



New Zealand since 1984: Elite succession, income distribution and economic growth in a small trading economy

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Abstract

Four interrelated patterns of structural change in the New Zealand economy since 1980 are identified and analysed, against the backdrop of a growth rate which fell substantially behind the rest of the OECD in the late 1980s and early 1990s before recovering, but without catchup, from 1993.

The changes discussed are: a shift in sharemarket capitalization from formerly-dominant productive activities in agriculture, manufacturing and construction to the current predominance of utilities, transport and finance; a sharp increase in overseas investors' share of the economic surplus, from around 20% to over half of post-tax corporate profits; a steady rise in international indebtedness at the same time as sovereign foreign-currency debt was eliminated; hence overseas debt was successfully privatized; a weakening of regulatory control over monopoly profits, opening the way for a surge of rent-seeking activity during the 1990s. The neoliberal reform programme has achieved fiscal and monetary sustainability, increased market flexibility, and insulated the economy against external shocks. At the same time it has led to denationalisation of economic surplus, ongoing current account deficits, and a significant diversion of resources from productive use into rent-seeking.

Introduction

New Zealand since 1984 has undergone one of the most radical and far-reaching sets of neoliberal economic reforms in the western world, with wrenching effects on its social and political fabric. The ostensible aim was to shock the economy off its path of long-run relative decline compared with the rest of the OECD club of rich countries. Interwoven with this inclusive national agenda was a struggle among competing elites for control of the national state, and hence of the direction of economic policy.

This struggle was fought out in several arenas simultaneously and did not proceed at the same pace in all of them. It was partly a generational succession as entrepreneurs, officials and politicians reared and educated in the prosperous decades of the 1950s and 1960s pushed aside the older generation with its memories of Depression and the Second World War, and attitudes formed in the social-democratic heyday of the mid twentieth century, the era of the welfare state and activist economic management. Partly it was an ideological clash between two incompatible views of the world: an inclusive corporatist view which assigned a central, integrative role to the state as the agent of the people, and a strong neoliberal 'Chicago-school' view in which the pursuit of individual self-interest reigned supreme and the state was peripheral (Bertram, 1993, 1997). Partly it was a simple contest for political spoils and sectoral economic advantage

between two sets of vested interests: those based in agriculture and manufacturing on one side, versus financial and services-oriented investors and managers on the other. Partly also it was a constitutional contest as the division of powers and the balance among legislature, courts, Cabinet and the public service was renegotiated; the two decades after 1980 witnessed fundamental changes in (for example) the electoral system, the organization and management of the civil service, the status of official information, the independence of the Reserve Bank, and the mechanisms for addressing the century-old grievances of the indigenous Maori people.

The neoliberal policy programme and associated ideology captured first the two key economic departments, Treasury and the Reserve Bank, in the early 1980s. An ascendant Treasury then drove the economic policy changes of the subsequent two decades. Resistance from other parts of the state apparatus meant that reform advanced in a sequence dictated more by politics than by economic theory, starting with financial liberalization, floating of the exchange rate, corporatization and privatization of state-owned enterprises, withdrawal of subsidies and protection from traded-goods producers, only later moving on to labour market liberalization and the attempt to dismantle the welfare state. Ultimately it was in the last two areas that the reform programme ran out of momentum and political legitimacy and eventually went into reverse following the adoption of a proportional-representational voting system in the mid

1990s, which curtailed the ability of ministers and officials to drive through unpopular economic and social policies.

The sort of shock therapy practiced in New Zealand, associated internationally with the so-called 'Washington Consensus', has lost some of its attraction as the experience of the 'economies in transition' of the former Soviet bloc has unfolded (Stiglitz, 2001; Blejer and Skreb, 2001). Stiglitz in particular has been trenchant in his criticisms of policy packages which force through privatization, financial liberalization, and market deregulation, without due attention to the importance of sustaining a viable legal and cultural infrastructure of laws, property rights, and restraints on the abuse of market power. A recent reviewer of Stiglitz's book (Hazledine, 2002, p. 259) noted its 'resonances for New Zealand', and it is certainly the case that many New Zealand economists, as well as the voting public, have been uneasy about the impact of the reform programme on the evolution of the country's economic and social structure.

Two decades on from the election of the Lange-Douglas Labour Government in mid 1984, enough time has passed to permit some evaluation of the long-run macroeconomic impacts of the neoliberal programme.

Some observations relate to possible negative consequences of reform which failed to materialize. The exchange rate, cleanly floating since 1985, has not collapsed (though Bertram, 2002 suggests that it may have come close to doing so in 1999). Nor did the economy suffer the sort of externally-driven financial crisis that was induced by capital flight in Mexico, Argentina, Asia and Russia in the course of the 1990s.¹ GDP growth stopped for a decade or so, but then quietly resumed from 1993, albeit at much the same rate as in the pre-reform decade. There was nearly (but again, not quite) a fiscal crisis in 1989–1990, but by the late 1990s the Government was running a steady and apparently sustainable fiscal surplus, with public debt falling relative to GDP. The distribution of income across individuals, as measured by household surveys and census data, became more unequal in the first decade of reform, but this trend was checked and partly reversed in the 1990s, particularly at the bottom end of the distribution (where New Zealand provided more protection for its poorest groups than did, for example, Sweden – Chatterjee *et al.*, 2003).

The virtual destruction of the country's manufacturing sector in the late 1980s, as protection was withdrawn while the exchange rate was kept overvalued by tight monetary policy, left a surprisingly small residue of long-term unemployment and deprivation relative to the experience of deindustrialisation in some other countries such as the UK. The subsequent virtual destruction of the formal labour movement via the 1991 Employment Contracts Act seemed to have remarkably little impact on either real wage rates or the distribution of the product between profits and wages, while the reversal of that industrial policy via the Industrial Relations Act of 2001 has equally to date had almost no perceptible impact on wages or employment, notwithstanding the heated tone of political debate as the new law went through Parliament. These observations underscore the importance of international labour mobility, especially

among New Zealand, Australia, and the Pacific Islands, in determining the state of the New Zealand labour market.

On the other hand, neoliberal reform proponents who expected miraculous results to follow radical institutional change and market deregulation have been disappointed. The long-run economic growth rate has not accelerated sufficiently to move New Zealand back up through the OECD rankings, and productivity growth has failed to take off, continuing to run more or less in step with Australia in aggregate terms (labour productivity has fallen behind and capital productivity has moved ahead) (Black *et al.*, 2003). Privatisation and corporatisation of state-owned enterprises provided only modest improvements in quality of service (mostly in telecommunications) while conspicuously failing to improve the timing and adequacy of investment in basic infrastructure; in the early 2000s both the electricity system and the rail network suffered supply failures attributable to asset stripping and under-investment, forcing a return to Government intervention. At the same time, privatisation combined with market deregulation opened the way to takeover of infrastructure assets by overseas investors, and delivered large capital gains to speculators in the newly-floated shares of utility companies.

Ultimately, the possible consequences of even radical reform are constrained by macro-economic trends. A century and a half of historical experience as a small open economy suggests that New Zealand's long-run economic performance is paced by export growth and that the main structural constraint on raising living standards is represented by the balance of payments. In a 1992 paper Bertram argued that "*floating the exchange rate and deregulating the domestic economy have not freed New Zealand from its long-standing foreign exchange constraint, nor altered the basic nature of that constraint*" (Bertram, 1992 p. 43). The economy's inhabitants can collectively spend only as much foreign exchange as can be earned (by exports) and/or borrowed in each period. There are sustainability constraints on the feasible rate of borrowing, imposed by the long-run prospects for increasing net export earnings (that is, the amount of foreign exchange earned from exports and not required to finance imports of goods and services) since the servicing of external debt and equity liabilities imposes a claim on the flow of foreign exchange available to the economy in each period.

Neoliberal economic thought gives low weight to such concerns. From the structuralist point of view, however, a strong net-export performance requires that the economy's producers of tradeable goods and services be profitable and secure, relative to non-tradeables. Otherwise, resources of entrepreneurial talent, investment finance, and skilled labour tend to flow into sectors whose growth weakens rather than strengthens net-export growth. Prior to 1984, New Zealand policymakers had seen it as their task to support the directly-productive sectors supplying tradeable goods, whether for export or as import substitutes. The neoliberal reform agenda, on the contrary, placed faith in the market mechanism to deliver an appropriate sectoral balance. Hence the deregulation process removed protection from tradeables

and exhibited no qualms about sharp increases in the relative profitability of non-tradeables.

