3. ADJUSTING TO INTERNATIONAL CHANGE

The New Zealand economy is too small to generate rapid growth without strong export performance. Small gains in our share of overseas markets would increase our wealth considerably.

We cannot escape the effects of changes taking place elsewhere in the world. We need to adapt and exploit the opportunities offered by these changes.

Government policies should encourage New Zealand firms to adopt this international focus. Policies should avoid creating insular attitudes or imposing unnecessary risks or costs on activities that compete with the rest of the world.

INTRODUCTION

Political changes in many countries in the late 1980s have made the world a more uncertain and in some respects a more threatening place. The New Zealand economy cannot escape these developments.

For example, we experienced the international rise in interest rates which followed the moves towards unification in East and West Germany, and Iraq's invasion of Kuwait. The price of oil has doubled on world markets in only the last four months. New Zealand's wool trade has been adversely affected by recent events in China and by the rationing of foreign exchange in the USSR. Prices for our butter declined this year as a result of large increases in EC export subsidies. Applications to emigrate to New Zealand increased following the agreement between the British and Chinese Governments on the repatriation of Hong Kong in 1997, and after the military coup in Fiji.

These political events have captured headlines. But they have overshadowed a number of important and largely positive developments in international commerce which gathered momentum over the 1980s. The main changes have been the globalisation of financial markets, moves towards further regional trade integration, and increased structural adjustment reforms across developed and developing countries alike.

All of these have increased the economic interdependence of countries. For instance, a natural outcome of the dismantling of capital controls, and the removal of restrictions on foreign direct investment in many countries, has been the growth in transnational corporations, mainly in the process-manufacturing and high-technology sectors. The moves towards regional economic integration include the Closer Economic Relations treaty between New Zealand and Australia, the 1992 EC single-market programme and the US/Canada free-trade agreement. These have largely developed as a result of the search for the gains from freer movement of investment and technology among countries.

This chapter looks at the implications of this changing world environment for New Zealand, and discusses alternative policy options.

NEW ZEALAND'S STRATEGIC POSITION

The strategic choices open to New Zealand are shaped by the following characteristics of the New Zealand economy:

- New Zealand is a small island economy a long way from the major markets of Europe, North America and Japan. It is unable to influence significantly world market prices. Its terms of trade (the imported goods that can be bought with a given amount of exports) are determined by forces outside its control.

- New Zealand lacks strategic significance in terms of the defence needs of major countries. It is therefore unable to secure the financial aid that countries such as Israel, Mexico, the Philippines or Cuba have enjoyed.

- The country is not richly endowed with mineral or energy resources. It is one of the world's most efficient producers of pastoral products and has a comparative advantage in growing softwood. A narrow range of agricultural products account for approximately 45% of export revenues. New Zealand's future prospects will therefore continue to be affected by agricultural policy in Brussels and other international capitals.

- Manufacturing in New Zealand remains reasonably highly protected. It is based around adding value to primary production or producing goods generally embodying unsophisticated technologies. Manufacturing exports (including aluminium) are equivalent to around 8% of GDP, or about a third of export revenues.

- The quality of the nation's productive capital is lower than desirable as a result of poor investment decisions in the past and the lingering effects of import licensing, which dampened the incentive to introduce new technologies.

- The labour force has poor educational attainment by OECD standards. A recent New Zealand Planning Council report indicated that 46% of New Zealand's workforce have no formal school qualification, while 60% lack a tertiary qualification.

- The country has "lived beyond its means" over the past two decades. This is demonstrated by recurrent balance-of-payments deficits, and the rapid rise in external debt. A large proportion of the population is dependent upon the state for its standard of living.

- New Zealand has traditionally been a capital importer, and it is unlikely that domestic savings will be sufficient to finance our investment needs in the foreseeable future.

- The economy is still adjusting to the comprehensive stabilisation and liberalisation policies of the late 1980s, and more recently to a deterioration in its terms of trade. The outlook over the next 12 months is for slow growth, rising unemployment, increasing external debt and, unless policies are changed, a deterioration in the financial deficit.

On the basis of the foregoing, a number of development options are ruled out:

- New Zealand lacks the energy and mineral resources to acquire substantial wealth through extractive industries like some of the Middle East oil producers (e.g., Kuwait, United Arab Emirates), or mineral producers (such as Australia, Nauru and Bougainville). Even to the extent it has such resources, the importance that New Zealand society places on environmental values means that the rate of resource depletion will probably be limited by prudent judgements about sustainable development. Harvesting of forests on the scale of the hardwood extraction in the Amazon Basin would probably be unacceptable to New Zealanders.

