

# TREASURY WORKING PAPER

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## Facts about Economic Integration: How Integrated is New Zealand with the Rest of the World?

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### Abstract

The paper provides comparative data about New Zealand's current level of market and policy integration with the rest of the world. Market integration occurs when two or more economies function as a single market. It is likely to be evidenced by high flows of goods, services, capital and labour and convergence of prices. Policy openness and integration are means governments might use to encourage, impede or direct market integration. Indicators include lack of barriers to cross border flows and similarity or compatibility of policy settings between countries.

The paper concludes that New Zealand has a relatively high level of integration with the global economy. The widespread perception, however, that New Zealand is a great deal *more* open and integrated than the rest of the world is not supported. We are broadly similar to other advanced economies in both openness of policies and integration of markets, and significantly less integrated than other small economies. New Zealand started opening comparatively recently. The perception that we are 'leading the bunch' may have arisen due to the rapid liberalisation required to catch up with other advanced economies and overcome the burden of distance.

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## Summary

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The paper aims to inform a discussion of the objectives and future directions of New Zealand's external economic strategy by providing comparative data about New Zealand's current level of integration, in terms of markets and policies, with the rest of the world. There is a perception that New Zealand is a great deal more open and integrated than the rest of the world – this paper aims to test that view.

### Integration

*Market Integration* occurs when two or more economies function as a single market. It is likely to be evidenced by high flows of goods, services, capital and labour and convergence of prices.

*Policy Openness and Integration* are means governments might use to encourage, impede or direct market integration. Openness involves goods, services, capital and labour being free to move across borders and is a necessary condition for market integration. It is evidenced by lack of barriers to cross border flows. Policy integration is evidenced by similarity or compatibility of policy settings between countries.

Even with high policy integration, market integration may not occur because of lack of *social integration*. Differences in culture, language and values make it unlikely that two economies will function completely as a single market.

The paper documents a range of indicators to answer the questions:

- How integrated are the product and factor markets of New Zealand with those of other countries?
- How integrated are various policy settings of New Zealand with those of other countries?

### Goods

Integration in the goods market is similar to, or greater than, other advanced economies. Trade in goods, at 45 percent of GDP in 1996, was well above the global average (29%) and the average for high-income countries (39%). Measures such as the import penetration rate support this.

However, theory would suggest – and evidence points to – small countries trading relatively more than large countries to offset the disadvantage of small internal markets and to achieve gains from scale. In this respect, New Zealand appears less integrated than other small economies. Trade in goods is 70% of GDP for Finland and 122% for Ireland.

Our tariff rates on goods are, on average, similar to those of other advanced countries. New Zealand, Australia and Canada tend to have lower tariffs on primary products and higher tariffs on manufactured products than the EU,

Japan and the US. New Zealand and Australia make much less use of non-tariff barriers than most other OECD countries.

New Zealand was relatively late in opening its economy to international competition. The liberalisation of tariffs that we saw over the 1980s and 1990s may therefore simply have reflected 'catch-up', in order to keep pace with international trends.

## **Services**

New Zealand's services sector is integrated into the world economy to a similar degree as the service sectors in other countries – trade in services as a share of New Zealand's total trade in goods and services is similar to the proportion globally.

However, the services sector in New Zealand is not picking up on global integration as quickly as in other countries. Globally, trade in services has grown at a slightly faster rate than trade in goods whereas in New Zealand, growth in services trade is slower than growth in goods trade.

It is difficult to observe and measure the overall level of trade in services, and internationally there are service industries that are highly regulated. However, it is likely that greater use of the Internet will see significant expansion in international trade in services.

## **Capital**

Capital markets are well integrated in foreign direct investment, with the ratio of FDI to GDP similar to the global rate. The level of foreign ownership in New Zealand is similar, and in some instances higher, than that observed internationally.

Portfolio investment flows into and out of New Zealand appear to be less significant than in other countries, which may partly reflect earlier restrictions on capital flows and a relative lack of experience in international investment decisions.

In terms of policy integration, there are currently few restrictions on capital movements.

## **Labour**

New Zealand's labour market appears relatively more integrated internationally than many other countries. The proportion of the labour force born offshore is high by international standards (18.8% in 1995).

New Zealand's labour market is most significantly linked to Australia and the UK, reflecting the policy of free movement of labour between New Zealand and Australia and historical ties with the UK. The traditional "OE" helps grease the wheels of labour flows out of, and subsequently returning to, New Zealand.

## Conclusions

Market integration globally has risen sharply over the past twenty years, most noticeably in the capital markets, but also in markets for goods and services. Generally the evidence suggests that New Zealand is relatively well integrated with global markets. New Zealand started behind the trend but has now caught up to be in line with most other advanced economies. We would expect, however, a small, isolated economy to be *more* open than the average for advanced countries. New Zealand remains considerably less integrated than other small economies.

New Zealand currently has relatively few policy barriers limiting integration in any of the markets. However, it is our hypothesis that the recentness of New Zealand's policy liberalisation, as well as the barrier of distance, has served to limit the effect that policy liberalisation has had in many other countries.

The perception that New Zealand is 'leading the bunch' internationally is not well supported:

- We are in line with advanced economies and less integrated than small economies
- Much of our liberalisation involved catching up with the rest of the world
- It is likely that distance mutes the effect that policy openness has on market integration.

## 1. Introduction

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Integration is occurring. Every day individuals and businesses are making decisions and taking actions that cross national borders. In this environment the government has some degree of influence over the pace and nature of integration, but by no means control. Policy can oil the wheels of integration, or put sand in the wheels; it cannot drive the machine.

In order to make policy in such a complex environment, the government needs to have good information about where New Zealand is currently positioned. It is important that discussions are grounded in a common understanding of the facts. There is a widespread perception that New Zealand is a great deal more open and integrated than the rest of the world. This paper sheds light on the degree to which that perception is based on fact.

We aim to answer the empirical question: how integrated is New Zealand with the rest of the world? To do this, the paper documents and assesses comparative data about New Zealand's current level of market integration across the goods, services, capital and labour markets. It also gives an indication of levels of openness or integration of policy settings as they relate to the goods, services, capital and labour markets. We discuss how far along the integration process New Zealand is currently, how far we have come, and how New Zealand compares internationally.

The paper does not set out to evaluate whether New Zealand *should* be more integrated or not. Further discussion on the costs and benefits of integration is contained in a companion working paper: *Economic Integration, Sovereignty and Identity: New Zealand in the Global Economy*, by Megan Claridge and Sarah Box (2000). Claridge and Box provides a framework for thinking about the benefits and costs of market integration. It analyses how cross border flows of goods, services, capital and labour affect the living standards of New Zealanders in terms of both productivity and incomes as well as other, broader, aspects of living standards. Particular attention is paid to the areas of spatial economic analysis and national sovereignty and identity. It is hoped that both these papers will inform a discussion about the objectives and future directions of New Zealand's external economic strategy and provide a platform for further work.

## 1.1 Structure of the Paper

The paper is structured as follows:

- Section 2 introduces the notion of integration and distinguishes market, policy and social integration.

To determine the extent of integration, both product markets (goods and services) and factor markets (capital and labour) are examined. We deal with the product and factor markets in turn, documenting flows, price behaviour and barriers for each.

- Section 3 addresses the goods market
- Section 4 addresses the services market
- Section 5 addresses the capital market
- Section 6 addresses the labour market

Section 7 pulls these indicators together and draws conclusions.

This paper ends with a brief annex comparing the features of the regional blocs of which New Zealand is a part (Australasia's CER and APEC), with other regional blocs around the world, specifically the European Union and NAFTA. This can help us identify areas in which there may be scope for further integration should we wish to pursue it.

We begin by clarifying what is meant by integration.

## 2. Integration

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Integration is a relational term: it lacks meaning separate from discussion of *what* is being integrated. As in Claridge and Box (2000), we distinguish three dimensions of integration: market integration, policy integration and social integration.

### 2.1 Market Integration

In this paper we are primarily interested in *market integration*: how integrated are the product and factor markets of New Zealand with those of other countries?

Market integration between two, or more, economies occurs when they function as a single market. Integrated markets will not sustain price differences for very long; any difference will be arbitrated away through quantity and price movements. Goods markets, for instance, are integrated if people in different regions have access to the same goods at similar prices and trade in these goods occurs between regions.<sup>1</sup> If markets are integrated we would expect to see mobility (labour moving between countries, goods trade, capital flows etc) and relatively quick price convergence (wages equalising, similar goods prices in different areas). For two countries with integrated markets, a shock in one country will quickly flow through into the other by price movements and flows. If markets are not integrated we would expect to see little, or no, mobility and no, or very slow, price convergence.

We focus on the goods, services, capital and labour markets. These markets are not independent of each other. If all markets between two countries were integrated then we would observe rapid adjustment through both product and factor markets. However, it is often the case that some markets are more integrated than others, arising from restrictions on flows in certain areas (eg, capital controls, immigration restrictions). In this situation adjustment follows the path of least resistance: flows and prices respond quickly in the market that is the most integrated, leaving the other less integrated markets heading toward price convergence gradually over time. Note also, that there cannot be integration in only one market. There will not be trade unless people are allowed to exchange some capital assets (eg cash): there is no point selling something to someone if you cannot use the proceeds. Thus capital market restrictions can in theory restrict trade markets.

