Essay

Competing and cooperating: Growing New Zealand's economic relationship with Australia

David Skilling

22 March 2007

thenewzealandinstitute

The New Zealand Institute

The New Zealand Institute is a privately funded think-tank that aims to introduce new and creative thinking into the economic and social policy debate in New Zealand. We are committed to the generation of debate, ideas, and solutions that creatively address New Zealand's economic and social priorities in order to build a better and more prosperous New Zealand for all New Zealanders.

The Institute's members come from a variety of backgrounds in business, education, and community service, and have a wide range of views on issues. But we are all committed to contributing to building a better and more prosperous New Zealand.

The Institute produces creative, provocative and independent thinking, focusing on key issues that will have a major impact on New Zealand's economic and social future, and engages with New Zealanders in order to develop solutions to address these issues.

Our work draws on the best ideas and practice from around the world and feed these into the New Zealand debate. And we are committed to political neutrality and evidence-based analysis. We recognise that great ideas can come from anywhere on the political spectrum – left, right or centre.

The New Zealand Institute
PO Box 90840
Auckland 1142
New Zealand
P +64 9 309 6230
F +64 9 309 6231

www.nzinstitute.org

Essays

The New Zealand Institute publishes an occasional series of essays on a variety of relevant issues. These essays are and will be written by Institute staff and members – and may also be commissioned from people external to the Institute – with the aim of providing a range of considered perspectives and stimulating discussion. These essays represent the personal views of the authors, and have not been through the normal review processes that other Institute work is subject to.

Acknowledgement

This essay is based on remarks initially delivered to a Legal Research Foundation conference, 'Whose Law Is It Anyway?', held at Parliament Buildings on 9 March 2007.

Competing and cooperating:
Growing New Zealand's economic relationship with Australia

Dr David Skilling

1. Introduction

Australia is New Zealand's top export and foreign direct investment (FDI) destination, is New Zealand's largest source of imports and FDI, and is New Zealand's primary tourism market. As such, the Australian market is a source of considerable economic benefit to New Zealand. On the other hand, New Zealand is running a large and persistent trade deficit with Australia, has a substantial imbalance in terms of investment flows with an increasing incidence of Australian ownership of the New Zealand economy, and experiences the exit of many thousands of New Zealanders to Australia every year.

Australia is easily New Zealand's most important economic relationship, but it is not a straightforward picture. Concerns about the loss of economic sovereignty to Australia sit alongside the significant market potential offered by Australia. Monochromatic views of the economic relationship, which focus entirely on the positive or negative aspects, do not provide a useful guide to the policy approach that should be adopted by the New Zealand government.

This essay sets out to offer a view on what New Zealand should be aiming to achieve in growing its economic relationship with Australia. How should New Zealand define its national interest, and how should these interests best be promoted in the context of discussions around the trans-Tasman economic relationship?

In particular, this essay considers the likely contribution of the government's single economic market (SEM) agenda, drawing on an evaluation of the development of New Zealand's economic relationship with Australia since the introduction of the CER agreement in 1983. What is New Zealand's likely place in a single economic market with Australia?

This essay will argue that the SEM process is unlikely to substantially strengthen New Zealand's economic relationship with Australia in the manner claimed, just as the rhetoric around the success of the CER agreement runs ahead of the actual outcomes achieved. And in addition to the relatively limited economic upside that can be expected from a SEM, there are some risks associated with aspects of economic integration with Australia.

As a small, remote economy, New Zealand is particularly exposed to the tendency for firms, people, and capital, to locate in larger, more prosperous economies. Indeed, this force is a significant driver of the trans-Tasman economic relationship. As a consequence, the major priorities for growing the relationship in a way that promotes New Zealand's national interests are those policies that position New Zealand to compete for economic activity. Going forward, New Zealand needs to place greater emphasis on strengthening its competitive position rather than simply focusing on reducing barriers to the trans-Tasman flow of resources.

2. New Zealand's economic relationship with Australia

The starting point for a discussion about New Zealand's strategy with respect to Australia should be a clear sense of the current state of the relationship in terms of the key bilateral outcomes. The trans-Tasman economic relationship should be assessed in terms of measures such as trade, investment, and people flows.

This is distinct from how the relationship is commonly talked about. Questions about the health of New Zealand's economic relationship with Australia are commonly answered with reference to the state of the SEM discussions rather than the nature of the economic outcomes that are being generated. The language used in this regard makes it easy to confuse ends and means; the removal of barriers through the SEM process and the quality of the official relationship often seem to be talked about as ends in themselves.

The following discussion examines New Zealand's trade, investment, and people flows with Australia as a way of understanding the broad shape of the trans-Tasman economic relationship since CER was introduced. To what extent has the removal of barriers to economic interactions between the two countries stimulated increased trans-Tasman economic activity?

Trade

Australia is New Zealand's largest trading partner, taking about 20% of New Zealand's exports of goods. New Zealand's exports to Australia have grown at 8.9% a year since 1983, which perhaps sounds impressive. But Australia's imports from countries other than New Zealand have grown at 9.4% annually over this period, which means that New Zealand has lost export market share into Australia over the past two decades. More recently, New Zealand's exports to Australia have grown at 4.2% a year since 1994, the same rate as New Zealand's exports to the rest of the world, while Australian imports have grown at 8.4%. These numbers provide little evidence of a substantial CER effect.

Figure 1[1]

More generally, as described in Figure 2, there was a structural shift underway in the destination of New Zealand's exports that pre-dated CER in which New Zealand's exports were shifting away from the UK towards Australia, with whom New Zealand had historically traded very little, and other countries. Strong growth in the share of New Zealand's exports that were sold into the Australian market would have been expected even without a contribution from CER.

Figure 2

It is also worth noting that New Zealand has consistently run a substantial trade deficit with Australia over the past two decades. New Zealand's trade deficit with Australia currently stands at $802 million, or 12% of New Zealand's exports to Australia.

