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## **RODNEY'S RAVINGS**

How strong can the economy grow on a sustainable basis?

### **EXECUTIVE SUMMARY**

In recent years the Reserve Bank and most economists have been inclined to assume that the New Zealand economy can grow at around 3.5% per annum in volume or real terms without it causing an inflation problem. Prior to the recent "slowdown" in growth, the economy had grown at 3.7% per annum over the previous 12 years, which gave substance to the view that the economy's growth potential was around 3.5%.

Many a silly conclusion has been arrived at by selective analysis of history and/or by only looking at a piece of the puzzle not the whole picture. During the 12 year period from 1993 to 2004 that economic growth averaged 3.7% per annum the unemployment rate fell from 10% to 4%. The logical implication of this is that for economic growth to average 3.7% per annum over the subsequent 12 years the unemployment rate would have to fall from 4% to -2%. And that is just plain impossible!

While most economists seem oblivious to this fact, the starting point matters for assessing the economy's non-inflationary growth potential over the subsequent 5-10 years. In the early 1990s the unemployment rate was exceptionally high and most firms were operating their plant and equipment well below full capacity. This meant that for an extended period of time economic growth could run above the long-term sustainable rate without resulting in undesirable inflation and other implications (like the massive external deficit NZ now has).

But if the starting point is one with an exceptionally low unemployment rate and with most firms operating pretty close to full capacity (as it is now), the non-inflationary growth potential for the economy over the subsequent 5-10 years is much lower (i.e. below our 2.4% estimate of the long-term sustainable rate). And that is the challenge New Zealand, and especially the Reserve Bank, now faces.



Rodney Dickens  
Managing Director and Chief Research Officer  
Strategic Risk Analysis Limited  
[rodney@sra.co.nz](mailto:rodney@sra.co.nz)

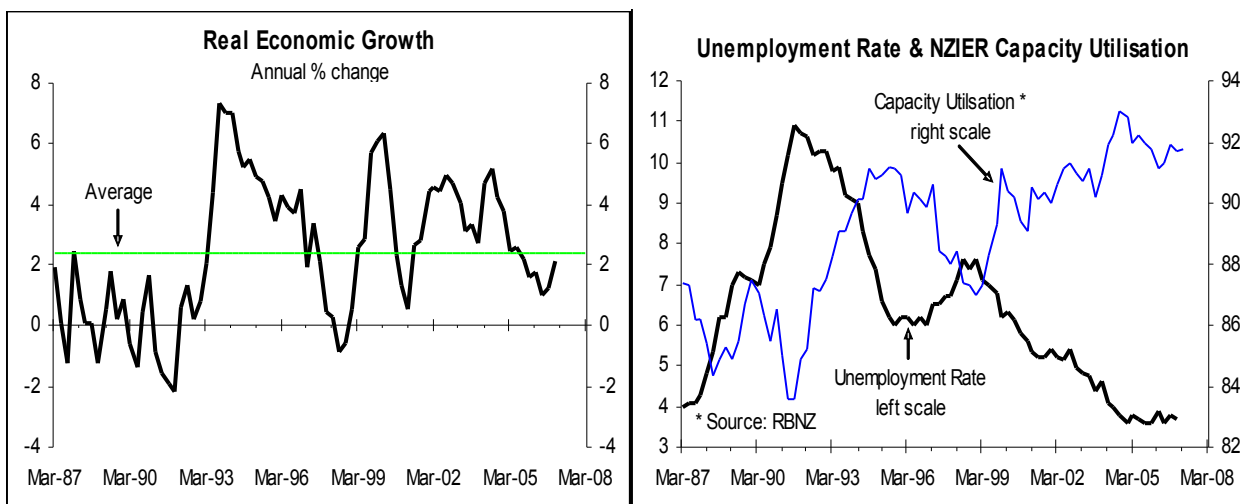


**The sustainable rate of economic growth and the economy's scarce resources**

The left chart below shows the history of annual economic or GDP growth for New Zealand as far back as we can obtain reliable data, or at least semi-reliable data, with growth measured in real or volume terms. The historical average growth rate over this period has been 2.4% per annum (the blue line), which is close to our assessment of the economy's long-term growth potential when the starting point is neutral/normal.

In the late-1980s and early 1990s the Reserve Bank was hell bent on getting inflation under control using high interest rates (in those days, high meant 22% mortgage interest rates). The consequence was that economic growth ran well below average (the left chart), while the unemployment rate skyrocketed and firms ended up operating at well below normal capacity utilisation rates (the right chart). Inflation was slain – or that was the popular view – and the stage was set for the glory days of high economic growth.