One complication is that, while the presence of flows is evidence for integration, the absence of flows is not conclusive proof of lack of integration. Lack of mobility *may* indicate lack of market integration or it may indicate an integrated market that is in equilibrium. We can only tell which of these scenarios is true by studying price behaviour and flows after a shock to one location – if we still don't observe mobility after a differential shock we can infer that the markets are not integrated.

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<sup>1</sup> Coleman 1999 pg 4

To fully test market integration we would need to undertake more targeted work looking at price behaviour over time, particularly in response to shocks. In the absence of such an in-depth study, this paper uses the price data we do have available, plus observed flows, as indicators of market integration. It's not conclusive proof, but it gives us a much richer picture.

It is worth noting that even within a country, markets may not be fully integrated. It is important to keep this domestic perspective in mind when considering how integrated we might aim for our markets to be in an international context.

For the purposes of this analysis, we take market integration to be evidenced by high flows in the goods, services, capital and labour markets, and price convergence in those markets. We present evidence of flows and prices in these markets, between New Zealand and the rest of the world.

## 2.2 Policy Integration

Government policy may affect the degree and nature of market integration.

*Policy openness* allows cross border flows to occur. It implies a lack of barriers to market integration. That goods, services, capital and labour are free to move across borders is a necessary condition for market integration. However it is not sufficient; even if policies are extremely open, flows may not occur for other reasons. Openness implies the potential for market integration to be achieved.

*Policy integration* refers to the level of similarity or compatibility between policy settings in two countries. Policy integration will be one means by which governments might encourage market integration and lack of policy integration one explanation for lack of market integration. If, say, systems of health regulations and standards are similar between two countries this is likely to facilitate trade in the goods market to which these standards relate. If countries recognise each other's occupational regulations then integration in the service and labour markets is likely to be higher.

These two terms overlap and blur together to some degree. Difference in policy settings, for instance, is often referred to as a 'behind the border' barrier impeding openness. The aim is not to attempt a scientific taxonomy of classes of government policy but rather to distinguish clearly between events in the market (flows, price movements) and policy instruments designed to affect those events.

Dimensions of policy openness and integration include:

- Tariffs and non-tariff barriers
- Regulations and common institutions regarding, for example:
  - trade in services
  - standards (eg on health and safety, environment, occupational licensing)
  - competition policy and legal systems

- transport and communication (aviation, shipping, telecommunications, postal)
- Trade agreements and membership of international organisations
- Monetary policy
- Fiscal policy
- Investment rules
- Immigration policy
- Political arrangements (eg EU)

As well as documenting flows and prices as indicators of market integration, the paper attempts to track the degree to which New Zealand policy settings are integrated with the rest of the world. In many cases, we will have a unilaterally or multilaterally determined policy that is consistent across countries: it then makes sense to talk about New Zealand's level of policy integration with the rest of the world in a broad way. In other cases, levels of integration with other countries will vary according to regional agreements. The annex introduces the issue of regional integration.

### **2.3 Social Integration**

Policy integration will not be the sole determinant of market integration between two countries. The level of social integration is also likely to be important. For example, labour flows are more likely to occur between countries that share similar languages, cultures and value systems. There is evidence that this may also be true of trade flows. These less explicit 'social' barriers to trade limit the amount of market integration that can be achieved even with perfect policy integration. Policy integration may be able to increase the level of social integration between two countries to a degree, but the timeframes tend to be very long.

This paper confines itself to documentation of market and policy integration; social integration is much more difficult to analyse empirically. Helliwell<sup>2</sup> has done some work documenting 'border effects' between Canada and the United States. It would be interesting to know the degree to which border effects place an upper limit on the effectiveness of policy integration in achieving market integration in New Zealand's case. The New Zealand – Australia relationship would be a particularly interesting case study, since in terms of culture and ways of life, we have more in common than practically any pair of countries in the world.

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<sup>2</sup> Helliwell (1998)

## Summary: Integration

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Market Integration occurs when two or more economies function as a single market. It is likely to be evidenced by high flows of goods, services, capital and labour and convergence of prices.

Policy openness and integration are means governments might use to encourage, impede or direct market integration. Openness involves goods, services, capital and labour being free to move across borders and is a necessary condition for market integration. It is evidenced by lack of barriers to cross border flows. Policy integration is evidenced by similarity or compatibility of policy settings between countries.

Even with high policy integration, market integration may not occur because of lack of social integration. Differences in culture, language and values make it unlikely that two economies will function completely as a single market.

### 3. Goods Market

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#### 3.1 Volumes

Globally, the integration of goods markets across borders has increased as witnessed by the increase in the volume of goods traded as a share of GDP. International trade in goods has grown at a faster rate than world GDP. As a consequence, the ratio of goods trade to output globally has nearly trebled since 1950.<sup>3</sup>

In New Zealand, trade in goods (the sum of merchandise exports and imports) represented 45% of GDP (measured on a purchasing power parity basis) in 1996. This has increased from just under 30% of GDP in 1986, illustrating the increasing openness of the economy over this time.<sup>4</sup>

When this is compared with other high-income countries we see that New Zealand is not dissimilar in either the share of trade or the change over this decade (high income countries increasing from 27% to 39% over this period).<sup>5</sup>

However, New Zealand's trade in goods is appreciably lower than many other small countries (see Table 1). Typically one would expect the ratio of trade to GDP in small countries to be greater than that in larger countries to offset the disadvantage of small internal markets and to achieve gains from scale. Small countries are therefore a more relevant comparator, and in this respect New Zealand appears less integrated. We often compare ourselves with countries such as Finland and Ireland: trade in goods is 70% of GDP for Finland and 122% for Ireland.

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<sup>3</sup> The ratio of trade to output probably understates the true degree of integration because of the growth in services as a share of output in advanced economies. A more appropriate measure would be merchandise (goods) exports to tradeable output. For a comparison, in the US between 1950 and 1992, merchandise exports to GDP rose from 3.6% to 7.3%, while as a share of tradeables output they rose from 8.9% to 34.8% (Source: World Economic Outlook May 1997, IMF).

<sup>4</sup> Updated Statistics New Zealand national accounts data due for release in December 2000 may produce different trends, particularly for imports, depending on how the computer deflator is treated.

<sup>5</sup> Another important indicator would be (value-added which is traded)/(GDP) since some exports have large imported components. This is especially true where a country is part of a manufacturing circle which imports expensive things, adds a small bit and re-exports. New Zealand does not seem to do much of this, so the figure would not change much for New Zealand. Such an indicator may, however, give lower figures for other countries.

Table 1: International Comparisons of Merchandise Trade as a Share of GDP

	1986	1996
<b>New Zealand</b>	30	45
Australia	24	34
United Kingdom	33	46
United States	14	19
Finland	52	70
Sweden	62	87
Norway	68	80
Denmark	59	74
Ireland	87	122
Netherlands	87	106
Switzerland	67	90
Hong Kong	112	248
Singapore	191	316
<b>High-income countries</b>	27	39
<b>World</b>	21	29

Source: World Development Indicators 1998, World Bank

Globally, growth in trade amongst nations has been faster for manufactured products than for agricultural or mining products during the 1990s. However, in New Zealand exports of manufactured and primary products have grown at a similar pace through the 1990s (5.5% and 5% per annum respectively). This is just exports, however, and taking into account imports may show a different result as growth in manufactured imports is likely to be stronger than growth in primary imports.

The share of trade in output is the most commonly cited indicator of market openness, but it is only one. An additional measure is the import penetration rate.

The import penetration rate is the proportion of goods consumed in the economy that are imported as opposed to being made domestically. For manufactured products, the import penetration rate has risen from 32% in New Zealand in the 1970s to 40% in the mid-1990s (OECD, 1999).<sup>6</sup> The trend of rising import penetration ratios is common around the world, although New Zealand's import penetration rate is high by OECD standards, and compares with 31% in Australia.<sup>7</sup> The only OECD countries to have similar or higher import penetration ratios for manufactured products are Canada and Mexico (the penetration rate in both countries increased following NAFTA) and the relatively remote and small nations of Iceland and Norway.

<sup>6</sup> The import penetration rate for manufacturing is defined as the ratio of manufacturing imports to apparent consumption of manufactured goods (domestic production minus exports plus imports).

<sup>7</sup> Again, the new chain weighted SNA series may give slightly different results.

Reviewing these two indicators gives slightly mixed results. Looking at the share of merchandise trade in GDP would suggest that the level of openness of New Zealand's goods markets is not dissimilar to other high-income countries, although lower than some other small economies. However, the import penetration rate suggests that the goods market in New Zealand is more integrated with the world than is the case in most other OECD countries.

### 3.2 Prices

Another way to examine the extent of product market integration is to examine the degree of convergence across countries in the price of traded goods. Empirical studies have consistently found large and persistent differences in the price of goods across countries (accounting for exchange rate differences) except for some highly homogeneous commodities such as gold (see Rogoff for a review of the empirical evidence on absolute and relative PPP).

Work by Coleman and Dalziel (1998) looking at retail prices in New Zealand and Australia suggests that New Zealand is not as integrated with Australia as Australian states are with each other. On average price differences between Australia and New Zealand exceed price differences within Australia. Prices in Australian cities display strong tendencies to move together, and any residual price differences disappear fairly rapidly in subsequent quarters. In contrast, New Zealand prices do not tend to move at the same time as their Australian counterparts and tend to adapt only slowly in subsequent quarters to a shift in the Australian price or in the exchange rate.