Investment

Australia is New Zealand's largest destination and source of foreign direct investment (FDI). Australian investment into New Zealand currently stands at $40 billion, or about 25% of New Zealand's GDP, much of which has been the purchase of existing New Zealand companies rather than greenfields investment. New Zealand's investment into Australia currently stands at $9 billion, or about 6% of New Zealand's GDP. There have been few large New Zealand investments into Australia that have been sustained on a successful basis. Fletcher Building stands out as a notable exception to this trend.

Figure 3

There have been substantial inflows of Australian FDI into New Zealand over the past decade or so, as have been widely documented. This has led to many high-profile purchases of New Zealand firms by Australian firms – mainly to serve the domestic New Zealand market – as well as several relocations of major New Zealand firms to Australia. These changes in the location of economic activity and in the location of ownership of economic activity are much larger and more significant than the change in the bilateral trade relationship. Indeed, the scale of this activity has generated an increasingly high profile public debate about the so-called hollowing out of the New Zealand economy.[2]

---

[1] The charts are displayed at the end of this essay.

[2] To give just a few examples of headlines from 2006: 'NZX at risk as raiders eye vulnerable firms', Dominion Post, 6 March 2006, 'Sharemarket at risk of losing biggest firms', New Zealand Herald, 9 March 2006, 'Editorial: New Zealand business like branch of Australia', New Zealand Herald, 30 March 2006, 'Fletcher looks to jump ditch', New Zealand Herald, 4 April 2006.

People

New Zealand has a very substantial deficit with Australia in terms of people movements. Since 1979, a net average of 15,700 New Zealanders a year have departed on a permanent or long-term basis for Australia. As a consequence, New Zealand has a very large diaspora in Australia.

Interestingly, prior to about 1973, New Zealand was a net importer of people from Australia. This was about the same time as the Australian per capita income level overtook New Zealand's per capita income level.

Figure 4

Summary

The conventional wisdom is that CER has been enormously successful, and has generated substantial benefits for New Zealand. New Zealand's Ministry of Foreign Affairs & Trade, for example, claim that "CER is one of the most comprehensive, effective, and mutually beneficial free trade agreements in the world". And according to a report prepared by NZIER for the New Zealand Trade Consortium "[CER] has become the cornerstone of our trade policy and arguably the most successful free trade agreement signed".

In a Ministerial Joint Statement at the CER 20th Anniversary Forum, it was claimed that "CER has strengthened the economic relationship between Australia and New Zealand, thereby assisting both economies to better position themselves globally. By eliminating barriers and promoting free trade, it has doubled trade between us in real terms and created wealth and employment in both economies".

However, the numbers reported above suggest that it is not appropriate to get carried away with regard to the contribution of CER to strengthening New Zealand's economic relationship with Australia. The extravagant claims about the transformational effects that CER has had on the New Zealand economy and on the trans-Tasman economic relationship do not seem to be supported by the experience of the past couple of decades.

The bilateral economic relationship is not growing rapidly compared to relationships with other countries with whom New Zealand (and Australia) do not have trade agreements, and New Zealand is running significant trans-Tasman imbalances on trade, investment, and people. A reasonable interpretation of these data is that CER has not had the substantial effect often attributed to it. The benefits have been much more modest.[3]

Of course, agreements like CER need to be assessed in broader terms than simply trade and investment flows. These agreements allow for a more efficient resource allocation, as countries specialise in areas where they have comparative advantage. This leads to productivity and income gains, and consumers benefit in terms of a wider range of cheaper goods and services. Overall, however, it is hard to argue that CER has had other than a modest effect on New Zealand's economic relationship with Australia.

3. Assessing the Single Economic Market agenda

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).

The SEM agenda is seen as the logical next step after the CER agreement. According to New Zealand's Ministry of Foreign Affairs & Trade, "CER has proved to be a remarkable success,

[3] It may be that CER was valuable in kick-starting New Zealand's economic reform and liberalisation process in the early 1980s, but its direct effect on trade and investment flows has been less transformational.

but looking forward CER should continue as a dynamic agreement, adapting to the changing requirements of business in an increasingly interdependent world. In this light, the New Zealand and Australian Governments have committed to explore a long-term vision for a seamless trans-Tasman business environment – a Single Economic Market (SEM)".

And Finance Minister Michael Cullen recently noted that "CER has also been highly successful as a spur to the internationalisation of both economies. It has encouraged business people and the general public to understand the vital importance of international linkages and led to a more competitive, dynamic business environment in both countries. For these reasons, advancing the Single Economic Market agenda is an important element of our strategy to increase our international connections".

The basic argument is that CER was good, so continued progress in this direction will generate even better outcomes. However, the discussion in the previous section counsels caution in terms of expectations of the likely effect of SEM on the trans-Tasman economic relationship. At most, a SEM will deliver similar outcomes as CER given that it is effectively an extension of CER.

Indeed, the economic benefits from a SEM are likely to be smaller in magnitude given the more limited SEM agenda relative to CER. It is difficult to believe that making progress on the issues on the SEM agenda, such as strengthened coordination of business law, will transform New Zealand's economic relationship with Australia. There are diminishing marginal returns to much of the SEM agenda relative to reducing tariffs and other barriers under CER.

And on the issues that might make more of a difference, such as the mutual recognition of imputation credits, there does not seem to be much likelihood of progress. Indeed, the absence of material economic upside suggests that the major motivation for the SEM agenda is not strictly economic in nature.

The major driver of the trans-Tasman economic relationship

An important reason why the removal of barriers through the CER and SEM processes has not had a transformational effect on New Zealand's economic relationship with Australia is that there are more important economic drivers of the relationship. The economic relationship between Australia and New Zealand involves a large, relatively prosperous economy sitting close to a much smaller, less prosperous country. In such a context, reducing the barriers to the free flow of resources across the Tasman does not automatically deliver benefits to the New Zealand economy because New Zealand has a significant exposure to the international mobility of people, firms, and capital.

