THE TREASURY
Kaitohutohu Kaupapa Rawa

International Connections

Speech delivered by
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Thanks very much Russell for that introduction, and also for the opportunity to address the NZ Institute of International Affairs this evening. I am delighted to have the chance to discuss an issue which your members, and the Treasury, have a shared appreciation of - namely, the importance to New Zealand of strong connections with the world economy. I look forward to not only sharing my perspectives with you, but also to hearing your observations, and fielding your questions, about this country's connections to the world, and how they might be better developed.

It is nearly 15 months since I started work here in Wellington as one of two deputy Chief Executives at the Treasury. It has been a steep learning curve for me, coming, as I did, from a career in the UK civil service and regular interaction with the crowded and dynamic market place that is modern-day Europe and with the wider group of officials at the OECD. There are many appealing things about New Zealand for someone coming from Europe. The clean, green brand remains a big drawcard. The shorter commute. The rugby. Of course there is the issue of being far from everywhere. That remoteness has engendered in New Zealanders a strong streak of resourcefulness and independence, what Kiwis like to call a can-do attitude. It is a country that, quite rightfully, often gets credit for punching above its weight. And I have seen plenty of evidence of that in the short time I have been here.

Before I go any further I would like to make a few remarks – wearing my hat as Acting Secretary to the Treasury – about the world economic outlook. It is a mixed sort of picture. While there are signs the global economy is recovering, there have been some set-backs recently. The recovery is being driven by emerging economies, in particular China and other

Asian countries, and there are some additional benefits for New Zealand via Australia. Activity in the major developed economies has been slower to rebound as they were more directly affected by the global crisis and their economic challenges are more entrenched. Temporary shocks have also adversely affected economic activity, in particular the Queensland floods in Australia and the earthquake in Japan. These events are expected to reduce growth in the short term – today Australia reported a 1.2% fall in GDP in the first three months of this year – but rebuilding in both countries will boost it subsequently.

Notwithstanding this positive headline picture, there remains an elevated level of risk around global growth. While there are some upsides, on balance the risks are weighted to the downside for the forecast period as a whole. As a result, the international economy remains a source of potential downside risk to New Zealand, with the possibility of rising global imbalances causing increased policy tension, the need for significant structural and fiscal policy change in many developed economies, and continued financial difficulties in a number of peripheral European economies. There is also the possibility of higher food and fuel prices eroding disposable incomes, especially in developing economies.

What can be said is that the global recovery is more assured than it was in 2010 as the recovery has become more strongly established.

Since Treasury finalised its economic forecasts for the Budget in mid-April, the outlook for the global economy has eased slightly with weaker data reported in the United States and in China, leading to a modest correction in some commodity prices. Concerns about euro area sovereign debt have intensified again. In our Budget forecasts we developed a scenario in which rising consumer prices and monetary tightening, especially in developing countries, bring a slowdown in world growth, though we are still a long way from such a scenario.

My last comment on this is that the chief challenges for policy-makers in this environment are the timely withdrawal of monetary and fiscal stimulus in such a way as to support growth and manage emerging inflation pressures, especially in developing economies. Little has been done so far to reduce global imbalances between high-savings, low-consumption economies (such as China) and heavily-indebted, high consumption economies (such as the United States).

What I want to do this evening - as someone who is unreservedly internationalist in outlook - is to bring you some fresh perspectives on the importance of international connections, and canvass some of the work that the Treasury is doing to ensure New Zealand is better connected with the world - that is, ideas we are looking at for improving the flows of people, capital, trade and ideas that are crucial to productivity and economic growth. I should state at the outset that these views are those of Treasury and not necessarily government policy.

It might be useful at this point to reflect on a few of New Zealand's openness indicators. These provide us with some useful background. For instance, according to the OECD, New Zealand's small size and distance from markets may have depressed the level of GDP per capita by up to 10 per cent over the long run. This aligns with relatively poor export performance – New Zealand's ratio of exports to GDP is in the bottom half of the OECD. New Zealand export's share of world trade has been roughly constant at around 0.36 per cent since 1990.

