‘Tales from the South Pacific’

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For most of my life, Australia has been known as the 'lucky country'. For an even longer time New Zealand has been referred to as 'godzone' (as in God's own country). And it's true. Both nations have enjoyed seemingly charmed existences as rich, lightly populated modern economies.

When the term 'lucky country' was coined in the 1960s - by one of those disaffected 'intellectuals' the academy seems to specialize in producing - the intention was ironic. Seeking an explanation for the local version of the post-WWII 'economic miracle', Donald Horne argued that Australia simply had to be lucky. In Horne's Olympian opinion, Australia was run by second rate people and on second-rate ideas. His thesis was that the country was temporarily riding high on the sheep's back due to global prosperity. Eventually, the luck would run out.

Horne, of course, was wrong. The successes that both countries have experienced haven't been all down to luck and nature's bounty. In the recent Heritage Foundation/Wall Street Journal Index of Economic Freedom, Australia came in at #3 after Hong Kong and Singapore, and New Zealand #5. Ireland is #4, but once the impact of the crisis-cum-stimulus sweeps through the political process, next year may be another story altogether, and especially for Ireland. In the latest Legatum Institute Prosperity Index of economic competitiveness and livability, Australia is #1 and New Zealand #9. Both countries clearly have a lot going for them.

Even more importantly, both countries have a lot going for them despite the global financial crisis. In the areas of economic growth, banking and finance, Australia and New Zealand are ahead of the international pack. How well we are weathering the storm is not down to luck. How well we

will continue to weather the storm, as is always the case, will come down to good or bad public policy.

The Australian and New Zealand economies went into the global financial crisis with much better starting points in some important respects than the rest of the world. Both economies had enjoyed strong rates of economic growth and sound public finances for the past few years. The balance sheets of their banks and corporate sectors were also relatively strong. Indeed, the Australian banks are still earning solid, if reduced, profits; and the market capitalisation of the four major banks currently places them amongst the top 20 in the world, with one in the top 10. Again, more than luck is at work here.

Australia though has been better managed than New Zealand in a number of important areas during the last decade and more. It has a much lower government spending ratio to GDP. It has achieved relative gains in international rankings for competitiveness and economic freedom at a time when New Zealand, despite always ranking very highly in the past, has started to slip. New Zealand has also experienced a marked relative decline in productivity growth, and a strong net migration outflow in favour of Australia.

New Zealand started to expand government spending strongly relative to GDP after 2004 and went into recession in early 2008. The better managed Australian economy has outperformed its Trans-Tasman neighbor in the early stages of the crisis and subsequent global economic downturn.

Nevertheless, both the Australian and New Zealand economies may still defy the world. However, as small, open economies with large traded-goods sectors, it is impossible for either country to avoid the consequences of a global recession, but the downturns being experienced are relatively modest compared to other developed economies. Each new day though brings news of the harsh reality of economic conditions affecting the rest of the world and these will have an impact on the two countries.

As small open economies, Australia and New Zealand are price-takers in capital markets, so the effects of the credit crisis necessarily flow through to both economies. But both economies have proven more resilient than might have been expected.

In the third quarter of 2008, the Australia economy expanded just 0.1% q/q, but 1.9% y/y. While well below trend growth of around 3.5%, this is not yet recession territory. The December quarter showed a slight drop, but y/y growth I still positive.

By contrast, New Zealand growth contracted for the third consecutive quarter in Q3, to be down 0.1% y/y. New Zealand is more trade exposed than Australia and has a slightly lower trend growth rate and so is more vulnerable to a downturn. New Zealand also had much tighter monetary policy going into the crisis.

The Australian economy is dipping off a stronger base as we have been one of the fastest growing economies in the OECD in recent decades. The potential for continued strong growth remains very positive.

Australia and New Zealand's large current account deficits and high interest rates relative to the rest of the world are symptomatic of this strong growth potential.