Indeed, New Zealand is probably the most exposed country in the developed world to the forces of international factor mobility.[4] Internationally, there is a very pronounced tendency towards agglomeration, in which people, firms, and capital tend to concentrate because higher returns can be earned in larger centres of activity.

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 where they can access large output markets. This will generally be in areas of existing concentrations of economic activity. 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.

Indeed, the trend towards agglomeration of economic activity is one of the more notable trends in international economic activity. 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

[4] 'Lessons from the world's economic laboratory: What can Australia learn from the New Zealand experience?', available on the New Zealand Institute website at www.nzinstitute.org

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".[5] These agglomeration trends are reinforced by the actions of various government agencies that compete to attract economic activity into their locations.

New Zealand is not well placed in such a competition for mobile factors, and the potential for the exit of people and firms from New Zealand has been observed over the past decade. This is neither inevitable, nor necessarily one-way traffic, but it is a powerful force.[6] New Zealand has specific issues with respect to Australia, because of the differences in scale and in relative wealth levels. New Zealand's exposure in this regard may mean that New Zealand's place in a single Australasian market may be a relatively peripheral one, with the exit of people and companies to Australia. Over time, this will compromise New Zealand's economic performance and its ability to compete effectively in international markets.

This economic reality has significant implications for the type of policy approach that is appropriate for New Zealand. In particular, an approach that is simply focused on achieving a more efficient Australasian allocation of resources may not be sufficient to generate benefits from a New Zealand perspective. The risk is that the globally efficient resource allocation may involve resources flowing away from New Zealand – if, for example, a unit of capital is more highly valued in Australia than in New Zealand. This may be good for the Australasian economy as a whole, but it is not obviously beneficial for New Zealand.

In some instances, reducing barriers and encouraging integration is clearly positive and mutually beneficial. But encouraging integration is not always in New Zealand's national interest given its position as a peripheral economy. Rather than simply asserting that a SEM is good for New Zealand, there is a need to run the argument forward and consider New Zealand's likely place in an Australasian single economic market.

As an example of how liberalisation does not benefit New Zealand, consider the debate of several years ago around the prospective merger of the Australian and New Zealand stock exchanges.

There is little doubt that New Zealand is a stronger economy than would have been the case without the NZX. Without a functioning, vibrant local exchange, it is more difficult to hold onto large, listed firms who will seek out more liquid markets offshore. And growing the next generation of firms from a New Zealand base will be more difficult. The absence of a New Zealand stock exchange would compromise the ability of New Zealand firms to raise New Zealand capital to fund this growth, and there would be much less reason for firms – and the professional services community that surrounds the capital markets – to locate a presence in New Zealand.

The recent debate around supervision of the banking sector is another example of where the potential for loss of control to Australia was seen to undermine New Zealand's economic capacity.

In this regard, it is instructive to examine the Australian approach to the effects of agglomeration. Australia is exposed to many of the same pressures for companies and people to exit to larger centres, although it is a few steps up the food chain relative to New Zealand because of the larger size of its domestic market. However, Australia has, at least on occasion, been much more deliberate in promoting its interests when confronted with these forces. On some measures, about 50% of the ASX50 has some form of ownership restrictions imposed on it (e.g. the four pillars banking policy) and the Australian government has intervened in some transactions involving the foreign takeover of Australian companies (e.g. the post-merger restrictions imposed on BHP Biliton and the rejection of the Woodside deal).

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

[6] 'Choosing to compete: Increasing the magnetism of the New Zealand economy', available on the New Zealand Institute's website at www.nzinstitute.org

The Australian view appears to be that a strong domestic corporate sector is in the national interest.

More broadly, of course, some regions within Australia, such as Tasmania, have experienced the exit of people and firms to larger centres within Australia. However, federal government transfers are made to such regions to help equalise incomes across the country. This is also the case in common market areas such as across the European Union countries, where transfers are made to areas exposed to the loss of economic activity. Obviously no such mechanisms exist in the context of the trans-Tasman economic relationship.

In sum, the objective from a New Zealand perspective should not be to maximise Australasian welfare, assuming that New Zealand will benefit proportionately, but to act to strengthen New Zealand's position. Of course, New Zealand needs to be outward-looking and internationally engaged, and should be looking to develop a strong economic relationship with Australia. But the end-game is to grow a strong and successful New Zealand economy not simply to become part of an Australasian economy.

Priorities for the SEM agenda

Understanding the nature of these economic drivers provides some guidance into how New Zealand should approach the SEM agenda. It is vitally important that New Zealand's strategy with respect to Australia be guided by a hard-headed focus on the desired economic outcomes. In particular, the objective of policy should be to grow great New Zealand companies into the Australian market and to compete successfully with Australia so that firms, people, and capital choose to locate in New Zealand. This can be measured in terms of New Zealand's export growth to Australia, the level of New Zealand investment into the Australian market, and whether firms and people choose to locate in New Zealand rather than Australia. It is important to recognise that New Zealand is competing with Australia to be the preferred location for these resources.

An important step in this regard is to be clear what success looks like in terms of the economic relationship with Australia. What is it that New Zealand is trying to achieve in terms of the bilateral relationship?

In a recent New Zealand Institute report, we proposed a specific aspiration for the size of New Zealand's economic relationship with Australia by 2020 in terms of exports and outward direct investment.[7] In particular, we proposed that there be a goal to grow the economic relationship from $18 billion in 2005 to $41 billion by 2020, as described in Figure 5. The major contribution of specifying numerical targets is to focus the conversation on progress towards achieving these targets rather than on the process. It also gives an explicit way of monitoring progress over time.