The resulting trends in New Zealand's economic structure have left the economy in the early 2000s still constrained by dependence on a narrow set of primary-product sectors, albeit supplemented by two new services-based export sectors, tourism and education. This structural dependence on natural-resources-based industries to earn foreign exchange continues to block the path to higher growth rates of per capita income. This constraint has been, if anything, tightened rather than relaxed by institutional innovations such as the Reserve Bank Act 1989 which gave the central bank independent authority to pursue a tight anti-inflationary monetary policy; on several occasions the Reserve Bank of New Zealand (RBNZ) has held up the real exchange rate (hence depressed the profitability of tradeable-goods producers) and reinforced the premium on New Zealand interest rates relative to other OECD countries.

Besides bringing no change in the structural foreign-exchange constraint, the New Zealand reforms have had a very mixed impact on another area which has recently been emphasized in the literature on economic growth: the extent to which resource diversion ('rent-seeking') provides a source of private profit, relative to wealth creation (Olson, 1982, 2000; North, 1990; Hall and Jones, 1999; Parente and Prescott, 1999). The political economy of deregulation in New Zealand included a downgrading of the analytical capability of government departments, and the abolition of key departments and agencies which had formerly been devoted to the health of tradeable-goods sectors. At the same time regulatory restraint on the exercise of monopoly power was largely swept away under the Commerce Act 1986, which narrowed regulation down to a narrow concern with economic efficiency, politicized the process, and in its original wording placed a heavy burden of proof on any party seeking legal remedies against anti-competitive behaviour by large firms. The resulting regulatory environment was tailor-made for rent-seeking behaviour (Buchanan *et al.*, 1980; Rowley *et al.*, 1988; Tullock, 1989), and the privatization of state-owned assets fed into the market a steady stream of opportunities for profitable diversion of resources from productive activity into rent-seeking by infrastructure companies in sectors such as telecommunications, ports, railways, electricity and gas, airports and the like.

The deadweight burden of rent-seeking elites restraining New Zealand's economic growth has increased in two steps over the past thirty years; first the rise of financiers and promoters of large energy-related industrial projects in the late 1970s, and then the heyday of investment houses and newly commercialized infrastructure operations in the late 1980s. Both the Muldoon Government's 'Think Big' programme of 1977–1983 and the soft privatisation of state assets under Roger Douglas, David Caygill and Ruth Richardson (successive Ministers of Finance from 1984 to 1994) enabled private interests to appropriate large rents to themselves at the expense of the wider public, in the process skewing the economy's sectoral balance away from that which would

have resulted from the functioning of a genuinely-neutral market mechanism.

Major economic trends

Four major economic trends which appear in the New Zealand data can be traced directly to the impact of the reforms. The remainder of this paper is devoted to tracing these and considering their implications for New Zealand's future. The trends are:

- A radical shift in the focus of investor attention, and hence in the nature of economic commentary, speculative investment, and policy priorities, away from the directly-productive tradeable-goods sectors which had been the mainstay of twentieth-century economic history (agricultural production and processing, plus manufacturing and engineering industries) and towards the service sectors such as utilities, finance, business services, tourism, and education;
- A simultaneous radical shift in control over the economic surplus, away from the hands of the nascent national bourgeoisie of the 1970s and into the hands of overseas investors, as ownership of the economy's capital stock and natural resources shifted steadily abroad;
- A continuing, but sustainable, increase in the economy's international indebtedness, representing the legacy of large and continuing deficits in the current account of the balance of payments, with those deficits themselves increasingly driven by the outflow of profits and interest to overseas investors, and with the composition of the debt exhibiting a radical switch from the government to the private sector;
- An increase in price-cost margins (hence profits) in several sectors, mainly supplying non-traded goods and services, where companies enjoy either positions of natural monopoly or various degrees of political protection – a trend which Kalecki (1943) would have described as a rise in the economy's 'degree of monopoly'.

To provide the backdrop to the discussion which follows, Figure 1 traces the path of New Zealand's per capita Gross Domestic Product, measured in purchasing-power-parity terms, relative to the 115 national economies covered by the most recent version of the Penn World Tables, PWT 6.1). From fourth in the world in 1950 on this measure, New Zealand dropped back sharply to the bottom of the leading bunch of economies between 1970 and 1980, picked up momentum again in the early 1980s, but then stagnated from 1985 on while the rest of the OECD forged steadily ahead. By the time New Zealand's growth resumed in 1993 at a pace comparable with the OECD mainstream, New Zealand had fallen nearly \$5,000 per capita behind and had drifted back to the position of a leader among the middle-income countries. Several of the fast-growing Asian 'tigers' can be seen overtaking New Zealand during this period. Only Switzerland, among the affluent OECD economies, exhibits a similar slide down the rankings over the last three decades of the past century, although Japan after 1990 may have suffered a similar slowdown (Kehoe and Prescott, 2002).

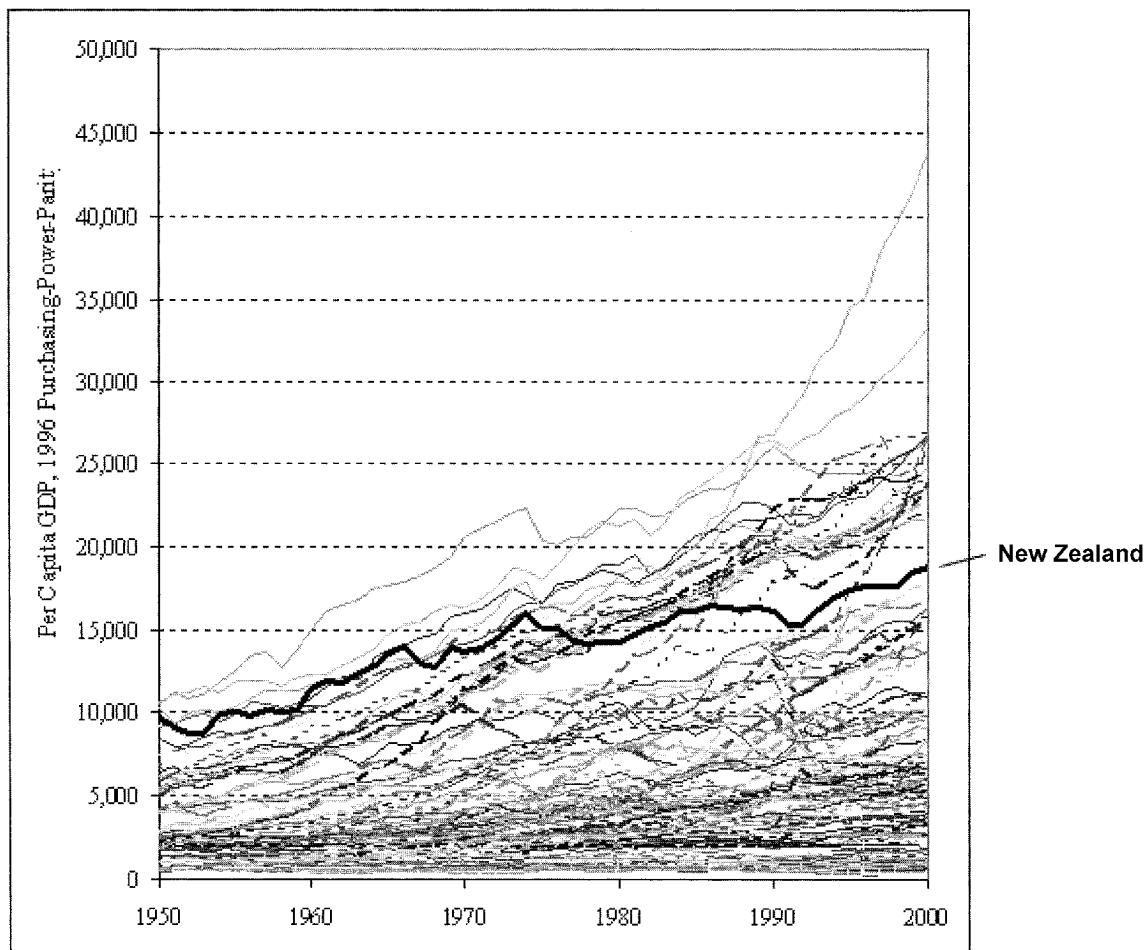


Figure 1. New Zealand GDP per Capita Compared with 114 Other Countries, 1950–2000.

