THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Should we be concerned about profits going offshore?

Date:	13 July 2010	**Report No:**	T2010/1266

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** that we consider the argument about profits going offshore has a weak economic basis—we think the relevant policy focus should be the overall saving and investment balance rather than specific transactions. **Refer** a copy of this report to the Prime Minister.	23 July 2010
Associate Minister of Finance (Hon Simon Power)	**Note** that we consider the argument about profits going offshore has a weak economic basis—we think the relevant policy focus should be the overall saving and investment balance rather than specific transactions.	23 July 2010

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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Minister of Finance's Office Actions (if required)

Refer a copy of this report to the Prime Minister.

Enclosure: **No**

13 July 2010

Treasury Report: Should we be concerned about profits going offshore?

Executive Summary

Concern about 'profits going offshore' is commonly used as an argument against a number of different policies. Both of you have been asked questions about this argument recently.[1] The argument is generally used in relation to:

- foreign ownership (e.g. discussion about the purchase of Crafar farms or the impact of Australian-owned banks' profits); and

- government asset sales (e.g. whether New Zealand ownership of Kiwibank provides macroeconomic benefits).

'Profits going offshore' is only part of the picture.

From a national accounting point of view, the relevant indicators are the balance of payments and international investment position. These indicators can be characterised as follows:

- New Zealand's current account flow is dominated by net investment transfers (i.e. net 'profits going offshore', where profits also includes debt servicing costs), reflecting past net investment by foreigners.

- New Zealand's stock of net international investment is highly negative, but is dominated by debt. That is, in net terms New Zealand mainly *owes* a lot to the rest of the world rather than being *owned*.

For the sale of any particular asset to a foreign investor, the key points are:

- ***The price a purchaser pays should represent the expected future stream of profits.*** In general, we would expect the sale price to be efficient and reflect the underlying commercial value of the asset.

- ***The main driver of 'profits going offshore' is the national saving and investment balance.*** Selling an asset to foreigners will only have a significant effect on the current account deficit if it affects these fundamental drivers.

- ***The macroeconomic effects depend on the use of the proceeds from the sale.*** The impact on the current account is unlikely to be significant, and long-term real incomes would be expected to increase if the foreign investment brings economic benefits (as the evidence suggests it does, on average).

The more important focus should be the overall saving and investment balance.

We do not think it makes sense to be concerned about 'profits going offshore' per se. The more important places to focus from a macroeconomic perspective are the overall saving and investment balance and New Zealand's overall external vulnerability. As you know from our other advice to you, we <u>do</u> see reasons to be concerned by New Zealand's external vulnerability, but any policy response needs to be linked to the fundamental drivers.

[1] For example, Hon English in the House (Question 1, 27 May 2010) and Hon Power at Select Committee (Vote SOEs, 6 June 2010)

Recommended Action

We recommend that you:

a **refer** a copy of this report to the Prime Minister.

Agree/disagree.

Tim Hampton
Manager, Macro Policy 1
for Secretary to the Treasury

Hon Bill English
Minister of Finance

Treasury Report: Should we be concerned about profits going offshore?

Purpose of Report

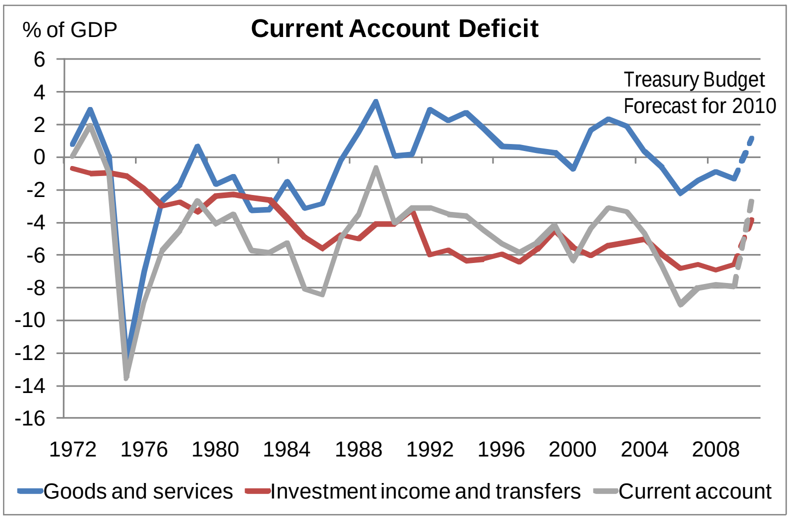
1. This report analyses the macroeconomic impact of selling a private or government asset to foreign investors, focussing on the impact on the current account and GDP.