Figure 5

The SEM agenda should be evaluated in terms of whether there is a demonstrated effect on the ability of New Zealand firms to expand into the Australian market by way of exporting or investing, and whether New Zealand becomes more attractive to firms and people as a location. Aspects of the SEM agenda have the potential to make a contribution to achieving these outcomes by making it easier and more efficient for New Zealand firms to access the much larger Australian market from a New Zealand base.

For example, the mutual recognition of documents supporting securities offerings will allow capital to be more easily raised on both sides of the Tasman. In general, mutual recognition is likely to be a better approach for New Zealand than harmonisation because in many instances, New Zealand's policy and regulatory settings are lower cost than in Australia; for example, as assessed by the World Bank's Doing Business Index. New Zealand should be careful not to negotiate away an area in which it has some competitive advantage.

[7] 'Competing to win: An external strategy for a changed world', New Zealand Institute Discussion Paper 2006/3, November 2006.

Greater coordination of activity of various regulatory agencies on both sides of the Tasman also seems worthwhile in many instances, although the benefits are unlikely to be game changing.

Another issue that is sometimes included in the SEM agenda is the mutual recognition of imputation credits. This issue is of strategic importance because New Zealand's dividend imputation scheme is one factor that dissuades some New Zealand firms from pursuing international expansion (as taxes paid overseas on international income do not generate imputation credits). It also means that New Zealand firms that have Australian income and a large Australian shareholder base come under pressure to relocate their head office to Australia. In this sense, New Zealand's tax system makes the agglomeration pressure more acute.

This issue of mutual recognition of imputation credits has been widely discussed and debated, but there does not seem to be a high likelihood of making progress on this issue because of reluctance by Australia to make changes, and it seems to be off the agenda. Perhaps a better solution still might be for New Zealand to unilaterally move to a different system of taxing company and dividend income.

Currency union is sometimes talked about as important in terms of encouraging greater international engagement by New Zealand firms by reducing exchange rate volatility with Australia and lowering transactions costs. However, the volatility between the New Zealand and Australian dollars is not as significant as with other currencies, and so the benefits may not be substantial. In any case, 80% of New Zealand's exports go to countries other than Australia and a trans-Tasman currency union is unlikely to make much difference in this respect. It is also unclear whether such a move will address the agglomeration issues by making it more likely that New Zealand firms go global from a New Zealand base.

Long term it seems unlikely that New Zealand will retain an independent currency, given that there is an apparent trend towards the consolidation of currencies. However, it is not clear that this is a short term priority, particularly given the apparent reluctance for politicians on either side of the Tasman to invest political capital in this issue.

Summary

In general, focusing on removing barriers to trans-Tasman resource flows has limits. Although in many instances, acting to foster greater economic integration will be beneficial for New Zealand, this is not always the case. And more importantly, this process does not address New Zealand's exposure to agglomeration that is due to its position as a small, remote economy. Moves to achieve a more efficient resource allocation should be approached cautiously given that the most efficient location for resources may be in Australia rather than New Zealand. It may be that New Zealand's place in an Australasian single economic market is a reasonably peripheral one unless deliberate action is taken to make it otherwise.

This is obviously not to say that aspects of the SEM agenda should not be progressed. There are benefits from some parts of the agenda, as described above. But it is a claim that we should be realistic about the size of the upside. SEM will at best contribute modestly to strengthening New Zealand's economic relationship by reducing some costs faced by New Zealand firms in doing business in Australia. So the SEM agenda should not be the major New Zealand priority in terms of developing the trans-Tasman relationship. Aspects are worth proceeding with, and it is important to ensure that there is some momentum in the trans-Tasman relationship, but there are other more pressing priorities for action in order to position New Zealand for advantage.

The overall point is that New Zealand's SEM agenda needs to be informed to a much greater extent by a clear sense of strategic purpose. Based on public statements, there appears to be little clarity about what New Zealand is trying to achieve. Cooperation is emphasised, almost for the sake of it, without a clear sense that New Zealand is competing with Australia in several respects.

Recognition that agglomeration is a powerful force driving the trans-Tasman economic relationship fundamentally alters the way in which New Zealand should approach its relationship with Australia. It is not simply a mutually beneficial relationship, although that is obviously part of it, but also a relationship in which there is a strong competitive dynamic. To a much greater extent than is currently the case, New Zealand's economic strategy with respect to Australia should be based on a clear understanding of New Zealand's place as a peripheral part of the single economic market and should prioritise those actions that strengthen New Zealand's competitive position.

Competing is not a zero sum proposition, where actions to advance New Zealand's interests necessarily harm those of Australia. But New Zealand should be working deliberately to strengthen New Zealand's competitive position so that it is better able to respond to respond to the pressures of agglomeration.

4. An agenda for action

Beyond these actions that specifically address New Zealand's economic relationship with Australia, there is a broader agenda for action that should be pursued to strengthen New Zealand's competitive position. This agenda goes well beyond the trans-Tasman issues that are discussed between Wellington and Canberra, and includes business action as well as government action. This section outlines the major priorities in this regard.

Business action

The experiences of New Zealand firms in Australia have relatively little to do with issues relating to CER and the SEM. Both the success stories and the failures are due in much greater measure to the nature of the decision-making within firms and the competitive environment that they face than issues relating to formal trade barriers and the like. Relationships, networks, unions, domestic regulation, the toughness of the competition and so on, are issues that New Zealand firms regularly cite as being different in Australia than in New Zealand. Most of these issues are beyond the reach of public policy and can only be addressed by strengthening the aspiration and capacity of New Zealand's firms. Progress in the economic relationship is contingent on the behaviour and performance of New Zealand firms.