Source: Penn World Tables PWT6.1

It seems increasingly likely that 1993 marked an upturn in New Zealand's trend growth rate, ending the policy-induced standstill of the 1980s. (The business cycle turned upwards sharply in 1993, but until the next cyclical trough had been passed, in 1999, it was not possible to estimate changes in long-run trend growth. However, several recent papers have now undertaken such estimates; see e.g. Mawson, 2002; Razzak, 2002; Buckle *et al.*, 2002.)

The new long-run growth rate of per capita GDP is not, however, noticeably faster than that prevailing in other OECD countries, which implies that the unusually radical scope of economic reform in New Zealand has not imparted any particular growth advantage in the long run. It is clear that in the short run, the reform process between 1984 and 1993 held the economy back relative to other OECD countries, especially neighbouring Australia. (This view is not uncontested. It will probably always be a matter of debate whether the 1985–1993 growth collapse should be attributed to the reform process or to unsustainability of the previous growth process. Reform advocates strongly argue the latter case (Evans *et al.*, 1996); however, Australian experience under more moderate and carefully-implemented reforms does suggest that New Zealand should have been able to sustain its previous growth path – cf. Easton (1997, pp. 257–258); Dalziel (1997, 2002).)

Sectoral refocusing

One good indicator of changes in political economy is the sharemarket, which besides providing a continual barometer of investor sentiment and expected company profitability, serves as an important conduit for raising capital and as the main arena in which capital gains are realized by speculators. Table 1 shows the market capitalization of companies listed on the New Zealand stock exchange between 1980 and 2000, classified according to the economic sector in which each company had its main activity. Figure 2 plots the changing sectoral composition of sharemarket capitalization.

Insofar as the sharemarket is indicative of the commanding heights of the economy, Table 1 traces a sea-change. In 1980, no less than 75% of sharemarket capital value was in agriculture, primary processing, manufacturing, engineering and construction – the 'hard' productive sectors. By 2000 these sectors combined accounted for only 21% of market capital value. Finance and investment companies surged from 5% of the market in 1980 to 28% in 1990 as a wave of takeovers swept through the New Zealand economy. Much of this increase reflected the absorption into investment company books of companies formerly active in agriculture, processing and manufacturing. Then finance and investment companies fell back to 6% of the market by 2000, partly due to the selling-down of their portfolios of assets,

Table 1. Sectoral Breakdown of Sharemarket Capitalisation, 1980–2000

	1980		1985		1990		1995		2000	
	\$m	%	\$m	%	\$m	%	\$m	%	\$m	%
Agriculture, including stock & station agents	243	6.1	1,788	9.9	1,180	11.0	7,534	15.3	1,188	2.9
Primary processing, engineering and manufacturing, construction	2,748	69.0	6,631	36.7	4,743	44.0	12,455	25.4	7,472	18.1
Finance, investment and property companies	182	4.6	5,323	29.4	2,957	27.5	6,718	13.7	2,497	6.1
Utilities and transport	130	3.3	357	2.0	662	6.1	18,395	37.4	18,259	44.3
Retail, wholesale and services	622	15.6	2,371	13.1	971	9.0	3,393	6.9	7,797	18.9
Other	59	1.5	1,615	8.9	256	2.4	638	1.3	4,017	9.7
Total	3,984	100.0	18,084	100.0	10,770	100.0	49,133	100.0	41,230	100.0

Sources and notes:

1980 from *Stock Exchange Journal of New Zealand* October 1980, pp. 355–372, figures for ordinary shareholders' funds (all subsequent years' data are market capitalisation).

1985 from *New Zealand Stock Exchange Annual Report 1985*, pp. 22–35.

1990 from New Zealand Stock Exchange, *Sharemarket Review for the year ended 31 December 1990*, pp. 8–13.

1995 from New Zealand Stock Exchange, *The Fact Book for the year ended 31 December 1995*, pp. 15–17.

2000 from New Zealand Stock Exchange, *The Fact Book for the year ended 31 December 2000*, pp. 13–15.

partly to losses on overvalued investments, and partly to the shift offshore of a few leading companies (particularly Brerley Investments Ltd, the dominant investment house of the 1980s, which is now listed in Singapore).

From only 5% in 1980 and 6% in 1990, utilities and transport companies had risen to 44% of market capital value by 2000. Among the current market leaders are companies such as Telecom Corporation, Auckland International Airport, Contact Energy, Natural Gas Corporation, Air New Zealand, Port of Tauranga, TranzRail and UnitedNetworks – all post-1985 entrants to the sharemarket.

The picture is of an economy which (at least so far as local investors were concerned) underwent in the 1980s a precipitous downgrading of investor focus on agriculture, industry and construction as investment switched to speculative and asset-stripping operators engaged in the takeover and reconstruction of previously-existing companies. Then, in the 1990s, funds moved into utility operators, predominantly companies established to take over the operation of assets installed over the preceding decades by national and local government for the ostensible purpose of providing public services at low cost to users. Following the wave of privatisation and corporatisation between 1985 and 1994, these service operations, many of them with substantial monopoly power, became the economy's most conspicuous source of profits for local shareholders.

Changing control of economic surplus

Profit is the driver of a capitalist economy. It is the quest for profit that drives the firms which organize production and undertake the investment which, over time, determines the sectoral form of production. Bertram (2001) investigated the evolution, over the period 1962–1998, of the shares of wages and profits in New Zealand's domestic product, and found that in the aggregate, the share of corporate profit in net output (that is, GDP excluding capital depreciation) was virtually unaffected by the massive reform programmes of the 1980s (see Table 2 and Figure 3). Between 20% and 25%

of net domestic product accrues to corporate net profit before tax, and company tax takes a steady 5% of net product, leaving around 15–20% for after-tax net profit. This corporate profit share fluctuates with the business cycle, rising in periods of cyclical upswing and falling in recessions.

Two conclusions were drawn by Bertram (2001, p. 25):

Firstly, the structural reforms which began in the mid 1980s had no apparent effect on the aggregate profit share over the long haul. Insofar as the profit-squeeze diagnosis of slow economic growth had any force in the early 1980s, there has been no redistribution towards capital since then...

The second major stylized fact to emerge ... is the near-euthanasia of domestic capital, as the deregulation of capital markets and privatization of state assets has shifted large swathes of the economy into foreign ownership.... Clearly the immediate future of economic growth in New Zealand now lies in the hands of foreign investors to an extent that would have been unthinkable twenty years ago.

Balance of payments data show that profits and interest payments accruing to these overseas investors have almost completely accounted for the recorded current-account deficit in the New Zealand balance of payments since the mid-1980s (Figure 4). From some \$3 billion a year of net profit and interest outflows in 1987, they had risen to \$7 billion per year by 1997 and the current account deficit matched this. Since the current account deficit indicates the net amount of new overseas borrowing by the economy each year, Figure 4 suggests that New Zealand serviced most of the cost of its overseas indebtedness by new offshore borrowing over the period of reform and was still doing so as of 2001.

