DIRE PREDICTIONS OF UNIVERSITY ECONOMISTS PROVE TO BE TOTALLY WRONG

Three years ago the 15 academics listed below wrote a letter to *The New Zealand Herald* attacking the government's economic strategy. All were members of the Economics Department of Auckland University. The academics wrote:

> We wish to state in the strongest possible terms our view that in the present state of the economy, and in the midst of an international recession, the deficit-cutting strategy is fatally flawed. It can only depress the economy further and because of this it will be to a considerable extent self-defeating .... .

Students at the university will soon be facing examinations. Three years to the month after the event, they may like to know whether their teachers deserve a pass mark for their predictions. And taxpayers may wish to judge just how good the 15 academics they support are at their jobs.

By way of background, it may be recalled that on taking office in late 1990 the National government was advised that a continuation of Palmer-Clark-Caygill policies would blow out the financial deficit from 3.3% of GDP in 1989/90 to almost 5% in 1991/92 and to 6.3% by 1993/94. The expenditure cuts, which the academics opposed, were directed at avoiding such a fiscal disaster.

The financial deficit was reduced to 2.3% by 1992/93 as a result of the government's decisions. A surplus equal to around 0.5% of GDP is expected to be recorded in 1993/94 (see Table 1) and increasing surpluses, boosted by a cyclical upturn, are now in prospect.

Was the economy further depressed as the academics predicted? Not at all. In fact economic activity stopped contracting shortly after the letter was written, remained pretty flat through to September 1992 and then began to grow strongly. The cumulative annual average rate of economic growth between the year to June 1992 and 1994 will be around 8% (see Table 2, column 2). The level of economic activity in June 1994 is likely to be almost 11% higher than when the letter was written (column 3).

Influences other than the deficit reduction contributed most to the low level of economic activity recorded in 1991 and 1992. External demand was particularly weak. Our terms of trade fell by 6.6% and 1.3% in the years to June 1991 and 1992 respectively.

Table 1
Financial Balance

Year Ended June	Financial Balance	Financial Balance to GDP
	$m	%
1991	-2,559	-3.5
1992	-2,449	-3.3
1993	-1,789	-2.3
1994	422	0.5

The government's estimate is shown for 1994.

Table 2
Rate of Economic Growth

Year Ended June	Annual Average Rate of Growth in Real GDP	Annual Rate of Growth in Real GDP
	%	%
1991	-1.2	-3.0
1992	0.4	3.3
1993	2.3	3.2
1994	5.1	3.8
1992-1994	8.0	10.7

The observation for 1994 includes the NZIER's forecast for the March and June quarters. The annual rate of growth is calculated using seasonally adjusted data.

New Zealand is now experiencing its most sustainable recovery for at least 20 years. 70,000 additional jobs have been created since June 1991, investment is growing strongly, the balance of payments is in a sound position and business and consumer confidence is high.

By the end of June, 12 quarters will have passed since the economy stopped contracting. This is almost twice as long as the average length of all cycles at least since 1965 (6.4 quarters). There are no signs of pressures that would bring the expansion to a halt.

There are unambiguous signs that economy is headed in the right direction. I would be the first to argue, however, that the job of reinvigorating the economy is unfinished, and that debt and government spending are still too high.

The policy of deficit reduction has not proved to be "fatally flawed" as the academics asserted. Rather the government has achieved its aim of balancing the budget within 3 years.

The academics' mistaken view reflected naive Keynesian thinking and failed to take into account the dampening effects on economic activity associated with high levels of debt and borrowing, high risk premia in interest rates, a crowding out of the private sector by the public sector, and continuing low levels of business and investor confidence.

By arguing that economic growth would correct the deficit, the academics did not appreciate that New Zealand had a structural deficit rather than a cyclical deficit. A structural deficit cannot be corrected by a cyclical upturn. (Similarly those who incorrectly argue that the emerging surplus should be spent are confusing a cyclical and a structural surplus.)

The alternative strategy followed by the government counteracted the negative effects of the deficit cut on demand and increased the economy's international competitiveness. The key elements were:

- greater consistency between monetary and fiscal policies. This was a direct result of the deficit and expenditure cuts. They took pressure off interest rates and the exchange rate;

- more competitive wage fixing procedures under the Employment Contracts Act; and

- increased productivity arising from microeconomic reforms.

Most of the policies which have driven the recovery were consistently opposed by the Auckland University critics of the post-1984 strategy, and others such as Professor Bryan Philpott of Victoria University. Besides resisting a fiscal correction, they also favoured a currency devaluation. This was to be implemented at the expense of the government's inflation target.

For their policy to be effective, a real and not just a nominal exchange rate adjustment was necessary. Past devaluations had failed because employees in sectors protected from international competition were soon compensated for the reduction in their real incomes. The resulting price pressures spread throughout the economy and quickly eroded the initial gains enjoyed by exporters and importers. The benefits of the 1984 devaluation, for example, were washed out within a couple of years.

The academics never adequately explained how a real depreciation would be achieved and subsequently sustained. They seldom acknowledged that devaluation is tantamount to a real wage cut. The abandonment of inflation targets would have undermined confidence in monetary policy, raised inflation expectations and started a new round of price increases. Under those conditions any real exchange rate decline and upturn in activity would have been short-lived.

Some of the critics of the strategy subsequently argued that monetary policy was eased in 1991 by the Reserve Bank to depreciate the currency as they had advocated, and that this explains subsequent growth. Their argument does not withstand scrutiny. Monetary conditions eased during 1991 in response to lower inflation and inflationary expectations. The Reserve Bank was able to further ease monetary policy in September 1991 without putting in jeopardy its inflation goal. This would not have been possible at a significantly earlier stage and without the complementary measures that the government had adopted. The overall policy package was vastly different from that advocated by the critics.

The thrust of New Zealand's economic strategy commands widespread support among authoritative agencies such as the IMF and the OECD, and internationally respected economists. It has, however, been persistently opposed by numerous New Zealand academics who peddle outdated ideas that are not supported by mainstream economists.

The minister of finance's 1991 observation that open letters advocating an U-turn in government economic policy had had a chequered history has proved to be prophetic. She referred to a similar dire warning that 364 British economists sent to Mrs Thatcher in 1981. Their letter coincided with the start of the longest expansion that the United Kingdom had experienced since the war. This lesson apparently escaped our academics.

A fail grade is the only mark that could be fairly awarded for their dismal effort.

Conrad Blyth (Professor)

Allan Catt (Professor)
Susan St John (Mrs - Senior Lecturer)
Keith Rankin (Mr - Lecturer)
Mr Robert Scollay (Mr - Lecturer)
Keith Jones (Dr - Senior Lecturer)
John Horsman (Mr - Senior Tutor)
Tony Endres (Dr - Senior Lecturer)
Steve Jones (Associate Professor & Head of Dept.)
Basil Sharp (Dr- Senior Lecturer)
Anjum Siddiqui (Dr - Lecturer)
Martin O'Connor (Mr - Lecturer)
Susan Laurenson (Mrs - SeniorTutor)
Gillis McLean (Mr - Senior Tutor)
Grant Fleming (Mr - Lecturer)