A recent New Zealand Institute report canvassed some of the issues around creating Kiwi global champions – New Zealand firms that are significantly and successfully engaged in the global economy.[8] There are issues around a need for greater aspiration with respect to international expansion at the firm level as well as for high quality execution. There is also a need for firms to develop a clear sense of the nature of their competitive advantage, and what they bring to the market that is genuinely distinctive. Simply assuming that because, say, the Australian market is five times as large that the firm will automatically be able to sell five times as much as in New Zealand, or that financial success in New Zealand translates into financial success in Australia, is unlikely to be a recipe for success.

Issues relating to successful expansion into Australia by New Zealand firms should be the subject of intensive discussion alongside public policy issues. Business education, knowledge sharing, and the like, have the potential to have as significant effect on achieving a much improved economic relationship with Australia as many aspects of the SEM agenda. Indeed, public policy action will have a limited effect unless it is matched by firm capacity and aspiration to expand into the Australian market.

Government action

Achieving superior economic performance in the context of the small, remote New Zealand economy, which is highly exposed to international factor mobility, requires policy that is focused on making New Zealand the location of choice for internationally mobile people, capital, and firms because of the quality of the policy environment and the broader business

[8] 'Creating Kiwi Global Champions', New Zealand Institute Discussion Paper 2006/2, August 2006.

environment. New Zealand can only compete by offering a compelling case to locate in New Zealand.

There needs to be a clear sense of strategic purpose. New Zealand needs to develop a clear value proposition; on what basis does New Zealand want to compete as a peripheral economy in an intensively competitive global environment. Rather than simply creating a level playing field that supports the efficient allocation of resources, the challenge is to create an environment in which there is a compelling value proposition to locate in New Zealand.

The aim should be to have companies growing into international markets from a New Zealand base, and have them retain a New Zealand presence as they grow because of a view that New Zealand provides a great location. This in turn will attract people and capital to New Zealand rather than being drawn to other locations. So what sort of environment do we need to create in New Zealand to make this possible? I think that there are five general types of policy priority that should be considered, to make the New Zealand economy more ‘magnetic’.

First, there is an ongoing need to strengthen New Zealand’s competitive position through improving the regulatory and tax system, improving the education system, investing in basic infrastructure, and so on. The quality of these policy foundations is one way in which New Zealand can differentiate itself from its competitors. Interestingly, the desire to have a headline company tax rate that compares favourably with Australia is one of the major themes in the government’s Business Tax Review.

But high quality basic policy settings are increasingly common across developed countries, and often do not provide the basis for sustainable competitive advantage – Australia can match New Zealand’s settings it wants. The notion of setting policy in such a way as to achieve competitive advantage should be extended to other areas of policy, as described below.

Second, there is a need to build a larger pool of domestic capital to fund the international expansion of New Zealand firms. New Zealand has very low household savings rates and is heavily reliant on foreign capital. Although it is positive that New Zealand firms can access global capital, doing so means that New Zealand firms seeking to go global will often relocate offshore to be closer to their foreign shareholder base (as well as the returns flowing to the foreign investor). Domestic capital provides an anchor, so that these firms retain a New Zealand presence even as they go global. It is ownership of New Zealand companies that are going global that will generate wealth for New Zealand.

The trans-Tasman investment imbalance described above reflects very different savings policy choices made in Australia and New Zealand over the last couple of decades. And the increasing Australian ownership of the New Zealand economy will continue for as long as New Zealand’s household savings rates remain low, as there will not be sufficient New Zealand capital available to fund the expansion of New Zealand companies. Senior figures in New Zealand’s capital markets regularly point to the risk of more departures of major New Zealand companies unless meaningful policy action is taken to increase household savings.

Indeed, on current course and speed the extent of foreign ownership of New Zealand companies is likely to increase. The Reserve Bank report that superannuation funds under management in New Zealand are currently NZ$31 billion, and that these funds have increased by about NZ$4 billion over the past five years. This contrasts sharply with the Australia situation, where there is a large and growing pool of capital as a consequence of its compulsory superannuation scheme. Private sector pension funds under management in Australia are forecast to rise from about NZ$840 billion in 2004 to about NZ$3.0 trillion in 2015.[9]

A more ambitious savings policy is required in New Zealand to build a larger domestic pool of capital. KiwiSaver is a good start, but much more is required.

[9] Presentation by Andrew Mohl to an AMP conference, January 2006.

Third, New Zealand policy should have a clear focus on investing in immobile assets that make mobile factors of production, like companies and people, more productive in New Zealand than elsewhere. These immobile assets include transport, communications, and research infrastructure that make firms and workers more productive. Another form of immobile asset is the development of distinctive capabilities that are unique to New Zealand and difficult to relocate; for example, specialised knowledge and networks in a particular industry.

One lesson from New Zealand is that investments in people, who are highly mobile internationally, through the education or research system, need to be complemented with policies and actions that make these graduates productive in New Zealand. Otherwise, the risk is that they leave to pursue international opportunities, which reduces the benefit to New Zealand.

Fourth, New Zealand also has to create the conditions in which New Zealand can grow firms into international markets from New Zealand. By making it easier for firms to expand into Australia and other offshore markets from New Zealand, it helps to position New Zealand as an attractive base to locate globally oriented companies. Measures such as CER and the SEM agenda are helpful in this regard, but reducing barriers to market entry is only part of the challenge. The New Zealand Institute has released a series of reports over the past year on how to increase the extent of international economic engagement by New Zealand firms.

Fifth, New Zealand should aggressively head-hunt inward foreign direct investment (FDI) and people that will contribute to the productive base of the New Zealand economy. Governments at both national and state level compete to attract people and companies – and indeed, some New Zealand firms have received financial incentives from Australian state governments to locate their operations there.

The overall intuition is that New Zealand's policy emphasis increasingly needs to be on competing aggressively. Small, remote countries do have options available to respond to their exposure to international factor mobility and agglomeration that extend well beyond putting the basic policy foundations in place. Even small countries can exercise some influence over their environment if they choose to do so.

