

Essay

Playing the long game:
Strategic priorities for the
trans-Tasman economic relationship

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1. Introduction

Australia is New Zealand's most important economic relationship by a significant margin. Determining how best to approach this relationship is therefore a matter of significant importance for New Zealand decision-makers.

The past 25 years of the trans-Tasman economic relationship, since the signing of CER, have been guided by a fairly coherent vision of strengthened trans-Tasman economic integration culminating in a single economic market. This work is still ongoing, through the Single Economic Market (SEM) agenda, but for the most part this is now 'flat of the curve' work with relatively limited economic benefits seeming likely. However, there does not seem to be a guiding vision for the next 25 years of the relationship that extends beyond filling in the remaining details of the SEM agenda and managing issues as they emerge.

Although public opinion polls suggest that the trans-Tasman relationship is in good heart, and that there is public support for the current programme of economic integration, there are risks with the current policy approach. The absence of a strong, explicit strategic direction increases the risks that the relationship will not make significant progress and that both countries will look elsewhere to pursue their strategic priorities.

This essay argues that there is a need for a new strategic vision that will guide the next 25 years of the trans-Tasman relationship. However, there is a wide distribution of views within New Zealand as to what this should look like. Some argue that ongoing integration with Australia should be urgent priority and that all remaining barriers should be removed as rapidly as possible so that New Zealand firms can better access the Australian market.

Others argue that New Zealand should actively aim to protect its independence, and that it is more likely to have a prosperous future by emphasising its distinctiveness rather than through integration. The argument is that the current approach that aims to remove barriers to the free flow of resources between Australia and New Zealand is likely to lead to a hollowing out of the New Zealand economy with New Zealand becoming an increasingly peripheral part of the Australasian economy.

The claim made in this essay is that the way in which New Zealand approaches its economic relationship with Australia ought to be seen in the context of New Zealand's overall place in the world. This essay argues that significant changes in the global landscape mean that the priorities for the trans-Tasman relationship are likely to look quite different over the next few decades than they have over the previous few decades. In particular, it is argued that New Zealand's policy should shift from a primary focus on encouraging inward-looking economic integration, that is aimed at growing the bilateral economic relationship with Australia, to an outward-looking focus that has the objective of partnering with Australia in order to position New Zealand to more successfully compete in the global economy.

2. The current state of the economic relationship

The Australian and New Zealand economies are tightly integrated, with substantial flows of goods and services, investment, and people, across the Tasman. Many firms have significant operations in both Australia and New Zealand. Indeed, for many New Zealand firms, expansion into Australia is the first step beyond the domestic market.

Australia is New Zealand's top trading partner, accounting for about 20% of New Zealand's exports. And 6% of Australia's exports are sold in the New Zealand market, making New Zealand the 6th largest export market for Australia.

The trans-Tasman investment relationship is even stronger. Australia has just under \$50 billion in direct investment in New Zealand, accounting for over half of New Zealand's inward

direct investment.¹ And 60% of New Zealand's outward direct investment, some \$11 billion, is invested in Australia. When portfolio investment is incorporated, Australia has about \$80 billion invested in New Zealand. This investment plays a significant role in the New Zealand economy, and gives Australian investors a clear reason to be interested in New Zealand's economic performance.²

The high levels of trade and investment between Australia and New Zealand are an indication of the success of the trans-Tasman economic integration project. Good progress is now being made in developing a single trans-Tasman economic market, with a significant programme of work being undertaken to remove the remaining barriers to doing business between the two countries.

The Single Economic Market (SEM) project includes a range of actions to remove barriers between trans-Tasman economic interactions, to harmonise some laws and regulations, and to enhance coordination in a range of business law areas (cross-border insolvency, financial intermediaries and securities, financial reporting standards, recognition of companies, IP regulation, co-operation between competition agencies, and so on).

And recent announcements have indicated progress is likely to be made on the trans-Tasman portability of private retirement savings, an Investment Protocol to encourage trans-Tasman investment, and a new Tax Treaty. It has also been agreed that proposals for the mutual recognition of imputation and franking credits will be considered, although significant uncertainty remains as to the probability of making progress on this issue.

However, many of the issues under discussion as part of the SEM agenda are transactional in nature, and the economic gains are on the 'flat of the curve'. That is, the gains are unlikely to be of the same magnitude as those obtained previously. Many of the issues around regulatory harmonisation or mutual recognition are highly technical and only of significant interest to relatively small communities of people.

Among other things, this means that the current trans-Tasman agenda does not capture the public imagination (or, by extension, the imagination of politicians). This makes it more difficult to assemble and sustain a constituency that will support ongoing efforts at strengthening the relationship with Australia.

Opinion poll work undertaken in 2007 indicated the existence of strong support for the trans-Tasman relationship, and for the current level of economic integration, as summarised in Figures 1 and 2.³ 70% of New Zealanders and 71% of Australians have a positive or very positive view of the other country. And 83% of New Zealanders and 74% of Australians think that the level of economic integration is either about right or that it should go further.

Figure 1: Public attitudes with respect to Australia and New Zealand

Figure 2: Public attitudes with respect to the extent of trans-Tasman economic integration

However, as the trans-Tasman relationship has become a more technical, detailed project, the level of public engagement has reduced. Evidence of this can be seen in the apparent demise of the therapeutics legislation in the New Zealand parliament, as well as the lack of serious, sustained attention paid to New Zealand by Australian leaders (for example, New Zealand was not mentioned during the recent Australia 2020 summit). Of course, part of the reason for this is that the trans-Tasman relationship is going well and is relatively problem free, which makes it less necessary for people to pay it significant attention.

¹ Direct investment is defined as a stake of greater than 25% in the target company. Stakes of less than 25% are classified as portfolio investment.

² The New Zealand Institute, 'The state of the trans-Tasman economic relationship', June 2008.

³ Public opinion poll conducted by UMR in Australia and New Zealand, April 2007, commissioned by the Lowy Institute for International Policy and the New Zealand Institute.

The strategic decision for New Zealand to make is whether to maintain the trans-Tasman relationship on current course and speed, responding to issues and opportunities as they emerge, or whether to inject greater ambition into the relationship.

However, there is a wide distribution of views within New Zealand as to which strategic approach to pursue. Indeed, some argue that there is no need for a new guiding vision and that the SEM agenda provides sufficient direction for the relationship. The priority is to make as much progress as is possible on the programme of economic integration. In this argument, issues such as a common border, the mutual recognition of imputation credits, and a common currency should be on the agenda. The goal would be for a completely unified trans-Tasman economic market on the basis of a view that this will generate material economic benefit for New Zealand.

Others argue for a greater emphasis on New Zealand's independence, claiming that New Zealand is competing with Australia in large measure rather than being primarily engaged in a cooperative relationship. In this view, New Zealand should chart its own course and compete independently in the global economy. The argument is that integrating further with Australia will lead to increases in size of the bilateral deficits, particularly the significant investment deficit. Over the past two decades, Australia has become a substantial owner of the New Zealand economy with New Zealand becoming a branch office economy. It is claimed that New Zealand should not expect much upside from integrating with Australia, and that it should seek to develop other relationships.

And, of course, there are many more points of view that lie between these two positions. The view advanced in this essay is that New Zealand should continue to engage and integrate with Australia, but do so in the context of a clear view as to what New Zealand is trying to achieve. There is a need to do a better job of publicly articulating what the strategic future of the trans-Tasman relationship can and should be.

Determining how New Zealand ought to proceed with respect to the trans-Tasman relationship should be seen in the context of the broader strategic environment that New Zealand faces. In particular, the way in which New Zealand engages with Australia should be part of an overall view as to how New Zealand should position itself to compete in the global economy. This suggests that changes in this external environment should have an impact on New Zealand's strategic approach to Australia – as indeed has been the case over the past century and more.