The significance of this lies in the failure of the current account balance to track progressively further above the net investment income balance over the two decades following commencement of reform. As a small open economy, New Zealand relies on its success as a trading nation to provide the foreign-exchange resources to service a rising overseas

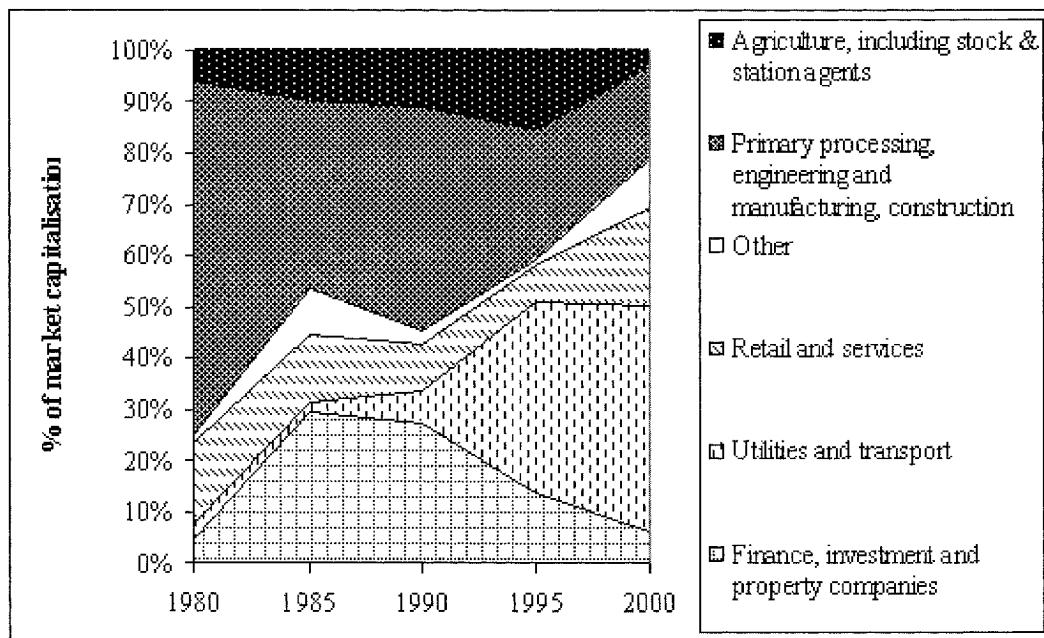


Figure 2. The Changing Sectoral Focus of the New Zealand Sharemarket.

Source: Table 1.

Table 2. Corporate Profit Share of Net Domestic Product: Decade Averages, Percent

	Net after-tax profit to local owners	Overseas owners' net after-tax profit	Company tax	Total
1962–69	15.5	2.2	5.2	22.9
1970–79	17.1	3.3	4.8	25.2
1980–89	12.4	6.4	4.3	23.0
1990–99	8.1	8.3	5.0	21.4

Source: Bertram (2001).

debt. A large-scale inflow of overseas capital implies a rising servicing burden on the balance of payments. Hence it is important for long-run sustainability that the capital inflow not only raises domestic investment above the level that it would otherwise have attained, but also serves to fund the expansion of sectors which make a contribution to net-export performance. What is required is the expansion of sectors which either produce tradeable goods and services directly (thus potentially providing export earnings or replacing imports) or contribute indirectly to the expansion of tradeables.

Figure 4 suggests that neither of these outcomes resulted from overseas investment into New Zealand over the two decades after removal of exchange controls and floating of the exchange rate.

Exchange controls were formally in place until 1984, but the institution responsible for implementing them (the Reserve Bank of New Zealand) effectively abandoned its task in the face of a run on the New Zealand dollar during the months leading up to the July 1984 snap election in which the Muldoon Government was defeated. This abdication of the Bank's responsibilities contributed to the severity of the

exchange-rate crisis and subsequent devaluation, and hence to the huge profits realized, at the expense of the general public, by speculators against the currency, many of them local financial-sector insiders. Those speculative profits, of the order of nearly a billion dollars, fuelled the subsequent wave of takeover activity and rise of finance and investment companies in the second half of the 1980s, discussed in the preceding section. (One interpretation of the 1984 events is that senior staff in the Reserve Bank regarded the speculative run on the dollar as a welcome means of destabilizing the Muldoon Government, with whose economic policies both the Reserve Bank and the Treasury were strongly at odds, as their subsequent briefing papers to the incoming Lange Government make clear – Treasury, 1984; Reserve Bank, 1984).

Even the pretence of exchange controls vanished following the 1984 election, and the floating of the New Zealand dollar in March 1985 completed the liberalization of balance of payments flows. Thereafter, overseas investors were free to purchase New Zealand financial assets, while New Zealanders were similarly free to invest overseas rather than at home. In such a deregulated market setting, the significance of rising foreign control of local enterprise changes in a way which is important for macroeconomic management.

Prior to 1984 under exchange controls, capital controls, and a fixed exchange rate, New Zealand investors held few overseas assets, mostly foreign-currency deposit, in overseas banks that could be used to circumvent import control restrictions on the purchase of imported goods such as motor vehicles. In that era, any increase in overseas ownership of the New Zealand economy implied a rising claim against net export earnings, to enable profit and interest to be repatriated. Unless export earnings increased, profit and interest outflows would drain the Government's foreign exchange reserves, and hence put pressure on the fixed exchange rate.

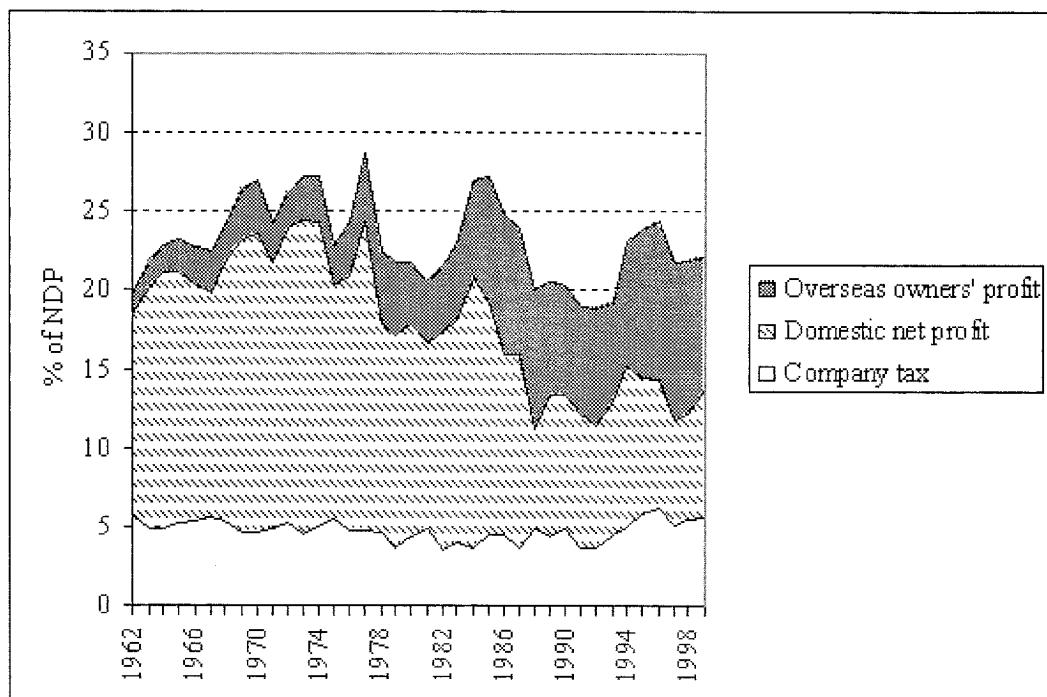


Figure 3. Shares in Net Domestic Product of Company Tax, Domestic Net Profit, and Overseas Owners' Net Profit, 1962–1999.

Liberalisation in 1984–85 meant that future balance of payments crisis would take the form not of falling reserves and a forced devaluation, but simply of a fall in the value of the floating New Zealand dollar. This provides incentives for net exports to rise to fill the gap, while at the same time imposing losses of wealth on anyone with contractual commitments to service overseas debts in foreign currency, but relying on funding in New Zealand dollars. (Such a process of exchange-rate depreciation squeezing firms with large overseas-currency-denominated debts was a central feature of the East Asian financial crisis of 1997–99 – cf. Stiglitz (2001, Chapter 4).)

The new policy regime made it possible for the Government to remove itself from centre-stage in the face of balance of payments pressure. In this respect New Zealand's reforms have followed through the logic of a more-market approach to an extent which has proved very effective in insulating the economy from what might otherwise have been negative consequences of increasing overseas ownership. Financial crises in other countries during the 1990s often resulted from attempts to defend a fixed or managed exchange rate or from devaluation-induced increases in the burden of servicing government debt.

Over the two decades since floating its currency, New Zealand has been remarkable for the absence of any direct intervention in the foreign exchange market. The Reserve Bank has at various times used monetary policy to raise the exchange rate indirectly, but this has been for the purpose of moderating inflationary pressure from import prices, and has not involved the Bank using foreign currency reserves to intervene in the market itself. Because foreign exchange reserves no longer have to be held to defend the currency, and given that the Bank's reserves are not committed to that pur-

pose, a flight of capital from New Zealand cannot 'bankrupt the country' in the old-fashioned way. A decision by overseas investors to desert New Zealand *en masse* would simply drive down the exchange rate, forcing the fleeing investors to take large capital losses, and in the process writing-off part of the economy's liabilities to the rest of the world.