The OECD (1999) has conducted a study comparing manufacturing prices across countries as an indicator of whether domestic policies limit market access (i.e. prevent prices from converging across countries). Countries where prices appear to be consistently lower than in trading partners may be considered to be more open than countries with relatively higher prices, as they are exposed to greater (international) competition. A comparison of nine OECD countries using 1993 data found that New Zealand almost always has manufacturing prices below the OECD average - only the US and Canada performed better.<sup>8</sup>

The evidence on price convergence between New Zealand and other economies is similar to that observed elsewhere - that typically a price differential remains. However, the price data is weak relative to other measures of goods market integration. Therefore it would seem sensible to place more importance on the evidence of volumes of trade and barriers to trade than on the evidence from prices.

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<sup>8</sup> The nine OECD countries included in the study were the US, Canada, New Zealand, the UK, Italy, Australia, France, Germany and Japan. A shortcoming of this study is that the data used includes indirect taxes and distribution margins so therefore incorporates Government policy and a portion of service sector pricing across countries.

### 3.3 Barriers

#### 3.3.1 Tariff Barriers

Tariff rates have fallen in New Zealand over the past fifteen years. The simple average applied tariff rate in New Zealand was 16% in 1984. This had fallen to 8.5% in 1993 and 4.2% in 1998.<sup>9</sup> Tariff rates in New Zealand are lower on primary products than on manufactured products, although both have fallen during the 1990s. The average tariff rate on primary products in New Zealand fell from 4.4% in 1992 to 2.5% in 1997, and tariffs on manufactured products have fallen from 9.9% to 6.3% over this same period.

Most OECD countries have held tariffs broadly constant during the 1990s after reducing the tariff levels - on industrial goods in particular - up until the late 1980s. However, both Australia and New Zealand have pursued further unilateral trade liberalisation during the 1990s.

New Zealand's average tariff was 3.2% in 1999, down from 4.2% in 1998 and 5.4% in 1997.<sup>10</sup> As Table 2 illustrates, we have very similar average tariff rates to a number of other advanced economies. We also seem to be in the middle of the bunch for many small economies that we compare ourselves with.

*Table 2: Average Tariff Rates in 1999*

	%
Hong Kong	0.0
Singapore	0.3
Sweden	1.0
Japan	2.0
Norway	2.0
Switzerland	2.0
Luxembourg	3.0
Australia	3.0
New Zealand	3.2
United States	3.3
Ireland	3.5
Finland	3.5
United Kingdom	3.6
Canada	3.8
Chile	7.3
China	18.7

Source: Global Competitiveness Report 2000, World Economic Forum

<sup>9</sup> In fact, the tariff rate in 1984 understates the degree of protection in the New Zealand economy at this time, because of the extensive use of quotas rather than simply tariffs (see the following section).

<sup>10</sup> 1997 and 1998 figures from the World Development Indicators 1998, World Bank

Tariffs on primary products in New Zealand are lower than in virtually all other countries, however, with only Australia and Canada having similarly low tariffs on primary products. The big economies of the US, EU and Japan all have lower tariffs on manufactured products than New Zealand does, showing that New Zealand is not at the frontier for low tariffs on manufactured goods. Table 3 below shows the tariff rates for 1997 for primary and manufactured products.

*Table 3: Average Tariff Rates in 1997*

	All products	Primary products	Manufactured products
New Zealand	5.4	2.5	6.3
Australia	5.7	1.2	6.8
Canada	6.0	4.0	6.5
Chile	11.0	11.0	10.9
China	17.8	17.8	17.8
European Union	6.9	10.4	5.6
Japan	6.0	9.1	4.8
United States <sup>11</sup>	6.0	6.9	5.8

Source: World Development Indicators 1998, World Bank

### **3.3.2 Nontariff Barriers**

New Zealand has also reduced nontariff barriers during the past decade, another indicator that there are now fewer barriers to increasing integration occurring. Whereas in the early 1980s quantitative trade restrictions covered more than 40% of imports, this fell to 14.1% of national tariff lines in 1988, and in 1996 nontariff barriers were applied to just 0.7% of tariff lines.

New Zealand and Australia make much less use of nontariff barriers than most other OECD countries. Nontariff barriers applied to only 0.2% of total imports in New Zealand in 1996. This compares with 0.6% of total imports in Australia, 7.7% in the US, 6.7% in the EU, and 7.4% in Japan.

The IMF has constructed an Index of Trade Restrictiveness, which tries to encompass both tariff and nontariff barriers by combining measures of the restrictiveness of both types of barriers. On this index, the overall restrictiveness of a country's trade system is ranked relative to protection levels in all fund members. This measure highlights the extent of liberalisation over the past 15 years in New Zealand. New Zealand has moved from a rating of 9 in 1984 to 1 in 1993, where 1 represents the most open trade regime and 10 the most restrictive.<sup>12</sup> However, since then IMF staff have re-estimated the case for New Zealand, taking into account producer boards. Latest estimates instead place New Zealand as a 4 on the Index of Trade Restrictiveness, where 1 to 4 is considered open.<sup>13</sup>

<sup>11</sup> 1996.

<sup>12</sup> IMF (1998, p14).

<sup>13</sup> This compares with the following ratings for other countries: Australia 1, Hong Kong 1, Singapore 1, Chile 2, Canada 4, Denmark 4, Finland 4, Germany 4, Ireland 4, Japan 4, Korea 4, United Kingdom 4, United States 4.

Although the degree of openness has increased considerably in New Zealand and is now similar to other advanced economies there is evidence that New Zealand was relatively late in opening the economy to international competition. Sachs and Warner (1995) have categorised the timing of trade liberalisation across a wide range of developed and developing economies. They judge a country to have a closed trade policy if it has at least one of the following characteristics:

- Nontariff barriers covering 40% or more of trade
- Average tariff rates of 40% or more
- A black market exchange rate that is depreciated by 20% or more relative to the official exchange rate, on average, during the 1970s or 1980s (i.e. a measure of exchange control)
- A socialist economic system (to cover countries that relied on central planning rather than overt trade policies to maintain a closed economy)
- A state monopoly on major exports (eg in sub-Saharan Africa where export monopolies on foodstuffs were used in part to maintain low domestic prices of food for urban residents)

Under the Sachs and Warner definition New Zealand is classified as closed until 1986, compared with 1950-60 for most other developed economies.<sup>14</sup>

*Table 4: The Year of Opening of Various Developed Economies*

Pre-1950	United States Switzerland
1952	Canada
1959	France Germany Luxembourg Netherlands
1960	United Kingdom Finland Norway Austria Belgium Spain Sweden
1962	Japan
1964	Australia
1985	Israel
1986	New Zealand

Source: Sachs and Warner (1995) p25

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<sup>14</sup> The date of trade liberalization is taken to be the year from which the economy is open continuously through the end of the sample period, 1994. New Zealand is dated as opening in 1986 because quantitative trade restrictions covered more than 40% of imports in 1981 and 1983.

This illustrates how late New Zealand was relative to other economies in opening its borders, highlighting how far behind other advanced economies we were in this respect (and how much distance we therefore had to catch up in the 1980s and 1990s). The perception that we are 'leading the bunch' may have arisen due to the rapid liberalisation required to catch up with other advanced economies and overcome the burden of distance.

### **3.3.3 Costs of Trade**

Small countries are expected to have a much larger fraction of external trade than larger countries to counter for the fact that they have fewer internal producers and fewer gains from internal trade. This result has been confirmed empirically by Helliwell (1998). However, as seen above, New Zealand's trade ratio is relatively low compared with that in other small, wealthy economies.

Our low trade/GDP ratio may be a function of New Zealand's distance from key trade partners. Distance matters: trade between a pair of countries falls about 1% for every 1% increase in distance.<sup>15</sup> Further empirical work suggests that distance is a much bigger barrier than the costs of transport and communication alone would suggest.

The cost of transport and communications has been a key barrier to New Zealand's trade in goods, although this barrier has fallen in recent times. Technological improvements, particularly in transportation, communications and information technology, have reduced the costs of doing business internationally. For example, sea freight costs fell 70% in real terms between 1980 and 1996, air freight costs have fallen by 3-4 percent a year, the per minute cost of international phone calls has fallen by about 2% a year in the 1990s in industrial countries (and 4% per year in developing countries).<sup>16</sup> In addition, the advent of the Internet enables firms to market their products to a much wider market more easily than was previously possible. All these factors have contributed to the global growth in trade, but should perhaps bring relatively more benefit to those countries that are further away.

Nevertheless, studies suggest that New Zealand exhibits a relatively high degree of home-country bias – the bias towards purchasing a product from a domestic supplier relative to a foreign firm, after accounting for size, distance, location, and whether the countries share a common language or border. Shang-jin Wei (1996) found that New Zealand's home bias was above the OECD average, suggesting we are less integrated than other indicators would suggest. According to this measure, New Zealand is less integrated with the global economy than Australia is, but has a similar degree of home-bias as Finland. The US was found to have the lowest home-bias.<sup>17</sup>

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<sup>15</sup> Frankel and Rose, 2000.

<sup>16</sup> Global Economic Prospects and the Developing Countries 1997, World Bank.

<sup>17</sup> The home-bias is estimated as the average over the period 1982-1994. Therefore the New Zealand results could be influenced by the high degree of restrictiveness over the initial part of the period. New Zealand will be an outlier on the distance measure, which may reduce the degree of certainty around the estimate.

### 3.3.4 Regulatory Barriers

The persistence of home bias, even accounting for factors such as distance, may reflect the existence of other “behind the border” barriers. The OECD (1997) has noted that the costs of social regulation appear to be increasing while the costs of economic regulation are falling as deregulation introduces competition into more sectors.