2. An important caveat is that this report makes no comment on the broader pros and cons of relevant policies. The focus is simply on the strength of the 'profits going offshore' argument.

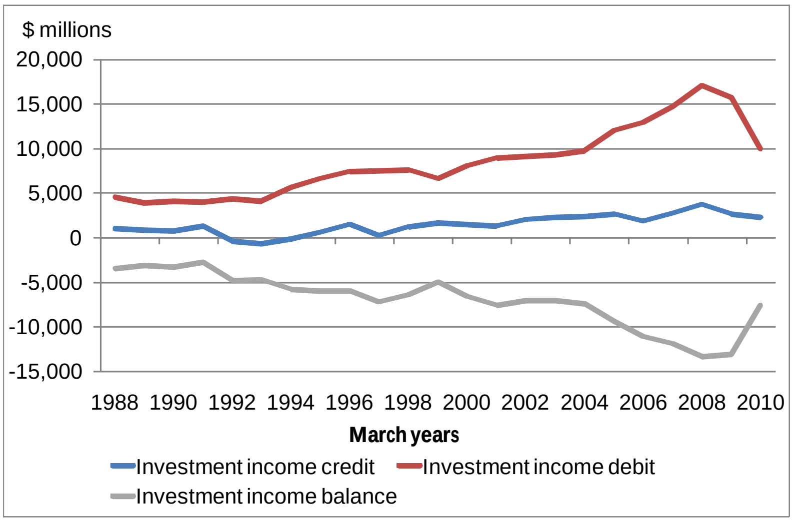
Analysis

New Zealand's external position

3. New Zealand's current account deficit is dominated by investment income and transfer, because goods and services have been largely in balance over the past decade.

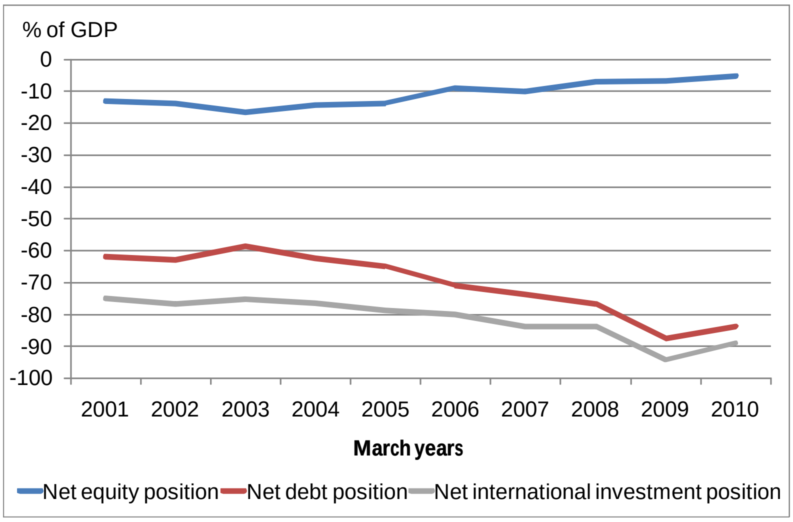


4. The investment income balance component of the current account includes both 'profits from offshore' as well as 'profits going offshore', but is dominated by the latter. Note that investment income includes income from both equity (e.g. dividends) and debt (e.g. interest).



5. Of the $9.9 billion gross income from foreign investment in New Zealand in the year to March 2010 (i.e. the last point on the red line in the chart above), 14% was direct investment income from debt, 22% was portfolio investment income from debt, 36% was direct investment income from equity, 7% was portfolio investment income from equity, and the remaining 21% was other investment income.

6. The result of a long period of current account deficits is a very high net international investment position (NIIP), at about -90% of GDP. The overall position is predominantly made up of net debt rather than net equity. That is, New Zealand's investment position with the rest of the world is better characterised as *owing* a lot rather than being *owned*.



Macroeconomic impacts of an asset sale to a foreign investor

Sale price and the future stream of profits

7. There are two sides to the sale of an asset: a one-off payment to the seller and an expected stream of profits to the buyer. If the price is efficient, these two sides of the transaction should be equivalent: that is, the purchase price represents the net present value of the future stream of profits (i.e. the commercial value). In general, in respect of sales of government assets the value of the business to the purchaser should exceed the commercial value of the asset if retained in Crown ownership because of the greater efficiencies likely to be achieved in private ownership. A competitive sale process should ensure that the value of those expected efficiency gains are captured by the Crown in the sale price.