And although New Zealand scores reasonably well on international measures of ease of trading across borders, it does not rank among the highest scoring countries. Remaining tariffs are low but not negligible. Excluding preferential access through FTAs, New Zealand retains tariffs on 42 per cent of tariff lines. By value, around 20 per cent of imports attract a tariff, reducing to 10 per cent once New Zealand's current FTAs are concluded and implemented. In addition, some countries score significantly better than New Zealand's performance in terms of non-tariff barriers (largely requirements for documentation).

Looking at some other indicators:

- 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,
- New Zealand is highly dependent on foreign capital, with a net asset position of around negative 82 per cent of GDP.

The topic of international connections that that I want to canvass is a broad area, so I thought it best to concentrate on what I see as three key areas.

Those three areas are:

- First, the important part that **domestic policy settings** play in the mix of things that we do to attract the investment, resources, knowledge and specialist skills that will deliver a stronger economy.
- Second, the importance - too often understated in my view - of strong personal ties with key players in the countries with which we are looking to build closer and more productive links - what is now routinely referred to as **people-to-people relationships**.
- And third, I want to deal with the challenge that New Zealand has in endeavouring to make sure its voice is being heard, and its interests are being heeded, as economic **integration gathers pace** in our region. The blunt reality is that if we're not part of the action - if we're not at the table, to use diplomatic parlance - the country will miss out on the greater prosperity that these closer ties can deliver.

1 Domestic Policy Settings

But let me begin by talking for a few minutes about domestic policy settings, and the crucial role they play in helping to stimulate the flow of people, capital, trade and ideas.

It is clear that a variety of policy settings can influence such flows. The way we shape policy in areas such as tax, education, labour, immigration and management of the environment will invariably affect the attractiveness of New Zealand as a destination for people. It doesn't matter whether those people are investors, students or simply someone looking for a better, safer place to live and work. We are all living in a global village - moving ourselves or our money, seeking out better opportunities, has never been easier. The extent to which New Zealand's regulatory settings –take into account its impact on flows of trade, capital and people will always be important. While the clean, green and uncrowded labels might be enticing, the remoteness from world markets might, in the eyes of some, dampen the appeal of New Zealand. So the decision as to whether or not a foreign owned firm sets up shop here, might come down to the ease of doing business. Or how favourable tax laws are. Or the immigration rules. Or how prescriptive we are about minimum wage rates. The list could go on.

Some of you might have followed the story of the big Swedish furniture outlet called IKEA, and its attempts to find a site for a store in the North Island. IKEA is a big and successful global company that offers quality, attractively-priced furniture. Its presence in Auckland or Hamilton would have generated jobs and greater competition in the home furnishing sector.

But the company ran into so many obstacles that it eventually abandoned its plans to establish a New Zealand branch. Domestic policy settings relating to roading infrastructure, the Environment Court process and the approach of the local council managed to sink IKEA's plans.

Domestic settings undoubtedly matter hugely to New Zealand's attractiveness as a destination for FDI, or foreign direct investment. And it is clear that considerable benefits flow from the foreign investment that this country attracts. A recent study by Treasury estimated that, between 1995 and 2005, foreign investment lifted national income by $5.9 billion. That is a formidable amount of money to an economy of this size – equating to a lift in income over that period of around $2,600 per worker.[1]

It has become fashionable in some quarters to question the wisdom of liberalising our FDI regime, with the most popular counter-arguments relating to the loss of control of land assets and the "exporting" of profits.

I would like to address both of these counter-arguments in a little more detail.

On the **loss of control of land assets**, the implicit assumption here is that a foreign owner would behave differently from a New Zealand owner, for example whether they use the land productively or protect important social and environmental features such as walking access or heritage value. If that is the case, then the issue at hand is really how the land is used, rather than who owns the land. There are a number of regulatory mechanisms governing land use in New Zealand. The protections offered by these forms of regulation govern all land owners - irrespective of nationality.

We consider that the same standard of protection should apply regardless of who owns the land. On that basis, requiring foreign investors to meet higher standards, through the Overseas Investment Act, would not be necessary.