So is the strong population growth in both countries in recent years. Australia's population rose 1.7% in 2007-08, faster than India (1.6%) and Indonesia (1.2%). Immigration was at record levels, accounting for 60% of the 1.7% increase. For the same period, NZ population growth was 1%, which is still high by the standards of advanced economies. Assuming that Julian Simon is right, population growth will be good for economic growth

The big story behind the statistics is that Australia and New Zealand's structural, as opposed to purely cyclical, growth performance also owes much too market-oriented reforms of the 1980s and 1990s. These reforms have improved the flexibility of the Australian and NZ economies and their resilience to external shocks such as the global financial crisis. We can thank a number of distinguished members of the Mont Pelerin Society for their roles in this, notably Sir Roger Douglas and Ruth Richardson in New Zealand and John Stone in Australia (who is at this meeting).

Australia and New Zealand are often stereotyped as just commodity exporters. In reality, the Australian economy is little different from the United States. Two-thirds of our economy is in services. Mining and agriculture combined account for only around 10% of Australia's GDP.

Consequently, the global commodity price boom has actually contributed relatively little to real growth. Higher commodity prices reflected

depressed commodity production and export volumes, so the contribution to real and direct economic growth was small overall, though strong in the resource rich States of Queensland and Western Australia.

The economic booms in the resource-rich states of Australia came largely at the expense of resources diverted from other states and sectors of the economy. The net gains from the commodity price boom were therefore smaller than many Australians realise. The global commodity price bust will therefore not weigh on the Australian and New Zealand economy as heavily as many gloomy commentators assume, though it will clearly have an important negative impact.

A freely floating exchange rate – perhaps the key market reform of the last 25 years - plays an important role in moderating the impact of external shocks on the Australian and NZ economies. Just as a rising AUD and NZD reduced the impact of rising world commodity prices on the two economies, the recent sharp fall in AUD and NZD will support commodity prices denominated in these currencies.

The floating exchange rate also insulated Australia and NZ from the worst of the oil price shock. Local increases in oil prices are much lower than the increase in the world price.

Housing and Financial Markets

The Australian and New Zealand housing market and financial system have both fared much better than their overseas counter-parts, although the New Zealand housing market has fared worse than the Australian markets. In Sydney for instance, prices have started falling, especially at

the high end, but at this point, overall, not at the rates seen in the US or UK.

Perhaps the main advantage Australia and New Zealand have enjoyed is that government-subsidised sub-prime lending never took off in Australia or New Zealand. Mercifully, neither country had the equivalent of a Freddie Mac or Fannie Mae. Government-support for low income housing has been much more limited and transparent, and did not encourage reckless lending or borrowing by low income groups.

The major Australian and New Zealand financial institutions have maintained their lending standards and avoided excessive leverage, although some of the investment banks took on more aggressive exposures. Australian banks had not completely forgotten the lessons from earlier experiences with commercial property booms and busts in the late 1980s and early 1990s.

The exposure of Australian financial institutions to structured debt products has been relatively low. Although some of the major banks took large write-downs, other institutions had no direct exposure at all to these instruments which were at the heart of the global financial crisis.

Some smaller finance companies with property market exposures have failed, especially in New Zealand. But these have not been systemically important institutions and thus have not caused problems for the broader financial system. In recent days however, the first New Zealand institution that had been underpinned by a government deposit guarantee has failed, resulting in a taxpayer payout to depositors. It is unlikely to be the last such failure.

While Australia and New Zealand housing markets have seen some big cyclical swings in dwelling investment and house prices, this has not caused major problems for Australia's largest financial institutions (which also own New Zealand's banks). Aussie banks remain well capitalised and therefore are able to continue lending.

The number of home borrowers in arrears on their home loans has remained low, even with the economy deteriorating. This may of course change.

Non-recourse type mortgages, common in the US, do not exist in Australia and New Zealand. Home borrowers cannot simply walk away from their homes. They still need to discharge their mortgage debt. This means that Australian and New Zealand borrowers face a very different set of incentives compared to US home borrowers. Australian and New Zealand financial institutions have not been inundated with so-called 'jingle-mail.'