8. In practice, the price may differ from how the asset is valued by the seller for several reasons. For example, the buyer and seller may have different expectations on the future stream of profits because of differences in view on business opportunities or different expertise they would bring to the business. Or a discount may apply if the sale is not undertaken competitively (e.g. a distressed sale).

9. As long as the sale is made voluntarily based on commercial criteria, both parties must see value in the transaction and therefore the sale should be beneficial for both parties. The higher the price achieved in any asset sale, the more unambiguously better off the seller is. The rest of the analysis in this report focuses on the effects of asset sales on the balance of payments and GDP. The nature of these effects is largely unaffected by the actual sale price.

Effects of foreign ownership on the balance of payments

10. The fundamental drivers of the current account deficit are national saving and domestic investment.[2] Selling an asset to foreigners will only have a significant effect on the current account deficit if it affects these fundamental drivers.

11. When an asset is sold to overseas investors, these overseas investors will be required to pay for their purchase of the New Zealand asset. The impact on the current account deficit will depend on how the seller of the asset uses these funds:

- If the funds are used to increase spending, national saving would fall and the overall current account deficit would increase.

- If the funds are used to invest in overseas equity, there would be no change in national saving or domestic investment and therefore no effect on the current account deficit.[3]

- If the funds are used to repay overseas debt, there will be a deleveraging of New Zealanders' balance sheets. The composition of New Zealand's NIIP would change by reducing debt owed to foreigners and increasing equity owned by foreigners. Overall this would be expected to reduce New Zealand's vulnerability, because the vulnerabilities associated with a high NIIP are somewhat greater for debt than equity.[4] However, New Zealanders would pay a premium for this reduced vulnerability. Profits earned by overseas investors will be recorded as an increase in factor incomes earned by foreigners (which will increase the current account deficit), and the interest saved due to a lower level of foreign debt will be recorded as a decrease in factor incomes earned by foreigners (which will decrease the current account deficit). However, these effects will not be of equal size: because equity is riskier from the perspective of an individual investor, the cost of equity is typically higher than the cost of debt (the equity risk premium); therefore net factor incomes earned by foreigners will increase because the additional equity returns now accruing to foreigners will typically exceed the reduced interest payments to foreigners.[5] All else equal, national saving will fall and the current account deficit will increase by the amount of the equity risk premium. It is worth noting that deleveraging would be expected to modestly reduce New Zealand's external vulnerabilities.

12. The above dynamics are summarised in the diagram on the next page:

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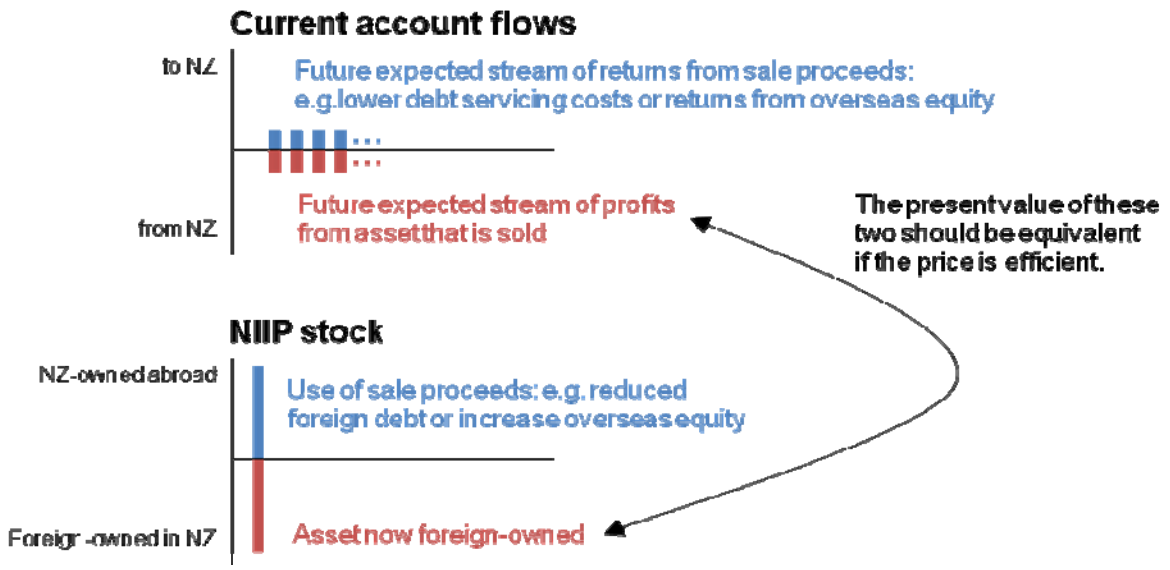
[2] Using national accounting identities, it is straightforward to show that national saving less investment equals the current account balance.

