

New Zealand's Role in the Pacific Century

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Good evening everyone.

I am delighted to be here and appreciate the efforts of *The New Zealand Initiative* to facilitate this event.

The underlying theme of my talk, following on from your discussions today, is how to raise and sustain New Zealanders' living standards and quality of life in the years ahead. This resonates strongly with me as the chief executive of an organisation with the vision of being a world-class Treasury working for higher living standards for New Zealanders. Indeed we are now embedding our Living Standards Framework as the cornerstone of our processes when developing policy advice. As you'd expect, economic growth is one of the key ingredients for improving living standards, but we also consider policy from the perspective of sustainability for the future, reducing risks, social infrastructure and equity considerations. This approach will be reflected in what you hear from me this evening and what you'll see from the Treasury in the future.

I want to share with you some insights on what's been happening in the international and domestic scenes, and what this means for New Zealand's role in the Pacific Century. There are a number of points I want to make. Business leaders are operating in an interconnected world – a world where change is constant and the pace

of change is accelerating. It's in New Zealand's national DNA to be adaptable and responsive, and we've already made a lot of changes to adjust to the new international order. But if New Zealand is going to lift its living standards and be more competitive in the world, we have to focus on the things that matter for making this happen. It's also going to require a paradigm shift – a change in the way we think as well as what we do.

Of course even then we can't take success for granted. Your challenge as businesspeople is to seize the opportunities opening up to you and make them work, because we all know nothing gets handed to us on a plate. And this evening I also want to challenge you to not just take advantage of change, but to use your voices as advocates for change. You have a role to stand up and speak out about what you see as the right policies and the right priorities for New Zealand to prosper.

Global interconnectedness and change

Over the past month or so I've spent time in Europe and Asia. In fact I've just come back from a trip to the Republic of Korea and the People's Republic of China, which included the World Economic Forum's annual *Summer Davos* event. What really hits me about the countries and international events I go to is the interconnectedness of the world. I get to speak with a wide range of people from nations around the globe, and often find that we are all talking about similar issues, dependencies and opportunities. Everyone is interested in growth, sustainability, inequality and education. Most people are talking about reform. People in Europe and the United States want to know what's happening in China, and people in China want to know what's happening in the United States and Europe. One of the people I met was from a New Zealand firm, designing in Auckland and manufacturing in Malaysia, largely for a Korean-based multinational.

Because of global interconnections, countries around the world have felt the impact of the structural shift in the centre of activity in international trade and investment flows to economies in Asia and around the Pacific Rim.

This shift in the hub of international activity – what some have termed the Pacific Century – could hardly represent a more profound change to the international context in which to run an enterprise based in New Zealand.

Since the 1970s, we've had the challenge of adjusting to a world where the centre of activity has been moving much closer to home, a process that, in the Treasury's assessment, is both accelerating and permanent.

This change is so fundamental and important that it is being considered not only in New Zealand, but around the Asia Pacific region and beyond. For example, the Australian Government has commissioned a White Paper to consider the likely economic and strategic changes in the region and what more can be done to position Australia to take advantage of them.

In many cases, the scope and pace of change within the Asia Pacific region is immense. For example, no visitor to Korea and China returning after a few years can miss the remarkable and rapid transformation in those societies. Over recent decades, the income per person in these countries has risen massively.

In 1980, when the United States' income per person (GDP per capita PPP) was US\$12,249, New Zealand's income per person was US\$8,247, Korea's was US\$2,302 and China's was US\$251.

According to data compiled by the IMF, the United States' income person had risen by 295% since 1980 (to stand at US\$48,387 by 2011) and New Zealand's had risen by 235% (to US\$27,668), while over the same period Korea's had risen by 1277% (to US\$31,714) and China's had risen by 3241% (to US\$8382).

More recently we have seen stronger growth in South America too. Again according to the IMF, since 2000 GDP per capita has grown by 90% in Argentina, 75% in Chile and 63% in Brazil, compared to growth of 37% in the United States and 41% in New Zealand.

These numbers of course represent deep changes in living standards, in lifestyles, in individuals' world outlooks and expectations.

Since 1970, China and Korea have been a central part of a wider phenomenon of formerly poor, inefficient and relatively unproductive economies transforming and uplifting themselves through integrating their domestic economies into the international system.

By adopting policies which progressively opened up their own enterprises to offshore opportunities and competition, they've reaped spectacular productivity gains. At the same time, their quality standards have risen to meet the high expectations of consumers in far wealthier societies that buy a large share of what these countries make.

It is a process which has propelled far-reaching changes within Asia-Pacific societies, most visible in the rapid acceleration in urbanisation and a rise in their own highly demanding domestic consumer markets.