3. A Dynamic Relationship

This discussion notes that New Zealand has changed the way in which it has approached its relationship with Australia several times over the past century or so, in response to changes in the strategic environment in which it operates. Indeed, over the past 150 years or so, the trans-Tasman relationship has moved through several distinct phases. The following section then describes some of the external challenges and opportunities that are likely to confront New Zealand over the next few decades, to provide some guidance as to the nature of the next generation of trans-Tasman policy.

In the early days of New Zealand's European settlement, and through much of the 19th century, there was a tight economic relationship between Australia and New Zealand. The strong trade and investment relationship between the two countries was unsurprising. Australia was the only other country of size and development that was physically close to New Zealand. In 1865, about 70% of New Zealand's exports went to Australia. These exports were mainly agricultural or timber products, with Australia exporting manufactures to New Zealand.⁴ James Belich notes that Australasia was seen as effectively one economic unit through much of the 19th century.

⁴ An Encyclopedia of New Zealand, 1966.

In 1901, New Zealand was offered a chance to join the Australian confederation as one of the founding states. New Zealand turned down the opportunity to join, for a variety of economic and political reasons. In terms of the economic reasons, there were some short-term indications that New Zealand was better off striking out on its own. During the 1890s, when confederation was being discussed, there was a severe drought in Australia, combined with falling wheat prices, and strikes. And as Figure 3 notes, New Zealand's real per capita income was rising and overtook that of Australia in the mid-1890s.

Figure 3: per capita incomes, 1870-1910

There were also some reasons to believe that New Zealand's longer-term economic prospects were better than those of Australia. The introduction of refrigerated shipping in 1882 was a transformational event in New Zealand's economic history, allowing New Zealand to develop significant new strength in its economy by accessing the UK market. The combination of new transport technology and a large, secure market was profound. New Zealand's exports to Australia declined markedly after the introduction of refrigerated shipping, with exports being sent to the UK market. New Zealand began to look North rather than West.

Over the next several decades, New Zealand's economic development proceeded largely independently of Australia as New Zealand built a 'protein bridge' to the UK on the back of refrigerated shipping. The UK provided a market that absorbed the majority of New Zealand's exports. James Belich refers to this time as a period of recolonisation with the UK.⁵ A deliberate political and economic decision was taken to integrate New Zealand with the UK.

Figure 4 shows that the UK took about 80% of New Zealand's exports of goods in 1920, with only about 5% going to Australia. Indeed, by 1952 only 1.6% of New Zealand's exports were sent to Australia. As Tim Groser has noted, "New Zealand and Australia did not interact with each other directly across the Tasman, but only indirectly through a giant mirror placed in Britain".

Figure 4: New Zealand's exports by destination.

But changes in the international economic and political environment meant that this arrangement could not be sustained. In the period that followed the Second World War, the colonial system came under increasing pressure and the UK became increasingly engaged with Europe. The preferential access that New Zealand had enjoyed to the UK market was significantly reduced. And New Zealand was unable to obtain the same level of preferential access into the European market.

This created a need for New Zealand to develop new markets into which to sell its (largely) primary sector output. New Zealand couldn't rely on the same, fairly secure, international environment in which the UK was effectively underwriting the New Zealand economy. There was also increasingly a recognition that the UK was not the only game in town, as other markets, such as the US, became much more significant.

These changes coincided with Australian incomes catching up to New Zealand. For the 60-70 years after federation, New Zealand's per capita incomes had exceeded those of Australia on a fairly consistent basis. But New Zealand's 70 year bet that independence from Australia was the correct strategic choice looked like it was beginning to turn negative. Australian real per capita incomes overtook those of New Zealand in the late 1960s. And this trend has continued. Australia's per capita income level is now about 30% higher than in New Zealand.

Figure 5: Australian and New Zealand per capita incomes 1870-2006

These factors combined to generate a much greater focus on developing New Zealand's economic relationship with Australia. There was increasingly a view that Australia needed to

⁵ James Belich, Paradise Reforged: A History of the New Zealanders from the 1880s to the Year 2000, 2002.

become more of a strategic economic priority for New Zealand. One manifestation of this was the signing of the New Zealand Australia FTA in 1965.

New Zealand's economic relationship with Australia grew rapidly over the 1970s as New Zealand rapidly diversified away from the UK market. Australia was not the only high growth trade relationship over this period. New Zealand found other markets in Asia, the Middle East, and elsewhere. The structural shift away the UK and European markets commenced in the 1960s and continued through the 1970s.

One of the landmarks in the development of the trans-Tasman economic relationship was the negotiation and signing of the CER agreement in 1983, which was – and remains – one of the highest quality bilateral trade agreements in the world. The aim of this agreement was to foster stronger trade and investment links between the two countries. Particularly from a New Zealand perspective, this was motivated by a desire to grow strong external economic relationships – and foreshadowed the broader opening up of the New Zealand economy that was to come through the 1980s. A single economic market with Australia offered the prospect to New Zealand firms of accessing an additional 20 million person market on better terms.

As noted above, economic integration with Australia is now being pursued through the Single Economic Market (SEM) process, which aims to remove all barriers between trans-Tasman commerce and allow for the free flow of resources.

Australia is now New Zealand's most important economic relationship, ranking first in terms of trade and investment flows. It is a much bigger, and more prosperous, economy, and looms large from a New Zealand perspective. This is a significant change from the situation that prevailed in 1960.

This historical discussion demonstrates that changes in the international political and economic landscape, such as the entry of the UK into the European Community, have had a direct influence on New Zealand's approach to the trans-Tasman economic relationship. The record of the past century shows that New Zealand's economic relationship with Australia has never proceeded in isolation of broader international developments but has changed in response to a changing strategic environment. Figure 6 provides a stylised description of these developments.

Figure 6: The trans-Tasman relationship over time

The implication of this analysis for the contemporary trans-Tasman policy debate is that New Zealand should approach the trans-Tasman relationship within the context of the broader global environment. Serious consideration needs to be given to changes in the international strategic environment, so that New Zealand can make timely strategic decisions and adjust its policy with respect to Australia as appropriate.

So what is the nature of the international environment that New Zealand faces and how is this changing over time? The next section describes a few trends that will impact on the global economy over the next few decades and assesses New Zealand's current approach to trans-Tasman policy in this regard. Section 5 then describes some possible features of a policy approach to Australia that incorporates the changed global economy, and provides guidance as to the priorities for action for New Zealand.

4. The emerging strategic context

The following discussion describes three trends that will have potentially significant effects on New Zealand's ability to compete successfully in the global economy over the next few decades. The first is the significant increase in international factor mobility that is part of the intense process of globalisation, and the pronounced tendency for labour and capital to concentrate together. The second is the increasing regional emphasis in international economic activity, both in terms of the pattern of transactions as well as the various arrangements that surround this activity. And third, the opportunities and challenges

generated by the economic return of Asia. Although these are not the only trends at work, it is clear that these developments will have a major effect on New Zealand.

Globalisation and agglomeration

Over the past few decades, there has been very substantial growth in the scale of cross-border flows of goods and services, as well as firms, capital and people. Firms, capital, and people are much more mobile across borders, and can increasingly choose their location to earn higher returns. This increased international mobility is due to changes in technology and business models as well as a more intense competition for global talent.

These flows of people, capital, and firms are not evenly distributed. Some locations are much more likely than others to be the destination for these factor flows, because they offer superior returns and opportunities. There is a powerful dynamic for factors of production to concentrate in large cities and regions, because this is where higher returns can be earned (due to higher levels of productivity). This can become a self-reinforcing process.

As Tony Venables, one of the world's leading economic geographers, notes, "proximity is good for productivity; dense configurations of economic activity work better than sparse or fragmented ones. Mobile factors – firms and possibly workers – will locate in order to take advantage of higher productivity, and this creates a positive feedback. Firms and workers go where productivity is high, and by so doing tend to further raise productivity, creating an uneven distribution of activity and spatial income disparities".⁶

Companies prefer to concentrate their activities where they can access specialised inputs, be it staff, professional advisors, or inputs into the productive process, as well as efficient access to output markets. This will generally be in large areas of existing concentrations of economic activity. To some extent the ICT revolution and the decline in transport costs have reinforced this agglomeration process. The higher returns companies make in these locations mean that they can offer higher wages, attracting labour from other locations. Areas like Silicon Valley and the City in London are not disappearing because of the heightened importance of tacit, localised knowledge, which cannot easily be communicated electronically.