We also want to ensure that the way that land is used will help improve or at least maintain the overall living standards of New Zealanders. While good economic performance is the principal determinant of living standards, Treasury also recognises that a broad range of other factors also contribute to people's standard of living. These factors might include, for example, the impact of a land use proposal on freshwater stocks, or fish stocks, or the cultural or recreational values of an area.

It is our view that four capital stocks – financial, human, social and natural – make up the national wealth of New Zealand and they allow us to incorporate a broad range of material and non-material factors.

With regard to argument that FDI into NZ **will lead to 'profits going offshore**', this is a truism - I don't know of an investor who doesn't expect to earn a return on their capital. The more important issue to focus on here is the national saving and investment balance.
New Zealand requires foreign investment to meet the gap between national savings and national investment. If the idea of foreigners earning a return on New Zealand investment is unpalatable to some, there are two alternatives – lowering national investment or increasing national savings.

[1] http://www.treasury.govt.nz/publications/research-policy/wp/2008/08-03. Per worker calculations are based on FTEs.

Lowering investment would seem counter-productive to our growth ambitions. A higher rate of national savings would provide New Zealanders with greater scope to own assets that they want to retain control of, and entitle them to any returns on the investment.

New Zealand does have large external liabilities totalling around 82% of GDP[2], but around 80% of these liabilities relate to debt from borrowing offshore, with equity liabilities totalling only 20%.[3] Restricting foreign investment is unlikely to help to address this position and will only constrain firms from accessing the capital they need to grow. In addition, we need to remember that not all the profits of a firm that has investment from abroad are necessarily returned to its overseas investors. Some of those profits go to paying the wages of additional staff employed in New Zealand, to undertaking local R&D, and to continue growing the domestic business. Statistics New Zealand figures show that across the four quarters to December 2010, reinvested earnings from foreign investors into New Zealand totalled over $3.3 billion.

In addition, the official statistics show just how highly dependent New Zealand is on foreign capital to fund our shortfall in national savings. Foreign direct investment in this country is a critical path to international relationships, expertise, technology and ideas.

Let me briefly touch on two examples of how foreign investment helps NZ meet ambitious economic goals.

The Hamilton-based company BioVittoria is a venture capital-backed firm which is right now demonstrating the benefits of global connections. It recently partnered with the British-based multinational agribusiness Tate & Lyle to market a new calorie-free, fruit-based sweetening product. The BioVittoria CEO says the new partnership opens the way for his company to get a foothold in the *US$50-billion a year* global sweetener market. BioVittoria's backers are also admitting that it is difficult for expansionary New Zealand technology companies to raise capital in the New Zealand market to support growth into major international markets. Hence the need to look to foreign investors.

The other good example is the wine industry. New Zealand's top wines are among the best in the world, and total wine exports now exceed one billion dollars each year, roughly 25 times more than where exports stood only 15 years ago. The stunning development of this country's wine industry - from a relatively small and family-based sector into a capital intensive and technologically advanced industry with real global connections - has largely happened because of overseas money.

But the reality is that New Zealand does not score well on international measures of openness to foreign direct investment. 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.

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

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2 At 31 December 2010 New Zealand's net international liabilities were $159.0 billion (81.7 percent of GDP: http://www.stats.govt.nz/browse_for_stats/economic_indicators/balance_of_payments/BalanceOfPayments_HOTPDec10qtr/Commentary.aspx

3 Refer to Table 11: http://www.stats.govt.nz/~/media/Statistics/Browse%20for%20stats/BalanceOfPayments/HOTPDec10qtr/bopiip_Dec10qtr_all_tables_revised.xls

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. If we are to continue to screen foreign investment, and Treasury has consistently recommended removing all screening, it needs to be kept to a minimum and under constant review.

2 People to People Relationships

I want to turn my attention now to what we characterise as people-to-people relationships: the ties between individuals in this country and individuals in those countries with which we seek to develop deeper and more productive - from an economic point of view - relationships.