For these countries, including China, the challenge ahead is to manage this structural transformation process in a way that is more sustainable. There are early signs that this is happening. They are looking to adjust their growth model so there is less reliance on the United States and European markets, and more reliance on their own consumer markets.

For economists, the strengthening emerging economies represents a structural shock to the mature advanced economies in Europe, North America and Australasia – in some ways as profound as the changes taking place in the emerging societies themselves.

Policy-makers in mature economies have had to be nimble to recognise the nature of the structural shock to global production and distribution, and to adjust to the realities of the emerging new order of things. Because when the world changes, you've got to change too or risk being left behind.

Thankfully, New Zealand has a great history of being responsive and adaptable. We've had to be – and more importantly, right now we've got to be.

The structural reforms adopted in New Zealand over the last quarter of a century have in part represented our society's efforts to adjust successfully to the competitive challenges posed to our living standards by an emerging new international order.

New Zealand's adjustment to re-emergence of Asian economies

In case there is any doubt about how much New Zealand has already changed in recent years, let me recap some of the changes since the mid-nineties.

- **Trade:** Since 1996, the value of our goods exports to Asia has more than doubled and the value of imports from Asia has almost quadrupled. China is now our second largest trading partner and, more broadly, as of 2011, six of our top ten trading partners were in Asia. Overall, around 40% of our export trade is with Asian countries, compared with 22% with Australia, 11% with the European Union and 8% with the United States.
- **People:** Over the same period, we have become a much more diverse society. The proportion of New Zealanders who define themselves in the census as Asian has grown faster than any other broad ethnic group, from 5% in 1996 to around 10% in 2006. This is projected to reach 15% by 2026. At the same time there has been a growing diaspora of New Zealanders in Asian countries. This flow of people from and to Asia has helped to build durable business networks.
- **Tourism:** Also since 1996, both visitors to our country from the wider Asia Pacific region and New Zealand visitors to the Asia Pacific region have grown by over 75%.
- **Education:** Over 80% of international students in New Zealand are from Asia.
- **Diplomacy, regional Forums & Agreements:** New Zealand now has embassies and consulates in 12 Asian countries and has regular senior level discussions with nations throughout the region. Our officials are closely involved in multilateral efforts to build stronger ties across the Pacific – from the APEC economies to the CER-ASEAN and East Asia Summits and, of course, as one of the founding parties to the ongoing Trans-Pacific Partnership negotiations. The next round of these negotiations will be hosted in Auckland in December. In terms of bilateral efforts to reduce barriers to investment and trade, New Zealand has free trade agreements with China, Thailand, Singapore, Malaysia and Hong Kong. We're also in the process of negotiating agreements, or undertaking feasibility studies, with India, Korea and Japan.

In short, we are a nation with strong political, professional and personal bonds across the Asia-Pacific region. It's up to New Zealand enterprises to make the most of that.

Factors underpinning positive outlook for New Zealand

In the middle of these structural changes, 2008 saw a different kind of shock, the Global Financial Crisis.

There are of course significant issues yet to be worked through in the international economy as a number of developed societies adjust to fix excesses built up in the period leading up to the Global Financial Crisis. Public and private debt burdens are in the process of being adjusted lower in a number of mature economies, a development which inevitably involves a period of weak domestic demand in large parts of the rich world.

But it is important to business leaders to not lose sight of the bigger picture for the global economy and for New Zealand's place in it.

And I believe we can look at the big picture with a sense of optimism. New Zealand is well-positioned geographically, strategically and economically to grow relatively strongly in the decades ahead as we are increasingly integrated into the Pacific Rim economies.

- Consumer and industrial demand from emerging economies has supported a higher terms of trade and it is expected to continue to underpin our terms of trade into the future. In a nutshell, they want to buy what we've got.
- As the barriers to New Zealand-based exporters of goods and services go down, the potential to increase New Zealanders' incomes from interaction with the growing markets of the Pacific Rim goes up.
- Broadband is bringing New Zealand closer to the rest of the world.
- It is reasonable to expect that there will be progress to adjust growth models in Asian economies in the direction of less reliance on richer consumer markets in North America and Europe, and more reliance on servicing their own growing consumer markets. It's a key plank of China's economic plan.
- It is also reasonable to expect that there will be progress on Asian financial market integration, to match the big gains in integration of goods and services product markets in recent decades.

We must continue to change, adapt, and focus on the things that matter

But we can never take success for granted. To be successful, to be best-positioned to reap the potential benefits available to us from the changing international environment, we must continue to adjust and adapt. And a main point that I really want to press home this evening is that our international competitiveness depends on our domestic policy settings and business environment. I'd like to take a few minutes to go through some of the key things that make a difference.

