NZ Manufacturers and Exporters Association
The independent voice of manufacturers and exporters

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Dear Don

2025 Taskforce – Contribution to Second Report

Thank you for persisting with the efforts of the 2025 Taskforce. Questions around investment and productivity need to be asked and the answers debated. Generally we have seen the contribution to growth provided by comparative advantage fall with respect to the growth associated with competitive advantage. In general, if an economy is increasingly simple in terms of its productive capacity and export profile it should be no surprise that the relative performance of that economy slips in comparison to economies that are expanding productive capacity and becoming increasingly complex.

You will be more than aware that capacity and complexity requires broad investment based on understanding customer needs, research and development, productive capability, distribution and the marketing of value. Such investment, or the absence of investment, has long been a discussion point in New Zealand.

Obviously most competitive positions are a combination of both comparative and competitive advantage, the greater the reliance on competitive advantage the more mobile the activity and the more transient the overall advantage. The very mobility of complex activity exposes the impact of macroeconomic policy across jurisdictions. It should come as no surprise that when one jurisdiction smiles upon research and development activity, such activity migrates towards those favourable jurisdictions. This migration of activity has the invidious impact of reducing critical mass of capacity in the source jurisdiction; its process is slow and subtle but nonetheless devastating over the medium term. Such a process has been happening in New Zealand for several decades. The relationship between New Zealand, Australia and the rest of the world today is similar to the relationship Ireland had with the England and the rest of the world in the middle of the last century.

We have attempted to answer your specific questions in the attached paper. Briefly, we are engaged in the attrition of capability in our economy as productive complexity is starved of investment. Unless the forces that have delivered this outcome change there can be no reason to anticipate that the trends of decades will spontaneously change.

New Zealand has a number of comparative disadvantages; we are a long way from markets which impacts cost, customer and channel understanding, and broad appreciation of just how far we are slipping behind our more prosperous competitors. New Zealand is a small economy that provides a tiny home market that quickly becomes even smaller as producers focus on niche opportunities.

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New Zealand companies must face the difficulties of export markets very early on in their growth cycle, often saturating local markets with considerably less than $10m in revenue.

These difficulties are compounded by policy settings that do not restrain the cost of capital, exacerbate currency volatility and pump asset bubbles. The tendency to favour consumption over production, favour asset appreciation over cash flows, choose to have higher interest rates, and run an exchange rate that has no relationship to our trade performance, have drained the ability of the trade exposed sector to invest in itself. The outcome is clear to see, as is the future if nothing changes.

Farming, often seen as the salvation of the New Zealand economy, will be lucky to save itself; lacking the profitability to invest in lifting productivity and being volume limited for the most part.

Over time, competition commoditises everything. The only force that resists commoditisation are those things seen as in some way new, different, cheaper or better. That innovation requires investment or decent margins from current activities. Largely New Zealand firms have been starved of investment (more money to be made from property speculation), revenues have been decimated and margins eliminated by a mostly overvalued exchange rate.

Don, one way or another if returns to effort in the trade exposed sector don't improve all that will remain will be activity based largely on comparative advantage, any major competitive advantage will be lost, living standards will fall and the economic pressure to leave will increase. Not a pretty picture but it is a direct outcome of our policy choices: no effective research and development tax credit, no depreciation advantage, high interest rates, and an overvalued currency – with such policy settings why anticipate anything other than what we have?

Yours sincerely

John Walley
Chief Executive

2025 Background Comment Second 2025 Taskforce Report

What more can be said about when and why the income gap with Australia merged? Can New Zealand's small size and distance from market really explain the timing of the widening of the gap or are other explanations more plausible? Can more be said about the significance of Australia's mineral resources?

The income gap between Australia and New Zealand really began in the mid 1960s. The difference in GDP per capita has widened during the 70s and 80s reform period and this trend has continued for at least 25 years. Now in 2010, the difference in living standards has become largely obvious even for the general public.

The small size and distance from market have often been used to explain the recent poor economic performance in New Zealand. It is true that as a small country New Zealand cannot rely on the domestic market and enjoy economy of scale to the extent of others and its remoteness has increased the cost of exploiting overseas markets, but size and location are inherent characteristics of a country and New Zealand used to be one of wealthiest countries in the world. There must be other factors which trigger the change in performance.

New Zealand has been heavily involved in international trade since the early 1800s. Changes in international trade policies and trade patterns had significant effect on the New Zealand economy in the last two centuries. Pre-1870, New Zealand mainly concentrated on exporting non-perishable sheep products, native timber and gold to Australia. With the advent of refrigerated shipping in the 1880s trade focus shifted to meat and dairy exports to the UK. By the mid-1890s Britain took more than 80% of New Zealand exports. During the First World War New Zealand and the United Kingdom operated a purchasing agreement which guaranteed prices in return for New Zealand sending all of its exports of meat and dairy produce to Britain. The heavy demand in Britain spurred the rapid development of farming and brought huge prosperity to New Zealand. Naturally New Zealand's trade relationship with other countries (e.g. Australia and the US) waned.

