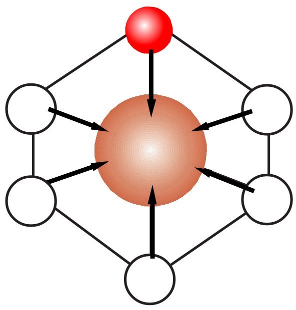
## OPENNESS AND INTERNATIONAL LINKAGES



Smallness poses a particular set of issues for economies. Geographic isolation poses another. And New Zealand, tucked away at the bottom of the South Pacific has both – in spades.

Over the last two decades the New Zealand economy has increasingly opened up to the world. This is a story about overcoming geography – the tyranny of distance – and the disadvantages of small size and relative isolation from the world's big markets.

*Openness is good for growth*

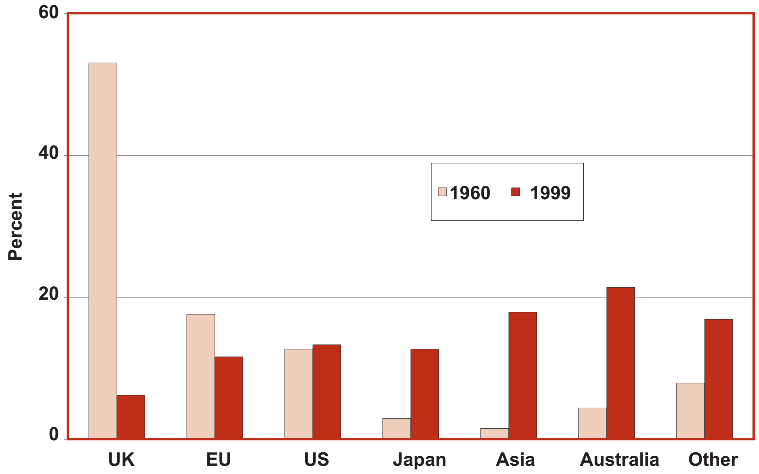
Rapid technological changes mean, to an extent, that globalisation, reflected in the greater mobility of goods and services, people and capital, is inevitable. Attempting to resist it, as New Zealand did in the 1970s, is costly. Welcoming it, through increasing openness and international linkages, carries risks, but that openness is also good for growth.

Empirical work shows a clear link between the openness of an economy and growth – which is correlated to the length of time an economy has been open. Openness gives New Zealand access to capital, competitively priced goods and services, skilled labour, new networks and markets, technology, other cultures and fresh perspectives.

Openness has fostered diversification – in what we export, how and to whom. The loss of the British market as the prime destination for agricultural products forced us to look for new arrangements and opportunities in Australia, Asia and North America, in turn forcing us to think less like producers of commodity goods and more like marketers.

*Diversification - getting to know the neighbours*

*Export destinations in 1960 and 1999*




As we have become more integrated with the global economy, competitive pressures on our firms have grown, providing a spur to improved dynamism and efficiency. All of this is important in a small, peripheral economy where domestic competitive pressures are weaker and opportunities for specialisation are limited.

Open financial markets and low trade barriers act as a discipline on economies, constraining both the prices that people will pay, and the policies that can be implemented. Some may see this as a constraint on sovereignty. In particular, there are concerns about the impact of external openness on income distribution, though it is difficult to disentangle this effect from the myriad of forces that affect income distribution.

## Trade: lifting New Zealanders' incomes

*Freer trade will lift incomes*

Continuing to work towards a more liberal global trading environment will be important in lifting future New Zealanders' incomes. New Zealand has a 'multi-track' approach to trade policy, with unilateral, bilateral, regional and multilateral levels, allowing us to take whatever opportunities exist to influence

### *I came to New Zealand but it was closed …*

Xavier Sala-i-Martin's (1997) study found that an economy's growth rate was strongly correlated with the length of time it has been open to trade.

Using a five-dimensional criterion of 'openness' developed by Sachs and Warner, New Zealand was judged to have opened in 1986, many years after most developed countries:


While New Zealand rates poorly on this measure of time open, the quality of our openness rates highly in most international comparisons. The 1999 competitiveness report of the World Economic Forum gives New Zealand the following marks out of 59 countries on criteria of:

| | |
|---|---|
| Tariffs and quotas | 3 |
| Hidden import barriers | 5 |
| Access to foreign capital markets | 5 |
| Exchange rate volatility | 37 |
| Exchange rate alignment | 9 |

Contributing to an overall rank of 13 out of 59.