Until the early 1990s, capital flight had the potential to be costly for New Zealand because the Government carried a large sovereign debt exposure denominated in overseas currency. A fall in the exchange rate would have forced the Government to increase domestic taxes sharply in order to meet the increased cost of servicing its external debt. Well aware of this risk, successive New Zealand Governments from the late 1980s on placed heavy emphasis on reducing the stock of sovereign debt owed in foreign currency, and replacing it as necessary with New Zealand dollar-denominated bonds. The successful achievement of this objective was probably the single most important fiscal policy outcome of the 1990s, and places New Zealand in a very unusual position among heavily-indebted countries: virtually all the economy's overseas debt has either been privatized (so that foreign-currency liabilities are owed by the private sector, not the Government) or is denominated in New Zealand dollars (so that exchange rate depreciation has no impact on the local-economy burden of servicing the public debt).

Figures 5 and 6 show the transformation of the public debt position since 1990. Government has run fiscal surpluses for much of that period, using the proceeds to pay down the net public debt from about 60% of GDP to about 20% (Figure 5). In addition there was a rapid reduction in the foreign-currency public debt, from around \$15 billion at the beginning of the 1990s to zero by 1997 (Figure 6). Achiev-

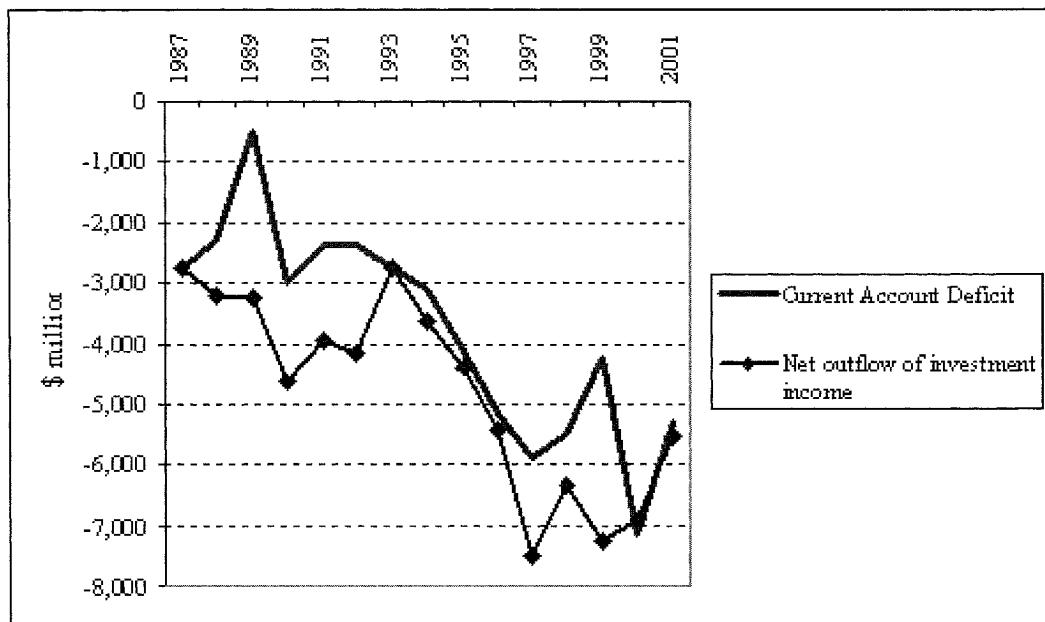


Figure 4. Investment Income Net Debits and the Current Account Deficit, 1987–2001.

Source: Bertram 2002.

ing the latter process without driving down the exchange rate was made possible by privatisation, as state-owned assets were thrown onto the market and snapped up, in many cases by overseas investors. Thus privatisation created large capital inflows, the foreign-currency proceeds from which were used to retire foreign-currency public debt. (The Government was also able to reduce its debt by loading it onto the books of state-owned enterprises prior to their privatisation.)

The very conservatively-oriented fiscal policies of the 1990s, enshrined in the Fiscal Responsibility Act 1994, have left the Government's fiscal position sustainable beyond reasonable doubt. No rational speculator is likely to take a gamble on the possibility of either default on Government bonds, or an attempt by Government to prop up an unsustainable exchange rate in order to limit its debt servicing costs. On the contrary, Government's incentives are, if anything, to stand back and accommodate depreciation of the exchange rate, because of the prospect that such depreciation could stimulate domestic economic activity and hence increase tax revenues, lightening rather than increasing the burden of servicing the public debt.

The remaining net public debt shown in Figure 6, of around \$20 billion (20% of GDP) represents entirely New Zealand dollar-denominated obligations. Many of these bonds are held by overseas investors and hence represent external liabilities of the economy as a whole – but all exchange-rate risk, and hence all exposure to the consequences of capital flight, falls on the holders of those bonds.

The combination of zero net foreign-currency public debt and a freely floating exchange rate thus makes New Zealand immune to the sort of financial crises that have afflicted Russia, Mexico and Argentina in the past decade. The risk could remain, of a crisis of the sort that struck East Asia in the late 1990s – abrupt flight of short-term capital, driving down the exchange rate and bankrupting private companies

with large foreign-exchange exposures. Two factors contribute to making the New Zealand economy resilient against those type of crises also: the common practice among private sector firms of contractually hedging their overseas-currency exposures in forward markets; and the high level of overseas ownership of New Zealand enterprises, which means again that a large part of any capital losses resulting from currency depreciation would fall on overseas, rather than local, investors.

An implication of the foregoing discussion is that the very large capital inflows of the early 1990s served to finance not primarily new capital formation, but the transformation of the public-sector balance sheet. Consequently it is not surprising that capital inflow did not result in a subsequent strengthening of the current account of the balance of payments, sufficient to enable rising profit outflows to be paid for from rising export proceeds. A capsule summary of the process is that real assets held by the public sector were passed to overseas owners in exchange for the elimination of foreign-currency sovereign debt exposures. This was an ownership switch, not a process of net new wealth creation resting on new productive investments funded from offshore. Hence no surge of economic growth driven by overseas-funded investment was to be expected, and none eventuated.

On the contrary, the most dramatic development following the transfer of state assets to overseas investors (as well as to local shareholders, to an extent that has varied by company and over time) was a transfer of wealth within the economy, from the users of infrastructure services to the new owners of infrastructure assets, as deregulation allowed monopoly profits to be secured by driving prices up and costs down (see below).

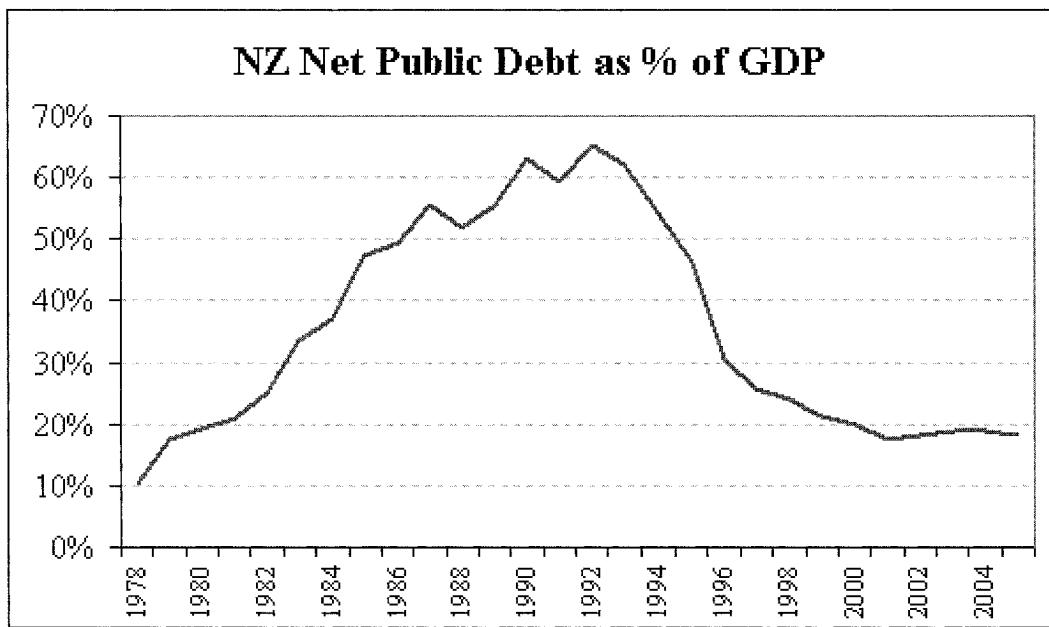


Figure 5. Net Public Debt as a % of GDP.

