

Full steam ahead into tricky overseas waters

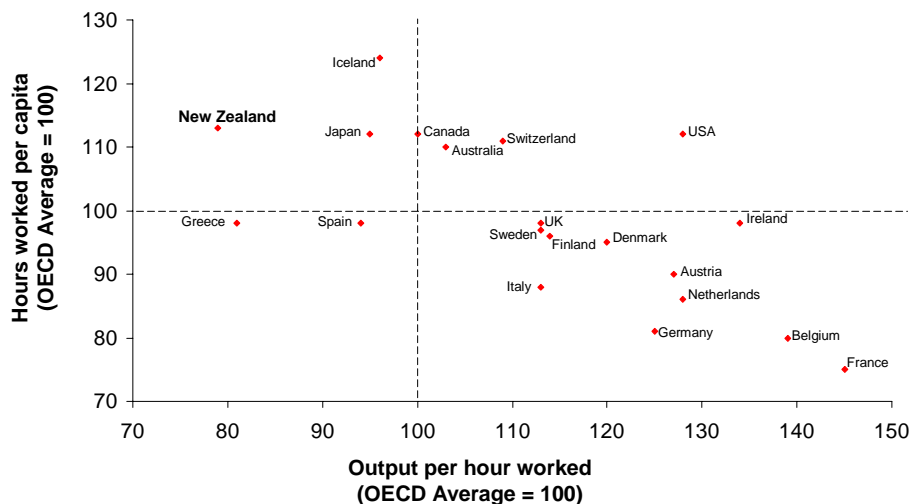
By Dr David Skilling

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The New Zealand economy has generated strong economic growth over the past 15 years, with growth rates higher than in previous decades and that compare well against countries like Australia and the US. The challenge now is to build on this and to look ahead to the sources of future economic prosperity – to move from good performance to great performance.

This is a significant challenge because, despite strong recent economic growth, New Zealand's per capita income ranks 21st out of 30 OECD countries and remains over a quarter lower than in Australia. New Zealand's per capita income is well below the OECD average because New Zealand's labour productivity – the amount of value produced for each hour worked – is just 79% of the OECD average, which more than offsets New Zealand's relatively high level of hours worked per capita.

HOURS WORKED AND LABOUR PRODUCTIVITY, 2004



Source: Groningen Growth and Development Centre and the Conference Board, Total Economy Database, August 2005

And it is not clear that New Zealand's current course and speed will deliver economic growth over the next 15 years at the level that New Zealand has generated over the past 15 years. This is because key drivers of New Zealand's recent growth are not sustainable at their current levels.

Two thirds of New Zealand's economic growth generated since 1990 has been due to growth in hours worked, as unemployment has reduced and labour force participation has risen. Only one third has been due to labour productivity growth. New Zealand's labour productivity growth rate of 1.0% over the past 15 years is in the bottom quartile of OECD countries.

Indeed, New Zealand has only maintained its relative income position in the OECD since 1990 by working more hours to almost exactly offset its declining relative labour productivity level. This is not a sustainable way to proceed. Over the next 15 years New Zealand's labour force is projected to grow at about half the rate at which it has grown over the past 15 years.

This means that the way in which growth has been generated since 1990 will not be sufficient to deliver the type of economic future that many New Zealanders aspire to, characterised by high and growing incomes and world-class opportunities. Having the lowest rate of unemployment in the OECD is cause for celebration, but New Zealand now needs to build on this achievement by raising labour productivity.

Substantially higher labour productivity growth will be required just to maintain economic growth rates at their average rate since 1990. And to move into the top half of the OECD by 2020 will require additional labour productivity growth. These are demanding goals in the context of New Zealand's historical productivity performance. But the good news is that countries like Ireland, Finland, and Australia have turned in performances at these levels over the past 15 years.

New Zealand needs to chart a course between complacency and fatalism. We cannot afford to become complacent on the back of our recent strong economic performance, because it cannot be sustained on current course and speed. Neither should we adopt the fatalist view that achieving demanding productivity goals is beyond us. Other small countries have demonstrated that it is possible to do this, and New Zealand can do likewise.

The key question, then, is what are the priorities for action to generate this improvement in labour productivity growth? Why is New Zealand's income level still so much lower than in most other OECD countries despite economic policies that, while not perfect, compare favourably to other OECD countries and are more a source of competitive advantage than disadvantage?

One obviously distinctive feature of New Zealand is its combination of a small domestic market and remoteness from other major markets. There is a well-documented link between the effective size of a market and productivity. And so there is good reason to believe that the relatively small scale of the New Zealand market has acted to persistently constrain New Zealand's labour productivity growth.

The small scale of the New Zealand economy reduces the incentive of firms to invest and means that some types of economic activity are not feasible in New Zealand. A lack of scale also reduces the intensity of competition, lessens the extent of specialisation, and means that there is less scope for productive firms to grow. This is an important reason why the policy reforms in New Zealand have not led to even greater economic gains than they have.

In this context, expanding the effective size of the New Zealand market through increased international economic activity, in terms of New Zealand firms exporting and investing abroad, becomes vitally important in achieving substantially higher productivity growth. The New Zealand domestic market is too small to generate and sustain significantly higher growth rates without a much greater proportion of New Zealand's national income coming from international activity.

Indeed, it is hard to find a high growth experience in a small developed country that has not been heavily oriented around expanding its international economic activity. The evidence linking international engagement to improved productivity at a firm and industry level, as well as at a national level, is compelling. And these benefits can be expected to be even larger in the context of a small economy like New Zealand.

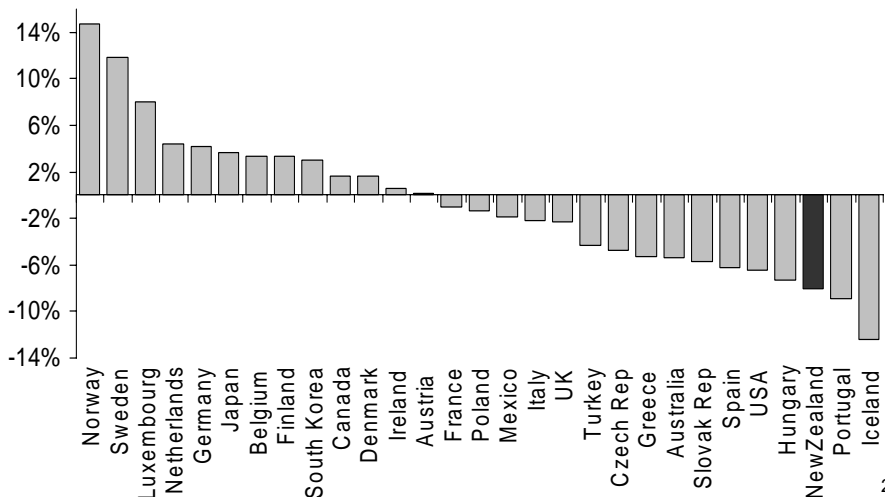
Of course, increasing New Zealand's growth is about getting many things right, including addressing issues around infrastructure, savings, tax, education and so on. But policies that increase the efficiency of the domestic economy need to be coupled with a clear focus on international engagement so that the productivity gains from domestic policy changes can be

leveraged across a much larger market. As we have seen over the past 15 years in New Zealand, policy change without an increase in international activity does not deliver the sustained productivity growth that New Zealand needs.

The key to substantially raising labour productivity, then, is to take the New Zealand economy to the world. We have spent the past 20 years increasing the efficiency of the domestic economy. But in order to move the New Zealand economy forward over the coming decades, we will need to take it to the world and work towards having many more New Zealand firms competing successfully in international markets.

Achieving this goal will require a step change in course and speed. For a small country, New Zealand is unusually reliant on domestic drivers of growth, like private consumption spending and residential real estate investment, with relatively low levels of exporting and outward foreign direct investment. This is reflected in New Zealand's current account deficit of 8% of GDP, driven by merchandise trade and investment income deficits, which is among the largest in the developed world.

CURRENT ACCOUNT AS A % OF GDP, 2005



Source: OECD Economic Outlook (forecasts); Statistics NZ (actual)

The priority now is to substantially increase the extent of New Zealand's international economic activity. Efforts are already underway in this area, but they are not sufficient. The vital importance of this issue to New Zealand's economic future, combined with New Zealand's current low level of international economic activity, means that additional action and real seriousness of purpose is required from both business and government.

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