Source: Sala-i-Martin, X "I Just Ran Four Million Regressions". Sachs J and Warner A, "Economic Reform and the Process of Global Integration", Brookings Papers on Economic Activity I:1995. Global Competitiveness Report by the World Economic Forum as reported in NZ Herald, 18 November 1999.

*New Zealand takes a multi-track approach to trade policy*

the world trading economy. The tracks are mutually reinforcing – giving New Zealand the flexibility to tackle a range of trade issues in a variety of fora while working for the single goal of freeing up world trade.

Unilaterally, New Zealand has maintained a steady programme of tariff reduction. Remaining tariffs are scheduled to go by 2006. The objective of that programme has been to make the New Zealand economy more efficient and competitive, by moving new investment away from industries that can never be competitive in New Zealand, and removing the costs those industries impose on the export sector. Setting a clear programme of tariff reduction with a fixed and credible end point provides a degree of certainty for industries, workers and communities.

At the bilateral level Australia has been of crucial importance, and there is scope for continued work to secure more of the gains of integration with the Australian economy. Further gains will be in 'behind the border' issues, in making regulatory systems and standards more compatible and in enhancing border efficiency. These issues will arise in all trade liberalisation processes.

### *Isolation – more than distance and size*

Historically, trade flows have been explained by gravity theories – where size and distance explain the strength of the trade between two nations, just as it explains the force of gravity between two masses.

Borders can upset these predictions. An example of this is Canada, where provinces close to the US border have considerably more trade with distant Canadian provinces than with closer and larger US States.

Trade agreements can help. Prior to the US-Canadian Free Trade Agreement (FTA) the ratio of Canadian inter-province trade to cross border trade was 17:1. Since the FTA the ratio has dropped to 12:1.

Source: Helliwell J, "The Scope for National Policies in a Global Economy", NZ Economist Conference Paper, 1999.

There are a number of important developments in free trade areas: a Singapore–New Zealand free trade area is being negotiated. An ANZAC–ASEAN free trade area and a New Zealand–Korea free trade area are to be studied by the parties involved.

A free trade area involving New Zealand, Australia, Singapore, Chile and the United States is under discussion.

At the regional level, APEC continues to provide a useful vision and vehicle for moral suasion, promoting economic co-operation and political contacts.

*Trade talks will highlight tensions between liberalisation and environmental and employment standards*

Our multilateral focus is on the Seattle World Trade Organisation round starting in November.

Both the free trade area discussions and the Seattle round are likely to raise issues about the linkages between trade liberalisation and employment and environmental standards, behind the catch-cry "free trade with a human face". This has the potential to be a major divide between the wealthy nations, led by the US, and the poor. For New Zealand, managing the tensions between our clean green branding and adding greater value as a food producer will become more challenging.

Services, an increasingly important earner for New Zealand, will be a major focus of negotiation of the free trade agreement with Singapore, in any other free trade discussions, and in the WTO round. Also looming on the horizon is e-commerce with its attendant implications for maintaining the indirect tax base, consumer protection regimes and for marketing.

## Investment and migration

*Foreign investment brings new ideas, technology and connections*

Openness to investment from overseas gives us better access to external technology and markets, while adding to the total stock of investment. New Zealand generally has few barriers to inwards foreign direct investment, but it will be important to maintain our attractiveness as an investment destination.

Following the Asian economic crisis of 1998, there has been a good deal of discussion about reform of the "International Financial Architecture". There is now some consensus about the key issues. New Zealand will continue to hold a position of some influence as co-chair of the APEC Finance Ministers' process until September 2000.

### *E-plastic? Fantastic!*

Hopping on the bandwagon of e-commerce doesn't need to be a hi-tech or costly strategy.

A New Zealand plastics manufacturer searched the Internet for companies who were likely to require the type of plastic components the firm built. They were sent e-mails introducing the company, its capabilities, and offering prompt service.

