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No country is an island: Moving the New Zealand economy forward by taking it to the world

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EXECUTIVE SUMMARY

New Zealand has generated strong economic growth in the 15 years since 1990. This growth performance is a significant improvement on the growth experience of previous decades and also compares well with most other OECD countries. The challenge now is to build on this recent performance and to look ahead to the sources of future economic prosperity – to move from good performance to great performance.

Sustaining New Zealand's recent good economic performance, and then improving it further, is an important national priority. Despite strong recent economic growth, New Zealand's per capita income ranks 21st out of 30 OECD countries and remains over a quarter lower than in Australia.

And it is not clear that on current course and speed the next 15 years will deliver economic growth of the type that New Zealand has generated in the 15 years since 1990. This is because key drivers of New Zealand's recent growth are not sustainable at their current levels.

Two thirds of the economic growth generated since 1990 has been due to increases in the number of hours worked, as unemployment rates have reduced and labour force participation rates have risen. Only one third of New Zealand's growth has been due to labour productivity growth – the amount of value produced for each hour worked. New Zealand's annual labour productivity growth rate of 1.0% over the past 15 years is in the bottom quartile of OECD countries. Most other developed countries have placed a much greater reliance on labour productivity growth.

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

This means that in order to maintain economic growth rates at their current levels, a substantial improvement in labour productivity will be required. And to move into the top half of the OECD by 2020 will require additional labour productivity growth. This is a demanding goal in the context of New Zealand's historical productivity performance. But the good news is that countries like Ireland, Finland, and Australia have turned in performances at these levels over the past 15 years.

To generate such a substantial improvement in labour productivity growth will require significant improvements in capital intensity – the amount of physical capital that workers have to work with – and in total factor productivity (TFP) – the efficiency with which resources are used to produce value. New Zealand's business investment has been consistently lower than in Australia and other OECD countries and TFP growth in New Zealand has consistently been in the bottom quartile of the OECD, despite improving over the past couple of decades.

So what are the priorities for action to generate this improvement in labour productivity growth? Although there is no single thing that needs to be done – growth is about getting lots of things

right – this report looks to identify the constraint on growth that, if addressed, would lead to substantially improved economic performance. The puzzling factor in this regard is that many of New Zealand’s economic policies and institutions compare well to other OECD countries, and are not an obvious source of disadvantage.

However, one area in which New Zealand does differ substantially from other OECD countries is in terms of its combination of a small domestic market and remoteness from other major markets. The evidence suggests strongly that the small effective size of the New Zealand market has a powerful effect on New Zealand’s economic performance, and can be linked to lower labour productivity growth because of its negative effect on business investment and TFP growth.

The lack of scale in the New Zealand economy reduces the incentive of firms to invest and means that some types of economic activity that have large up-front costs are not feasible in the New Zealand market. A lack of scale also restricts the ability to generate TFP growth because it reduces the intensity of competition, weakens the agglomeration effect, and means that there is less scope for productive firms to grow.

The implication of this analysis is that expanding the effective size of the New Zealand market through increased international engagement, in terms of New Zealand firms exporting or investing abroad, will be a critical part of raising labour productivity in a substantial and sustained way. New Zealand cannot raise its labour productivity performance by relying largely on a 4 million person

domestic economy. It is necessary to derive a greater proportion of New Zealand’s national income from international activity in order to sustain and raise productivity growth.

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

Growth is about getting many things right, and a wide range of policies will be required to lift New Zealand’s labour productivity by raising capital intensity and TFP growth; for example, education and innovation policy, savings policy, infrastructure investment, the tax system and labour markets. But policies that increase the efficiency of the domestic economy need to be coupled with a clear focus on international engagement, so that the productivity gains from domestic policy changes can be leveraged over a much larger market. And as we have seen over the past 15 years in New Zealand, policy change without an increase in international activity does not deliver the type of sustained productivity growth that New Zealand needs.

There is a long way to go in this regard. New Zealand’s international performance over the past 15 years, in terms of both exporting and outward direct investment, does not compare well against most other developed countries. The level and growth of New Zealand’s exports



and outward direct investment over the past 15 years is lower than in most other developed countries. New Zealand's current account deficit of 8% of GDP is among the worst in the developed world and is driven by a worsening trade deficit, due to weak exports and strong domestic demand for imports, and a substantial investment income deficit that is due to the high degree of foreign ownership of the New Zealand economy.

The priority now is for business and government, as well as the broader

community, to assume a greater international orientation and to consider how best to substantially increase the extent of New Zealand's international engagement. Efforts are, of course, already underway in this area. But the message of this report is that the importance of this issue, and New Zealand's current low level of international economic activity, means that achieving substantially increased exporting and outward direct investment by New Zealand firms needs to be a first order priority for both business and government.