This means that, as Michael Porter has recently noted, "The more that things are mobile, the more decisive location becomes". The world is not so much flat, as Tom Friedman has claimed, as it is lumpy.

New Zealand is not the only country contending with international factor mobility and agglomeration, but it is particularly exposed to these forces by virtue of its small size and physical remoteness. Indeed, New Zealand is probably the developed country in which these trends are most obvious.

This is not one-way traffic, and obviously some people and companies do choose to move to New Zealand. But there is a strong tendency relationship towards agglomeration, which is evident in the large number of New Zealanders now living abroad and the tendency for firms to exit New Zealand. According to the OECD, New Zealand has the highest proportion of its skilled population living offshore of any OECD country. An average of about 70,000 New Zealanders a year have left New Zealand on a permanent or long-term basis over the past decade, about half of them to Australia.

These global dynamics also explain some of the observed outcomes in the trans-Tasman economic relationship, such as significant deficits in terms of investment and people flows.⁷ There has been a substantial increase in Australian ownership of the New Zealand economy with little reverse traffic. This dynamic has occurred within the domestic Australian economy as it has become a more integrated economy, and it is not surprising that this has occurred in a

⁶ Anthony J. Venables, 'Shifts in economic geography and their causes', paper presented at the 2006 Jackson Hole Symposium.

⁷ 'Competing & Cooperating', New Zealand Institute essay, March 2007.

trans-Tasman context as New Zealand has effectively become part of the Australasian economy.

This degree of international factor mobility did not exist when the latest phase of trans-Tasman economic integration was commenced about 25 years ago. The major type of international economic interaction was trade flows, with the locations of people, capital, and firms being relatively fixed. This is not an argument that New Zealand was wrong to seek to integrate with the Australian economy, but it does suggest that New Zealand needs to approach the trans-Tasman relationship from a broader perspective than simply reducing barriers.

In particular, the challenge for New Zealand is to develop a relationship with Australia that enables it to 'bulk up' such that New Zealand can better attract people, companies, and capital that could choose to locate elsewhere.

The rise of regionalism

The globalisation of economic activity has been an important story over the past couple of decades, with massive increases in cross border trade and investment flows, the fragmentation of production chains, and so on. But there is also a distinct regional or local dimension to economic activity.

It is interesting to note that the average distance of trade has been steadily reducing over time, with much of the growth in international trade flows being with nearby countries. Similarly, the relationship between physical distance and the level of international trade and investment flows has increased over the past few decades. This evidence is not consistent with a story about the declining importance of physical location.

Intra-regional trade and investment has been growing at a much more rapid rate than has global growth. For example, in 2005, the WTO estimates that 73% of European trade was intra-European, 55% within North America, and 51% in Asia. These intra-regional trade flows have been growing strongly, and have been an important driver of global trade growth.

There are several reasons for this. The growth of fragmented production chains is a key reason, particularly in Asia, in which different stages of the production process are located separately (and frequently in different countries). Another reason for the local emphasis is that to an increasing extent, successfully accessing markets requires deep understanding of the markets. This means that simply reducing barriers at the border, such as tariffs, is only part of the answer in terms of assisting firms to expand into global markets. Information flows are often local, making it easier to understand markets that are closer to home.

The rapid growth in regional economic activity is reflected in a large increase in regional trade agreements and other regional arrangements and institutions. Globally, there are now about 200 officially notified regional agreements with another 100 or so currently in negotiation. In Asia alone, it is estimated that there are over 90 separate agreements (the so-called 'noodle bowl').⁸ Most developed countries are now part of a larger regional grouping. The European and American groupings are the more established, with the Asian groupings less so. New Zealand is one of only a handful of small, developed countries that remain outside of these major established groupings.

In contrast, there are some risks around the multilateral process. For example, it looks unlikely that there will be a meaningful outcome from the current Doha Round of the WTO. And even if there is, it is not clear that there is meaningful political support for future Rounds. Governments appear less willing to expend political capital on multilateral liberalisation. Sentiment in the US, for example, appears to be shifting from selective support of free trade to a more protectionist stance.

⁸ Richard E. Baldwin, 'Multilateralising regionalism: Spaghetti bowls as building blocs on the path to global free trade', *NBER Working Paper 12545*, September 2006.

It is possible that these various regional groupings will formalise, with preferential trade and investment access for countries on the inside. In this scenario, regional institutions will become a more significant driver relative to multilateral institutions. This creates an exposure to a significant risk that New Zealand is locked out of these arrangements and that firms located in New Zealand are therefore disadvantaged in accessing these markets.

Participation in these regional groupings is particularly important for small countries. The progress in liberalising world commerce has enabled small countries to access much larger global markets, and therefore enabled them to be economically successful even without a large domestic market. Indeed, economists have noted that the open international trading environment is a significant explanatory factor for the growth in the number of countries over the past several decades.⁹ But increasingly it is the regional arrangements, such as the European Union, which deliver this protection for small countries.

By virtue of history and geography, New Zealand is not hardwired into these emerging regional arrangements. New Zealand is not physically part of the Asian or European regions. Increasingly, being on the outside of these agreements will be a source of competitive disadvantage. New Zealand is unusual in not being part of a major grouping, and is therefore particularly exposed to the risk of multilateral institutions decaying.

Historically, the core element of New Zealand's external strategy has been investing in the multilateral approach, particularly through the WTO. New Zealand has long argued that priority should be placed on multilateral institutions, such as the WTO and the UN, because small countries have little negotiating power or influence in bilateral situations.

New Zealand has relatively few other agreements, until recently. However, New Zealand has signed several FTAs over the past several years, with countries like China, Singapore, and Chile, and is actively discussing FTAs with several other countries. This changed emphasis is due to a recognition of the need to diversify New Zealand's approach away from multilateral approaches. It also recognises a need to manage the downside risk that is becoming increasingly evident with countries, including Australia, signing FTAs with countries that New Zealand has not secured agreements with.

There is a need for New Zealand to develop partnerships and alliances that enable New Zealand to engage externally to a greater extent. Overall, it may become a more difficult competitive environment for small countries that are outside these regional groupings. Small countries need to be able to find partners and alliances, and cannot simply rely on an open multilateral system.

And beyond trade agreements, the projection and advancement of New Zealand's national interests will also require the development of partnerships. For example, international partnerships around issues such as climate change, research and so on. These partnerships are often regional in nature, rather than global or multilateral.

The economic return of Asia

The economic rise of Asia has been a notable feature of the global economy over the past few decades, with the rise of the East Asian tigers followed by rapid growth in China and India. China's contribution to global GDP growth has exceeded that of the US for the first time this year, and that trend is likely to continue.

The world's centre of economic gravity is shifting very rapidly towards Asia. As Figure 7 shows, the well-documented economic rise of Asia should be seen as the economic return of Asia. Until the start of the 19th century, Asia was the dominant economic region, accounting for over 60% of global GDP. This was about the same as the population share of Asia, indicating that it was punching its weight in an approximate sense.

Figure 7: Global GDP shares, 1500-2000

⁹ Alberto Alesina and Enrico Spolaore, *The Size of Nations*, The MIT Press, 2003.

For a variety of reasons, the 150 years that followed saw the relative economic decline of Asia and the relative rise of Western Europe and North America. What has happened over the past few decades is the commencement of a process in which the Asian economies will become a much more significant part of the global economy. Economies like Japan and South Korea are already substantial economic forces. And other Asian economies, such as Vietnam with an 80 million person population, are growing quickly.