One response came from a US company who sent, by return e-mail, a CAD file of a product it required. The New Zealand manufacturer had a prototype made and duly delivered to the US company in five days. The time zone difference had allowed the New Zealand firm to work 'overnight' on the proposal. This led to a full production order, where e-mail was used to regularly update the United States customer on progress of the mould manufacture. Close to $2m was earned in total as a result of this contract. In spite of the shipping distance, the service provided by the New Zealand firm was faster than their competition in the US who were literally sited next door to the customer.

Migration has the capacity to add to New Zealand's skill base, and to widen our set of international links. We compete with other bigger, wealthier economies for migrants and demand for places will vary across the business cycle. But we will also lose people as New Zealanders choose to travel and work or study overseas – partly in response to the local business cycles and partly in response to the heavy international demand for skills.

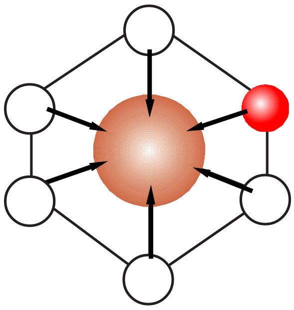
*Migration adds to our skill base, widens our links*

Our focus should therefore be on maintaining and marketing New Zealand as an attractive place to live and to invest, and a competitive place from – and with – which to do business. Consistent policy signals will count here – changes that are not well signposted could have a dramatic effect on international perceptions of New Zealand. At a more mundane level, there may be further scope for increasing collaboration between our agencies abroad, ensuring that tourism, trade and investment, and immigration authorities are telling a consistent and mutually reinforcing story about New Zealand as a destination.

### Next steps

- review progress and strategies for Singapore free trade area
- review progress and strategies for other free trade areas
- assume co-chair of APEC Finance Ministers' process – till September 2000
- review progress and strategies for Seattle World Trade Organisation round, paying particular heed to environmental and labour standards issues.

## MACROECONOMIC STABILITY

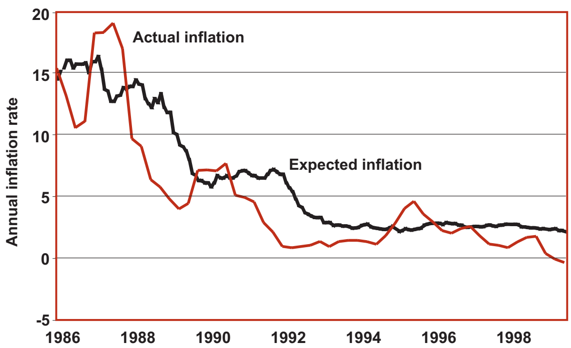


Over the next few years, monetary and fiscal policy settings can make a major contribution towards sustaining the current economic expansion and therefore improving the prospects for ongoing job growth and higher incomes. Sound macroeconomic policy settings are important in fully reaping the benefits of microeconomic reforms.

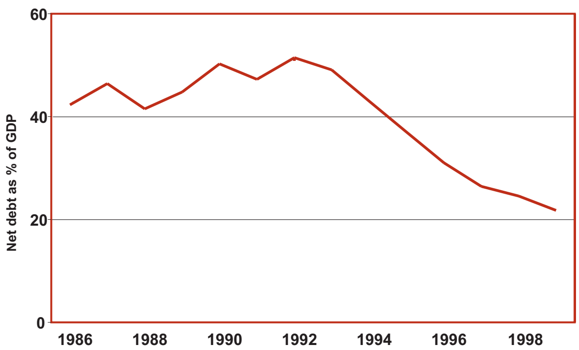
For New Zealand, much of the last 10 years has been about establishing credibility as a modern, open economy; about convincing New Zealanders and the world that New Zealand is serious about lifting our economic performance. Within the framework of the Reserve Bank Act and the Fiscal Responsibility Act (FRA), clear targets and a firm hand have contained inflation and led to a more sustainable fiscal position.