I recently visited China as part of a small delegation led by the Deputy Prime Minister and Minister of Finance, the Hon Bill English. What it brought home to me was the enormous importance of building and maintaining close personal ties with people - and I am referring to people at all levels, not just in political leadership roles - in the nations that we are seeking to do business with. What struck me was the considerable warmth of our Chinese hosts. New Zealand and New Zealanders are genuinely well regarded in China. This has been helped by the story of Rewi Alley, the Kiwi who lived and worked there for 60 years and became one of the best-known friends of the Chinese people. New Zealand politicians and officials have invested significant time and energy into building stronger ties with their Chinese counterparts, and we are now reaping the benefits of that. When NZ signed a Free Trade Agreement with China in 2008 we came became the first developed country to forge such a deal with China. It is evident that that also meant a lot to the Chinese.

China is now New Zealand's 2nd-largest trading partner with total merchandise trade worth NZ$11.1 billion (October 2009-2010), an increase of more than a third from 2008 (the FTA entered into force in Oct 2008). On average, we now trade with China in six hours the same value we traded in one year in 1972, when diplomatic relations were established. And I'm sure you know Prime Minister John Key and China's Premier Wen Jiabao have set a goal of doubling two-way trade by 2015.

Growth in two-way trade since 2008 has exceeded the average annual growth rate of New Zealand's other major trading partners, and in 2009 was higher than the growth rate for China's trade with the rest of the world. As trade between our two countries continues to grow into the future, we can expect two-way investment to similarly expand. The delegation that I was part of met with Vice President Xi Jinping - he is widely regarded as the man who by next year could be President - and Vice Premier Li Keqiang. We also had engagements with economic decision-makers in Boao, Beijing and Shanghai. The meetings provided excellent platforms for building NZ's profile with leading Chinese corporate players and government agencies. In fact the strength of the bilateral relationship between New Zealand and China was a core theme underpinning these discussions, and was reflected in the level of access to influential Chinese decision-makers.

Why is this important?

It is important because these relationships are giving rise to parallel interest in two-way investment, currently at much lower levels - particularly Chinese investment in New Zealand. Let's be frank. As we look to the future it is clear that capital will increasingly come from Asia. The large current account surpluses run by Asian economies means that an increasing portion of global capital will come from that region, in particular China.

What the Chinese are signaling to us is that they want to have more long-term exchanges with New Zealand. They see these happening through cultural exchanges and linkages in education, and science and technology. Such exchanges will reinforce the political, trade and economic relationships that we already enjoy.

We cannot underestimate the importance of these people-to-people linkages. They are critical in opening doors and overcoming the cultural differences that exist between us. Building these relationships will ultimately help New Zealanders feel comfortable in terms of their knowledge of, and experiences with, other countries. I am not talking about relationships at just the political leadership level: I see them as relationships that can be built at three levels - at the political level, at officials' level, and at the 'people on the ground' level.

For instance there are large communities, here in New Zealand, of settlers from countries such as China, India and Korea. They are people who are involved in a wide range of business pursuits and have good networks in their countries of origin, or parents' countries of origin. I have no doubt that, collectively, they offer their adopted country a great opportunity to make new and productive connections.

3 The integration roadtrain

The third area that I foreshadowed in my introductory comments was that of increasing economic integration, and the need for New Zealand to not allow itself to be elbowed aside from that process. This needs to be a critical element in our international connections gameplan.

In recent times there has been a welter of activity as regional economies look to establish closer relationships and more liberal trading arrangements. The reality is that we don't know where some of these regional integration discussions will lead to. On one level it is very useful to have governments dealing with one another on a range of economic, trade and security issues.

A prime example is New Zealand's participation in the Trans-Pacific Partnership (TPP) and APEC, and which will lead to a continued reduction in barriers over time to trade and capital flows. But it is difficult to envisage what the endgame will look like.   Some of the questions being asked are: Will we have an East Asian free trade area, including New Zealand and Australia? Will some countries go further and take integration to a deeper level? Will there be a sub-group of nations that have a more advantageous arrangement than that enjoyed by APEC neighbours? The short answer is that we don't know.

What we are mindful of is that New Zealand, as a small player with limited resources, has some big challenges and we need to ensure we are at the table, so we can help shape the outcome of these critical discussions. There is a need to use wisely and smartly what resources we do have. It is also important that we bring to the table something that is different, and adds value. The CER story - deeper integration with Australia - is perhaps a unique experience we could look to share with other countries which are interested in the benefits of deep integration.