Macroeconomic stability

First up, it's clear that macroeconomic stability is important. We learned the hard way in the 1970s and 1980s that macro economic instability and inflexibility can be very costly to New Zealanders. Sound fiscal and macro policies are crucial, along with strong institutions like central banks, ministries of finance, or I might add a high-performing Treasury. I'd also include a strong voice in civil society and a vigorous business community as key elements of a solid platform that supports a stable macroeconomic environment.

Sustainable finances

Something else that matters is returning the Crown accounts to surplus. Sustainable government finances – or prudent fiscal settings, as we'd say at the Treasury, are a vital ingredient in efforts to assist our economy to continue to unwind imbalances built up in the lead-up to the GFC.

It will help to ensure the fiscal settings are not adding upward pressure on interest and exchange rates which erode the competitiveness of exporters and those that compete with imports.

Giving a clear signal to investors that the Crown accounts are back on a sustainable footing will also place New Zealand in a relatively more competitive position to attract the investment capital that we of course need to raise our economy's growth potential.

Structural reform

I want to emphasise another main point to you, and that's the importance of reform. Not superficial change, but much-needed and ongoing structural reform.

The Treasury provides a wide range of policy advice aimed at raising New Zealand's growth performance. In our *Briefing to the Incoming Minister* released earlier this year we gave advice on the following issues:

- The role that tax reform could play to reduce distortions to savings and investment decisions, and encourage a higher overall rate of national saving.
- Reforming the education system to improve educational attainment.
- Implementing welfare reforms with wider changes to improve social and labour force outcomes.

- Focusing science and innovation policy on firm-led research and development and commercialisation.
- Continuing network infrastructure investment and management.
- Managing natural resources more efficiently, including through continuing reform of the Resource Management Act.
- Ensuring the longer-term recovery strategy for greater Christchurch maintains confidence in the future of the city.

Let me give you a couple of examples from the issues I've just mentioned where we see a good case for reform.

First, you may be aware that the Treasury has spoken a lot about the education sector this year. We made a conscious decision to be at the forefront of debate about the critical importance of student achievement and teacher performance to raising growth and productivity over the long term.

Second, the Treasury is keen to see a continuation of recent progress to improve the speed and efficiency of the Resource Management Act, and to have it better articulate the national interest. In particular, we think it's important to refine the principles of the Act to give greater explicit recognition to economic growth alongside other values.

When I visited the Port of Tauranga a few weeks ago, they talked about their plans to deepen and widen their shipping channels so the port can accommodate bigger vessels. Larger ships will become increasingly common in the world and in New Zealand waters, and that should lead to lower freight costs for importers and greater competitiveness for our exporters. However, the Port has so far spent four years and \$2.5 million waiting for final resource consent to do the dredging. To me, that's a pretty clear illustration of why the RMA needs reform.

Foreign direct investment

Another area that makes a difference to our international competitiveness is foreign direct investment. New Zealand is highly dependent on foreign capital to fund our shortfall in national savings. We do not save enough to fund the investment needed to grow our economy, and foreign direct investment is crucial in bridging that gap.

Some of the other benefits of foreign direct investment for our country include driving growth in jobs, pay and output; bringing new skills and technology to our shores; and strengthening our connections to international markets.

Treasury analysis from 2008 concluded foreign capital flows into New Zealand lifted incomes by around \$3800 per worker between 1996 and 2006 in today's prices, and lifted wealth by \$16,000 per person.

The overall advantages of foreign direct investment for our domestic economy and international connections are undeniable. Yet for foreigners deciding whether to invest

in our country, too much of what they see and hear from New Zealand risks putting them off rather than pulling them in.

New Zealand does not score well on international measures of openness to foreign investment, and based on OECD data, restrictiveness has been reducing in most countries while there has been no reduction in New Zealand. There are a number of reasons for this, including foreign ownership restrictions in some sectors and investment screening for purchases of significant business assets or sensitive land. And it has become fashionable in some quarters to question the wisdom of liberalising our FDI regime.

It is Treasury's view that there are changes that could be put on the table to increase our attractiveness as a destination for foreigners to invest the finance, ideas and skills that we need from them. The most obvious one is to improve our domestic policy settings in areas like tax and regulation. Another is to reduce other costs and distortions associated with capital inflows, particularly in relation to tax treatment, which can be advanced through double-tax agreements. To put it bluntly, we need to be more welcoming of foreign direct investment, or that investment will go elsewhere.