Goldman Sachs estimate that by 2050 the size of the Chinese economy will be \$75 trillion compared to about \$40 trillion for the US. The Indian economy is also projected to have a GDP of \$40 trillion by 2050.¹⁰

Asia is becoming a much more significant driver of economic activity, and should therefore be an important strategic priority for New Zealand. This means that investing in relationship building in the region is vital, including through diplomatic and commercial (NZTE) representation in Asia. The recent signing of the FTA with China and opening of discussions with countries like India and South Korea are clearly steps in the right direction, but much more is needed to grow the economic relationship in a substantial way. Indeed, New Zealand's current level of economic engagement with Asia is relatively low.

From a materiality perspective, New Zealand's economic engagement with Asia will be a much more significant driver of New Zealand's economic performance than New Zealand's direct economic engagement with Australia. Priorities for action include developing a much deeper understanding of the Asian market, together with integrating into the emerging regional architecture.

Implications for trans-Tasman policy

These developments create significant challenges and opportunities for New Zealand as a small, remote, and independent, developed country. New Zealand is very exposed to international factor mobility, and it is also exposed to the apparent risks to the multilateral system and the emergence of a stronger regional feel to the international environment. New Zealand needs to ensure that it is well positioned to be part of the emerging regional architecture, particularly in Asia.

Most small, developed countries – such as those in Europe – have been able to benefit from proximate and prosperous markets. And the increasing ability for these countries to access global markets as tariff barriers came down over the past several decades has meant that small countries could be economically viable. However, this may become more challenging over the coming decades to the extent that the multilateral trading system comes under pressure.

Regional and bilateral alliances and networks will become increasingly important in this environment. New Zealand will need to invest further in developing these relationships in order to enable it to project a larger economic presence. This is important because increasingly the economic scale of countries matters for their economic success. Small countries need to be able to access large markets, access inputs such as skilled people, and develop relationship with other countries to better enable them to protect and project their interests.

This analysis clearly has direct implications for New Zealand policy with respect to Australia. In particular, it suggests that the current emphasis on inwardly-looking integration – growing the bilateral economic relationship – needs to be updated. This is not to say that New Zealand's current approach is wrong, but that it is increasingly insufficient. A new focus is required to enable New Zealand to effectively compete in the global economy.

¹⁰ Goldman Sachs, 'The N-11: More Than An Acronym', Global Economics Paper 153, March 2007.

Managing New Zealand's exposure to international factor mobility and agglomeration means that economic integration is no longer simply about achieving easier access for New Zealand firms to the Australian market. There is a need to project a larger economic presence to the world, as well as to participate more effectively in the emerging regional architecture in Asia. Specifically, New Zealand should approach the trans-Tasman relationship in this broader strategic context. That is, New Zealand should seek to supplement the current inward-looking focus with an outward-looking dimension.

It is too limiting to frame the strategic choices that New Zealand has with respect to the trans-Tasman relationship in terms of whether to slow down or speed up the current programme of economic integration under the Single Economic Market agenda. New Zealand needs to deliberately add an outwardly-facing dimension to the trans-Tasman relationship that is intended to better position New Zealand to compete in the global economy.

In any case, the current policy focus is unlikely to deliver significant additional amounts of economic upside. Most of the major obstacles to doing business across the Tasman have already been removed. The items that are currently on the agenda seem unlikely to unleash a torrent of trans-Tasman economic activity. Many of these initiatives are worthwhile but very much have the feeling of diminishing marginal returns in terms of growing the relationship.

And there is a limit to the economic returns from growing the trans-Tasman relationship given the relatively small size of the Australian economy (in a global context). A broader perspective is required to the relationship in order to generate the type of economic growth that New Zealand needs to begin to close the income gap with other countries.

An ongoing focus on inward-looking economic integration may also create increased risk for the New Zealand economy. In particular, there is a tendency for areas like New Zealand to become increasingly peripheral within the Australasian economy, as has been happening within the domestic Australian economy (e.g. Adelaide and Hobart).

There are some common elements in the inward and outward facing approaches, but there are also important differences. Consider, for example, the motivation for adopting a common currency. Using the inward-looking focus, the arguments would focus on adopting the Australian dollar so as to expand New Zealand's trade and investment links with Australia. An externally-focused approach to economic integration would emphasise concerns about the viability of small currencies, such as the NZD, given the potential for significant volatility and the risk premium associated with small, floating currencies. These are quite distinct arguments and may generate quite different policy recommendations.

There is widespread public support for the idea of Australia and New Zealand as partners, which is consistent with a focus on outward-looking integration. Figure 8 notes that 62% of New Zealanders and 85% of Australians regard the other country as a partner rather than as a competitor. This provides a solid foundation of support for an approach of outward-looking integration.

Figure 8: Australia and New Zealand as partners and competitors

5. An outward-looking trans-Tasman policy

This section outlines some ideas for next generation of economic policy with respect to Australia. Three classes of action are identified as priorities in this regard, and are discussed below. These should not be read as a comprehensive list, but rather as an indication of the type of issues that should be on the table for discussion. The aim is to stimulate a discussion as to where the two countries may be able to work together.

The obvious challenge is to identify issues where Australia and New Zealand have shared interests, and where both countries can add value to each other. It is easier to see where Australia can provide value to New Zealand than where New Zealand can add value to Australia. But for progress in the relationship to be sustainable, both countries need to be

contributing value. Intellectual energy should be invested in identifying possible areas of collaboration.

Clearly there will be areas in which a joint approach is not possible, and where national interests diverge. As is currently the case, the trans-Tasman relationship will be characterised by both cooperation and competition.

Projecting a larger external presence

As a small country, New Zealand needs to identify ways in which it can access larger markets, as well as ways in which it can protect and project its interests more generally. Proceeding in an independent manner is not likely to be sufficient to enable a small country to advance and protect its interests. Rather, the challenge for New Zealand is to develop the relationships through which it can advance its interests. In this regard, New Zealand should consider how best to partner with Australia to project a larger regional and global presence.

On a number of international issues, Australia and New Zealand have shared views and shared interests, and together may be able to exert a more substantial influence. For example, a joint approach to global climate change negotiations. The Australian and New Zealand positions are now well aligned and both countries are establishing emissions trading schemes. The upside is for New Zealand to be able to exert more influence on shaping the international environment than it could on a stand-alone basis.

In addition, there are opportunities for Australia and New Zealand to jointly develop standards and regulations. Having joint bodies may allow New Zealand to economise on the fixed costs of adopting these standards. The proposed therapeutic regime is a good example of this type of initiative. The benefit to New Zealand is not restricted to selling more to Australia but making it more likely that the standards used in New Zealand become regional standards.

In terms of international trade negotiations, there is probably limited scope for partnering with Australia on specific FTA deals because of differences in national interests; in general, trade policy is likely to be an area of competition rather than cooperation. But there are additional ways in which partnership may be appropriate, such as in terms of the WTO negotiations. But New Zealand and Australia may be able to offer some creative leadership in terms of high quality and comprehensive regional free trade agreements. This may be offering leadership around issues like the proposed Free Trade Area of the Asia Pacific (FTAAP), using CER or the P4 arrangements as a base.

The Asian economies are where New Zealand's economic future lies. But New Zealand, and to some extent Australia, are not yet central to the emerging regional architecture (although New Zealand is in the ASEAN + 3 grouping, and has signed FTAs with China and other Asian countries). Although considerable uncertainty remains as to what these arrangements will look like, both Australia and New Zealand want to be on the inside rather than the outside of whatever architecture emerges.¹¹

Partnering to achieve scale

A key reason for developing external partnerships with countries, including Australia, is that this allows New Zealand to achieve scale, by accessing resources that may not be available to New Zealand acting on its own. A relatively recent example of such trans-Tasman collaboration is the joint investment in the synchrotron, located in Victoria. This enables New Zealand researchers to access a piece of research infrastructure that New Zealand institutions would likely not have been able to afford by themselves.

Going forward, serious thought should be given to the ways in which Australia and New Zealand can partner to achieve scale. An example of this may be in the area of agricultural research that focuses on reducing methane emissions from ruminant animals. This is an issue

¹¹ Allan Gyngell, David Skilling, and Mark Thirlwell, 'Australia and New Zealand in a globalising world', Lowy Institute for International Policy/New Zealand Institute paper, May 2007.

to which both New Zealand and, to a lesser extent, Australia have a potentially significant economic exposure. New Zealand has significant research capacity and expertise in this area. However, it may be easier for New Zealand to scale up these investments in the context of partnering with Australia.

