests I've just outlined and the requirement for the Government to keep a controlling stake.

We should also remember that New Zealanders own substantial equity assets overseas, in fact almost as much as foreigners hold equity here.

If we are focused on sovereignty, then we should remember that it is the total picture that matters. Running current account deficits means that foreigners will acquire claims on the future income streams of New Zealand.

That's why the Government is focused on lifting national savings and improving competitiveness. If we don't do that, then our obligations to foreigners will inevitably increase.

New Zealand's infrastructure programme

Finally, let me touch on one area where we have successfully redirected capital.

Two years ago we embarked on New Zealand's largest infrastructure investment programme.

This included schools, state houses, hospitals, prisons and ultra-fast broadband. In addition, we have boosted spending on State Highways to $1 billion a year and we're investing more than ever on upgrading the national electricity grid.

This played a part in supporting capital spending which was otherwise weak.

Recently, statistics from construction industry research company Pacifecon showed that two thirds of all construction projects worth over $5 million in December and January were in the public sector.

The impact of almost $500 million of publicly-funded building projects which the Government fast-tracked two years ago has also become apparent.

These have included upgrades to over 11,000 state homes, 10 new schools which will open between 2010 and 2012, and acceleration of state highway projects.

Collectively, these projects have directly created around 4000 jobs, and are estimated to have indirectly created another 1200.

In addition, we've allocated $347 million over four years for our home insulation programme, which has so far insulated almost 89,000 homes around New Zealand and supported an estimated 2000 jobs.

The point is that the need for capital investment is dynamic. These projects were appropriate at the time, but future needs will be different. In a competitive economy investment, must be able to be redirected where it is needed.

Conclusion

In closing, I'm confident that New Zealanders understand the challenges we face. They are supporting the Government's direction to be more sensible and disciplined because it is what they are doing themselves.

The challenge now is to build confidence and get on with building a faster-growing economy. The global financial crisis was a major shock. But on closer inspection the glass is more than half full. For example, by world standards we have:

- low tax rates and generally a sound tax structure
- a flexible labour market
- generally improved regulatory regimes
- certainty about our emissions trading regime
- a financial sector that has remained sound

And on top of this we have strong terms of trade and solid growth in key trading partners.

Now is the time to build on this early momentum. The next few years will be about getting out of a survival mentality and into growth mode.

I note that a number of business leaders, including some of the major financial institutions, have been making these points publicly. As business leaders you all have a role in restoring confidence and making full use of this opportunity.

Thank you.