Exchange rate

I know that many exporters – particularly those who have not experienced a significant increase in the world price of their output – would say that one of the main macroeconomic issues affecting our competitive advantage is the foreign exchange rate. I've heard first-hand from some exporters how a high New Zealand dollar is making things challenging for them. On the flip-side, of course, a higher exchange rate has benefits to New Zealand consumers.

The recent strength in the exchange rate can be explained by a number of factors, including buoyant New Zealand commodity prices – although these have softened over the past few months – and improved risk appetite by international financial market participants. But taking a longer-term perspective, it seems clear that there is a more persistent relationship between the long-term average level of the exchange rate, New Zealand's high average real interest rates (relative to those of our trading partners), and the persistent gap between domestic investment and saving rates – as reflected in New Zealand's persistent current account deficits.

We know that New Zealand's high interest rate differential is not due to monetary policy, as our inflation rates have been no lower on average than in our trading partners. Rather, it seems that these outcomes arise largely out of our domestic savings and investment choices, which in turn are influenced by – among other things – domestic policy settings.

I am clear that the current monetary policy framework is sound. Instead, where we need to look is at underlying drivers of our economic performance. We want to explore some of these issues further, including better understanding how they drive the exchange rate.

What you will gather from all of this is that these issues are complex, and that you can't simply flick a switch and expect to solve the problem.

Paradigms are changing

A lot of what I've said this evening has focused on what central government does, or at least what it can influence. Now I want to turn the spotlight on you. Because another major factor in making New Zealand more competitive in the world and lifting our living standards is how you embrace changing paradigms. To succeed in the Pacific Century, our businesspeople need to think differently and act differently than they have in the past.

It can be daunting, and without question there are some big challenges. No New Zealand business person can duck the relentless increase in competition for skilled people and for capital. Global competition in labour-intensive mass production is well-advanced across international supply chains, and no business model here or anywhere can avoid its implications.

What New Zealand and New Zealanders cannot afford to do in the face of big challenges such as these is attempt to retreat into becoming more insular. If we do, we risk missing the opportunities opening to us from increased demand for the products and services for which we have competitive advantages.

New Zealand needs strong international connections of people, goods and services, ideas and capital with Asia-Pacific and the rest of the world if we are going to sustain ongoing improvements in our living standards.

I think it is uncontroversial to say that one of the basic lessons of economic history is that security cannot come through attempting to stand still. It can only be achieved through proactively engaging with an ever-changing international environment. Nobody is out there offering New Zealand a free lunch, and no nation is compelled to trade with us. That means you have to seize business opportunities no matter where in the world they are and make them work, otherwise they will be lost.

For a lot of business people it's going to take a change in attitudes and approaches to international connections. It's not enough to rely on a free trade agreement being signed and expect that a lot of the hard work in entering a new market has been done. It hasn't. Trading with the growing economies of Asia differs to what people may have experience trading with Australia, the United States or Europe. In Asian economies – which as I've said are now six of our top ten trading partners – relationships are a powerful driver of trade. You need to think about how you are going to make the most of our strengthening political, professional and personal bonds with others in the Asia Pacific region to create relationships and establish business connections.

I believe that if we're more welcoming of inward investment, open to new ideas, and attuned to other cultures, we'll be better connected and better able to tap into export markets.

Of course it's not just businesspeople that need to get their heads around the implications of a fast-changing world and what New Zealand needs to do to adapt successfully. We need to acknowledge also that changes and reforms designed to raise competitiveness work best when the general public understand and support the process. They have to know what's in it for them, their family and their country.

Your role in the national debate

It can't just be left up to the government and its agencies like the Treasury to tell them. And that's the crux of my challenge to all of you in the room this evening: be involved, and be heard.

Business is as much a part of civil society as anyone else, and it has a responsibility to engage with the wider community on the things that matter to New Zealand. It's a wasted opportunity to sit on the sideline and leave the important conversations solely to the politicians, public servants, protesters and political commentators. Businesspeople have a wealth of insight and experience to bring to the dialogue.

I want to call on you as business leaders to reach out to the public. Grasp opportunities to talk to people about your strategies and your export plans and ambitions. Help the community understand the connection between these activities, their impact on job creation, and New Zealanders' living standards. Engage with them on the policies and priorities that mean the most to you. And help to demystify what are in reality interesting, important and highly relevant national stories for all New Zealanders.

In closing, I believe that with barriers to New Zealand exports falling across the Asia Pacific region, rising incomes, and rising demand for what we have to offer, there is no question that New Zealand-based companies are well-positioned. New Zealand is open for business and in a sound position upon which to grow – how fast and how successfully is to a large extent in our own hands.