Government agencies need to be part of this process, and Treasury certainly is. Led by our Ministry of Foreign Affairs and Trade, government agencies with an offshore footprint have been developing NZ Inc Country Strategies – India and China have been the first cabs off the rank with Australia, the US and ASEAN to follow - which have a particular focus on mustering our offshore resources behind an agreed New Zealand government vision and concrete goals for each of these countries.

At Treasury we are considerably stepping up our engagement with these countries of key economic importance. We already have an annual strategic dialogue with our Indian and Korean counterparts, fledgling discussions with the US, and we are looking to put in place something similar with our counterparts in China.

Conclusion

Treasury's desired outcome in the international connections area is to see NZ becoming more integrated and connected into the global economy. We are primarily looking for a climbing New Zealand export share of world trade, and rising flows of foreign and overseas direct investment (FDI & ODI) as a percentage of GDP. At the moment our export share of world trade has stayed around the 0.36 per cent mark since 1990. ODI to GDP is half of the OECD average, and FDI is 30% of foreign investment.Treasury's work in the international connections area has a number of elements to it, including:

- A focus on International engagement, including intensifying our engagement with China at the working level, looking at setting up a strategic dialogue with our Chinese counterpart.
- Bringing a unique economy-wide perspective to the Trans-Pacific Partnership (TPP) which is one of the most important FTAs NZ is negotiating. We will be advising the government on the balance of benefits, costs and risks that NZ will need to consider in the course of negotiations.
- And on the domestic front, focusing our research agenda on understanding the domestic settings that matter most for international connections, and working with other agencies to ensure that the settings allow us to derive maximum benefit from these connections.

Increasing New Zealand's international connections will also help re-balance the New Zealand economy away from domestic demand (partly funded by high borrowing by households in the mid-2000s) and more towards external demand. This can be supported by a higher national saving rate and a smaller government sector which will encourage investment and allow resources to flow into the tradables sector, ie, part of the economy exposed to foreign competition. This in turn will provide a more sustainable basis for growth in the New Zealand economy and help correct internal and external imbalances.

In closing I want to reinforce the message that small, high productivity economies rely heavily on international connections, whether they be people, capital, trade or ideas.

Finally let me say something on **people flows**, both inwards and outwards. People flows matter a lot to growth, and vice versa. Immigrants comprise a substantial proportion of our labour force, and they play a key role in the exchange of ideas and innovation. Department of Statistics figures compiled in 2006 show that 23.8 per cent of the total New Zealand labour force were born overseas - a shade under half a million people at that time.

We need to be doing all we can to utilise migrants' skills effectively.

A lot has been said about how we lose our best and brightest, with survey measures showing that job opportunities are a key motivator for those going abroad. The New Zealand skilled diaspora has grown to be proportionally the largest in the OECD, with more than half of emigrants classed as highly skilled. It has reached the point whereby about one quarter of skilled New Zealanders are now living abroad - I am sure it is safe to say that everyone in this room knows someone in that category.

There is a considerable upside from having such a large offshore network of New Zealanders, and we should do everything we can to leverage off this vast array of business links and expertise. I have recently attended events organised by the expat network in Shanghai and Singapore and I was impressed by the interest our offshore Kiwis have had in the future of our country, and the opportunities the network is creating.

We also need to ensure New Zealand is an attractive place for skilled migrants and our own population. Increasing our rate of economic growth is crucial to ensuring that we can provide attractive, well-paying jobs for our best and brightest, so they need not go elsewhere to fulfil their career ambitions. It is pretty clear that higher economic growth is vital for providing an environment where talented New Zealanders want to be.

I want to encourage all of you to join the process of debating these issues. I have given you some of Treasury's thinking around three areas that we think are important and need to be addressed if we are to progress our growth prospects. But there are no easy answers to the issues that I have raised, and Treasury doesn't profess to have a monopoly on ideas.

What I do know is that it's really important for the future well-being of New Zealanders that we get our country on a stronger growth path, and that our international connections will be an important driver of our efforts to raise productivity.

Thank you very much. I'd be happy to take your questions.