External indebtedness

The previous section pointed out that the New Zealand Government has eliminated all its foreign-currency debt, and hence all taxpayers' exposure to exchange-rate risk on the public debt. At the same time the current account of the balance of payments has remained very weak, with ongoing private capital inflow supporting the New Zealand dollar exchange rate by providing sufficient funding to cover all import requirements and the servicing of external liabilities.

Continuing current account deficits inescapably mean rising net indebtedness of the economy to overseas investors, except to the extent that downward exchange-rate movements expropriate the value of assets held by those overseas investors. In this section the growth of New Zealand's net external indebtedness is traced and some implications are explored.

Table 3 shows the available data on net overseas holding of New Zealand assets. In contrast to the previous section, which laid stress on the currency in which individual assets are denominated, the figures in Table 3 make no distinction between assets denominated in New Zealand dollars and in other currencies. Thus a New Zealand Government bond, issued on the local market but bought and held by an overseas investor, appears as part of the economy's international liabilities; while foreign-currency bonds held by New Zealand investors appear on the asset side of the figures. Shares in New Zealand companies held abroad are liabilities, and shares in overseas ventures held by New Zealand residents are assets.² All assets and liabilities are valued in New Zealand dollars at the current exchange rate, so that capital gains and losses resulting from exchange-rate movements are included in the data.

The statistical framework for recording overseas debt has developed only slowly. The present-day statistics, embodying fairly comprehensive survey-based measurement

of international investment liabilities and assets, and hence the net international position of New Zealand as a country, go back only to 2001. Prior to that, a less comprehensive survey-based methodology provides figures back to 1992. For the period 1978–1992, figures have been taken from the study by Colgate and Stroombergen (1993).

These successive revisions to statistical methodology have increased the coverage of the statistics, which results in jumps at 1992 and 2001 which exaggerate the scale of the increase over nearly three decades, and the figures are not corrected for inflation which also exaggerates the upward trend, especially during the 1980s. The overall picture, however, is clear, and is confirmed by Figure 7 which plots the data as percentages of GDP. Total gross external debt in the mid 1980s had reached around \$40 billion (about 70% of GDP); by 2003 it was \$180 billion (about 130% of GDP). The net position in the mid 1980s was probably in the range 50–60% of GDP, and had risen above 80% by the mid 1990s.

While debt has risen, the ratios in Table 3 are well within the sustainable range for a developed OECD economy, and as already noted the low proportion of sovereign debt exposure greatly reduces the risk of macroeconomic instability arising from the debt. The private companies which carry New Zealand's overseas debt are able to hedge their exposure to short-run exchange rate changes, effectively providing insurance against any New Zealand replay of the Asian crisis of 1997–98; and some of those companies are large enough, and sufficiently internationally diversified, to intervene directly to prevent undesired exchange-rate fluctuations.

This is especially true of the large overseas-owned trading banks, which are big enough, relative to the New Zealand economy, to undertake the sort of currency-support operations long carried out by central banks in larger countries. In the aftermath of the Asian crisis, for example, when contagion threatened to cause a sharp downward adjustment

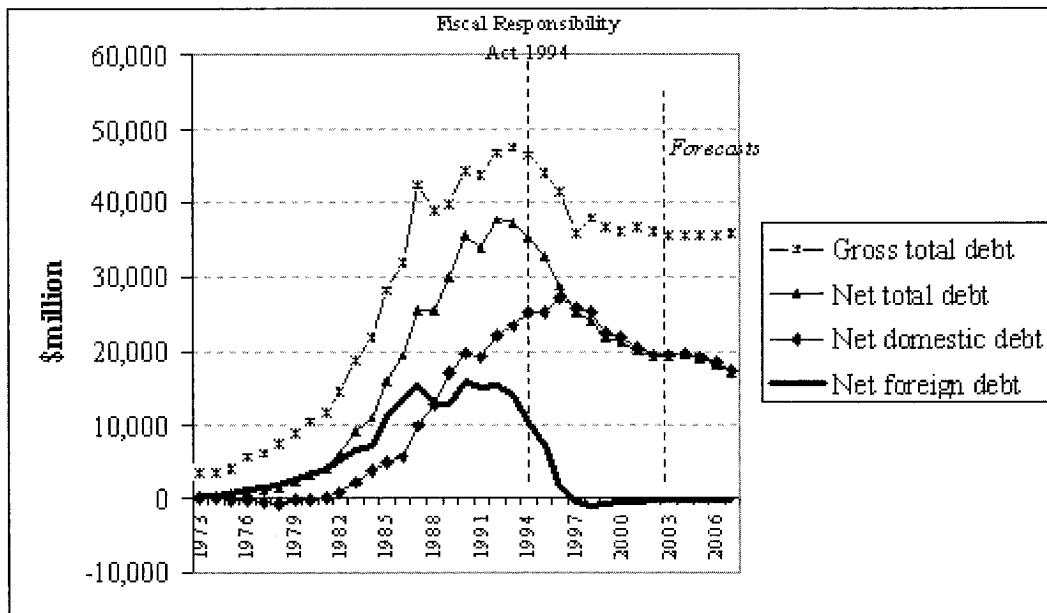


Figure 6. The Elimination of Sovereign Debt Exposure to Exchange Rate Fluctuations.

Source: Debt Management Office, The Treasury.

of the New Zealand dollar exchange rate due to short-term capital outflow, the trading banks collectively injected some \$10–15 billion of foreign currency deposits into their local affiliates, thus forestalling depreciation and signaling that yet another of the traditional macroeconomic management tasks of the state had become privatized in New Zealand (Bertram, 2002).

The ability of the private banks to control a major macroeconomic variable – the exchange rate – is indicative of the ease with which market power can be acquired and exercised in an economy as small as New Zealand's, in an era of globalization and large companies.

An earlier reminder of the same basic truth was the extent to which overseas investors, with very large disposable funds to invest, were able to lead the process of privatization in the late 1980s and early 1990s. State-owned assets were successfully disposed of during those years at a pace far in excess of the investment capacity of New Zealand interests, because of the presence in the market of overseas purchasers. Overseas buyers snapped up large stakes in the privatised assets in telecommunications, railways, electricity generation, gas pipelines, and electricity lines networks. These international investors were experienced in the regulatory practices of other jurisdictions, and had a sophisticated understanding of the opportunities for regulatory capture in the weakened institutional setting of New Zealand. The result was a decade of rising profitability for utility companies, achieved almost entirely by exploitation of the gaping loopholes in New Zealand's competition law and regulatory framework.

Monopoly rents in infrastructure companies

In 1986, the New Zealand Parliament passed the Commerce Act, which replaced previous legislation providing for the protection of competition in markets and regulation

of monopoly. The Act declared illegal a number of anti-competitive practices such as price-fixing agreements³ and the 'use' of a 'dominant position in a market' 'for the purpose' of eliminating or foreclosing competitors.⁴ As these provisions were tested before the courts over the subsequent two decades, it became apparent that the concepts of 'dominance', 'purpose' and 'use' placed a very heavy burden of proof on litigants seeking to restrain abuses of monopoly power by large firms, and in 2001 the Act was eventually amended to lower this burden somewhat.

More fundamental, however, was a consequence of the Commerce Act which passed almost unnoticed at the time of its passage. A long established principle of English common law, which had become part of the law of New Zealand, is the doctrine of 'prime necessity', which states that the owner of a natural monopoly facility must provide service to the general public at rates which meet the test of being fair and reasonable. In effect this amounts to saying that the taking of monopoly profits is against the law. Regulators in the UK, therefore, routinely hold down the prices charged by gas pipelines, electricity distributors, railway systems and other essential infrastructure providers to levels which ensure a fair return is obtained by investors on the funds they have committed to installing and maintaining the facilities, but prevent the use of the market power of natural monopolies to push prices up above costs and thereby extract monopoly rents from consumers of the service. Since a 1944 decision of the US Supreme Court (*Federal Power Commission v Hope Natural Gas Company*, 320 U.S. 591 (1945)) regulators in the USA have done likewise.