Aside from the 1998 recession and the temporary slowdown in economic growth in 2001 associated with a one-off shock, economic growth ran above the average rate from 1993 until the recent slowdown that started in 2005. The myth that the New Zealand economy could grow at around 3.5% per annum without causing inflation problems grew on the back of the period of strong economic growth from 1993 to 2004. However, as the right chart shows, over this period the unemployment rate fell dramatically and firms went from operating well below full capacity to somewhere around full capacity based on NZIER's survey.



Justifying a 3.5% estimate of the economy's sustainable growth rate on a conceptual or semi-theoretical basis goes something like this: let's assume that population growth averages 1.2% per annum (the historical average) and let's assume that productivity growth averages 2.3% per annum (based on a select period of historical experience when things were pretty good productivity-wise); or some combination of the two that adds up to 3.5%. Economists can justify anything if they put their minds to it.

But logic of the real world variety tell us that the economy was only able to grow at an average of 3.7% per annum between 1993 and 2004 because it was gobbling up more employees than were growing on the employee tree. It was a bit like eating what was killed for consumption each day plus a proportion of the contents of the pantry. If this behaviour is continued for an extended period then the pantry ends up empty and consumption levels have to fall back to a maximum of the daily kill, but if a drought or other inevitable shock comes along then Mother Hubbard, the dog and all will go hungry for a period.

New Zealand has eaten so heavily into the stock of unemployed people that for most industries the effective unemployment rate, measured on the basis of the number of long-term unemployed people actually making themselves available for work, is zero. Consequently, the main way to attract staff is to steal them from competitors and other employers, which bids up labour costs and in time leads to general price inflation. In this environment, in which bargaining power is heavily with employees, productivity growth, a key component of the economy's potential rate of economic growth, can be expected to drop to close to zero.

The latest data on labour productivity from Statistics New Zealand shows it at only 0.4% in the year to March 2006 compared to an annual average of 2.5% between 1988 and 2006. The tight labour market, which is here to stay until the Reserve Bank sacks the economy with much higher interest rates, means

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firms will have to pander to the whims of demanding employees for some years to come. And this implies that economy-wide labour productivity growth is probably running close to zero, while for some firms it will be negative. Zero labour productivity growth means, all other things being equal, that any increase in labour costs translates into increased cost per unit of production, or per haircut or cup of coffee in the service sector.

The latest round of bank pay negotiations can be viewed in the context of the inflationary implications of the current tight labour market: “Westpac staff will vote on a pay deal next week that would increase wages by up to 11.8 per cent, their union says. Finsec spokesman Andrew Campbell said the offer would bring wages for Westpac staff into line with workers at ANZ National Bank. Some tellers would receive pay rises of \$4000 during the next year, Mr Campbell said.” (Source: The Dominion Post, 14 April 2007)

But we live in a dynamic world (i.e. by the time Westpac get their pay rates up to levels that match ANZ National staff the staff at ANZ National will have achieved pay increases and Westpac staff will again be seeking catchup pay increases next year).

Labour is now the most scarce resource, which was reflected in the March survey by NZIER showing that: “A net 41% of firms reported it is harder to find skilled labour, up from a net 29% in the last survey.” (Source: NZPA, 10 April 2007). And scarce resources get to name their price in a market economy! But the dynamics that this unleashes is that firms get inventive in finding ways of increase prices to compensate for rising labour costs, which undermines the purchasing power of the pay increases leading to employees to seek bigger pay increases the next time they visit the negotiation table. And around and around the new inflation spiral goes.

The current starting point for economic growth in New Zealand is somewhere between frightening and terrifying. However, the price of the unsustainably high rates of growth over the last several years, which has created the labour market monster, can be put off for a while yet, with the government intent on winning next year’s election with the aid of the biggest election year lolly scramble since 1981.

But at some stage Mother Hubbard’s cupboard will have to be restocked and that is only achieved by eating less each day than the daily kill (i.e. getting the unemployment rate back up to a level that does not gift employees with the upper hand in pay negotiations, which is probably around 6%). And that means lean pickings for economic growth at some stage in the probably not too distant future (i.e. at some stage over the next 3-5 years). And lean pickings means an average growth rate below our estimate of the long-term sustainable average of 2.4% per annum.