- Protectionism is no answer, since New Zealand is too small to prosper through trading with itself. The size of our domestic market is roughly equivalent to that of Melbourne, or less than a quarter the size of London or Paris. Although increases in productivity in the non-tradable sector (i.e., those sectors of the economy whose output is unable to be traded internationally) could raise living standards, the greatest boost to New Zealand's living standards is likely to come through trading on international markets. All the successful small economies (e.g., Switzerland, Sweden, Finland, Denmark, Belgium, Hong Kong, Singapore) have relied upon international trade to acquire wealth. Those countries that did little trading internationally, (e.g., North Korea, Albania, Burma, Bhutan) or who protected their domestic markets (e.g., India and some of the South American countries) have remained among the poorer group of countries, or experienced little growth.

- Trade in traditional agricultural commodities alone is unlikely to provide a catalyst for economic growth, at least in the short run. World prices for the main agricultural commodities New Zealand produces have been falling in real terms for two decades. New Zealand is likely to face increasing competition in agriculture from countries in Eastern Europe over the 1990s. Chile is likely to be a major competitor in horticultural and forestry products. International trade in agriculture continues to be affected by a range of subsidies, quotas and pricing arrangements that artificially boost returns to farmers in other countries - and hence agricultural production - and depress world prices. Any rollback of agricultural protection as a result of the conclusion of the Uruguay Round in December 1990 is likely to be slow and not to affect New Zealand's agricultural export revenue appreciably over the next few years.

- The Government does not have the resources or expertise to finance a major programme of heavy industry. New Zealand's external borrowing in relation to GDP is already large, and previous investment in large energy projects in the 1970s has produced lower returns than expected as a result of cost overruns, commissioning delays and, until recently, depressed international oil prices. Very few governments have succeeded with these types of programmes. Most, like Spain, Brazil, Argentina, India and Algeria have had disappointing results from large-scale public projects. The inefficiencies associated with some of these investments in Eastern Europe are now also becoming clear.

Required is a development strategy that supports, and increases, the growth in strong, dynamic internationally competitive sectors and businesses. Such growth is likely to be based upon:

- products and processing that are much more attuned to the requirements of consumers in higher income economies

- production of manufactured products where skill, ingenuity and quality are important

- development of more efficient and quality services. This could range from tourism, to the export of health and education services, to design and consultancy that all earn foreign exchange. Our distance from other markets highlights the need for internationally competitive telecommunication and transport sectors

- much greater management and marketing skills, as well as a better trained and more adaptable workforce

- high levels of overseas investment by New Zealanders and by overseas investors in New Zealand. This will be an important element in developing market connections and top management skills.

MEETING THE HIGH-INCOME HIGH-EMPLOYMENT OBJECTIVE

Both major political parties seek a high-employment, high-income country. This can only be achieved if New Zealand exploits new opportunities and is able to react better and faster than other countries. It means moving out of those areas of production where New Zealand cannot compete.

Successful countries such as Japan and South Korea have been good at scaling down uncompetitive industries. (South Korea, for example, is cutting back its domestic textile and footwear production because of increasing competition from Thailand and Indonesia). The response of their firms has often been to invest in assembly operations in low-cost competitor countries. It means continual attention to upgrading and improving products. It means constant attention to market trends including new technologies and new designs that are likely to become important.

Limited resources do not imply poor living standards or low growth prospects. Countries such as Japan, Singapore and Hong Kong have dramatically improved their living standards through hard work and good economic management, despite having few natural resources. Other countries rich in resources (e.g., Nigeria and some of the countries in South America) have experienced large declines in living standards as a result of poor economic management. Critical to a country's economic performance is the quality of its economic management over time. This can be seen in the diverse performance of divided countries which have followed different development strategies (e.g., North and South Korea, East and West Germany), or in countries which border one another (e.g., Austria and Hungary or the United States and Mexico).

New Zealand's prospects for generating sustained improvements in its standard of living lie in becoming more export-oriented. Even small gains in market shares on world markets can lead to very large gains in national income. This means that producers must remain internationally competitive in terms of cost, quality and service. It means establishing industries and production techniques which result in New Zealand value added, and therefore labour, being priced highly on international markets.

Our past experience has shown that sustainable economic growth does not follow from easy monetary policies, periodic exchange rate devaluation or from a wide range of supports for businesses. These approaches encouraged management to adopt cost-plus attitudes or look to the Government as a major source of support. They did not cause management to concentrate on developing better industrial relations practices, improving productivity or building strong linkages into other economies.

Past approaches tended to shield New Zealanders from change in world prices. To achieve stronger growth over time it is critical that changes in world prices be reflected in domestic prices. This is essential if domestic producers are to respond quickly to changing international conditions.