The Commerce Act 1986 overturned this common law principle by removing from the courts the power to consider the rates charged by a natural monopoly, and placing in the hands of the Minister of Commerce the sole power to step in to regulate monopoly profits. The implication was that from 1986 on, the taking of monopoly profits was legal in

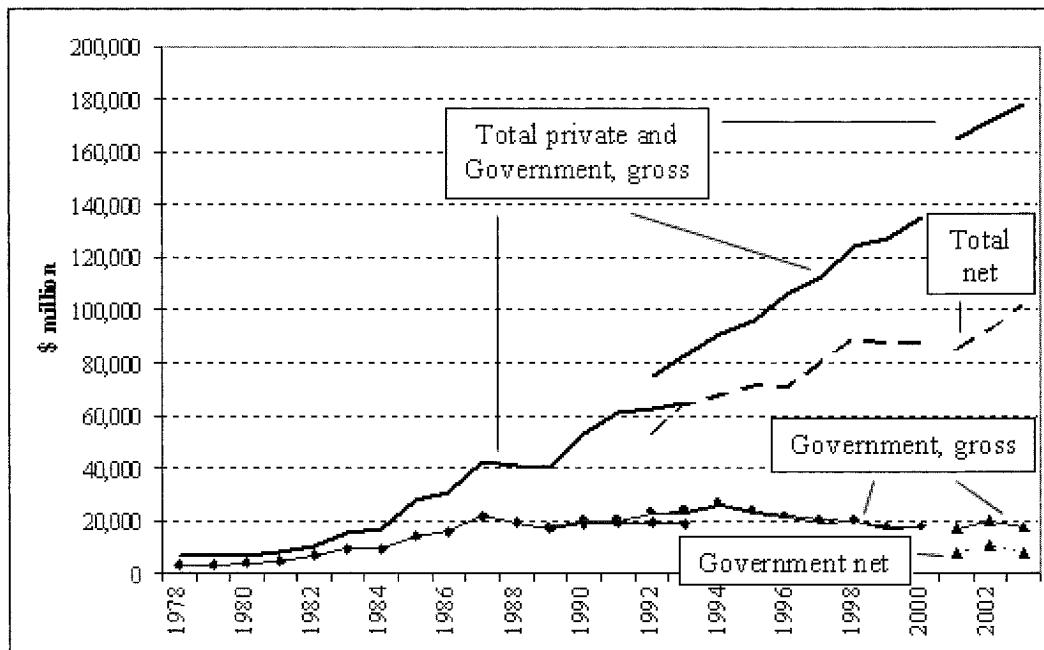


Figure 7. New Zealand International Liabilities, Gross, 1978–2003.

Sources: 1978–1992 series from Colgate and Stroombergen 1993 Table 1 pp. 14–17. 1989–2003 from INFOS series IIPA.S5ALA, IIPA.S5AAA, IIPA.S4AL1BO, IIPA.S4AA1BO, IIPQ.S5AL8B, IIPQ.S5AA8B, IIPQ.S5AA8A, IIPWQ.S5AA8A.

Table 3. New Zealand International Investment Position, 1980–2003

At March of:	Total indebtedness, gross		Total indebtedness, net		Official debt, gross		Official debt, net	
	\$ billion	% of GDP	\$ billion	% of GDP	\$ billion	% of GDP	\$ billion	% of GDP
1980	7.2	36.8						
1985	27.7	71.4						
1990	53.1	74.2			20.0	28.3	20.0	28.2
1995	96.0	110.9	71.1	82.1	23.4	27.1	22.9	26.4
2000	135.5	153.9	87.1	81.3	17.7	16.6	17.5	16.3
2003	178.3	137.1	101.5	83.1	17.7	13.6	7.9	6.1

Sources: as for Figure 6.

New Zealand unless the Government of the day stepped in to regulate a specific offender. The underlying principle was a familiar neoliberal argument that political accountability for any interference with the rights of private property should lie squarely with the elected Government. However, the right to monopoly profit had not hitherto been legally established as a right of private property in New Zealand – on the contrary, the common law proposition had been that private property rights did not extend to the right of a natural monopolist to price-gouge its customers.

The full implications of this radical extension of the rights of private property did not become obvious to most New Zealanders until the Privy Council declared, in a celebrated 1994 decision in the case *Telecom vs Clear Communications Ltd*, that the recently privatized telecommunications monopoly had the legal right to extract monopoly profits from its customers, unless the Minister of Commerce chose to exercise his or her executive discretion to intervene and regulate prices (in that case, the price charged by Telecom NZ Ltd for carrying a competitors' calls on its local-loop telephone network).

Well-informed insiders, however, were already aware by the early 1990s that no legal barrier prevented the owners of an infrastructure facility from raising their prices, and hence the value of the businesses, subject only to not triggering a political reaction from the Government. Regulatory risk had become a matter not of legal argument before courts and tribunals, but simply of politics. Provided the relevant Ministers were onside, a company's management could raise prices, profits and asset values with impunity, and customers would have no recourse except to the ballot box. A rising tide of lawyers, accountants, public-relations firms and economic consultants, employed by natural monopolies to deter Government from imposing regulatory restraints on profits, had become a feature of the political landscape by the late 1990s.

Natural monopolies in electricity, gas, airports and telecommunications were subject to regulatory requirements to publicly disclose their financial results, ostensibly to make transparent any excess profits they might be recovering. However, the opportunities for creative accountancy were substantial, and since consumers had nowhere to go for relief

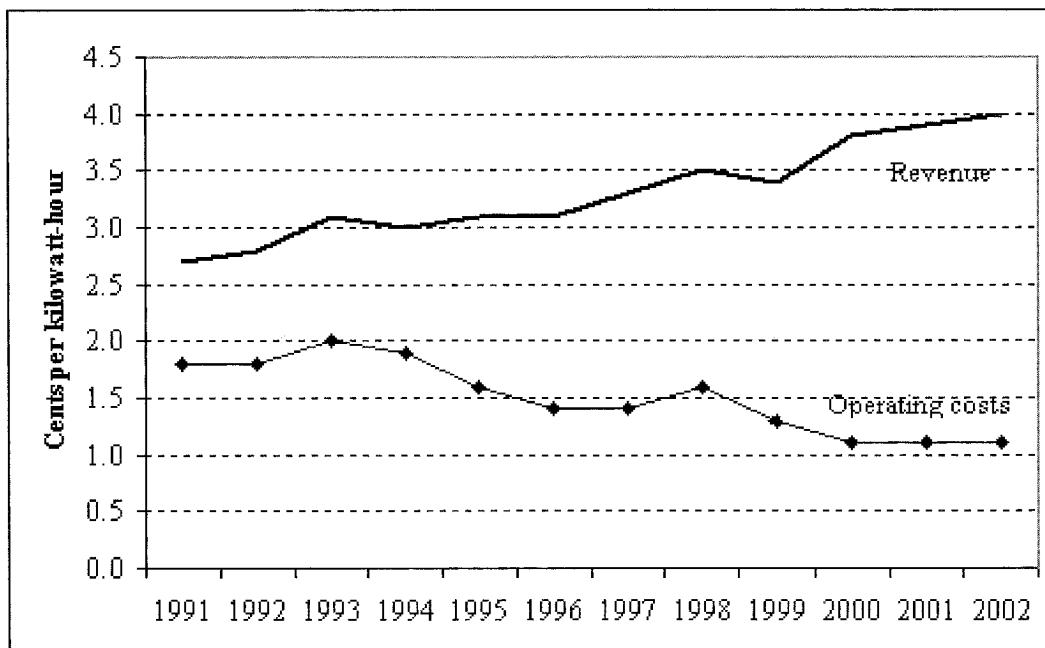


Figure 8. Price-Cost Margin in Electricity Distribution: Average over all Companies.

Source: *New Zealand Gazettes* for years since 1995; Ministry of Commerce *Electricity Industry Statistics* up to 1994. See Bertram and Twaddle 2003.

even if excess profits were disclosed, nobody had any strong incentive to engage in the arduous work of collating and analyzing the masses of financial information which began to pack the pages of the weekly *New Zealand Gazette*. The Government was ostensibly the party responsible for monitoring monopoly behaviour and stepping in if market power was abused. In practice, it was under-resourced and subject to relentless lobbying pressures. Ministers adopted a pose of studied indifference towards disclosed information, and their officials undertook no systematic analysis of the emerging patterns of monopoly behaviour. Where evidence of monopoly profits did become hard to ignore, Ministers chose to take the most cautious and inoffensive (to the monopolists) action possible.