The alignment of regulatory standards across countries, through mutual recognition or harmonisation, is one means of reducing barriers to trade. This, however, comes at a cost as increasingly we face trans-Tasman or wider international agreements that restrict our regulatory discretion.

Little progress has been achieved in the area of mutual recognition or harmonisation of standards internationally, with the exception of the Sanitary and Phyto-Sanitary Agreement.<sup>18</sup> New Zealand has made some progress in this area with Australia. The Trans Tasman Mutual Recognition Agreement provides for Australia and New Zealand to recognise each other’s standards in a number of areas (although it excludes some areas such as therapeutic medicines and some occupational regulation). Harmonisation is typically a harder process. However, one example of harmonisation between Australia and New Zealand is in the treatment of food standards, including genetically modified foods.<sup>19</sup>

As part of New Zealand’s Code of Good Regulatory Practice (agreed to by Cabinet in November 1997), one of the guidelines to be considered in designing regulation is international compatibility.<sup>20</sup>

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Furthermore, the estimate for individual countries is more noisy than the estimate for the OECD as a whole.

<sup>18</sup> The Sanitary and Phyto-Sanitary Agreement aims to harmonise international sanitary and phytosanitary standards as widely as possible, where the purpose of such standards is to protect human, animal or plant life or health.

<sup>19</sup> The relevant authority can make decisions by majority and includes the Australian and New Zealand Governments and each Australian state. This means an individual member can be faced with implementing systems that may be incompatible with its general policy approach.

<sup>20</sup> The Code states “... where appropriate, regulatory measures or standards should be compatible with relevant international or internationally accepted standards or practices in order to maximise the benefits of trade.”

## **Conclusions: Goods Market**

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New Zealand has become increasingly integrated into global goods markets over the past 15 years

- Trade as a share of GDP has increased at a slightly faster rate in New Zealand than has the global average over the period 1986 to 1996.
- Tariff rates in New Zealand and the extent of nontariff barriers have fallen considerably since the mid-1980s.

The New Zealand goods market is relatively integrated globally

- Measures of openness such as merchandise trade as a % of GDP, the import penetration rate, and the degree of exposure to foreign competition, all suggest that New Zealand is more integrated internationally than is the average for high-income countries
- Tariff rates are similar or lower than in other countries, and less use is made of nontariff barriers than in other advanced countries
- New Zealand is more integrated with Australia than we are with other countries, both in terms of the volume of trade (Australia is our largest export market), and in terms of mutual recognition and harmonisation of standards.

However New Zealand was opened to international markets much later than other advanced economies. This suggests that much of the trade liberalisation of the past 15 years in New Zealand may have been catch-up. One definition of openness (Sachs and Warner, 1995) suggests that New Zealand was closed up until 1986, whereas most other developed economies were opened to global markets by 1960.

New Zealand is not out on its own in terms of openness, and in some respects is behind other countries

- New Zealand's trade as a share of GDP is less than that of other small open economies, such as Finland and Ireland
- Tariff rates in New Zealand are not much lower than in a number of other countries, including Australia, Canada, Japan, the US and the EU (although the distribution of tariff rates across industries varies)
- An estimate of the home-bias in New Zealand is greater than the average for OECD countries

The evidence on prices in New Zealand is consistent with the evidence globally that there is little convergence of prices internationally.

## 4. Services Market

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International trade in services can be difficult to understand as services are thought of as intangible. The largest component of services exports in New Zealand is tourism receipts. Other examples of services that are traded internationally include freight and port services, financial services including insurance (eg insurance services provided by/to New Zealand resident insurers to/from foreign residents), government "services" (eg expenditure on commodities by embassies and consulates abroad), advertising and communication services, rent, royalties and licence fees.

Given that services represents two-thirds of total economic activity in most developed countries' economies, it is an area where greater international openness could bring huge advances in the amount of international trade in services. However, despite this, services remain an area where there is relatively limited data available.

### 4.1 Volumes

International trade in services accounted for just over 20% of the value of global trade in goods and services in 1996 (this is the same in New Zealand, at around 23%). The estimates, however, understate the full significance of trade in services. This is because they include the value of services traded across borders (eg transport) or by the temporary movement of people (eg tourism, education), but do not account for the value of services traded via a foreign supplier who has a commercial presence in a market.<sup>21</sup> It has been estimated that including the commercial presence ("ownership") concept of service trade could more than double the value of international trade in services.

Globally, trade in services has grown at a slightly faster rate than trade in goods, slowly accounting for a slightly larger share of total trade. In New Zealand, however, total trade in services has grown at a slower rate than goods trade (3.6% and 5.6% per annum respectively through the 1990s). This suggests that the services sector in New Zealand is not picking up on global integration as quickly as in other countries. When looking at the breakdown of exports and imports, however, we see that exports of services grew at virtually the same rate as goods exports during the 1990s. The difference is seen on the import side, with growth in goods imports outstripping import growth for services (6% compared with less than 3% per annum respectively).

The growth in trade in services internationally partly reflects the growth in goods trade (eg. trade in services such as transport and insurance increases with increased goods trade). However, it also reflects other factors such as

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<sup>21</sup> The *base* or *location* concept defines international trade in services as taking place only if the two parties reside in different countries. This is the concept used by the IMF and used in compiling GDP. Other definitions of international trade – including that of the WTO – incorporates the *ownership* concept eg the transaction of services where one party is a domestic operation of a foreign owned firm eg providing health care to foreigners.

technological progress – it is now much easier to trade various services internationally via the internet.

The data available on international trade in some services is incomplete. For example, financial services trade flows cannot be observed directly and instead are inferred from the service and intermediation charges of financial institutions, along with data from financial stocks and flows. There are indications that the degree of cross-border trade in financial services is increasing globally. We have seen strong growth in net international securities issued, rising from USD 111 billion in 1992 to USD 670 billion in 1998. Cross-border trade in financial services is most prevalent and longest established in the more sophisticated end of the market, eg wholesale commercial banking, investment bank, insurance, and financial information services.

## **4.2 Barriers**

The extent of trade in services is influenced by national policies on foreign direct investment (nearly half of all FDI flows into and out of the OECD economies are in the services sector, see OECD 1999), competition, intellectual property, professional entry requirements and registration (eg for the medical profession), and electronic commerce. For example, policies affecting internet access and transactions will have an impact on the growth of trade in services (and in goods). The complexity of these various issues presents problems in negotiating liberalisation of international services trade.

Two of the most heavily regulated sectors in advanced economies are the financial services sector and the aviation industry.

Regulation in the financial services sector occurs in part to minimise the risk that problems arising in particular institutions or markets could spread wider. Regulations aim to preserve confidence in the financial system. Within the OECD, two approaches are typically followed. A number of countries – including Australia, Finland, Japan, Mexico, Norway, Poland and Turkey – prohibit cross-border banking services. The most common approach, however, eg Germany, the UK, the Netherlands, is to permit the provision of wholesale banking services on a cross-border basis, with no host country regulation and/or reliance on home country regulation. There is a higher degree of regulation with respect to retail banking services.

New Zealand is somewhat unusual internationally in that virtually all of our banking sector is owned offshore. Many other countries have restrictions on foreign ownership of their financial sector. In this sense, New Zealand's finance industry is more open internationally than is the case in many other countries.

International air services have been exposed to very little multilateral liberalisation to date, with significant restrictions on competition and trade. Whereas trade in goods is generally allowed unless specifically restricted, trade in international air services is prohibited unless specifically allowed. There are over 3000 bilateral agreements worldwide covering issues of market access in

this industry. Although air services regulation is a worldwide barrier, it may be particularly significant for New Zealand because of our location.

Whilst there are regulations covering many parts of the service sector, the unregulated nature and increasing take-up of the Internet offers many opportunities for expansion of international trade in services. The technology of the Internet enables trade because it allows the provision of services remotely (such as education, financial and business services). New Zealand has a relatively high level of internet access – costs are lower than the OECD average and we have a greater number of internet hosts per capita.<sup>22</sup> In 1997 New Zealand's expenditure on information and communications technology as a percentage of GDP was well above the OECD average and, somewhat surprisingly, above that of other countries including the US, UK and Australia.<sup>23</sup> However, take-up in terms of e-commerce has been less spectacular. One survey concludes that, despite high adoption levels of email and websites, organisations are under-using the tools and technologies they have available to change or enhance elements of their business and that, in this regard, we are lagging behind many of our international competitors<sup>24</sup>

The existence of the Internet may lead to greater pressure for liberalisation in services sectors: firstly, because it becomes increasingly difficult for countries to regulate particular sectors, and secondly, because regulation may limit the ability of companies and individuals to fully take advantage of what the Internet may mean for the way in which they do business.

## **Conclusions: Services Market**

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**New Zealand's services sector is integrated into the world economy to a similar degree as the service sectors in other countries**

- **Trade in services as a share of New Zealand's total trade in goods and services is similar to the proportion globally**

**However, the services sector in New Zealand is not picking up on global integration as quickly as in other countries.**

- **Globally, trade in services has grown at a slightly faster rate than trade in goods. In New Zealand, growth in services trade is slower than growth in goods trade.**

**It is difficult to observe and measure the overall level of trade in services, and internationally there are service industries that are highly regulated. However, it is likely that greater use of the Internet will see significant expansion in international trade in services.**

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<sup>22</sup> OECD calculations based on Internet Software Consortium (ISC) data.

<sup>23</sup> OECD, ADB database and IDC data, March 1999.