This would enable New Zealand and Australia to develop knowledge and technologies that could assist to reduce domestic emissions of greenhouse gases. In addition, it may assist to develop new ideas that have commercial value and thereby contribute to the growth of New Zealand firms into global markets.

Another potential area for collaboration is between New Zealand and Australian external commercial resources that assist firms to expand into international markets. Agencies like NZTE and Austrade may be able to join forces so that Australia and New Zealand firms have better access to in-market support. This would most likely be in the context of physical infrastructure rather than the advisory, financial, or network functions of these agencies. For example, jointly providing shared office space or access to warehousing facilities. Australian and New Zealand firms would have some equal access arrangements to behind the border resources.

This would enable the two agencies to extend their geographic coverage in a more rapid and cost effective way. For example, opening a physical presence in second-tier Chinese cities. NZTE has offices in several Chinese cities, with plans to open an additional five offices in other Chinese cities over the next several years, and Austrade also has a physical presence in China.

And there are likely to be other public organisations and institutions where New Zealand and Australia can benefit from scale economies by cooperating.

Financial markets

Australia and New Zealand have well integrated financial markets and there is a free flow of capital between the two countries. There has been a long debate as to the best way in which to regulate and supervise the banking sector, given that this sector is almost completely owned by Australian banks.

There has also been discussion about the possible merger of the NZX and the ASX. The argument for this is to allow New Zealand firms to have access to a more liquid set of capital markets. However, the NZX has been rejuvenated and is an asset for the New Zealand economy, providing an accessible platform for New Zealand firms to access growth capital.

However, another issue that should be on the table for discussion is the potential for New Zealand to adopt the Australian dollar (I do not consider a new, joint currency because that seems to be politically infeasible).

As shown in Figure 9, the NZD is subject to significant fluctuations over time. The last exchange rate cycle ran from 2001 when the NZD was trading at 39USc to 2008 when it peaked at over 82USc. This introduces significant uncertainty into the New Zealand economy, and makes it much more difficult for New Zealand firms to expand into international markets.

Figure 9: NZD/USD and NZD/AUD, 1986-2007

The NZD is one of the most heavily traded currencies in the world; on some measures, ranking in the top 10 in terms of trading volumes. This is clearly greatly in excess of the trading volumes that would be suggested by New Zealand's economic size. Part of the reason for this is the 'carry trade', in which investors and speculators purchase NZD to benefit from New Zealand's high interest rates.

Indeed, a floating currency can be as much a source of shocks as it is a buffer – particularly for small countries – with regular departures of the exchange rate than that expected on the basis

of the fundamentals.¹² If that is the case, or even if it is neutral, it is not obvious that an independent monetary policy is worth the cost of the risk premium that is associated with small, floating currencies. The Bank of International Settlements recently noted that the “recurrent difficulties” in terms of significant inflows of capital pushing up exchange rates, and exacerbating imbalances in the domestic economy, “could eventually call into question the viability of some of the smaller currencies” (p. 147).¹³ This theme is reflected in a recent column in the Financial Times.

“Central bankers have a debatable effect on the real economy at the best of times. But for small countries with open economies, such as New Zealand, they must wonder why they bother at all. A week of gyrations in global capital markets has perfectly illustrated the battle that policymaking minnows face. New Zealand has long taken pride in being the pioneer of inflation targeting. On Thursday, its benchmark interest rate was raised for the fourth time this year – to 8.25 per cent.

But the campaign to temper rising prices has also encouraged heavy capital flows, pushing the New Zealand dollar to multi-decade highs as investors chase high-yielding currencies. The trouble is, the Reserve Bank of New Zealand is powerless to do anything about it. Direct intervention in the currency markets is always dwarfed by global currency flows. And interest rates cannot be lowered as the bank is legally mandated to focus only on inflation.

Weak housing data on Friday from the other side of the world triggered a flight from risky assets. The New Zealand dollar – popular with investors who have borrowed in low-yielding currencies such as the yen – is now under pressure. This is happening in spite of local interest rates being lifted two days previously, usually bullish for a currency. Little else domestically has changed.

New Zealand’s authorities will no doubt be grateful for the correction but they should be careful what they wish for. Currency volatility is destabilising and import-generated inflation could be a risk.”

Source: Lex column, Financial Times, 27 July 2007

It is difficult to prove that currency union will deliver improved economic performance for New Zealand. There are good arguments for and against currency union with Australia, as there are with other countries. The Reserve Bank has provided a useful summary of the arguments for and against currency union with Australia.¹⁴ It is unlikely that any of these arguments will be resolved conclusively over the next several years. However, the relatively positive experience of the Euro over the past decade provides some support for moving in this direction.

Currency union is as much a strategic positioning judgement as it is a technical economic decision. Indeed, the Euro currency project, for example, was due to a political motivation as much as an economic motivation. Similarly, currency union arguments in New Zealand should be seen in this broader strategic context. Currency union is both a substantive and symbolic statement as to New Zealand’s outward looking orientation.

¹² Andrew Coleman, ‘Three Perspectives on an Australasian Monetary Union’, in D. Gruen and J. Simon (eds), Future Directions for Monetary Policy in East Asia, Reserve Bank of Australia, 2002.

¹³ Bank of International Settlements, 77th Annual Report, 24 June 2007.

¹⁴ Chris Hunt, ‘A fresh look at the merits of a currency union’, RBNZ Bulletin 68(4), December 2005.

This outward looking focus is a much stronger argument for adopting a common currency with Australia than emphasising the benefits that would flow from growing the bilateral economic relationship. Australia accounts for 20% of New Zealand's exports, so 80% of New Zealand's exports would be outside of the common currency area. Rather the key argument is that exchange rate volatility would reduce and there would be a lower interest rate risk premium.

At the least, currency union should be the subject of a reasoned debate in New Zealand. Does New Zealand want to retain its monetary independence or make a statement that it wants to integrate more closely into the global economy? In this regard, it is important to understand that New Zealand does not have a substantial amount of independence at the moment, with the exchange rate only partly linked to New Zealand's fundamentals.

Public opinion polls suggest that there is reasonable support for this debate. A public opinion poll commissioned jointly by the New Zealand Institute and the Lowy Institute for International Policy in 2007 suggested public support on both sides of the Tasman for a joint currency. 49% of New Zealand survey respondents and 41% of Australian respondents supported the idea.

Figure 10: Public attitudes towards currency union

6. Concluding remarks

For the past 25 years, New Zealand has been focused on economic integration with Australia from the perspective of growing the bilateral relationship. Partly as a consequence of this policy emphasis, the scale of the trans-Tasman economic relationship has grown substantially over this period. The challenge now is to identify the priorities for action in terms of developing the trans-Tasman economic relationship over the next 25 years and beyond. What does the next generation of trans-Tasman policy look like?

The claim advanced in this essay is that there is a need for a new approach to trans-Tasman policy. The upside from growing the bilateral relationship further, through ongoing efforts to reduce barriers and align the legal and regulatory frameworks, is relatively small in the context of significantly improving New Zealand's economic performance. Although Australia remains New Zealand's largest single trading and investing partner, the international priorities for New Zealand increasingly lie in positioning itself to compete successfully in the global economy.

New Zealand needs to deliberately manage its exposure to international factor mobility, as well as the decline in the strength of multilateral institutions and the emergence of a more regional flavour to international economic arrangements. The challenge is for New Zealand to develop a much more significant international presence, and develop relationships and alliances that better position it to compete in the global economy.

The New Zealand approach to the Australian relationship should be seen in this context, rather than focusing primarily on growth in the size of the bilateral relationship. In this regard, there is a need to understand New Zealand's long-term strategic objectives to ensure that New Zealand plays the long game rather than taking the options that work well only in the short term.

