

## **Business NZ recommendations: response to global financial crisis**

The current global financial crisis brings the risk of damage to the New Zealand economy.

Although a potentially difficult time, this is not the first time that New Zealand has experienced a recession and we are now better informed and better placed to react in an effective and coherent manner than in the past.

Business NZ offers a set of recommendations below for responding to the current crisis, based on the need for an effective and coherent plan.

The current crisis has a different cause from past recessions. It is not, as claimed by some, a failure of markets or a failure of capitalism. Instead, it was interventions by governments and central banks – promoting the expansion of too-easy credit and underwriting mortgage and other schemes without sufficient asset backing – that caused the debacle.

The lesson to be drawn is not that there is something at fault within markets, but that governments can cause huge problems by intervening in markets.

It is by using markets and private sector business that the crisis will be overcome. The only means of turning around the economy and returning growth is by private sector business. Governments cannot grow an economy; they can only enable it by creating a framework within which businesses can grow. The overriding need is for the New Zealand government to ensure it has the right framework to enable business to bring us through the present difficult times.

The recommendations below are principles-based rather than ad hoc or knee jerk responses. It is important that actions taken in response to the crisis form part of a coherent plan and are not unduly affected by domestic electoral considerations or other pressures.

The temptation to over-regulate should be resisted. The crisis having resulted from inappropriate interventions by governments, there is no basis to suggest that more interventions will somehow fix the problem. Rather, there is a need to review existing regulations to discard or amend those that may be hindering the private sector from doing its job of creating wealth and well being for New Zealanders. Any immediate interventions that are clearly needed in response to the crisis should be accompanied by a clear exit strategy with time limits for the completion of the intervention concerned.

There is a moral hazard element to the decision to guarantee bank deposits, although in this case outweighed by the need to act in concert with other countries. Business NZ supports the decision, but we think that the New Zealand Government, in coordination with the finance sector and other governments, should be actively seeking ways to eventually remove these guarantees as international and domestic conditions permit.

## Outlook

The outlook for the international economy has deteriorated rapidly with reduced growth forecasts and a re-pricing of credit risk. New Zealand, like other countries, will see risk and uncertainty increase the cost of credit, investors become more risk averse and banks become more cautious in lending.

The reliance of New Zealand banks, companies and households on offshore finance - about one-quarter of bank finance comes from offshore - will place increased pressure on interest rates.

There is concern about the ability of New Zealand banks to source funds through wholesale markets in the absence of explicit government guarantees. While this has not been an issue to date, the need for banks to raise further significant capital within the next two or three months could bring this to a head unless the government steps in to guarantee wholesale transactions as well as retail deposits. However the risks, including unintended consequences associated with such guarantees, need to be thoroughly examined.

A big risk issue for New Zealand households, and to a lesser extent companies, is the level of debt and consequent liabilities. In recent years New Zealanders generally have lived beyond their long-term ability to pay, leaving New Zealand exposed to changes in international sentiment regarding capital.

Given the ongoing cost of servicing a large stock of debt and given that New Zealand's terms of trade have peaked, it is unlikely we will see improvements in the current account deficit for some time. NZIER Consensus Forecasts (September 2008) show deterioration in the outlook for the current account compared to previous forecasts in June 2008.

New Zealand is however in a relatively benign position in terms of fiscal and monetary policy settings. New Zealand banks have not been involved in many of the complex financial transactions that have caused significant losses for many large global institutions.

The Finance and Expenditure Select Committee has recently released its long-awaited report on the *Inquiry into the future monetary policy framework* which confirms that New Zealand's monetary policy framework is fundamentally sound and rules out the need for any changes to the Act or the conduct of monetary policy. It makes useful points regarding monetary policy needing assistance from fiscal and regulatory policy and also mentions the fundamental need to improve productivity outcomes in order to achieve long-term sustainable growth.

New Zealand has until recently maintained a relatively tight monetary stance in light of ongoing inflationary pressures, hence the Reserve Bank has room to reduce interest rates further if necessary.

New Zealand's operating balances have declined but are still in positive territory. Government debt is also low by international standards, providing a cushion against a potential downturn. The pre-election Economic and Fiscal Update showed a significant deterioration in fiscal position due to inappropriate expenditure and a contraction in tax receipts. However by international standards New Zealand is still in a reasonable position to weather any significant global downturn.

Growth is expected to pick up in 2009 as a result of personal income tax cuts, recovery in agricultural production from the drought of 2007/08, added expansion in the dairy sector from dairy farm conversions, reduced fuel costs, a more competitive \$NZ, and expectations of further cuts by the Reserve Bank in the OCR.

## **New Zealand response**

Responses to the situation must be thoroughly thought through to reduce the potential for unintended consequences. There is no silver bullet in either the short or medium term, although a number of actions can be taken to facilitate recovery and make the economy more resilient to any future shocks.