*Double gold - the twin achievements of macroeconomic policy through the 1990s*

*... bringing down inflation expectations*




*... and reducing net public debt levels*




In monetary policy the framework has allowed the Reserve Bank to learn from experience and to build on past achievements while remaining focussed on price stability. The Bank's hard-earned reputation for controlling inflation has embedded low inflationary expectations and has given it greater flexibility to look through one-off price shocks. This has been facilitated by a wider target band and recognition in the Policy Targets Agreement that there will be valid reasons for short-term deviation from the inflation target. This medium-term focus is likely to result in more short run variability in inflation, but may reduce variability in output, interest rates, and the exchange rate, and so enhance economic growth. Any changes to the agreement that weaken the Reserve Bank's primary task of maintaining price stability run the risk of damaging its ability to control inflation. This would reduce the flexibility that the Reserve Bank has gained and the benefits that result from increased flexibility.

*Maintaining price stability is the primary objective*

*A sound medium-term fiscal position lowers the risk premium and reduces uncertainty*

While the Reserve Bank's evolving approach should reduce variability in the real exchange rate, there is limited capacity for monetary policy to reduce exchange rate fluctuations. External shocks, fiscal policy, and microeconomic settings that affect price and wage-setting behaviour are some of the factors that will have a big impact on the exchange rate.

In fiscal policy we have seen consolidation of the Crown's position, continuing refinement of the accountability framework and Budget processes, and the establishment of long-term objectives for net debt and expenditure.

Maintaining a sound medium-term fiscal position lowers the risk premium on interest rates, avoids the need to react sharply to shocks and reduces uncertainty about government behaviour. The government is thus able to look through short-term variations in the fiscal balance and so reduce the need to change policy settings in a way that exacerbates swings in output and employment over the economic cycle. As a result, individuals and firms can better predict the behaviour of both the government and the economy, thus improving their ability to make decisions.

*Clear and credible fiscal objectives and a means of tracking progress*

A reputation for sound fiscal management is established through a track record of continued progress toward stated fiscal objectives. This is difficult. Although operating surpluses have been maintained and net debt reduced, progress toward the existing expense-to-GDP objective has been slower. Since the 1997 Budget, fiscal forecasts have included a provision for future initiatives, increasing the transparency of three-year expense assumptions. Even so, the expense-to-GDP ratio has not declined in the last five fiscal years, remaining in the 34-35 percent range since 1994/95.

### The current fiscal policy framework

There is no consensus amongst economists about the appropriate long-term objectives for net public debt and spending. However, experience suggests there are clear risks in running high levels of public debt. They constrain a government's options in the face of unforeseen events and require significant amounts of revenue for debt service – limiting options for spending and tax reductions. At the lower end, the net debt objective will depend, amongst other things, on the government's response to future fiscal pressures.

Governments have a number of objectives, including higher incomes and better social outcomes. Whilst the evidence is far from conclusive, smaller government is likely to be better for growth. Taxation has costs – particularly in terms of lowering people's incentives to work and to acquire skills – so the impact of the size of government on growth depends crucially on the effectiveness of public spending.

*Rapid changes in the size of government may compromise both the quality of the policy and its implementation*

Societal choices about the role and size of government change over time. In putting those choices into effect, the effectiveness and sustainability of policies should be paramount. It takes time to develop and implement good policy. Rapid changes towards either significantly smaller or significantly larger government are likely to compromise both the quality of that policy and its implementation. Fundamental changes will require sufficient buy-in from a broad constituency in order to avoid costly future reversal – implying a need for a strong focus on implementation and change management.

*Tight management of expenditure and revenue pressures*

Whatever the set of fiscal balance, debt and spending objectives chosen, our experience shows that they are hard to achieve. For example, the intentions in your fiscal plans to reduce the spending/GDP ratio over the next three years implies a greater measure of success in managing spending pressures than we have seen in recent years. This points to the need for a top-down cap on the total cost of policy initiatives, whether they be spending and revenue initiatives (e.g. changes in tax treatment of research and development spending) or policy changes that will change the level of Crown entity or SOE surpluses (e.g. changes to the funding of the ACC scheme). Such a cap should be combined with ongoing processes to maintain a robust tax base. To meet its fiscal objectives, the Government needs to also keep in mind the longer-term implications of particular spending and tax changes. Spending and revenue changes can have an impact on aggregate demand and inflationary pressures. Experience suggests that significant changes in fiscal settings should be spread over a number of years and should take into account the likely implications for monetary policy settings.