Developing relationships and alliances in order to build a more substantial regional and global presence will likely require foregoing some discretion or independence as a consequence. Indeed, many of the issues identified in this essay involve some reduction in New Zealand's independence – from monetary independence, to joint standards, to aligning our respective positions on climate change policy.

There are risks to New Zealand's economic prospects as a small, remote economy unless New Zealand finds ways to bolster its effective size. The task is to assess where it makes sense to reduce independence in decision-making, and where the costs exceed the benefits.

Striking this balance between giving up independence of decision-making (e.g. around monetary policy) and the benefits that come from having greater scale is an important and demanding task. There is a strong independent streak to much of the New Zealand debate.

But it is important to take a hard-headed look at the benefit generated by such an independent stance. On some policy issues this has worked well, such as the independence of the NZX, but on other issues it may not be appropriate, such as the therapeutics bill or currency union.

This 'outward looking' perspective provides new insights into New Zealand's policy approach with respect to Australia. It highlights new issues for attention, and places the trans-Tasman relationship in a broader strategic context with respect to New Zealand's place in the world. The strategic choice for New Zealand is how much independence to give up in order to obtain what it wants. New Zealand needs to play the long game in this regard.

FIGURE 1: ATTITUDES TOWARDS AUSTRALIA AND NEW ZEALAND

NEW ZEALAND <i>Using a scale of 1 to 5 where 1 means you have a very positive view and 5 a very negative view, what is your view of Australia?</i>							
1, Very Positive	2	Total positive 1+ 2	3	4	5, Very Negative	Total negative 4 + 5	Unsure
34	36	70	18	8	3	11	1

AUSTRALIA <i>Using a scale of 1 to 5 where 1 means you have a very positive view and 5 a very negative view, what is your view of New Zealand?</i>							
1, Very Positive	2	Total positive 1+ 2	3	4	5, Very Negative	Total negative 4 + 5	Unsure
30	40	71	18	6	4	10	2

Source: Public opinion poll conducted by UMR in Australia and New Zealand, April 2007, commissioned by the Lowy Institute for International Policy and the New Zealand Institute.

FIGURE 2: ATTITUDES TOWARDS TRANS-TASMAN ECONOMIC INTEGRATION

NEW ZEALAND <i>In your opinion, has economic integration between Australia and New Zealand gone too far, not far enough or is it about right?</i>	
	%
Gone too far	8
Not far enough	31
Is about right	52
Depends (volunteered)	1
Unsure	8
TOTAL	100

AUSTRALIA <i>In your opinion, has economic integration between Australia and New Zealand gone too far, not far enough or is it about right?</i>	
	%
Gone too far	5
Not far enough	16
Is about right	58
Unsure	21
TOTAL	100

Source: Public opinion poll conducted by UMR in Australia and New Zealand, April 2007, commissioned by the Lowy Institute for International Policy and the New Zealand Institute.

FIGURE 3: REAL GDP PER CAPITA, RATIO OF NEW ZEALAND TO AUSTRALIA, 1870 TO 1910

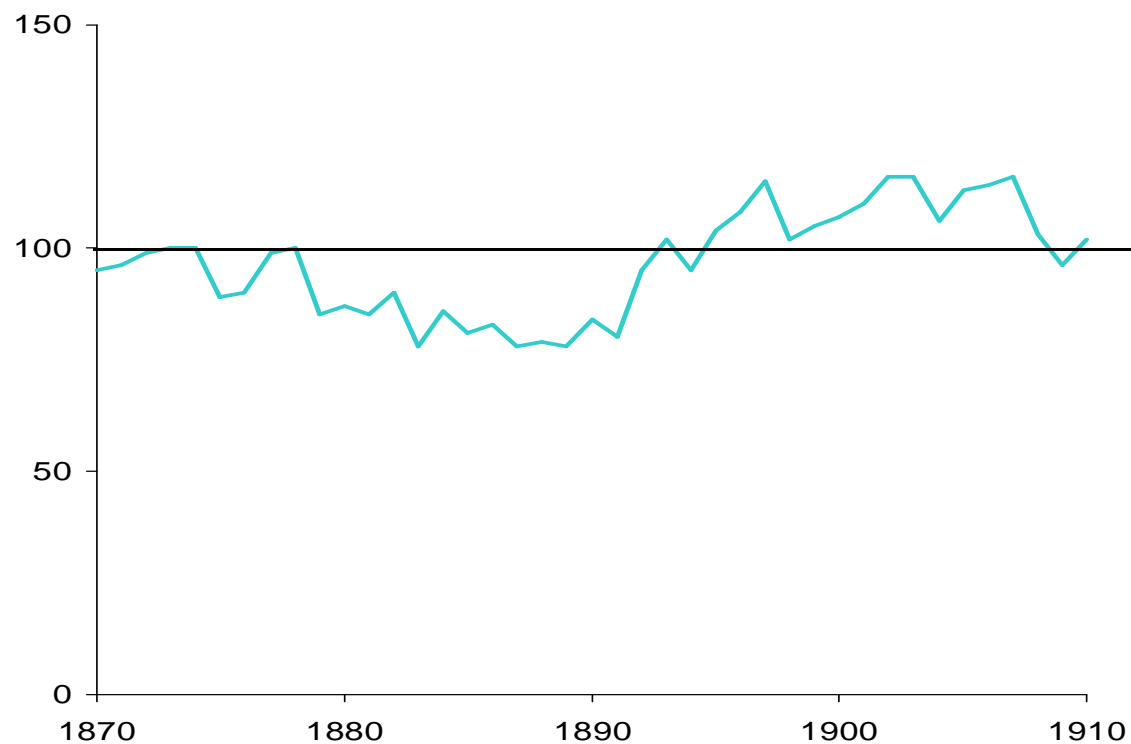
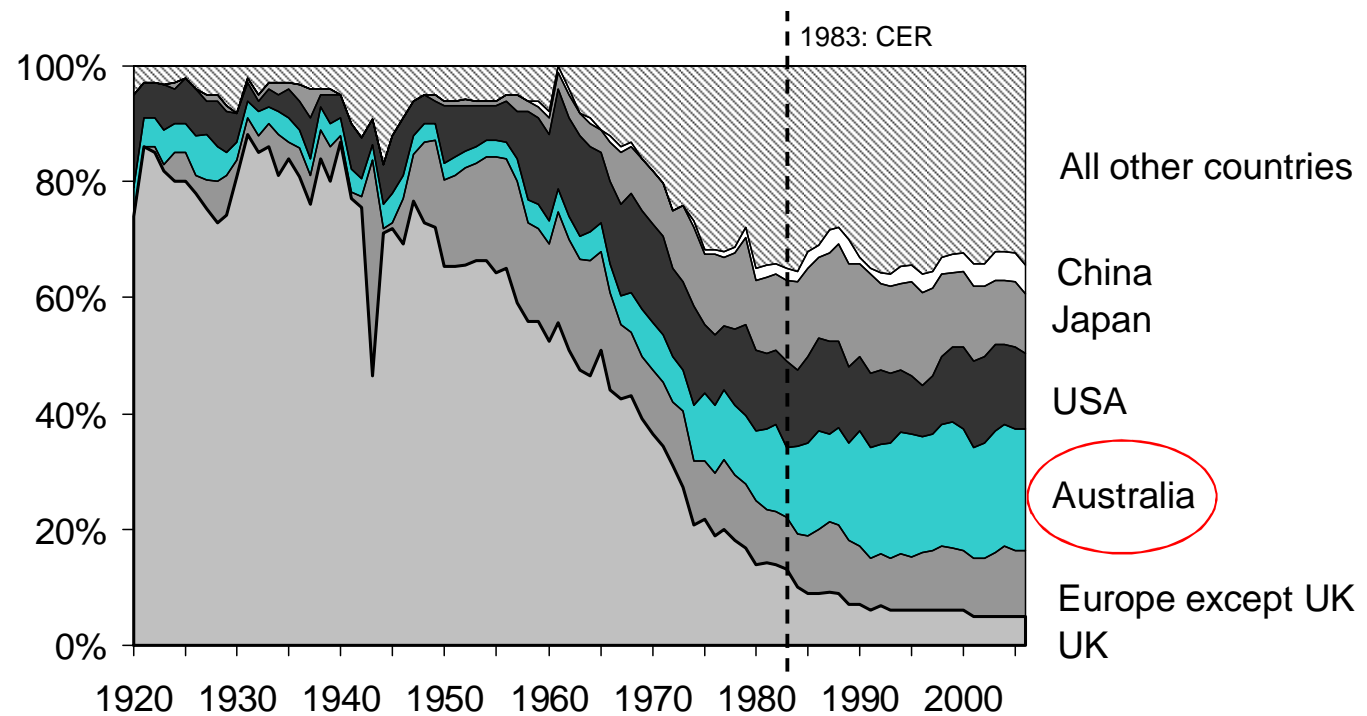
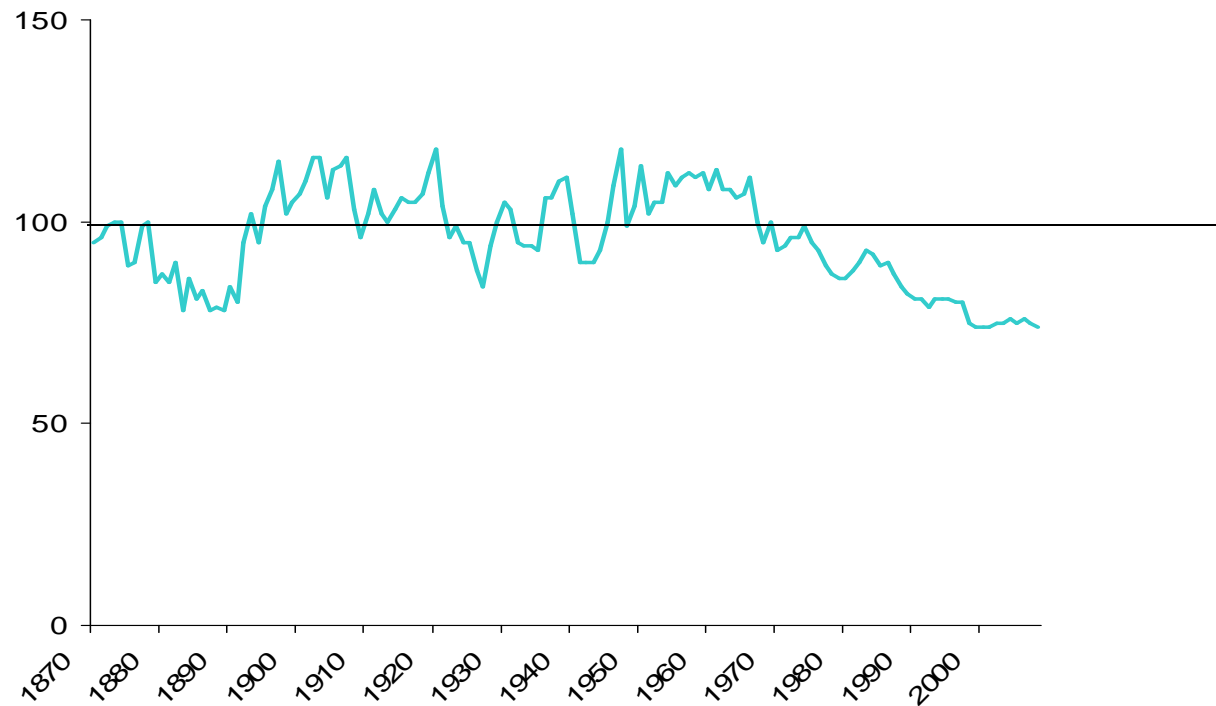