The government's role is to provide consistent leadership as uncertainty or inconsistency in policy approach will result in businesses and households deferring decisions which could delay economic recovery.

Widespread calls for greater regulation are generally unhelpful and ad hoc policy responses can bring significant unintended consequences further down the track.

Cost impositions on the business sector such as the emissions trading scheme should be softened, as in other countries, to ensure the costs are more evenly spread amongst the whole community of taxpayers. Increased labour market interventions and cost drivers such as significant increases in the minimum wage should not be progressed.

With the above in mind, Business NZ would be supportive of an investment-led, growth-promoting mini-budget or other high level plan shortly after the general election, to provide an economically cohesive reform agenda to shore up business and consumer confidence. There needs to be proper consultation with major stakeholders to get buy-in where appropriate. Business NZ is willing to assist in such a process.

Sound fiscal, monetary and regulatory policies without unnecessary constraints or cost impositions from government will facilitate rapid adjustment to changed circumstances.

Any policies or expenditure programmes should be squarely focused on raising productivity and increasing efficiencies in the economy, not on redistribution. Business NZ would support the review of a number of assistance programmes with the objective of reducing poorly targeted expenditure.

## **Recommendations**

Business NZ offers recommendations in the following policy areas: regulatory, expenditure and tax, infrastructure and product market competition, labour markets, skills, global interconnectedness and innovation:

### **Regulatory policy**

The ability of Government to regulate comes to the fore at a time of crisis. Any regulatory intervention in response to the current financial crisis must be thoroughly thought through, not knee-jerk in nature. Regulation by itself cannot improve growth and wealth outcomes but it can hinder them by increasing costs and uncertainty and can also have unintended consequences as with the Fanny Mae and Freddie Mac debacle. Beyond the short term it will be important to regularly review regulations to ensure the need for them still remains, and to ensure they do not conflict with the goal of economic growth.

## **Recommendations**

### **Short term**

- Consider government guarantee for wholesale market transactions to ensure credit to banks, companies and households is maintained.
- Slow down the implementation of the emissions trading scheme to minimise the transition costs to businesses and the public.
- Ensure new regulatory policies do not unnecessarily impact on business costs and flexibility.

### **Medium term**

- Review legislation and regulations to determine whether they are achieving the original objective and are still required.
- Introduce sunset clauses within all relevant new legislation or regulation.
- Introduce a Regulatory Responsibility Act.
- Establish a gatekeeper department independent from government to provide a separate view on all proposed regulation and undertake ongoing investigations into existing regulation identified as problematic.
- Clarify policy on property rights for natural resources to ensure efficient allocation, investment and environmental protection.

### **Expenditure and tax**

Tax policy has a major impact on growth and influences domestic and international investment decisions and the allocation of resources. Given that tax burdens derive from spending decisions by government, these decisions must be responsible and disciplined, especially in the light of the current financial crisis.

The following examples could be considered areas of imprudent Government expenditure which should be reviewed as circumstances permit:

1. Increased spending on *Working for Families* - This effectively makes three-quarters of working families recipients of social welfare. Government

redistribution policy increases administration and bureaucracy and, some analysis suggests, creates poverty traps. Tax cuts would provide greater incentives for all families and individuals to work harder and retain earnings for investment or spending as they see fit.

2. Interest free student loans (and proposed universal allowances) - This effectively provides subsidies for students to spend beyond their means without the incentive to retire debt as soon as possible upon graduation. Students are encouraged into debt with the knowledge they are not subject to the normal pressures of debt servicing, with some re-investing interest free funds for profit.
3. Expanding local government rates rebates to low-income earners, irrespective of assets held - This will reduce incentives for discipline in local government expenditure.
4. Increasing superannuation payments - This is not targeted at those in greatest need, given that superannuation is not subject to income or assets testing.

## **Recommendations**

### **Short term**

- Focus on investment in growth-promoting areas rather than redistribution.
- Introduce 'value for money' reviews of government expenditure.
- Bring forward personal tax cuts.
- Introduce depreciation rates that reflect the economic life of assets and take into account the changing economy e.g. move towards shorter life of assets in the ICT and other sectors.

### **Medium term**

- Work towards government spending below 30% of GDP.
- Progressively flatten tax scales.
- Remove discriminatory taxes on particular sectors of the economy.
- Review policies on expenditure in welfare areas including Working for Families, interest free student loans, superannuation payments and rates rebates.

## **Competition in product markets and infrastructure provision**

Over recent years reduced barriers to entry in the domestic economy and increased exposure to international markets have increased competition in the New Zealand economy. Competitiveness should continue to be fostered.