[3] This scenario is more likely in the case of a sale of a private asset, although in theory it could apply to a public asset (such as if assets sale proceeds were added to the New Zealand Superannuation Fund, much of which is invested abroad).

[4] In particular, high short-term debt leaves borrowers more vulnerable to a shock that leaves them unable to roll over or repay the debt. Around 40% of New Zealand's gross borrowing has a maturity of up to and including one year.

[5] This analysis of the impact on the current account deficit holds irrespective of whether profits earned by the now foreign-owned asset are repatriated or reinvested. This is because the current account records all profits (whether repatriated or reinvested) as an outflow of factor incomes paid to foreigners. To the extent that profits are reinvested, the benefits of higher investment should lead to higher growth in GDP.



Effects of selling an asset on GDP and GNI

13. This section traces out the effects of selling an asset on gross domestic product (GDP) and gross national income (GNI). GDP comprises the total value produced within a country. GNI is income accrued to New Zealanders; it comprises GDP, together with income received from other countries (notably interest and dividends), less similar payments made to other countries.

14. Once again, the effect depends on how the proceeds from the sale of the asset to foreigners are used:

- If a domestic asset is sold and the proceeds are used to invest in overseas equity, both GDP and GNI would be expected to increase over the medium to long term. This is because evidence suggests that foreign-owned firms are generally more productive than domestic firms,[6] and because spillovers from foreign direct investment can improve productivity.[7] Improved productivity would be expected to contribute to higher wages for New Zealand workers. Note that this evidence reflects on-average impacts and the effects in individual cases will vary. But if the productivity increase occurs for a particular asset, the New Zealand asset will be making a stronger contribution to the New Zealand economy. In addition, the additional profits from that firm accruing to its overseas owners would be offset by the expected additional income for New Zealanders from the increased offshore equity holdings.

- Where sale proceeds are used to repay debt, GDP and GNI would still be expected to increase over the medium to long term due to increased productivity. However, in the short term, because increased equity returns accruing to foreigners will typically exceed the reduced interest payments to foreigners, GNI will fall by the extent of the equity risk premium. This will increase the wedge between GDP and GNI.[8]

[6] For example, see T2009/2747, "Why do foreign-owned firms perform better than New Zealand-owned firms?"
[7] For example, see Treasury productivity paper 09/01, "International Connections and Productivity: Making Globalisation Work for New Zealand". For some recent New Zealand evidence, see Iyer et al (2010), "Foreign and Domestic Ownership: Evidence of Productivity Spillovers from New Zealand Firm Level Longitudinal Data," NZAE conference paper.
[8] A wedge between GDP and GNI simply reflects that economic activity in New Zealand is higher than net income accrued to New Zealanders (because of the extent of this economy's use of foreign capital). To the extent that GNI is a better measure of New Zealanders' living standards, the important factor is the long-run *level* of GNI, not the *gap* between GNI and GDP.

However, because GNI would be expected to grow faster over the medium to long term, eventually the level of long-term real GNI is likely to increase.

Conclusions

15. The three main points from the above analysis are:

- **The price a purchaser pays should represent the expected future stream of profits.** In general, we would expect the sale price to be efficient and reflect the underlying commercial value of the asset. The higher the price achieved, the more unambiguously better off the New Zealand seller is from any asset sale.

- **The main driver of 'profits going offshore' is the national saving and investment balance.** Selling an asset to foreigners will only have a significant effect on the current account deficit if it affects these fundamental drivers. The flipside is that to the extent that 'profits going offshore' is seen as a problem, the place to focus is the aggregate national saving and investment balance, not any particular sale.

- **The macroeconomic effects depend on the use of the proceeds from the sale.** Using the proceeds of an asset sale for investment in overseas equity would have no impact on the current account. Using the proceeds to repay overseas debt would increase the current account deficit slightly (to reflect the equity premium), but would reduce New Zealand's external vulnerability – i.e. it would reduce the extent of New Zealand's leveraging. In both these cases, long-term real incomes would be expected to increase if the foreign investment brings economic benefits (as the evidence suggests it does).

16. In sum, we think focussing on 'profits going offshore' has a weak economic basis because it focuses on only part of the picture. So we do not think it makes sense to be concerned about 'profits going offshore' per se. The more important places to focus from a macroeconomic perspective are the overall saving and investment balance and New Zealand's overall external vulnerability. As you know from our other advice to you, we <u>do</u> see reasons to be concerned by New Zealand's external vulnerability, but any policy response needs to be linked to the fundamental drivers.