Australia has also benefited from a predominance of variable rather than fixed rate mortgage debt instruments. Australian borrowers are thus very familiar with the idea that interest rates are cyclical and are less likely to over-commit based on temporarily low interest rates.

The predominance of variable rate mortgages means that monetary policy is very effective, flowing through to retail interest rates almost immediately. Australian monetary policy is, therefore, more potent than US monetary policy.

In contrast to other housing markets, the Australian market is chronically under-supplied. Australia has not been building enough homes in recent years to meet underlying demand.

Australian house prices fell just 3.3% in the year ended in December 2008 as demand softened. However, the shortage of supply will almost certainly limit the magnitude of further declines. On top of this the Australian government has implemented generous cash payments to encourage first home-buyers into the market. Typically these have been capitalized into prices, and recent data supports this.

Australian and NZ financial markets have also been relatively well regulated compared to other countries.

Following the 1997 Wallis inquiry into the Australian financial system, prudential supervision of the financial system was taken away from the Reserve Bank of Australia and given to a newly created regulator, the Australian Prudential Regulatory Authority (APRA).

This was a move opposed by the Reserve Bank of Australia at the time. But the guiding principle was sound and consistent with the view that monetary policy and prudential regulation are separate functions, and must be conducted independently of one another.

This model has so far proved to be successful in Australia. Contrast this with the UK, where the creation of the Financial Services Authority as a separate entity from the Bank of England, also in 1997, is now widely thought to have contributed to the problems in the UK financial system. The reasons for this are not entirely clear. But news reports in the last

couple of weeks indicate that the then Chancellor of the Exchequer, and now Prime Minister, pressured the chairman of the FSA into not examining risky lending practices. This tells us that as well as getting the institutional structure right, the way in which these institutions are used is also important. The political culture of nations and parties can never be ignored.

Australia and New Zealand also have relatively streamlined regulatory frameworks, unlike the hundreds of regulatory bodies that regulate the US financial system, which increase the scope for problems to grow between the cracks created by this multiplicity of regulators institutions.

It would thus appear that the lucky country has been lucky in these terms by making its own luck.

Policy responses

While Australia and New Zealand have both benefited from a relatively good starting point going into the crisis, the policy responses of the authorities in both countries have not been especially better than in the US, UK, and elsewhere. .

The Australian government instituted a ban on the short selling of stocks that went further than any other country. The argument in Australia was that we needed to introduce a more comprehensive ban to prevent our market being used as a proxy for short selling stocks in other markets. It has caused real splits in the Australian investment industry.

The Australian government also brought in depositor protection arrangements that went further than in other countries, again on the grounds that because other countries were doing it, Australian financial institutions had to be placed on the same footing as their overseas counterparts. This concern eventually led to wholesale funding guarantees.

There was no run on an Australian financial institution before the depositor protection arrangements were introduced. After their introduction, there was a run on many managed funds not covered by the guarantee. This forced many funds to freeze investor redemptions, creating real problems for many investors. The introduction of the depositor guarantee in Australia had the unintended consequence of creating an investor panic where there previously had been none.

The government has also intervened in the markets for residential mortgage backed securities and commercial property finance. These moves have only benefited producer interests at the expense of consumers and taxpayers.

The Australian government has thus been guilty of socializing risk and displacing private sector financial intermediation. There is little doubt that if a major Australian financial institution were at risk of failure, the Australian government, following overseas precedents, would be quick to bail it out.

Australia and New Zealand went into the global financial crisis with large budget surpluses. This was the result of strong economic growth and growth in tax receipts, and, in Australia's case, public sector asset sales.