FIGURE 4: DESTINATION OF NEW ZEALAND'S MERCHANDISE TRADE, 1920 TO 2006



Note: Data interpolated for the years 1932, 1942-5, 1950-3, 1960-2, 1969-70, and 1981, exports of goods only.
Source: Statistics New Zealand.

FIGURE 5: REAL GDP PER CAPITA, RATIO OF NEW ZEALAND TO AUSTRALIA, 1870 TO 2006



Source: OECD Development Centre; Groningen Growth and Development Centre and the Conference Board, Total Economy Database, January 2007, <http://www.ggdc.net>

FIGURE 6: CHANGES IN THE NATURE OF THE TRANS-TASMAN RELATIONSHIP

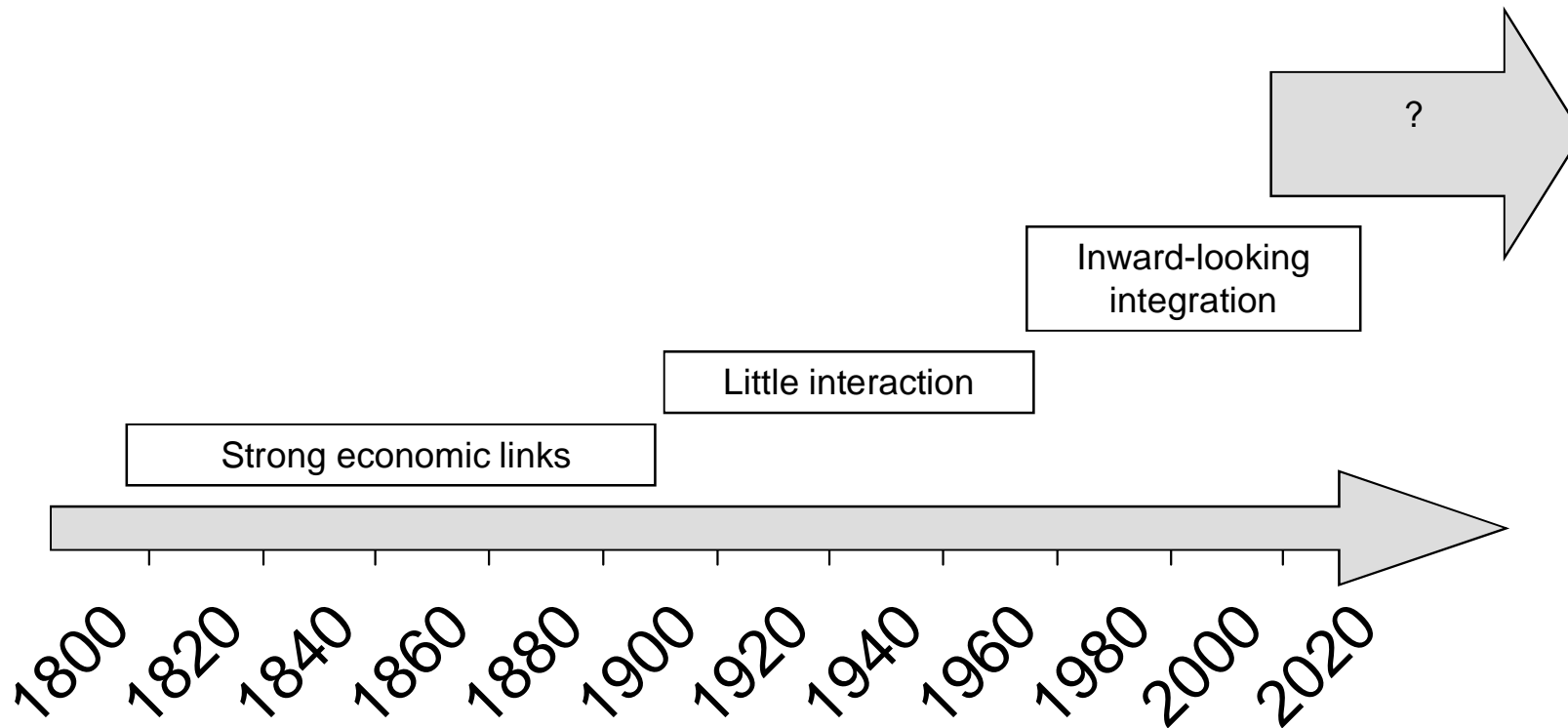
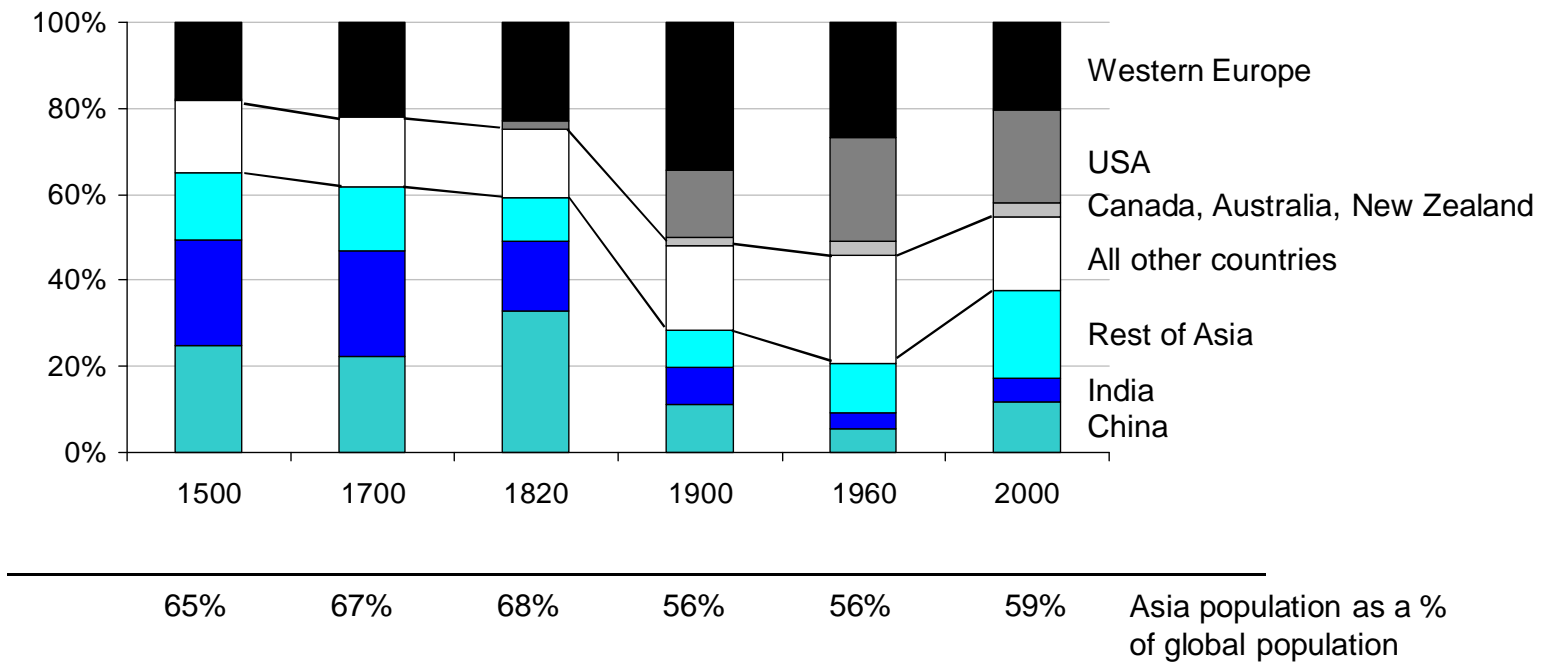