Up until the 1960s the United Kingdom remained as New Zealand's principal trading partner. However, when the United Kingdom joined the European Economic Community, trade with the United Kingdom declined significantly through the 1970s and reached its lowest point in real terms in 1984-1985. Bereft of a ready, high priced market New Zealand has been trying to fill the hole left by the United Kingdom. With the loss of market and decline in average relative return (milk, meat and fibre are worth about 20% today, in relative terms, what they were in the 1950s) New Zealand needed a solution to the small, distant and agricultural problems.

Since the 1980s most of the policy changes in New Zealand have followed the direction of the so-called "Washington Consensus". The consensus included ten broad sets of recommendations, which are completely reasonable in a general sense however for a small open economy like New Zealand, a complete and vanilla adoption of the scheme has been reported[i] as less than optimum,

Taking a couple of examples:

The Reserve Bank of New Zealand (RBNZ) operates an independent floating exchange rate regime; only intervening to counter extreme disorderly conditions in the currency market. In June 2007 the Bank announced that it had intervened in the New Zealand dollar market for the first time since the New Zealand dollar had been floated in March 1985.

Soon after that in July 2007 the New Zealand Trade Weighted Index (TWI) reached an historical high of 75.4, and in February 2009 the New Zealand dollar hit its recent low of 52.3. Now in June 2010 the NZ TWI has again appreciated 28.1 per cent to 67.0. This level of fluctuation creates extreme exchange rate risks, which have affected the investment and performance of the trade exposed sector.

The highly volatile New Zealand dollar is the result of large interest rate differentials. Speculative carry trade has separated the exchange rate from fundamental trade performance. We have not earned the exchange rate we have, that imbalance exacerbates the imbalances in the economy. The floating exchange rate is not the automatic stabiliser it was claimed to be; it ruins trade and trade investment. It is probably not an overstatement to say that this is the root cause of all that ails us.

In New Zealand, the market interest rate is guided by the Official Cash Rate (OCR), which is the overnight interest rate that the RBNZ uses to settle inter-bank transactions. By varying the level of OCR, the RBNZ keeps inflation within the Target Range (i.e. 1-3 per cent) on average, over the medium term. History has shown that inflation in the internal economy ignored these pressures and only severe pressure (exerted via the exchange rate) on the trade exposed sector brought the headline inflation numbers inside target.

It has become increasingly obvious that the effectiveness of the OCR mechanism should be questioned. The single instrument single target monetary policy has caused the tradable sector to suffer as inflation pressures appear in the domestic sector. The high level of interest rates has also increased the cost comparative of capital for New Zealand businesses, which has become a major barrier for investment, innovation and productivity improvement.

Up to this point it is interesting to note that Australia has also had the same trade pattern changes in 1970s, however their rich mineral deposits, and more importantly, a substantially larger domestic market, a more balanced monetary (multiple targets) and fiscal policy (compulsory super, and capital gains tax) have helped set them up for difficult times. After successfully avoiding recession during the recent global financial crisis Australia might be truly "the lucky country". If there is any chance for New Zealand to catch up we not only need to take advantage of our neighbours in terms of trade, but our Government has to provide the necessary incentives, and more importantly a favourable business environment, for the trade exposed sector to thrive.

What best explains the reported difference between economy-wide and measured sector productivity?

This economy-wide productivity provides a long-term perspective, a comparison with all members of the OECD, and a direct link to per capita incomes. The measured sector productivity data produced by Statistics New Zealand are more reliable and more detailed. However, not all industries are covered, excluded are those industries for which real value-added in the national accounts is largely measured using input methods, such as number of employees. These are mainly government non-market industries that provide services such as administration, health, and education, and are free or at nominal charges. The reported difference between the different types of productivity statistics are mainly caused by the difference in methodologies and data source.

How important are human capital issues in explaining the movement of New Zealanders to Australia and our productivity gap? What role has New Zealand's education system played?

Loss of the "best and brightest" to the "brain drain" has long been a problem for underperforming economies. The problem is reaching deep into the skills mix; professional, managerial and trade skills all have strong demand as education policies elsewhere have not responded to changing times.

Immigration is a much quicker fix for policy mistakes that take a generation to remedy. It is no surprise that a visit to an engineering shop in Australia sees many Kiwis, and visiting similar places in New Zealand sees Bangladeshi employees – all chasing success and economic improvement. Without change New Zealand has the prospect of becoming the most valuable mine owned by Australia – the mine where it gets capable and well trained people from.