This fiscal strength was not due to spending discipline. Indeed, good economic times undermined discipline on government spending, though the previous government was committed to maintaining budget surpluses. However, these budget surpluses are fast disappearing as governments in both countries use the surpluses for discretionary fiscal stimulus, on top of the deterioration we would automatically get due to the economic downturn.

The Australian and New Zealand governments have rolled out several fiscal stimulus packages. The former New Zealand Labour government got off to an early start with its May Budget in 2008, instituting a fiscal stimulus worth 3% of GDP, built largely around tax cuts. In 2003-4, core Crown (or government) spending in NZ was 29.4% of GDP. The latest estimate is that for 2008-09 it will be 34.6% of GDP. On current Treasury projections it will be above 35% of GDP through 2013. The OECD's latest economic outlook puts general government spending for New Zealand at 45 percent for 2009 and 2010 as against 35 percent for Australia.

In Australia, there have been no less than four major stimulus packages since October 2008.The budget balance has swung from a surplus of around 2% of GDP in May 2008 to a projected deficit of around 2% of GDP. This is likely to get even wider by the time the annual budget comes around in May 2009. However, though high by Australian standards, a 2 per cent deficit is still mild by international standards. And where other OECD countries may emerge from the recession with debt to GDP ratios of 70%, this may be as low as 10% in Australia.

The Australian government had previously paid off all of its debt in 2005 and was running up a positive net asset position, but now looks set to start accumulating net debt once again.

The case for fiscal stimulus in small open trade dependent economies with floating exchange rates like Australia and New Zealand is even weaker than for large, relatively closed economies like the US. Any increase in demand can be expected to leak into imports and put upward pressure on the exchange rate so that net exports decline.

All the other arguments against fiscal stimulus that have been raised in the US context apply with equal force for Australia and NZ. Unfortunately, the political imperatives facing politicians in Australia and New Zealand are no different than anywhere else. Their incentive is to be seen to be doing something, regardless of effectiveness or long-run consequences.

And in this regard, Australian and New Zealand policymakers at least in this current crisis seem no better than anywhere else. However, the institutional framework for the Australian and New Zealand economies has served these countries well. This is in no small part due to the market-oriented reforms of the 1980s and 1990s.

Unfortunately, this is not as widely recognized as it should be. The task for think-tanks like the one I head and for organizations like the Mont Pelerin Society is to continue to put the record straight and to continue to provide alternatives to ill-considered interventionist policy responses.

There is more to the South Pacific, as the title of my talk implies, than just Australia and New Zealand. They border the vast Pacific Ocean, which is dotted with around 30 sovereign states and dependencies with populations ranging from a few thousand to 6.5 million in the case of Papua New Guinea. Most of their inhabitants have probably not heard of the global financial crisis. This is not surprising, as the economies of these countries are typically based on subsistence, small scale agriculture, with some commodity exports (PNG in particular) and tourism. Most have become dependent on aid transfers, principally from Australia and New Zealand, and also remittances from family members resident in those two wealthy economies.

There is one feature of cultural life in many parts of the South Pacific that we, and the rest of the world, seem in danger of adopting, namely cargo cults. Depending on your definition, to believe in a cargo cult is to believe that a spiritual agent or high priest will deliver a munificent bounty to those who are true believers. Many people, both in Australia and New Zealand and around the world, have embraced fiscal stimuli and endless bailouts promised by politicians and technocratic advisers with the enthusiasm of cargo cultists. Like the island villager staring out to sea or into the air, looking for something to turn up without the effort and hard work to make it happen, this is a pretty forlorn objective for any of us.

On balance, however, we have reason to think the lucky country and godzone across the Tasman Sea that separates us will navigate the current crisis in better shape than most. If so, this won't just be due to luck, but thanks to the quality of our reforms and institutions put in place within the last generation. However, the poor policy responses that we are

beginning to see, particularly in Australia, may do much to erode the sound foundations that have been established over that period and its possible that we are in for tempestuous times not seen for more than thirty years. Let's hope not. I wouldn't want to see Donald Horne proven right after all this time.