These priority areas are outside the SEM discussions, but should be at the forefront of the conversation about growing New Zealand's economic relationship with Australia. And importantly, many of the priorities for action that are identified above are within New Zealand's control. New Zealand can grow its international economic relationships, including with Australia, through unilateral action in areas such as savings, tax policy, and the like, without needing Australian agreement.

Overall, the message is that New Zealand needs to work out on which basis it wants to compete, identify a value proposition, and develop a clear, coherent strategy. New Zealand needs to recognise that it can make choices that will strengthen its competitive position rather than accepting the world as it finds it. New Zealand needs to be prepared to fight to attract and retain talent, firms, economic activity, rather than just adopt a mood of resigned fatalism.

5. Concluding Remarks

Australia is a large and growing market for New Zealand, and yet there are substantial imbalances in New Zealand's economic relationship with Australia. New Zealand needs to move beyond the bromides that CER has been an unalloyed success and that Australia is our best friend. Although there is clearly some truth in these statements, such a monochromatic view of the trans-Tasman relationship does not adequately reflect the reality of the relationship or provide useful guidance to policy action.

Given the economic importance of the Australian relationship, New Zealand needs to take a hard look at the state of the relationship and what sort of strategy it ought to adopt. Benign neglect is unlikely to be a desirable or sustainable strategy long term.

The key driver of the relationship is the economic reality of agglomeration in which there is a tendency for economic activity to move from peripheral areas towards the centre. In the context of the trans-Tasman economic relationship, this process tends to advantage Australia over New Zealand. This has significant implications for New Zealand's policy approach.

In particular, it is not clear that New Zealand's current policy approach with respect to Australia is weighted appropriately as between competition and cooperation. New Zealand should obviously seek to cooperate with Australia where it makes sense to do so and where the two countries have shared interests. But it is also important to recognise that Australia and New Zealand are competing in many areas, and that a single economic market may not always be in New Zealand's national interest. Understanding how to better balance cooperation and competition is an important but challenging process. New Zealand needs to strike a better balance, and 'fight our corner' more effectively – in much the same way as Australia currently does.

To avoid New Zealand becoming more peripheral over time, it is necessary to build strength into the New Zealand economy. This involves actions such as a more ambitious savings policy, the competitive upgrading of New Zealand's policy and broader business environment, and making New Zealand a great platform from which to go global. Most of the priorities are not directly trans-Tasman in nature, but require unilateral action. And there is a critical need to have a well-developed and public strategy that guides New Zealand's policy with respect to Australia. New Zealand needs to aim much higher than simply becoming a peripheral part of an Australasian single economic market.

There needs to be a much more deliberate focus on promoting New Zealand's national interest. Efforts such as the SEM agenda should be part of this process, although this effort should be much more disciplined, but there are more important issues to be discussing in the context of growing New Zealand's economic relationship with Australia. The SEM agenda has been overplayed. It is time to focus attention on the issues that really matter to New Zealand firms. The response to first order challenges is not third order actions, even if they are desirable; the scale of New Zealand's actions needs to be proportionate to the scale of the challenge.

FIGURE 1: COMPARISON OF MERCHANDISE TRADE GROWTH: INTER-CER FLOWS AGAINST WORLD FLOWS

Compound Annual Growth Rate

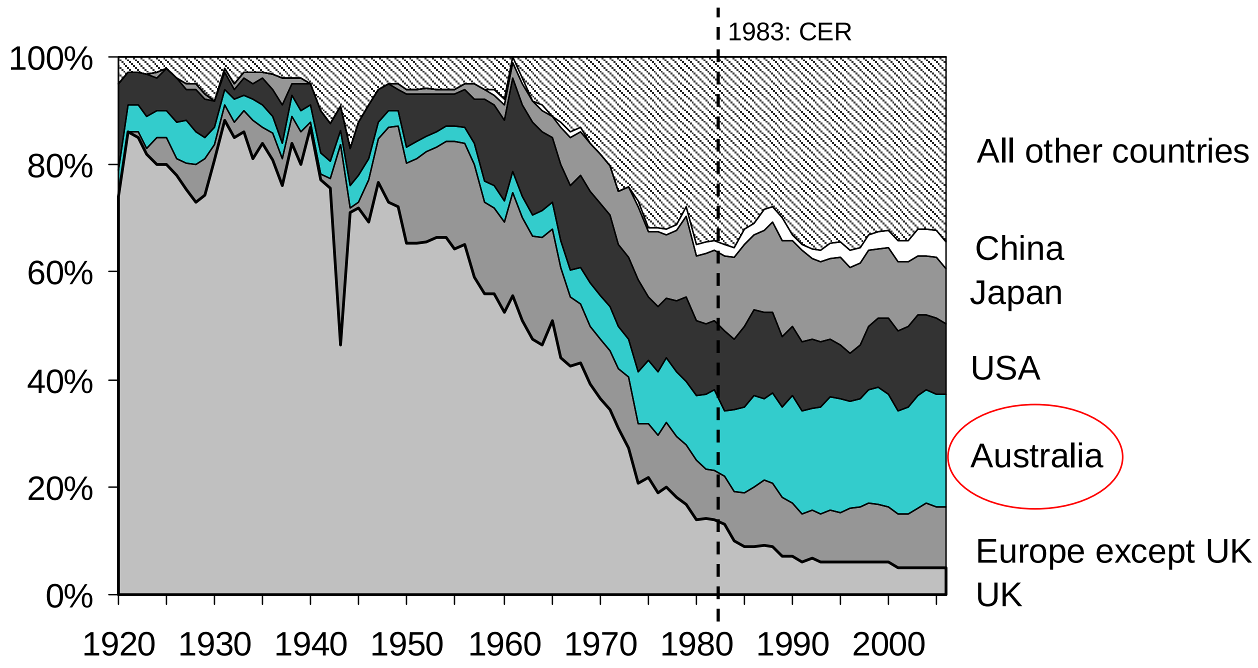
	1983-2006*	1983-1993	1994-2006*
NZ's exports to Australia	8.9%	14.8%	4.2%
NZ's exports to rest of world	5.8%	8.1%	4.2%
Australia's imports from rest of world	9.4%	10.7%	8.4%

Australia’s exports to NZ	7.5%	10.0%	5.6%
Australia's exports to rest of world	8.9%	10.6%	8.1%
NZ's imports from rest of world	7.4%	8.3%	6.7%

Note: Using preliminary data for 2006.