<sup>24</sup> Deloitte e-Business survey

## 5. Capital Market

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### 5.1 Volumes

#### 5.1.1 Global Trends

Globally, there has been considerable growth in capital movements over the past twenty years. Freedom of capital movement is not, however, unprecedented. There was free flow of capital internationally before World War I, with large amounts of capital flowing from the core western European countries to the rapidly developing economies of the Americas and Australasia. There is evidence not only of considerable flows, but also that interest differentials between the UK and the US narrowed between 1850 and 1913. (See WEO May 1997, IMF). But following the outbreak of WWI international capital markets became more closed. Indeed, it was only in the 1980s that capital flows returned to the rates seen at the beginning of the decade, as evidenced in the following table of foreign ownership of assets.

*Table 5: Foreign Assets as a Percent of World GDP*

1870	6.9	1945	4.9
1900	18.6	1960	6.4
1914	17.5	1980	17.7
1930	8.4	1995	56.8

Source: Globalisation and Growth in the Twentieth Century, IMF Working Paper WP/00/44

Nevertheless, the nature of the capital flows now differs to that at the beginning of the century. Firstly we see that offshore ownership of assets dwarfs that which we have seen previously. Secondly, the type of foreign investment is now much broader in scope. Foreign investment before WWI was directed into a narrow range of sectors, especially infrastructure projects and lending to governments. In contrast, foreign direct investment now is directed across a much wider variety of sectors. Portfolio capital flows are significant now whereas they were largely unheard of 100 years ago. Thirdly, daily flows are now considerable in contrast to the earlier period, reflecting communication and technology advances. (See Bordo, Eichengreen and Irwin, 1999)

During the 1980s and the 1990s the increase in capital flows has been dramatic – most considerably in transactions in heavily-traded, highly-liquid, financial assets (so called ‘hot money’). Transactions in bonds and equities across the major advanced countries were less than 10% of GDP in 1980 but had increased to over 100% of GDP in 1995. (Source IMF WEO, May 1997)

The size of portfolio and other investment inflows and outflows are significantly larger than flows of foreign direct investment (FDI) globally. Total global private capital flows (the sum of the absolute flows of direct, portfolio and other

investment inflows and outflows)<sup>25</sup> amounted to 14.5% of world GDP in 1996 – more in some countries such as Finland, the UK and Ireland, although less in New Zealand. FDI flows, however, only made up 2.2% of global GDP in 1996 – leaving portfolio and other investment accounting for over 12% of GDP.

Nevertheless, FDI flows have also increased over the past twenty years, although less dramatically. Globally, gross FDI flows (the sum of the absolute value of inflows and outflows) increased from 1.1% of GDP in 1986 to 2.2% in 1996.

### 5.1.2 New Zealand Trends – FDI

In contrast to the global trend, total FDI flows into and out of New Zealand have fallen over the past decade from 4.7% of purchasing power parity GDP in 1986 to 2.0% in 1996.

*Table 6: Gross Foreign Direct Investment Flows as a Percent of PPP GDP*

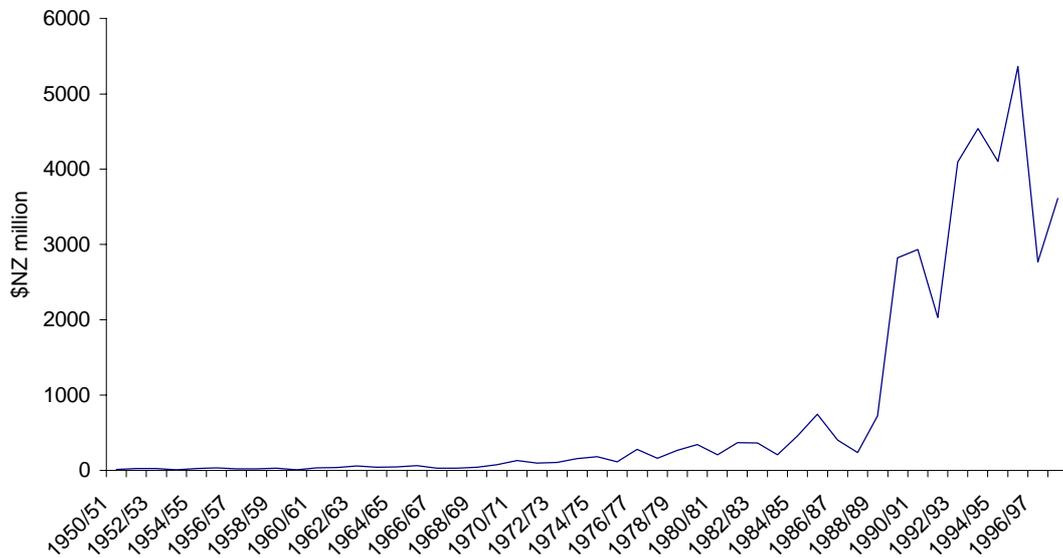
	1986	1996
New Zealand	4.7	2.0
Australia	4.5	4.2
Canada	1.9	2.3
Chile	0.5	3.0
Finland	2.0	5.6
Ireland	0.1	4.7
Japan	0.9	0.9
Singapore	7.5	17.5
United Kingdom	3.6	6.6
United States	1.4	2.6
High-income countries	1.6	2.7
World	1.1	2.2

Source: World Development Indicators 1998, World Bank

There are difficulties, however, with the comparisons used here. Capital flows, certainly in New Zealand, tend to be quite volatile. This makes comparisons of individual years more dubious as the result can be thrown around by the particular years chosen. It is therefore more useful to look at a time-series to see how flows have changed.

<sup>25</sup> Foreign direct investment is defined as cross-border investment in businesses where there is a non-resident shareholding of 25% or more. Portfolio investment is investment in a business with a shareholding of less than 25% and investment in long-term government or corporate debt securities. Other investment includes government and corporate sector loans and short-term bank funding transactions. These are the definitions under the 4<sup>th</sup> edition of the IMF's Balance of Payments Manual (BPM4). Under the 5<sup>th</sup> edition (BPM5), the threshold between FDI and portfolio investment is reduced to 10%.

Figure 1: Foreign Direct Investment Inflows to New Zealand



Source: IMF International Financial Statistics 1999

We can see from Figure 1 that the level of FDI inflows to New Zealand has increased significantly since the mid-1980s.<sup>26</sup> However, it is more insightful to look at a graph of FDI inflows as a % of GDP. In this we see that there was a structural shift in 1984 in terms of the FDI capital flows into New Zealand with the liberalisation of previously tight capital restrictions. In the years from 1972 to 1983 FDI inflows averaged 1.5% of GDP. Since then, however, they have averaged nearly 5% of GDP. This clearly shows the effect of liberalisation leading to greater capital market integration as evidenced by increased foreign direct investment in New Zealand.

<sup>26</sup> The graph is just of FDI inflows, whereas the table is of gross FDI flows. Therefore the magnitudes are not directly comparable. The table is shares of PPP GDP, whereas the graph is domestic GDP.

Figure 2: Foreign Direct Investment Inflows to NZ as a Percent of GDP

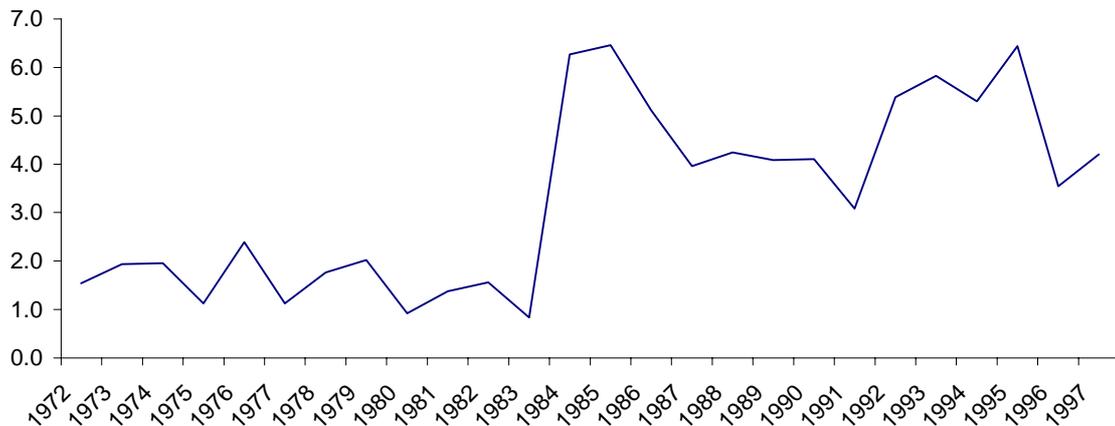
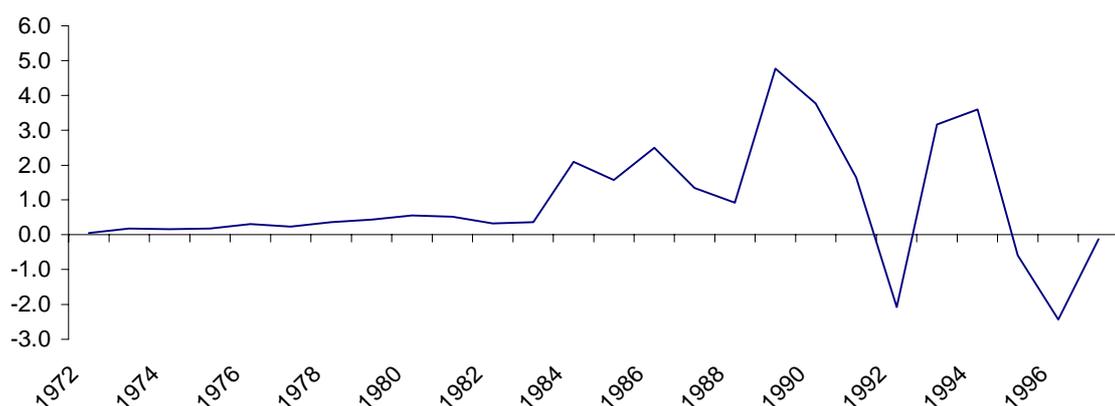


Figure 2 also shows that simply using the years 1986 and 1996 can be misleading. Given that the level of FDI flows into New Zealand in 1996 was below the average for the 1990s (as the country came off a period of very strong capital inflows and growth), this would suggest that New Zealand was not in fact below the global average for FDI flows in the mid-1990s because just taking 1996 alone gives an inaccurate picture for New Zealand.<sup>27</sup>

Another complicating factor when looking at the gross flows is the large swings in outward FDI during the past twenty years (see Figure 3). New Zealand foreign direct investment offshore has increased since capital market liberalisation. However, at times during the 1990s New Zealand has recorded negative foreign direct investment offshore, as New Zealand companies have borrowed from their offshore subsidiaries.