As a country we need to improve our management of risk from swings in international prices. Improved risk management for example could involve:

- finding new markets for established products (market diversification)

- moving into markets that pay more for higher standards of product design and product quality (product diversification);

- more extensive offshore investment by New Zealand companies, and greater domestic investment by foreign companies (investment diversification).

In short, New Zealand producers should be maintaining an outward focus and be looking to develop interdependency with other countries.

If this is to happen, it is crucial that the government remove barriers to growth and international competitiveness. The whole economy needs to be open to competition, so that all managers face incentives to improve productivity, invest in new techniques, and upgrade quality and skills.

For a small economy to attract investment, the overall stability and quality of policy is important. Given our insignificance relative to the much larger markets of the world, our economic policies need to err on the side of being better and more effective than those of other countries. This would imply:

- the need for low inflation so that producers can concentrate upon their costs and not have to worry about unpredictable government policies

- domestic policies that do not distort the linkages between world and domestic prices through border protection, subsidies and domestic regulations. Regulations in areas like Producer Boards can influence risk taking and innovation in products that constitute the major part of our exports.

- a labour market that does not limit productivity gains or prevent resources from being allocated to their most productive use. This requires approaches that do not reinforce protected positions and limit competition (e.g., regulations restricting competition in the professions, tariff policies, planning legislation).

- regulations in areas such as the environment, planning, capital markets and company law that are seen as creating a positive and stable environment for businesses while still not comprising wider social objectives. The ability for capital to move provides important incentives. It means that New Zealand producers need to generate financial returns commensurate with those elsewhere in the world to attract equity investment. If New Zealand enterprises underperform or fail to take up the opportunities created by comprehensive structural reforms, then there are no real barriers (other than some controls limiting foreign ownership in a few sensitive areas) which would prevent foreigners from doing so.

- a liberal approach to foreign investment and immigration is required in order to enable us to gain access to new technology and skills. This needs to be supported by an education system that can compete with the best in the world.

INTERNATIONAL CONSTRAINTS ON POLICY OPTIONS

The outlook on global pressures for protectionism will become clearer after the final Uruguay Round ministerial meeting in December 1990. The outcome will give a good indication of the strength of "multilateralism", and whether the moves towards trading blocks are likely to intensify. After the Brussels meeting the Government could consider the respective costs and benefits of regional trade integration with one or more of the larger countries in the Asia Pacific region (e.g., the United States, Canada, Japan, South Korea). From a New Zealand perspective, the case for extending regional arrangements would be greater if the GATT ministerial meeting failed to agree on a clear programme of reductions in agricultural protection.

Domestic policies need to take into account policy settings in other countries. Various influences can feed back and affect the operation of domestic policy instruments. These feedback effects are at their most obvious when governments change macroeconomic policy in unpredictable ways. For example, domestic interest rates increased following the deterioration in the fiscal position noted in the 1990 Budget. The easing of macroeconomic policy in France in 1981/82 was reflected in a deteriorating current-account position in France and an increase in German export growth. France was forced to devalue the franc three times before reversing macroeconomic policies in 1983.

Interdependence also carries important implications for microeconomic policies, especially in countries like New Zealand which are dependent upon foreign savers to finance part of their domestic investment. New Zealand competes with other countries for foreign savings. Foreign investors, in deciding where to invest, consider carefully how policies in areas such as taxation, planning procedures, tariff protection, corporate law, and capital market regulation compare with policies in other countries.

This does not mean that New Zealand should attempt to copy policies elsewhere, or try to attract foreign capital by offering preferential treatment for overseas investors. It means recognising the asymmetrical nature of the risks. In an increasingly interdependent world poor policies can be quickly 'punished' as investors shift their funds and their managerial skills elsewhere. This underlines the importance of New Zealand establishing policies broadly in line with or better than those in other countries. We must pay attention in policy design to international reforms. Especially, those in high-income, high-employment nations.

CONCLUSION

As a small open economy New Zealand's living standards will be determined by our ability to compete internationally and respond rapidly and efficiently to changes in the world environment. An outward focus by producers and policy-makers is essential. We need to be better at doing those things we are already good at, and look for opportunities to capture new technologies, diversify products and establish new markets.

An important prerequisite is consistent policies directed at securing and maintaining low inflation, and at improving productivity and workforce skills throughout the economy. All sectors need to be under competitive pressure to improve performance. This means exposing New Zealand producers to changes in the international scene - both favourable and unfavourable. Thus changes in international prices should feed through into domestic prices with as little distortion as possible.