Airport landing charges, for example, in the mid 1990s became subject to vocal complaints from large international airlines. In March 1998 the Minister of Commerce asked the Commerce Commission to inquire into the profits of airfield operators (Luxton, 1998). The Commission studied the issue for four years before issuing a draft report in July 2001 (Commerce Commission, 2001). Following conferences, further submissions and intensive lobbying, the Commission's final report in August 2002 recommended that Auckland International Airport's prices should be regulated. The Government sat on the recommendation for nine months before announcing that no regulation would be imposed (Dalziel, 2003).

Electricity distribution networks also began to attract attention for high disclosed rates of return, starting with a 29% disclosed accounting rate of profit for Vector Ltd (the Auckland network operator) in 1997 (*New Zealand Gazette* 1997, No 117, 8 September, p. 2777) and rising in a crescendo to UnitedNetworks' disclosed return on equity of 235.3% for 2000 and 346.8% for 2001 (*New Zealand Gazette* 2000,

No 111 28 August p. 2804, and 2001, No 104, 28 August, p. 2665). Again the official reaction was low-key and dominated by the desire to maintain a 'light-handed' regulatory stance.

Figure 8 shows that the corporatised electricity distribution industry raised prices, cut operating costs, and hence increased profit, over the decade following reform in 1994. Figure 9 shows the corresponding write-up of asset values in the books of electricity lines companies as their expectations of rising profits were brought onto the books, limited only by the 'limit price' replacement-cost valuation at which (in theory) a competitor would be able to capture their markets. (The 1994 disclosure regulations required a replacement-cost valuation to be calculated for each network, and Government policy statements signalled vaguely that revaluation above this level would be frowned upon.)

Table 4 sets out the figures, showing the net after-tax profits in this mature, slow-growing essential service industry rising from 0.3 cents per kWh to 1.2 cents per kWh as price-cost margins were pushed up

In early 2000, a Ministerial Inquiry was set up to investigate the electricity industry, including the network companies. Headed by Hon David Caygill (Minister of Finance in 1988-90 following Roger Douglas' resignation) the inquiry reported in favour of the companies' practice of raising the book value of their assets up to replacement cost, on the basis of their sharply increased profitability (Caygill *et al.*, 2000 p. 15). The Inquiry noted (paragraph 192) that the industry believed there was no 'credible threat' of price control being implemented, and suggested (paragraphs 193-200) that the Commerce Commission might hold an inquiry and be empowered to impose price caps on individual companies if it saw fit.

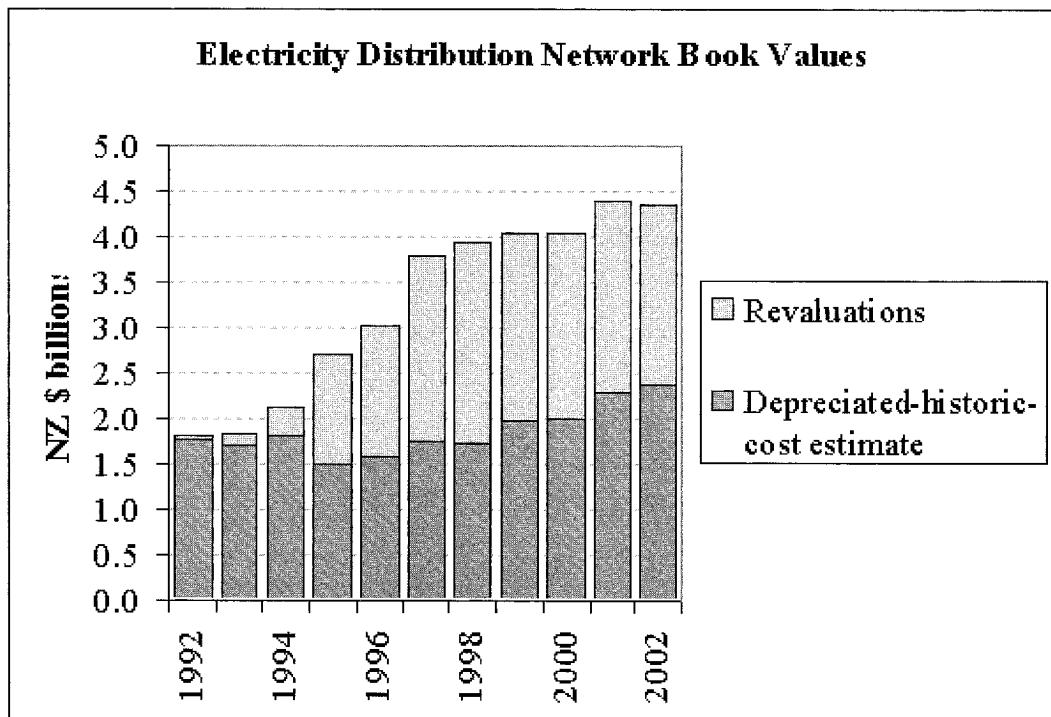


Figure 9. Electricity Lines Companies' Book Value of Assets, 1992–2002.

Parliament accordingly in 2001 passed an amendment to the Commerce Act giving the Commerce Commission the authority to inquire into asset values and excess profits, and to regulate if it wished. In response to this mandate, the Commission reported in December 2002 that it would not enter into the issue of asset revaluations (and the associated profits) between 1994 and 2002 (Commerce Commission, 2002b pp. 24–25 paragraphs 107–110) and in particular that (*Ibid.* paragraph 108) the industry's book values as at April 2003, inclusive of the \$2-billion-odd of revaluations (capital gains for owners) to that point, would be 'deemed to be historic cost' for the purposes of future price regulation (*Ibid.* p. 25 paragraph 108).

A recent study of the extent to which electricity network profits currently exceed the sectors' requirements for financial sustainability (Bertram and Twaddle, 2003) provides an estimate of about \$200 million per year, nearly 0.2% of New Zealand's GDP. Similar studies of gas pipelines and port companies indicate up to another \$100 million of annual excess profits in those sectors (Bertram *et al.*, 2001, 2002). Monopoly rents on this scale are significant at macroeconomic as well as microeconomic level, and the policy decision to leave them unregulated has resulted not only in distortion of investment incentives and high returns to rent-seeking diversionary activity, but also in a skewing of the underlying real exchange rate (the relative prices of traded and non-traded goods) in a direction that is unfavourable to the expansion of net exports, and hence prejudicial to the longer-run ability of the economy to achieve a relaxation of the foreign exchange constraint which remains the ultimate check on the growth of living standards for New Zealanders.

Conclusion

This paper has brought together a number of threads related to New Zealand's economic experience under a neoliberal reform programme. Neoliberalism has delivered a sustainable fiscal position, insulation of the economy from the worst risks of financial crisis, and greatly increased market flexibility across the entire economy with consequent gains in quality and competitiveness in many sectors. It has had no measurable impact on the distribution of the net product between labour and capital, but it has transferred about half the domestic surplus into the hands of overseas investors, as the counterpart to a significant rise in the overseas net debt over two decades. It has put a dent in the welfare state, but failed to eliminate it. But it has succeeded beyond expectations in extinguishing both the desire and the capability of Government to regulate economic activity. This outcome has exposed the economy to the corrosive effects of increased rent-seeking, as the quest for monopoly profits in sheltered sectors of the economy has diverted entrepreneurial attention from the central requirement of long-run macroeconomic sustainability, namely the expansion of net export earnings to fund rising living standards.

Notes

1. Bertram (1992) noted that 'there is a certain irony in a country which has floated its exchange rate and deregulated its domestic interest rate living in fear of capital flight' (p. 40), and experience since then has reinforced the point that this stance of macroeconomic policy confers, to a large extent, immunity from major financial crises of the sort suffered by the countries listed. The downside of this immunity is a real interest rate which runs persistently above those in many other OECD countries, placing a long-run restraint on New Zealand's domestic investment

and encouraging a short-term focus in the thinking of both private and public-sector decision makers.

2. Statistics New Zealand, *Hot off the Press: Balance of Payments and International Investment Position: March 2003 Quarter*, Table 10, note, states that the figures for 2001 still excluded \$2,365 million of international assets of managed funds, and \$5,506 million of equity assets which have been identified by a new survey.

3. Section 27.

4. Section 36.

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