Figure 3: Foreign Direct Investment Outflows from NZ as a Percent of GDP



Note: Where there is a negative sign (ie negative foreign direct investment offshore), this reflects New Zealand companies borrowing from their offshore subsidiaries.

Source: IMF International Financial Statistics 1999

<sup>27</sup> Assuming that gross global flows are not subject to as much volatility as are gross flows for an individual country.

It is useful to put these flows in the context of the stock of foreign direct investment, particularly given the volatility of flows from year to year.

In many respects the level of FDI in New Zealand is not significantly different to that of other small open economies. Most countries have seen a rise of several hundred percent in the inward stock of FDI since 1980. For New Zealand, along with other small open economies including Sweden, Finland, Hong Kong, Singapore and Israel, the increase has been more than ten-fold. However, the increase in New Zealand's outward stock of FDI over the same period has been less spectacular than in many of these other small countries (which also increased at least ten times), but nevertheless has increased four-fold since 1980.

*Table 7: Stock of Inward and Outward FDI as a Percent of GDP in 1996*

	<b>Inward FDI (% of GDP)</b>	<b>Outward FDI (% of GDP)</b>	<b>Inward less Outward FDI (% of GDP)</b>
New Zealand	52	15	37
Singapore	72	40	32
Australia	30	12	18
Ireland	21	7	14
Canada	22	21	1
United States	8	10	-2
Japan	1	6	-5
Hong Kong	16	72	-56

Source: World Investment Report 1998, United Nations

As Table 7 highlights, although New Zealand is well integrated globally in terms of the proportion of foreign ownership in New Zealand, there is a certain imbalance in that New Zealand ownership of offshore assets is much smaller. This is also the case in other countries too, such as Australia and Ireland. This is also reflected in the International Investment Position (total New Zealand investment abroad amounted to \$40 billion in March 1999, whereas foreign investment in New Zealand totalled \$126 billion) and the current account, where the flow of profits and earnings to offshore investors far outweigh the returns New Zealanders receive from our overseas investments. This home-bias may reflect historical factors (there were considerable restrictions on New Zealanders investing offshore prior to the mid-1980s) and perhaps a reluctance on the part of New Zealanders to take up investment opportunities offshore.

### 5.1.3 New Zealand Trends – Overall

Table 8: Total Private Capital Flows as a Percent of GDP, 1996

	New Zealand	World
FDI	2.0%	2.2%
Portfolio and Other Investment	4.7%	12.3%
Total Capital Flows	6.7%	14.5%

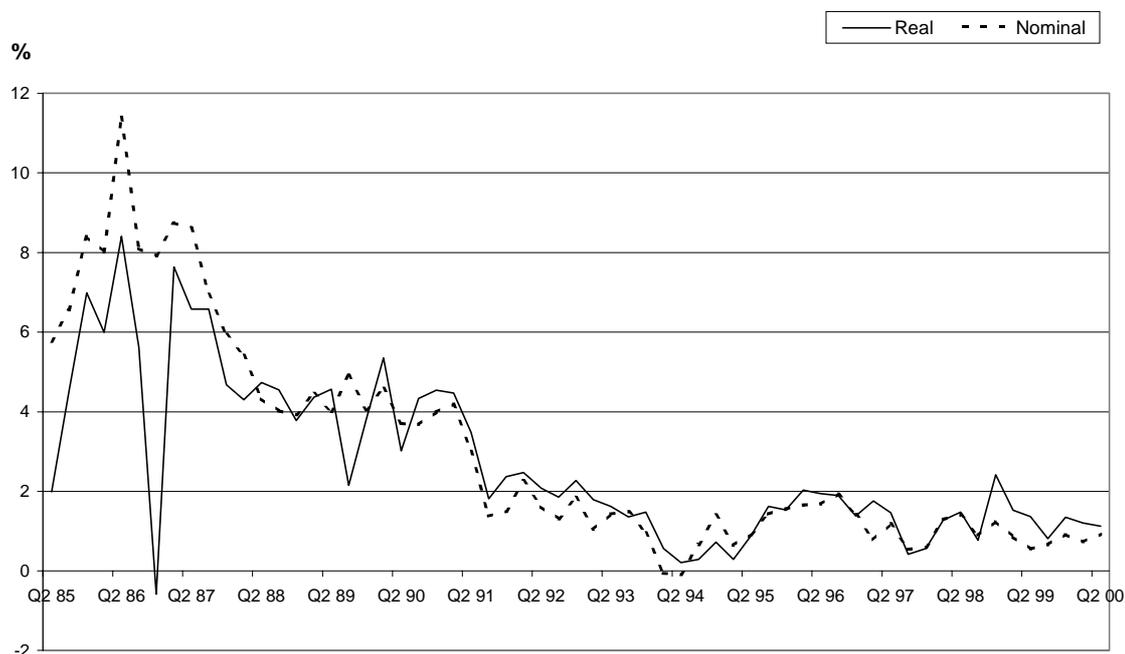
Table 8 summarises New Zealand's position in terms of capital flows. The data suggests that although New Zealand is relatively integrated in terms of foreign direct investment (as a percent of PPP GDP, gross FDI is little different to the global average), it is less so in terms of other private capital flows (portfolio and other investment). In New Zealand, other private investment inflows and outflows represented 4.7% of GDP in 1996. This compares with a global average of 12.3%, and 16.6% for high-income countries. In Ireland other private investment flows were over 60% of GDP in 1996.

## 5.2 Prices

In addition to the rise in capital flows globally, there has been considerable convergence in asset prices across countries. The differentials between onshore and offshore yields on the same instruments, denominated in the same currency, have fallen sharply over the past 15 years and are now negligible in most advanced economies. This suggests a high degree of integration.

Simply looking at the differential between 10-year interest rates in the US and New Zealand over the past 15 years shows that the premium demanded to hold New Zealand assets has fallen sharply over this time. Although this simple measure does not adjust for currency movements, it provides further evidence that the New Zealand capital market has become more highly integrated with international markets in recent time.

Figure 4: Interest Rate Premium between New Zealand and US 10 Year Bond Rates



Source: Datastream

However, there is not complete integration of international asset markets. Tests generally show that uncovered interest parity (that the return on an asset denominated in one currency is the same as the return on an asset denominated in another currency once the exchange rate movement between the two currencies is taken into account) does not hold, so that assets denominated in different currencies are imperfect substitutes.

Nevertheless, the price data on capital markets is stronger than that seen for goods markets, suggesting that capital markets are more integrated than goods markets are internationally.

### 5.3 Barriers

In industrial countries, relatively tight restrictions on capital movements began to be relaxed in the early 1970s. New Zealand was somewhat slower in following the move to dismantle capital and exchange controls, not introducing such measures until the mid-1980s. In recent years there has been a growing trend towards concluding international investment agreements, including bilateral investment treaties and double tax agreements.

Capital controls generally act as a tax on financial transactions, thereby deterring international flows of capital. Capital controls have been utilised in various countries at various points in history. While all industrial countries have free capital flows, many developing countries still maintain capital controls to limit the volatility of international capital flows. For example, until recently Chile

imposed controls on the inflow of capital to deter short-term investment, and during the Asian crisis Malaysia introduced controls to limit capital outflows.

Most countries tend to have restrictions on foreign direct investment, particularly in key industries such as communications, transport and financial services, and often over foreign ownership of land.

In New Zealand, there are prohibitions on certain types of foreign investment (fishing rights, and the “kiwi share” in Telecom and Air New Zealand), and other investments require the approval of the Overseas Investment Commission (OIC). Consent is required when an “overseas person” seeks to acquire 25% or more of New Zealand:

- business or property where the consideration of the acquisition exceeds \$50 million
- land over 5 hectares and/or worth more than \$10 million<sup>28</sup>
- land on most offshore islands
- “sensitive” land over 0.4 hectares (including land containing or next to reserves, historic areas, rivers, lakes, and on specified islands).

Consent is also required where the total expenditure to be incurred in establishing a new business exceeds \$50 million.<sup>29</sup>

It appears that these controls do not place a significant restriction on foreign investment into New Zealand. During the five years to 1998, the OIC granted 2,440 consents and refused only 13. All of the refusals were with respect to land sales to overseas interests. Since then the threshold for requiring OIC consent has been lifted, so that the regime is now even less restrictive.<sup>30</sup>

There are no restrictions limiting capital exports or the outflow of foreign investment from New Zealand (although there may be restrictions in the countries into which New Zealand’s foreign investment is flowing).