Relevant central and local government services should be opened to competition and government investment in infrastructure should be subject to rigorous benefit-cost testing to ensure value for money. Ongoing incentives to improve management capability in the private sector should be fostered in the public sector also.

Uncertainty surrounding water rights or resource consents can delay or deter investment in areas such as roading, hydro generation and transmission infrastructure, reducing the ability to plan ahead with confidence; meanwhile resources prices rise due to 'artificial' shortages.

## **Recommendations**

### **Short term**

- Improve signals and advance market warning regarding future large scale infrastructure plans to enable market participants to gear up to contribute.
- Institute infrastructure planning and provision in such a way to allow smaller market players to contribute in the short term.

### **Medium term**

- Bring forward infrastructure investment where possible.
- Ensure product and service markets are open to competitive pressures
- Continue support for the light-handed regulatory approach to product markets provided for under the Commerce Act 1986.
- Examine the possible introduction of a Merits Review so that regulatory bodies are accountable for the decisions they make in line with world best practice.
- Introduce market based systems for allocating natural resources.
- Ensure government investment in infrastructure meets benefit-cost testing for value for money.
- Open some central government services up to competition including accident insurance.
- Open some local government services up to competition including rubbish and water services.
- Improve performance monitoring of the public sector.

## **Flexible, responsive labour markets**

A time of financial crisis brings the need for more flexibility in labour markets to enable responsiveness to changed conditions. Unnecessary regulation should be avoided or reduced as it can result in individuals being locked out of the workforce. Government responses to the crisis should focus on enhancing access to the workforce and improving skill levels.

Businesses, employees and the government must all be aware of the changing nature of work and plan ahead accordingly. Parties past practices may not be in keeping with the need to improve the ongoing productivity of the workforce. The “one-size-fits-all” approach is unlikely to be flexible enough to meet the unique demands of the international marketplace. All parties must be constantly vigilant of practices whether voluntary or supported through mandatory regulation that reduce the potential productivity of the workforce.

A key focus of government interest in recent years has been the plight of those with fewest skills. This is appropriate and is likely to take on greater importance during the economic downturn. Some political parties have responded to the downturn by calling for significant increases in the minimum wage. This is more likely to harm than help those who are most at risk of being laid off. Other proposals for compulsory redundancy compensation would limit the ability of firms to get through the current crisis.

Government responses should focus on providing opportunities for those with fewest skills to lift their skill levels. The literacy and numeracy campaign will be useful in this respect, but Government may also want to consider some additional targeted assistance e.g. training vouchers for people on very low incomes.

## **Recommendations**

### **Short term**

- Relax rules on trial periods and fixed term contracts to enhance labour market access.
- Restrain growth in the statutory minimum wage to allow more people to enter and remain in the workforce.
- Improve systems for job-employee matching to reduce frictional unemployment, e.g. the active labour market *Security in Change* project.
- Support greater coordination of service delivery in relation to job opportunities and social welfare.
- Support transition assistance with relocation expenses associated with new job opportunities.

### **Medium term**

- Improve flexibility in the Employment Relations Act and Holidays Act subject to reasonable minimum standards.

## **Skills**

Although workforce skill levels have increased significantly over the last twenty years, significant gaps remain as constraints on growth. Current tertiary policy is delivering high level qualifications not matched to actual jobs. Availability of management skills is a concern, along with low literacy and numeracy skills in the workplace. Recent steps to increase funding for workplace literacy should continue.

## **Recommendations**

### **Short term**

- Investigate immediate steps to help retain apprenticeship and training levels.
- Bring forward and increase funding for workplace literacy and numeracy training.

### **Medium term**

- A stronger focus on school performance and accountability, particularly with regard to literacy and numeracy.
- Improvement in quality of management education.

## **Global connectedness**

The small size of New Zealand's economy means New Zealand is reliant on international trade and it is in our interests for restrictive trade practices in other countries to be broken down. Immigration policies need to reflect the importance of the international transfer of ideas, technology and innovative techniques.

## **Recommendations**

### **Medium term**

- Continue policies that facilitate international connections, trade and increased immigration of skilled people.

## **Innovation**

Globalisation and the integrating world economy mean that standards of innovation, quality and service are being set internationally and the onus is on New Zealand enterprises to keep up. By international standards R&D in New Zealand is relatively low, with the government sector playing a more significant role than the private sector. More effective R&D practices are required for New Zealand to compete internationally.

## **Recommendations**

### **Short term**

- Ensure R&D policies do not unnecessarily constrain investment compared to our major trading partners.

### **Medium term**

- Seek stronger incentives for universities, CRIs and other publicly-funded research organisations to work with firms on innovation and research commercialisation.
- Improve coordination among agencies responsible for the delivery of public support and set guidelines for the provision of grants to improve policy coherence.
- Better coordinate publicly funded research intended for commercial application.