FIGURE 7: DISTRIBUTION OF GLOBAL GDP SINCE 1500



Source: Groningen Growth and Development Centre and the Conference Board, Total Economy Database, September 2006, <http://www.ggdc.net>

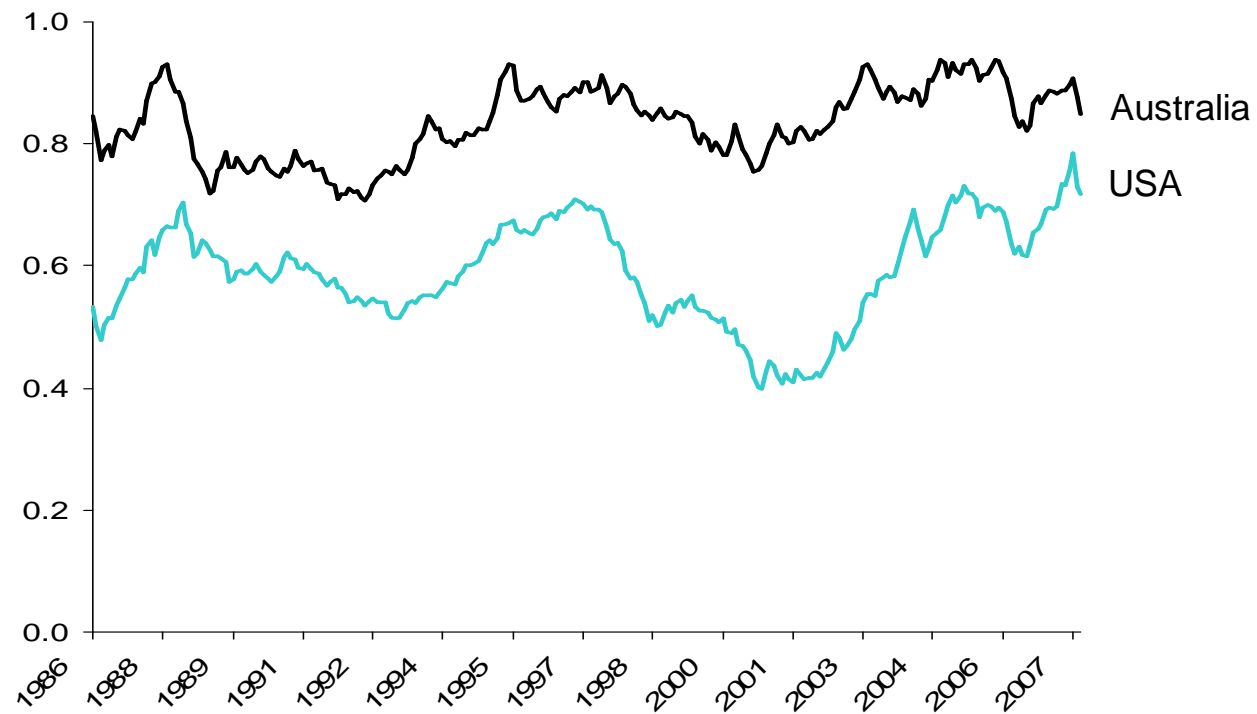
FIGURE 8: PARTNERS OR COMPETITORS

NEW ZEALAND <i>In your opinion, do you see Australia more as a competitor or more as a partner in engaging in a globalised world?</i>	
	%
Competitor	31
Partner	62
Depends (volunteered)	3
Unsure	4
TOTAL	100

AUSTRALIA <i>In your opinion, do you see New Zealand more as a competitor or more as a partner in engaging in a globalised world?</i>	
	%
Competitor	10
Partner	85
Unsure	5
TOTAL	100

Source: Public opinion poll conducted by UMR in Australia and New Zealand, April 2007, commissioned by the Lowy Institute for International Policy and the New Zealand Institute.

FIGURE 9: EXCHANGE RATE TO NZD, 1986 TO 2007



Source: RBNZ.

FIGURE 10: ATTITUDES TOWARDS CURRENCY UNION

NEW ZEALAND		
<i>Do you support or oppose the New Zealand and Australian dollars being replaced by a joint ANZAC dollar?</i>		
	MAY 00 %	APR 07 %
Support	29	49
Oppose	59	42
Depends (volunteered)	3	1
Unsure	9	8
TOTAL		100

AUSTRALIA	
<i>Do you support or oppose the New Zealand and Australian dollars being replaced by a joint ANZAC dollar?</i>	
	APR 07 %
Support	41
Oppose	42
Neither support or oppose	10
Unsure	7
TOTAL	100