Despite there being no restrictions on capital flows, it appears that a degree of home-bias exists. Home-ownership leads to home-bias – people generally purchase a house in the country in which they live. One explanation for this is that Government policies may create distortions that act as implicit barriers. For example, differences in tax treatment on capital between countries can reduce

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<sup>28</sup> A further Act, the Overseas Investment Amendment Act 1998, which makes foreign investment in land more restrictive, was passed by the House of Representatives in March 1998. However, the Act has not been recommended to the Governor-General yet for signature and therefore has no legal effect. It is expected to come into effect in early 2001.

<sup>29</sup> All applications involving land must be approved provided the applicant meets a test that takes into account business experience, financial commitment and good character. Land applications must additionally meet a national interest test. However, the Minister does have discretionary power. See Chapman, 2000, for a more thorough discussion of the rules governing FDI in New Zealand.

<sup>30</sup> The threshold for business investment was lifted from \$10 million to \$50 million in August 1999.

capital market integration. However, even accounting for home-ownership, it may well be the case that home-bias exists because of lack of information. This information issue has been partly solved with respect to portfolio investment because of the existence of managed funds. But foreign direct investment requires considerable knowledge about the company and economy in which you are going to invest your money.

In New Zealand evidence from the current account statistics indicates that the rate of return that New Zealanders have received on their investments overseas has been lower than the rate of return that foreigners have been receiving in New Zealand. In New Zealand there are only a few large companies with significant foreign direct investment offshore, and typically they have invested in the same industry in which they operate domestically, eg Carter Holt Harvey, Fletchers, the Dairy Board – highlighting the information problems. Furthermore outward investment is currently constrained in sectors with single-desk producer boards and these sectors represent a significant share of New Zealand's international linkages.<sup>31</sup> Deregulating these industries would help remove impediments to outward investment.

Whilst the performance of FDI in recent years may simply reflect the performance of the industry invested in, eg commodities, it may partly reflect a relative inexperience of New Zealanders in investing offshore, particularly given the barriers that existed historically.

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<sup>31</sup> In the case of pipfruit there is a "non-diversification" rule in the existing regulations, which aims to constrain ENZA Ltd's activities, including offshore investments. In the dairy industry, while there is no non-diversification rule in regulations, there is considerable debate about whether the current regulatory regime is the appropriate vehicle for pursuing the Dairy Board's growth strategy (which involves the Board acquiring interests in off-shore dairy companies).

## Conclusions: Capital Market

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There has been a dramatic increase in the integration of international capital markets over the past 15 to 20 years, of which New Zealand has been a part

- Global capital flows have risen dramatically and there has been considerable convergence in asset prices across countries
- The level of FDI flows, especially into New Zealand, as a percent of GDP has jumped since capital controls were removed from 1984

On some fronts the New Zealand capital market appears well integrated with global markets

- The level of FDI flows, especially inflows, to New Zealand as a % of GDP appears to be similar to the global average and the average for high-income countries.
- The stock of FDI in New Zealand is higher than in many other countries, including Australia, Ireland, Canada and the US
- New Zealand policies do not impose any significant barrier to the inflow or outflow of capital

However, it also appears that New Zealand's capital market is not as well integrated with global markets with respect to portfolio investment. Portfolio and other investment inflows and outflows represent a much smaller share of GDP in New Zealand than the global average, and lower than countries such as Australia, Ireland, Finland and the UK.

There is also evidence of a degree of home-bias in New Zealand investments, which may indicate a certain lack of experience in investing offshore. This may be part of the explanation for low portfolio investment by New Zealanders.

## 6. Labour Market

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Labour markets, even within a country, are typically sticky as a number of factors, such as family ties, often make people reluctant to move for the purposes of work. Globally, labour markets are generally even more highly segmented due to immigration policies, language, culture and other barriers to the international movement of labour.

### 6.1 Volumes

In order to assess volumes of cross border flows in the labour market, we would ideally need to examine trends in stocks (absolute and relative proportions of persons born outside their country of residence) and flows (inflows and outflows, indicating both aggregate trends and diversification of destinations for sending and receiving countries). Stock data is a lot more accessible and reliable than flow data; in this paper we restrict ourselves to the simple indicator of comparisons of proportions of persons born outside their country of residence. Obviously there is a lot more material that could be canvassed in the area of international migration, and in particular, migration flows into and out of New Zealand.

From a long term, global perspective, it does not appear that labour markets have become more integrated in recent decades. Prior to World War One, international migration played a key role in the integration of economies on both sides of the Atlantic. Again, after the Second World War migration of workers, along with capital mobility, contributed to economic and social integration. However permanent long-term migration seems to play a much smaller role in current trends in the globalisation of the world economy.<sup>32</sup> Of course, short-term movements dwarf anything we have seen in the past.

In many advanced economies, the share of the total population who were born abroad is below 5%, and exceeds 10% in only five OECD countries (see table 9 below). In New Zealand, around 17% of the resident population in 1996 was born overseas. 18.8% of the working age population were born outside New Zealand. In Auckland, however, the rate is much higher than the national average, at 31.2% in 1996.

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<sup>32</sup> Tapinos and Delaunay

Table 9: Foreign-born Labour and Population in OECD Countries, 1995<sup>1</sup>

	Foreign-born population as % of total population	Foreign-born labour force as % of total labour force
New Zealand <sup>2</sup>	17.0	18.8 <sup>3</sup>
Australia	22.7 <sup>4</sup>	24.0
Canada <sup>4</sup>	15.6	18.5
United States	9.3 <sup>2</sup>	9.3
United Kingdom <sup>5</sup>	3.4	3.6
Japan <sup>5</sup>	1.1	0.9
Finland <sup>5</sup>	1.3	
Ireland <sup>5</sup>	2.7	3.0
Switzerland <sup>5</sup>	18.9	19.4
Austria <sup>5</sup>	9.0	10.2
Luxembourg <sup>5</sup>	33.4	56.2

<sup>1</sup> All data is 1995 unless otherwise indicated.

<sup>2</sup> 1996 data. Figure for total population is not strictly comparable as it was estimated from another source.

<sup>3</sup> This is actually the foreign-born proportion of the working-aged population, rather than the labour force. These two statistics will be equivalent, however, if the participation rate of the foreign working-aged population is the same as the participation rate of the New Zealand-born working aged population.

<sup>4</sup> 1991 data.

<sup>5</sup> Foreigners are defined by nationality of descent, rather than place of birth as in the other countries. Due to differences in definitions and data collection practices, data across countries are not fully comparable.

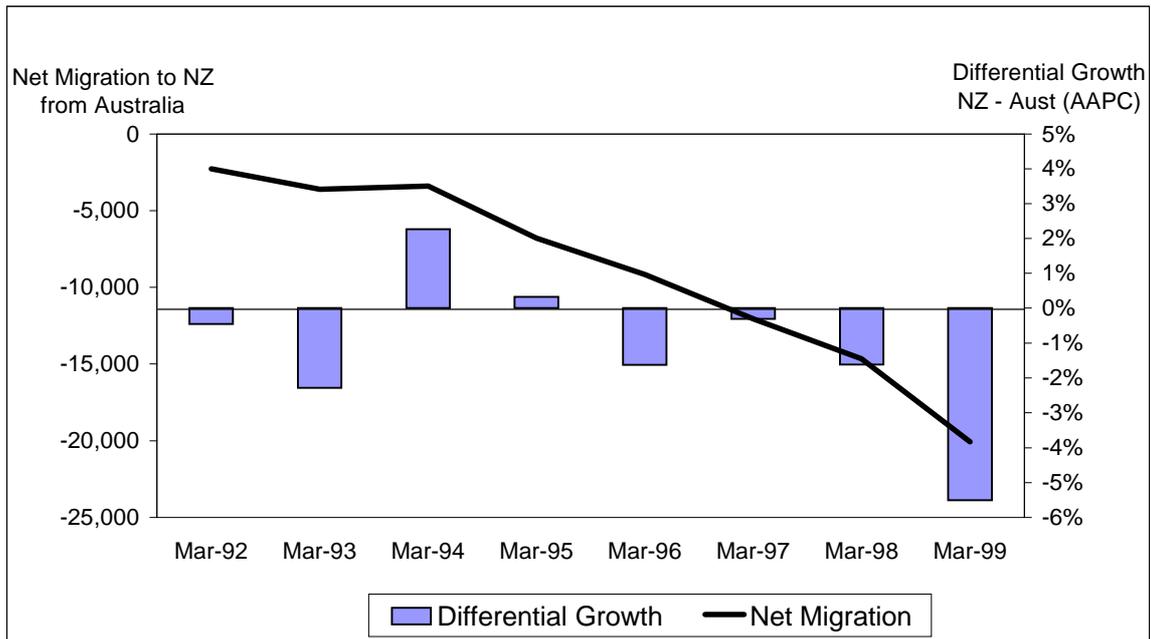
Source: World Development Indicators 1998, World Bank

There are large flows of migrants between New Zealand and Australia. In the period 1992-99, 47% of the permanent or long-term outflow of New Zealanders was headed to Australia. New Zealand-born residents make up 2% of the total Australian population.