*It's the framework that counts …*

The Fiscal Responsibility Act requires the Government to set out its long-term fiscal objectives. It would, however, be difficult for a Government to make decisions in a budget round by direct reference to these objectives. To deliver on its objectives, the Government needs a tool for managing individual decisions so that they match aggregate intentions. A system of three-year fiscal limits, with associated rules for counting to these limits, is one possibility.

- Such limits provide Vote Ministers and Chief Executives with clear signals on which to base expectations for budget rounds.
- A counting limit focuses Ministers on what they can control in the short-term, acknowledging that the wider fiscal balance will be influenced by cyclical variations and valuation changes.
- They provide a scoreboard for the Government on its progress relative to its fiscal intentions.
- They are accepted and understood internationally (the United Kingdom has three-year limits similar to ours).
- Alongside the three-year limits, progress toward the long-term fiscal objectives can be assessed with the 10-year progress outlooks required under the Fiscal Responsibility Act.

## The next three years ...

*A tighter fiscal policy is desirable*

The pre-election forecasts indicate average annual output growth of around three percent over the next three years and a steady improvement in the operating balance.

Looking forward, a number of considerations suggest that, desirably, the government should seek to run somewhat higher fiscal surpluses than those projected in the pre-election update.

By international standards New Zealand has a large current account deficit and high levels of external liabilities. There is a danger that a sharp change in investor confidence would result in an exchange rate fall that is excessive in a fundamental sense, with consequent economic costs. In these circumstances, the Government's fiscal policy assumes greater importance in market assessments of the situation. A key driver of investor confidence is the market's perception of whether the Government has the will and the ability to control its own finances. Ongoing surpluses are good evidence that it does.

### *Owing the world a living ...*

The current account measures flows of trade, investment income and unilateral transfers between New Zealand and the rest of the world. The current account balance is the difference between investment in New Zealand and New Zealanders' savings. The shortfall is met by foreign saving, so that the flip-side of a current account deficit is a capital account surplus, indicating the extent of net capital inflows. New Zealand has a history of persistent and large current account deficits, and a high level of external liabilities.

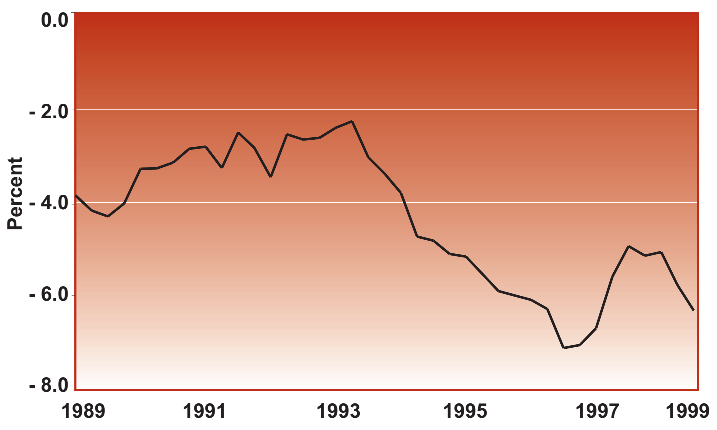
These capital inflows can be beneficial. People who expect their incomes to grow in the future can borrow when their income is low and repay the debt when their income is high. Similarly, it is better to borrow to undertake good investments than to let them go begging.

In the past, current account deficits often reflected government borrowing offshore. Since the early 1990s, fiscal surpluses have meant that New Zealand's current account deficit now largely reflects a gap between private sector saving and investment. Economic reform is likely to have attracted foreign investment, and access to foreign capital markets has increased households' access to credit.

Current account imbalances could signal a problem of either insufficient saving or inappropriate investment. Microeconomic reforms over the past 15 years, including financial market deregulation, tax reform, and monetary policy reform have helped to create a more neutral investment environment. However, government social assistance, especially retirement income policy, does reduce household incentives to save.

Saving and investment decisions are based on expectations of a number of factors that may prove over-optimistic. The best contribution the Government can make to making sure any adjustments are orderly is to maintain New Zealand's macroeconomic framework. This includes a freely floating exchange rate, sound prudential supervision arrangements, prudent fiscal management which demonstrates the Government's ability to manage its own finances, no public sector net foreign currency exposure, and no government guarantees of private sector loans.