Source: Australian Bureau of Statistics; Statistics New Zealand; OECD.

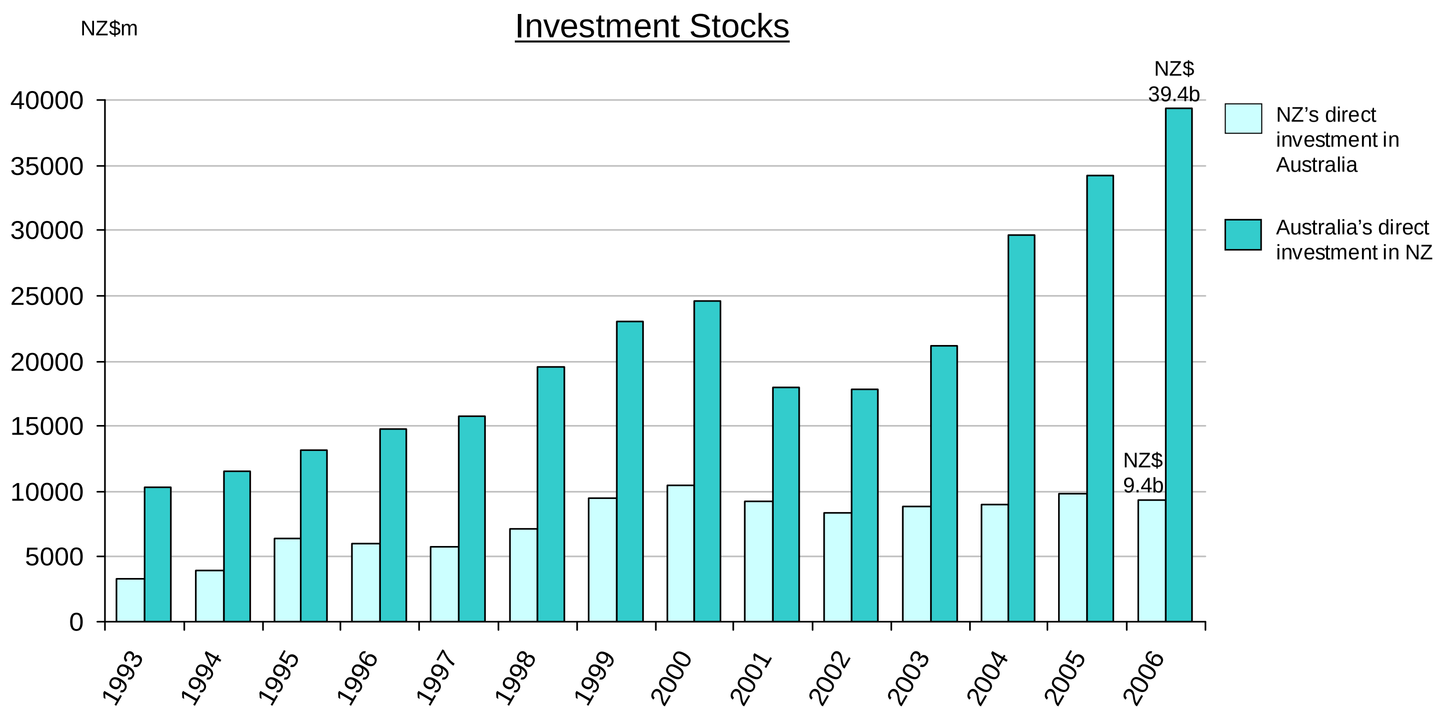
FIGURE 2: NEW ZEALAND'S EXPORT SHARE WAS SHIFTING TOWARDS AUSTRALIA BEFORE CER



Note: Data interpolated for the years 1932, 1942-5, 1950-3, 1960-2, 1969-70, and 1981.