There are two views on how to think about New Zealand-Australia migration flows. One is that the two labour markets are so integrated that flows are best thought of as, effectively, internal migration. The other is that there remain important border effects that separate the trans-Tasman labour markets. The truth is probably somewhere in between. Whichever view one takes, at a broad level migration flows between Australia and New Zealand can be explained by economic and demographic variables.<sup>33</sup> Evidence suggests that trans-Tasman migration is driven by the relative economic performance of the two economies. When the Australian economy is performing better than New Zealand, there is a larger flow of migrants to Australia, as illustrated in Figure 5.

<sup>33</sup> See, for example, Brosnan and Poot, 1987a and 1987b

Figure 5: Net PLT Migration vs Differential Growth between NZ and Australia



## 6.2 Prices

It is likely that we do not see the equalisation of wage rates even within a country, due to the rigidities within the domestic labour market. Therefore there is no reason why we should see wage rates across countries converge. This is reported in Coleman and Dalglish (1998) for New Zealand and Australia, where average wages in Australia are higher than those in New Zealand, and the difference between Australia and New Zealand is greater than differences between Australian states. Comparisons of wage rates across countries, however, really need to be undertaken at the sectoral or industry level, or the individual job level, as the average across the country could reflect a different industry mix or labour force composition between the countries.

## 6.3 Barriers

Any foreigner wishing to work in New Zealand requires a work visa to enter New Zealand. Conditions may be attached to the visa on the type and length of employment and employer. The Immigration Act requires immigrants to qualify for entry to New Zealand through a points-based system.

Exemptions from work visas are given to business visitors who intend to stay in New Zealand for less than a year and who will only negotiate or discuss business arrangements. Recently a long-term business visa has also been introduced to enable foreigners to establish businesses in New Zealand without requiring them to apply for residence.

Under the Closer Economic Relations (CER) agreement with Australia, Australian citizens and permanent residents are exempt from these requirements. Similarly, New Zealanders have visa-free status in Australia. Reflecting this,

there are large flows of migrants between the countries. As noted above, in the period 1992-99, 47% of the permanent or long-term outflow of New Zealanders was headed to Australia.

The next most important destination for departing New Zealanders is the UK (35%). This probably reflects a relative degree of openness to the UK labour market resulting from historical colonial ties. Britain provides 2-year work permits to New Zealanders aged 28 or under with relatively few conditions (compared to entry into some other countries for work).

A survey conducted by the US Census Bureau in the 1980s revealed that, when compared with the populations of other nations, New Zealanders move more often than any other nationality (NBR quoted in Lidgard, 1994).

An indicator of mobility amongst educated people is provided by the International Institute for Management Development (IMD). IMD ranks countries from 1 to 10, where 10 signals those countries least likely to experience a brain drain. On this index New Zealand had a ranking of just under 5 in terms of the likelihood of our educated people staying, indicating a moderate degree of labour mobility. In contrast, the US rates at 8, and South Africa rates at 2 - indicating a highly mobile population.

The Ministry of Education has conducted some work on whether there is a "brain drain" in New Zealand, by examining whether the proportion of highly skilled people in the outflow is greater than their proportion of the labour force. This found that relative to our resident working age population, New Zealand migrants are proportionately more highly skilled. When looking at the outflow solely to Australia, however, the skill levels of New Zealanders leaving for Australia closely correlated with those of our resident labour force. This suggests that in the trans-Tasman context, there is no brain drain. This work, however, does not examine the inflows (i.e., "brain gain") - including returning New Zealanders - which are important in examining the total impact of net migration on the skill level of the labour force.

New Zealand's admission policies are relatively easier than those of other countries, and often more transparent<sup>34</sup>. In 1991 the points system was introduced for immigrants applying for entry to New Zealand, along with an immigration target. There is still, however, provision for entry on social and humanitarian grounds. Current policy is to target immigration to increase New Zealand's human capital or capability (bearing in mind matching migrants' capability with opportunities in the labour market i.e. skill shortages), and to foster international linkages. The points system is based on qualifications and employability, work experience, settlement factors (eg family or community sponsorship and funds), investment capital that the migrant brings with them, registration requirements, and the human capital of partners. Also taken into account are English skills, good health and character.

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<sup>34</sup> New Zealand Immigration Service, 1998

## Conclusions: Labour Market

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Labour markets, both within countries and between countries, tend to be quite rigid. There are factors beyond regulation that limit movement of labour, such as family ties and language.

New Zealand's labour market is relatively more integrated globally than most other countries, although this openness is dominated by integration with Australia and the United Kingdom

- The proportion of the population in New Zealand who were born abroad is high by international standards at over 17%. In many advanced economies the ratio is below 5%.
- Australia and the UK are the two countries that departing New Zealanders are most likely to move to. This reflects the fact that there are no restrictions on trans-Tasman labour market flows and historical ties with the UK make it relatively easy for New Zealanders to get work permits there.

## 7. Conclusions

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This paper has set out to answer two questions:

- How integrated is New Zealand with international markets, as evidenced by the flow of goods, services, capital and labour, and the convergence of prices in these markets?
- How integrated are various policy settings of New Zealand with those of other countries? i.e., what policy barriers to integration exist?

New Zealand is integrated with the global economy, but the extent of our links tends to reflect our history, size and location.

Generally the degree of integration in the goods and services market in New Zealand is similar to, or greater than, that of other advanced economies. This is seen in such measures as the share of trade to GDP, the import penetration rate, and the use of tariff and non-tariff barriers.

However, we are not as well integrated as many other small countries. Typically one would expect, for example, the ratio of trade to GDP in small countries to be greater than that in larger countries. While New Zealand does appear more integrated than high-income countries on such a measure, our share of goods trade to GDP is smaller than that in a number of other small countries, including Finland and Ireland. This may be due to our remote location far from any large markets.

New Zealand started opening comparatively recently. The perception that we are 'leading the bunch' may have arisen due to the rapid liberalisation required to catch up with other advanced economies and overcome the burden of distance.

The New Zealand capital market appears to be relatively well integrated globally in terms of foreign direct investment – the ratio of FDI to GDP is similar to the global average. However, New Zealand seems less well integrated in terms of other investment flows, such as portfolio investment, as a proportion of GDP. It may be the case that other factors, such as a volatile exchange rate and a regime that historically made capital movement difficult, has contributed to this relative lack of integration.

With respect to the labour market, New Zealand is relatively more integrated than other economies. This is seen both in terms of the proportion of the population that was born offshore – large by comparison with most advanced economies (although smaller than in Australia) – and in terms of the flows between New Zealand and Australia and the UK. This reflects policy and history – in particular, open labour markets with Australia and the relative ease with which New Zealanders are able to work in the UK.

The evidence suggests that New Zealand has relatively few policy barriers limiting integration in any markets. Nevertheless, just because there are not policy barriers does not imply that greater market integration will occur than in

some other countries. This is because other barriers may exist, such as social or cultural barriers, or location. It is likely that, in the case of New Zealand, the barrier of distance has served to limit the effect that policy liberalisation may have had in other countries.

The perception that New Zealand is 'leading the bunch' internationally is, therefore, not well supported:

- We are similar to advanced economies but less integrated than small economies
- Much of our liberalisation involved catching up with the rest of the world
- It is likely that distance mutes the effect that policy openness has on market integration

## **Annex: Regional Integration**

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There are a large number of regional trading blocs globally – one estimate puts the number at 220 (Groser, 1999). Trading blocs have captured an increasing share of their members' trade. For example, in 1996 APEC countries exported 73% of their total exports to other APEC economies, up from 57% in 1970. A similar pattern is seen in NAFTA, where the share of exports has risen from 36% in 1970 to 48% in 1996 (World Development Indicators 1998, World Bank). This annex gives an indication of the key features of the regional trading blocs of which New Zealand is a part – CER and APEC – as well as those of the European Union (EU) and the North American Free Trade Agreement (NAFTA). Further work in this area could focus in more detail on comparisons between regional blocs.

CER came into force in 1983, creating a free trade area between New Zealand and Australia. Full free trade in goods was achieved in 1990. A 1988 protocol provides for free trans-Tasman trade in services apart from those specifically inscribed. Only eight of the original 21 inscriptions remain. With respect to capital markets, investors in each country are subject to the general foreign investment policies and requirements of the other country, although these are open by international standards. There has also been progress in the harmonisation and mutual recognition of standards and regulations, for example customs and quarantine issues and joint foods standards. In addition, New Zealand and Australia have no restrictions on the flow of labour between the two countries.

The APEC region is working towards the Bogor Goals of free and open trade and investment in the region by 2010 for developed economies and by 2020 for developing economies. Individual countries each year produce action plans indicating what progress they have made towards the Bogor Goals.

NAFTA came into force in 1994, providing to eliminate barriers to trade in goods and services between the US, Canada and Mexico. Groser (1999) has commented on the excessively litigious approach and strange rules of origin.

The EU has evolved and grown from the initial grouping of 6 countries establishing the European Economic Community under the Treaty of Rome (1957). This began a slow process from establishing a customs union to the formation of the European Union in 1992. On the capital market side, liberalisation has evolved to the introduction of European Monetary Union and the Euro in 1999, and the European Central Bank. There is also considerable harmonisation within the EU, for example, EC banking legislation deals with bank ownership of non-financial institutions, consolidated supervision, and accounting standards, amongst others. The EU single market for financial services is not yet complete, and a five-year action plan exists to improve the market further. There is also freedom of movement for EU citizens within the European Union. From the initial group of 6, there are now 15 member states, with negotiations underway to expand the EU further.

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