*Current account balance as a percentage of GDP, 1989 to1999*




Maintaining surpluses and continuing to reduce debt would provide more flexibility for dealing with the fiscal pressures of an ageing population, avoiding more substantial and costly changes in the future. Although there is much uncertainty about how our economy and society will evolve, our current projections indicate that as the population ages, the 'promises' inherent in current government spending and taxation policies and procedures will not add up. The issue is whether to continue adjustment now through reducing debt or accumulating assets, or to attempt to match future spending and revenue by some mix of reducing future expenditure and increasing taxes. Predictable, measured, well-signalled and widely accepted change will reduce the risk of sharp and costly adjustments or reversals later. At a minimum, it is important to maintain the current transparency mechanisms around the fiscal implications of population ageing.

*Caution is prudent in the face of uncertainty and known risks*

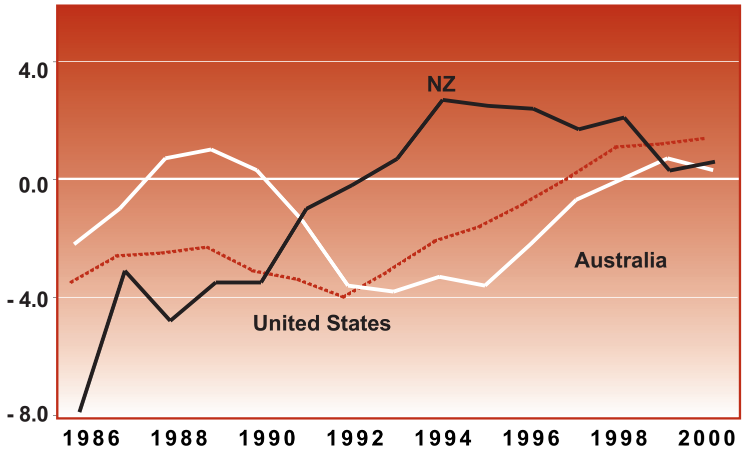
History and overseas evidence tells us that it is very easy to overestimate the extent of the improvement in the underlying fiscal position during a cyclical upswing. Changing fiscal settings on the basis of an apparent long-lasting improvement will result in a deteriorating position if things turn to custard. International experience shows how easy it is to get into this position and how difficult it is to regain ground. It is therefore important to let the cyclical features of the fiscal position operate during an upswing and bank the resulting fiscal surpluses. A cautious view of underlying economic performance reduces the risk of policy reversals, with all the instability and uncertainty they bring.

Changes in fiscal policy have a short-term impact on domestic demand and hence on inflation. Tighter fiscal policy will mean less pressure on monetary policy and hence interest and exchange rate settings, thereby making a

*Cautionary tales*

In the late 1980s, Australia and the United Kingdom ran fiscal surpluses, but found themselves in deficit following the onset of recession. The deterioration in their fiscal positions was accelerated by discretionary increases in spending and by tax cuts. In the case of the UK, this loosening was regarded as a prudent adjustment to increased trend growth. That view of trend growth later proved over-optimistic and fiscal policy had to be tightened as deficits expanded.

*Cyclically adjusted fiscal position*
*(as a percentage of potential GDP)*




contribution towards sustaining the current expansion. Experience suggests that significant changes in fiscal settings should be spread over a number of years, and involve consultation with the Reserve Bank. The mix of macroeconomic policy in Australia and the United States is arguably one reason behind their good economic performance in recent years, in that it has enabled them to capture the benefits of micro-economic reform. Both countries have strengthened their underlying fiscal positions since the mid-1990s. In contrast, New Zealand's underlying fiscal position has weakened somewhat since the mid-1990s. All other things being equal, this is likely to have put pressure on monetary policy over this period.

## Next steps

- make the most of the upswing in the cycle by running higher fiscal surpluses than projected in the pre-election forecasts
- set long-term debt and expense objectives to take account of the future fiscal pressures arising from population ageing
- adopt well structured and rigorous Budget processes, along with some form of three-year counting framework, to ensure individual decisions are consistent with the Government's priorities and fiscal intentions
- publish a Budget Policy Statement incorporating these fiscal decisions by 31 March 2000, as required by the Fiscal Responsibility Act.