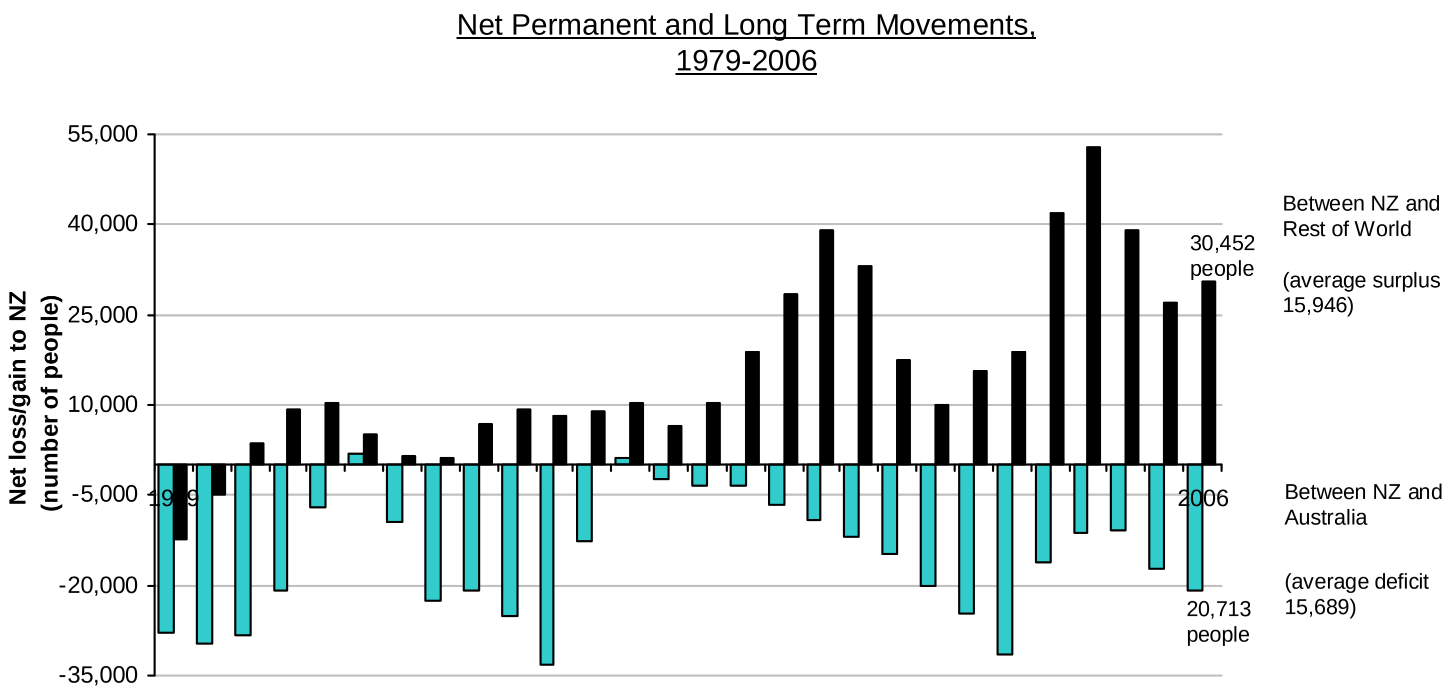
Source: Statistics New Zealand.

FIGURE 3: SUBSTANTIAL DIFFERENCES IN TRANS-TASMAN FDI



Source: UNCTAD (1993-2000); Statistics New Zealand (2001-2006). Data prior to 2001 not directly comparable

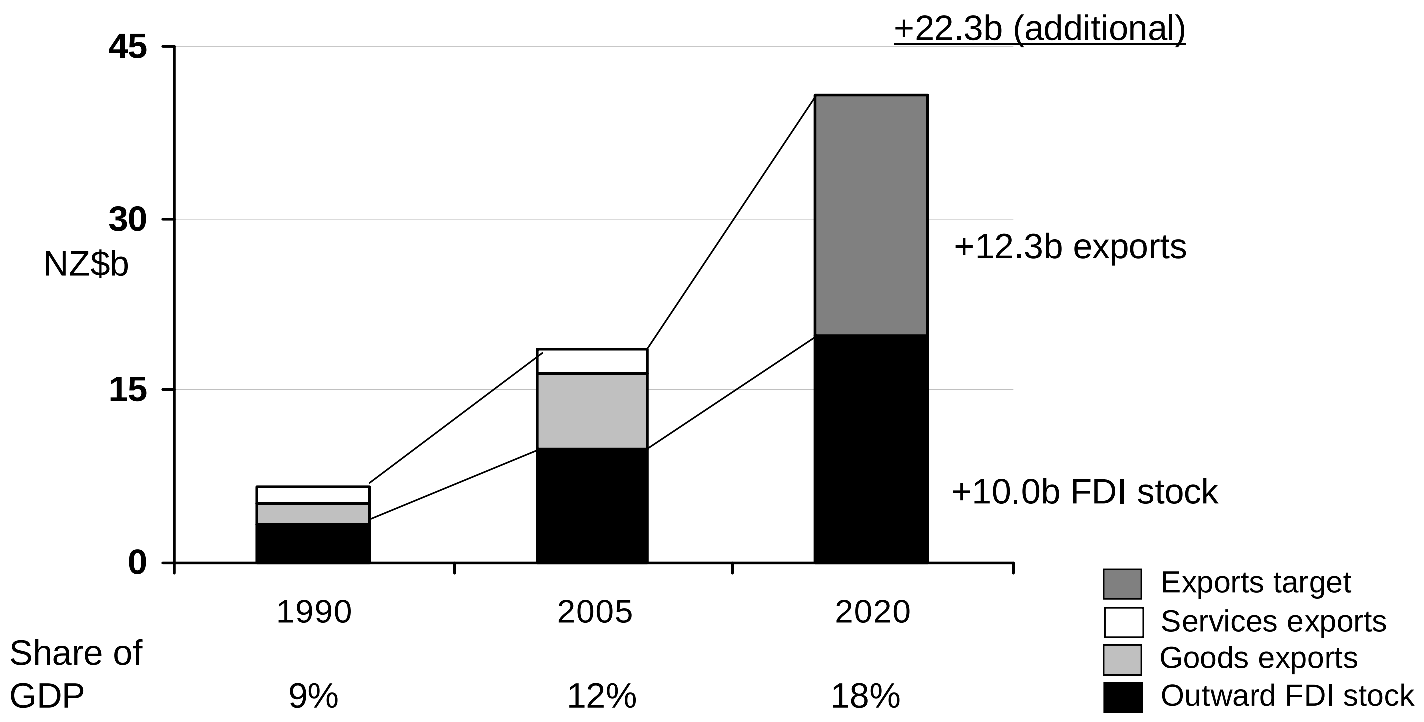
FIGURE 4: NEW ZEALAND'S PEOPLE DEFICIT/SURPLUS



Note: averages are straight-line averages.

Source: Statistics New Zealand.

FIGURE 5: PROPOSED TARGETS FOR NEW ZEALAND'S ECONOMIC RELATIONSHIP WITH AUSTRALIA



Note: 2020 target expressed in 2005$.

Source: WDI; Price Waterhouse Coopers; New Zealand Treasury; OECD; the New Zealand Institute calculations.