Every year our most capable leave for better pay and greater opportunity, no doubt this has led to a huge human capital loss for New Zealand. Quality human capital is the principle key to higher productivity, in order to close our productivity gap this issue must be dealt with at source. High achievers look for reward and opportunity, if our economy does not offer either they will seek success elsewhere. For many years we have been working on how to keep our talents by providing various types of incentive schemes but little has been achieved – incentives will not work only real reward and opportunity will cut it. To initiate any sort of virtuous cycle we need to ensure our productive trade exposed sector is set up for strong growth. Step one is simply that our trade exposed sector must be in a position to grow.

During the financial crisis, risk perceptions slowed New Zealand's brain drain, this will change and should be of no comfort. The graphic from the New Zealand Institute tells the story that unless the real economy grows and unless the real economy becomes more productive we have already lost the race. If that is the case our future as a poor farm and a threadbare theme park is cast.

Was our first report correct to downplay the significance of further government funded research and development in helping to close the income gap?

This comment was, is and always misguided. I know of no one in the real economy who agreed with this. Our consistent performance demonstrates the error. No other jurisdiction fails to support private research and development leaving New Zealand firms at a disadvantage. Research and Development (R&D) has the most obvious and direct impact on innovation and productivity. Compared with Australia and other OECD countries the level of business R&D investment in New Zealand is considerably less. When using government money to fund R&D the most important thing to remember is that one size does not fit all. Different sectors have their different needs. Centrally directed university and CRI based research may work the best for the primary or health sectors (where the needs are coherent and predictable), what the industrial sector needs are non-discretionary schemes (i.e. tax incentives work best when needs are random and varied).

That said all policy questions are insignificant compared to the impact of monetary policy on the exchange rate. By way of example see:

http://www.johnwalley.co.nz/100-materiality_fiscal_and_monetar.aspx

What might the reduction in government spending relative to GDP recommended in our first report mean for social outcomes?

Currently the National government is working on increasing the efficiency of government spending. If that is not an oxymoron the reduction in government spending should not cause huge social impacts. Somehow such changes never seem to happen as the 2010 budget foreshadowed increased crown debt at ~ NZ$1b a month for 36 months and balanced the budget in the out-years predicated on growth levels we have not sustained even in the good times.

Where might better regulatory practice lead to gains for New Zealand?

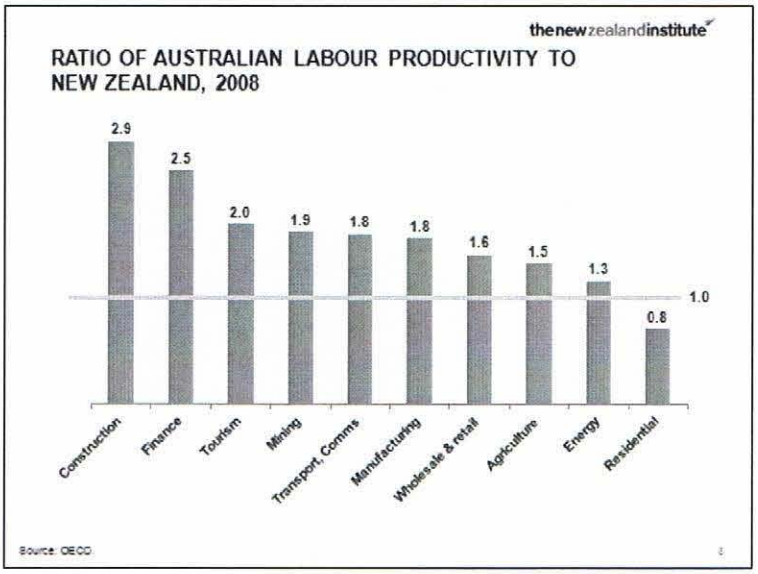
Reducing red tape will help businesses reduce operational costs and increase efficiency, somehow this never seems to happen unless some external force compels it, witness Greece.

What has Australia done well that we can learn from in terms of policies and are these perspectives from other countries that we can learn from?

The aging population problem is something all developed countries have to face. In terms of policies the Compulsory Superannuation Scheme is something New Zealand should seriously consider. Kiwisaver could be made compulsory, providing an additional policy tool to manage inflation and money supply.

In addition, the political recognition that the universal entitlement age for national superannuation needs to be raised to make national super affordable in the medium term, would be a significant step towards a sustainable economy.

Balanced fiscal policy, by removing the advantages still entrenched around capital gains we remain the odd jurisdiction out (not just different from Australia) in this regard, the presence of this tax distortion leads to many misallocations of investment. This graphic from Rick Boven of the New Zealand Institute tells its own story of incentives and distortions wrought by inappropriate fiscal and monetary policy.



[i] IMF Reports – "Rethinking Macro Economic Policy" (http://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf) and "Capital Inflow – The Role of Controls" (http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf)