

# Opportunities for prosperity

Labour Party Economic Seminar

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## Contents

Introduction ..... 2

A strategist’s perspective ..... 4

Problems with beliefs? ..... 5

Economic strategy ..... 7

Preferred strategy? ..... 8

Concluding remarks ..... 9

## Introduction

Good afternoon ladies and gentlemen, and thank you for the opportunity to speak with you this afternoon.

As Andrew has said, I am the Director of the New Zealand Institute.

The Institute is a non-partisan think tank and our purpose is to improve long term outcomes for New Zealand and New Zealanders. Our scope is economic prosperity, social well-being, environmental quality and environment productivity. In the short run there may be important trade-offs required but, in the long run, success in any one of these areas depends on being successful in all the others.

These days I am often introduced as an economist.

But my core skill is strategy. Strategy is about how to be successful, in business, or other areas, or how to best allocate resources to achieve a desired goal.

Strategists are interested in securing advantage, in winning, and in success.

Usually, strategists are not very interested in improvement as a goal because it is easy to improve something without making it successful.

In my previous roles I have developed strategy within many of the industries in NZ, usually working for one of the players. But for the last year or so I have been thinking about economic strategy for New Zealand as a whole.

I will begin today with some observations about New Zealand's economic position, then I will discuss some important economic issues and beliefs, and finally I will propose some policy directions that could contribute to improving economic prosperity.

## State of New Zealand economy

When you consider the economy you can look at it through different lenses. I am going to begin by giving a simple summary of our current economic position using a conventional economic lens then I will turn to how I look at it as a strategist.

New Zealand has four relative strengths as we navigate the ongoing global economic difficulties.

Our first relative strength is that exports have held up reasonably well because we export commodities, and because Australia and Asia are important markets for us.

Relatively resilient exports have combined with relatively low unemployment prior to the recession to keep unemployment from rising to the high levels seen in some other countries. That is our second relative strength.

Prior to the recession cheap money globally has driven asset price increases, especially in housing. In New Zealand, tax settings encouraged borrowing to fund residential and rural investment.

Policy settings that drove low savings rates in New Zealand contributed to high borrowing from overseas to fund the investments.

As a consequence New Zealand now has high private debt relative to other developed countries. That high private debt increases the current account deficit because the debt must be serviced.

But we do not have a huge overhang of housing stock here, as exists in some of the worst affected countries, notably the USA and Spain. That absence of stock overhang means that asset values have held up reasonably well. Asset values holding, avoidance of derivative risk losses that harmed many overseas banks, and a relatively resilient employment picture mean the banking system remains sound here. The sound banking system is our third relative strength.

Government faces a difficult balancing act today. High government spending is desirable to keep the economy going, as a stimulus and to hold employment up. But increasing government spending produces a higher fiscal deficit and increases government borrowing. Government borrowing is relatively low, which is our fourth relative strength, so increasing borrowing is possible, though the high private debt means caution is advisable.

Cutting government spending to reduce the fiscal deficit would be desirable, all other things being equal, but government needs to be careful that the economy does not falter.

The problem for us now is that other governments face the same balancing act and many of them lack the four strengths we have. Some governments are cutting spending because they cannot afford stimulus and they must contain their fiscal deficits. The US is in particularly poor shape and has limited policy options. So it is now printing money in an attempt to maintain stimulus. Printing money, or more politely 'quantitative easing', reduces the value of the currency which in turn reduces the value of debt and improves the relative cost position of local producers. The US and other currencies are therefore falling in value and the spectre of currency war has been raised. Our currency only appears to rise.

A rising currency in New Zealand reduces the competitiveness of our exporters and threatens to slow the economy. If our economy continues on the current track the economists are picking slow growth as the short term outlook. But globalisation means we do not control our own destiny. If there is further deterioration globally, or a shock, we will be affected too. Many firms have run down their financial reserves so there is limited resilience.

And currency is not the only issue. As spending is cut in other countries the natural desire to want to help local firms and maintain local employment combines with domestic political pressure to create incentives to introduce protectionist policies. Increased protectionism globally would have a similar effect on New Zealand; reduced exports and slowing the economy. If all goes well, there will not be further shocks and the economy will grow slowly.

## A strategist's perspective

I think that is all fairly standard thinking and it is important to understand all of that when you are managing an economy and trying to anticipate the future, but it is not the way I look at the economy. Here's the way I look at it as a strategist.

We cannot import the cars, tractors, computers and other goods that are not made here unless we export goods and services that people in other countries want. I cannot think of a small prosperous nation that has not built prosperity from successful trade.

If you export less than you import then you need to sell assets or borrow to fund the difference. If you borrow a lot as a country, and we have, then you need to export even more to cover debt servicing too.

So export volumes are important to balance the books. And we have agriculture, tourism and other exports to fund our imports and debt.

But export volumes that cover imports and debt are not enough to provide prosperity. Incomes depend on the productivity of export industries, and that is where New Zealand is not doing so well. Our leading export earners, which are agriculture and tourism, have relatively low productivity.

Agriculture has low productivity because our farming system has some disadvantages relative to important competitors. We must process and transport our exports and we may compete with local producers who avoid some of the costs we have, with producers in low labour cost countries, and with producers who are aided by subsidies or tariffs. Food prices are likely to continue to rise but even a doubling of agriculture export prices would not return us to the ranks of the most prosperous nations.

The productivity of tourism is constrained by competition from low labour cost countries and the many low skilled jobs in the industry.

So we need to grow high productivity exports too, and that means expanding exports of differentiated goods and services – value-added agricultural exports, information, communication and technology based businesses, and niche manufacturing.

And we are growing high productivity exports. Our largest 100 technology based exporting businesses, for example, account for around \$5 billion of exports, around 10% of the total. And there are many firms developing products and services for export. But it is not yet enough. And we have not been as successful as many other small countries.

Why not?

The World Economic Forum tells us that the income performance of the advanced economies depends on productivity and that productivity depends on innovation and business sophistication.

New Zealand has under-invested in innovation and is now trying to catch up. There has been an increase of effort but it is not enough and we are still behind. It is hard to be a leader exporting differentiated products and services if you are not a strong performer in innovation.

It is especially difficult to be a successful exporter of differentiated goods and services from New Zealand because our firms are so small when they have to internationalise. And despite the greater difficulty we do less than competing countries to help our internationalising firms.

Capital intensity is low in New Zealand. That is partly due to low savings and therefore low capital accumulation; partly to over-emphasis on residential housing investment due to the tax settings, and partly due to low return potential from investment in productive activities. So our businesses that have wanted to innovate and export have not had readily available capital, and the problem is especially acute now.

The talent development required for international business success has been neglected too. In New Zealand we are short of directors, entrepreneurs, qualified CEOs, international marketers, scientists and engineers, and development project managers. Typically, the leaders of our internationalising businesses learn on the job.

Let me pause here and connect these conclusions with economic theory. In conventional economic theory, production, or output, is determined by three things: technology or innovation, capital, and labour, which I prefer to call talent. I have just claimed that we are underperforming on all three economic drivers.

## **Problems with beliefs?**

Why are we underperforming?

In my opinion the root cause is our beliefs about what makes economies successful, and the principles that should be used for managing the economy. Here in New Zealand I think we do not have sufficiently clear and shared beliefs about what works. I am going to describe three widespread beliefs that have influenced our policies for a long time, that I think are unhelpful.

First, we have believed that if we get our institutions right and manage the macro-economy well then market forces will take care of the rest. I cannot think of another country that has pursued the prescriptions of economic liberalisation so persistently. The idea that we would tilt the playing field to favour our industries or businesses, or to encourage resources to flow towards particular parts of the economy, has been out of favour here for a long time. Policymakers in other countries do not share that view, though they will often offer the rhetoric.

And the reason for that, in my opinion, is that the branding that was used to sell the necessary reforms of the 1980s was so successful that it has become an impediment to our success now.

I have had the occasional conversation with senior officials on this topic where I have been told about the dangers of unintended consequences and inappropriate behaviours. Those risks are real but in other countries the response is to recognise those risks and learn how to manage them well while also tilting the playing field well. Here we prefer the simplicity and apparent safety of a hands-off approach.

Let me be very clear. Economic prosperity for New Zealand as for other countries depends on the competitive performance of exporting businesses. And if other countries are helping their businesses more so they can innovate and internationalise more successfully then we should expect to fall behind in prosperity.

The second belief that has been unhelpful is that competition is the only way to ensure strong performance.

Competition is a very good way to encourage strong performance but it is not always the best answer. Using competition to encourage performance in a small market can sometimes lead to fragmentation, preventing benefits from scale and specialisation. Let me illustrate what I mean with our science organisations. Almost 20 years ago the Department of Scientific and Industrial research in New Zealand was split up to form the Crown Research Institutes. The CRIs competed for research funding and that competition was meant to encourage strong performance. But the unintended consequence was that it became difficult to maintain capacity and capability if the organisation did not succeed in the latest round of funding bids, and the researchers spent quite a lot of time competing for funds instead of doing research. Successful CRIs compete well in New Zealand.

Contrast that with the approach in Switzerland, which was recently ranked the world's most innovative and competitive economy by the World Economic Forum. Research activity is grouped into virtual institutions where like activities are organisationally connected, even though they may be geographically dispersed. Funding is committed for six year periods. Performance is reviewed by a team that includes world-leading scientists and funding is increased or decreased based on the outcome of that review. The Swiss Institutes are at-scale, world-class, specialised and they perform well. They compete successfully against research institutes in other countries.

I do think competition is an important way to get strong performance. But we need to recognise the benefits of scale and specialisation too, and focus more on our performance relative to competitors in other countries.

The third belief that has harmed our economic performance is that resources should be shared out equally, or fairly.

The unintended consequences of spreading economic investments fairly are low levels of specialisation and investments that are often too small to make enough of a difference. The low level of specialisation of our universities is one illustration. Another is our effort to encourage cluster development which failed because resources were spread too thin. New Zealand's world ranking in cluster performance has fallen from 35<sup>th</sup> to 56<sup>th</sup> in ten years despite a programme that spread a small amount of effort across a large number of opportunities.

Other countries focus their efforts much more and commit substantial resources to achieve the goals they regard as important.

For example, Singapore has a strategy to increase inventiveness so it is funding 1000 PhDs at a cost of \$1 billion. Korea has a strategy to encourage green growth so it recently announced it will commit 2% of GDP, or \$85 billion to funding green business activities.

It is not yet agreed and understood what we want in New Zealand. Recently, when I have been speaking I have asked audiences if anyone knows what New Zealand's economic strategy is. No one has yet attempted an answer. To be fair, I did not even ask myself the question until recently. But it is a very important question. The leaders and managers of well managed businesses understand what their strategy is and the leaders and managers of well managed economies should too.

## **Economic strategy**

So what should be New Zealand's economic strategy? How will New Zealand achieve the goal of becoming a much more prosperous economy?

Let's consider the options. – I think there are several candidates and they are not mutually exclusive, but if we follow several strategies then we should understand how they fit together to deliver success.

We could sit tight and rely on agriculture price rises.

The world's population is growing. Developing countries are becoming richer, and increasing the proportion of protein in their diets. About 1% of agricultural land is being lost to production each year and the response to climate change will slow the clearance of forest for agriculture. Bio-fuels are competing for productive land. As a result food prices have risen by around 80% over the last decade and I expect they will continue to rise.

There are problems though with an agricultural strategy for prosperity.

There is a limited supply of suitable land and land per capita is declining.

Even doubling of our agricultural prices would not be enough to lift our average incomes to match the most prosperous nations.

And we would be exposed to concentration risk again. The UK cannot join into the EU again but what about bio-security threats, for example? Further, is it realistic to have more than 5 million city-dwellers living off the proceeds of a few tens of thousands of farmers?

We could develop our minerals, oil, aquaculture and other resources. That would be helpful provided we can identify or establish competitive resources, we can get a sufficient share of the gains, and the environmental consequences are acceptable. But minerals and oil and other resource-based businesses would only require a small workforce. How would the remainder of our workforce be engaged in productive work?

We could commit to stronger doses of economic liberalisation and let market forces lift economic performance. But we are already one of the most economically liberal countries in the world and that has not worked for us so far. Furthermore, the countries that have been the most liberalised, the Latin American ones, have been much less successful than the ones that have tilted the playing field, the Asian economies.

We could find and exploit lots of opportunities for economic improvement. Improvements are good; there are many improvement opportunities, and we should seek them wherever

they are available. But improvement does not necessarily lead to success. You can improve a poor competitive position and still have a poor competitive position.

We could do what the New Zealand Institute has argued for in our recent publication: 'A goal is not a strategy', which is do what the small prosperous nations do – grow exports of high value differentiated goods and services.

We have the pre-requisites for success. We have resources that can provide raw materials. We have sound research capabilities and we are inventive. We have access to markets. And we have enough emerging successful exporters of differentiated goods and services to know that more success is possible. Most important we know that the jobs are high value so success will lead to higher productivity.

There are many obstacles to overcome too, but nothing insurmountable.

## Preferred strategy?

I believe the best approach is a hybrid strategy. Grow high value resource exports including agriculture and minerals where that makes sense, pursue the many improvement opportunities, and aggressively grow exports of differentiated goods and services.

There are many things that can and should be done to improve New Zealand's success as an exporter of high value goods and services and the New Zealand Institute's next publication will offer specific policy directions. Important opportunities include:

- Establish world-class at-scale research institutions. Our research institutions perform well but they could do better and we suffer from fragmentation of effort. As I said before I like the Swiss approach that connects geographically dispersed researchers.
- Ensure there are sufficient talented scientists, engineers, entrepreneurs, marketers, directors and others to develop ideas, to form and grow businesses, and to sell successfully into overseas markets.
- Ensure there is sufficient capital available to give our internationalising businesses a better chance to succeed and to increase the chances that the businesses and wealth created will remain in New Zealand
- Develop and disseminate the specific knowledge that can help our internationalising businesses to succeed more often

More broadly, I have four suggestions to improve economic prosperity in New Zealand. These are all opportunities that are not very high profile but I think they all offer very worthwhile potential.

- The first is to establish a body, a council, with overall responsibility for the success of the innovation ecosystem in New Zealand. The council would connect science, education, relevant NGOs like incubators, the private sector, and Treasury so that ecosystem performance issues and opportunities could be dealt with quickly, and bottlenecks can be detected and remedied before they impede economic growth
- Second, encourage our researchers and academics to make more of a contribution to New Zealand. To illustrate the opportunity, New Zealand scores well internationally on

producing peer reviewed articles and papers but we score less well on the number of patents produced

- Third, improve the school-to-work transition. Our education system performs really well comparatively when literacy and numeracy are measured at age 15 but then we have low rates of school completion and high rates of youth unemployment
- Fourth, increase the supply of beneficial foreign direct investment into New Zealand. Our economy needs more investment capital but we are not attracting it successfully. The issue is difficult because some foreign investment is beneficial whereas other foreign investment is not, and many people have concluded incorrectly that all foreign investment is bad.

I am confident that prosperity can be increased a lot and that New Zealand can become a place people want to come to rather than leave. But it will require changing some beliefs and focussing investments and efforts where they can provide the greatest benefits.

## Concluding remarks

As a final point – all of what I have said is focused on improving economic prosperity. That is an important goal but it will not be sufficient for societal success. Global population growth to around 9 billion and a tripling of output by 2050 will create pressures on climate, water, food and other resources that will spill over to harm New Zealand in ways that we can only partially anticipate. Having a prosperous, technologically capable and resilient population will equip New Zealand to take advantage of the opportunities that will emerge and to respond to the shocks and challenges we will face.

We need to prepare for the world as it will be or might be, not as it was, or as we would like it to be. Our world will change in ways that mean that some of the success formulas from the 20<sup>th</sup> century will no longer be good guides. Leaders are thinking and should think much more about how to manage risks. We understand the benefits of globalisation and recognise the threats from protectionism and other forms of unhelpful economic competition such as “currency wars”. But we will not be the ones who determine what the important trends will be. So we need to be ready to adapt.

Thank you for the opportunity to share these ideas with you this afternoon and I wish you well with your conference.