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Competing on the World Market

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COMPETING ON THE WORLD MARKET

My topic for this morning's session is competing on the world market.

Not being a trade politician - if I can use that term - I intend to approach the subject by looking at changes on the domestic front in New Zealand which will dramatically alter our ability to compete in the 1990s.

At this time developments in the GATT Uruguay Round have a tendency to dominate thinking on trade issues.

In many respects this is appropriate because any movements on agricultural subsidies and protection will have dramatic effects on the New Zealand and Australian economies.

New Zealand, in particular, with its higher trade exposure than Australia and around 50 percent of exports comprising agricultural products, stands to gain significantly.

However, it would be wrong to let renewed optimism about the current GATT round obscure developments which are potentially more significant in securing a more robust economic performance for the New Zealand economy in the 1990s.

The capacity to improve competitiveness and translate that into rising living standards does not grow naturally out of benign changes in the world trading environment. A sustainable improvement grows out of a rise in productivity, increasing labour and skills availability, and an expanding and deepening of the capital stock.

The changes which the New Zealand economy has been going through since 1984 have been designed to create an environment where continuous economic expansion can occur. There has been an impressive amount of progress in reforming the economy to address many of the longstanding obstacles to economic growth.

In particular, measures to improve the microeconomic structure of the economy through deregulation of financial, goods, and more recently the labour markets are now beginning to yield dividends in the form of lower cost structures and improved productivity.

On the macroeconomic front the combination of tighter fiscal settings and better monetary policy arrangements have succeeded in bringing inflation down to very low levels. As a rule of thumb, you could say a decade ago that New Zealand's inflation would be double the average of the OECD. Today New Zealand's inflation rate is amongst the lowest and is likely to stay there for a number of years to come.

This may sound a bit remote from trade but when we begin to relate these developments to the environment facing New Zealand-based producers, we begin to see a remarkable turnaround in the operating environment they face.

Changes on the waterfront, for example, have lowered container handling costs to one quarter of their previous level. Log exporters tell me that the impact of port reform has been to shift New Zealand 1000 miles closer to their markets. For some agricultural commodities the impact of these reforms has been to lower farm gate to FOB costs by one third. While these changes in themselves are impressive, perhaps more significant has been a cultural change, in which watersiders and wharf workers can participate in a game of beating their own previous records for loading a ship each time it comes into port.

Most people looking at the New Zealand economy will focus only on the current state of the economic cycle. Like most English speaking countries, New Zealand has participated in the 'Anglo recession' which has gripped the United Kingdom, United States, Canada, Australia and New Zealand. By most indicators the state of the New Zealand economy is very poor. For example, less than 1 percent economic growth in the last year, unemployment at around 10 percent and some prospect of it rising further before it begins to fall.

Yet these familiar statistics hide a very much healthier underlying picture.

Back in 1983 New Zealand had low inflation, relatively low unemployment and was growing at 4 percent per annum. Those apparently good statistics were masking a highly overvalued exchange rate, suppressed inflation and a precarious fiscal and trade position. In other words most visible indicators looked good but the fundamentals were awful.

Now in 1991 we have the reverse situation.

The most visible indicators, with the exception of inflation, look awful, but the underlying position is extremely promising. New Zealand has considerable potential to grow based on raising its trade exposure.

In the short term, growth prospects will always be vulnerable to shifts in domestic and external demand. However, the economy's medium- and long-term growth potential are essentially determined on the supply side by trends in employment, investment and total factor productivity - to use the current jargon. Each of these three items is essential to sustained growth over an extended period of time.

There is a considerable amount of slack in the New Zealand economy at the present time. This shows up in the unemployment figures and low rates of labour force participation and capacity utilisation. Over the course of the 1990s and in the early years of the next century there will be fairly rapid growth in the working age population. When these factors are combined, New Zealand has the potential to expand significantly before labour availability would begin to be a problem.

New Zealand's problem in the past has seldom been a lack of labour or, for that matter, a shortage of capital. Lack of growth in the New Zealand economy has chiefly been the result of poor use of capital resulting in very low productivity levels.

For example, it is interesting to look at the sources of potential GDP growth on the supply side - between the two oil shocks and then again in the 1980s. Between the oil shocks New Zealand's potential GDP grew at an average 2.6 percent per annum. Labour force growth contributed almost 1 percent to that 2.6 percent figure. The contribution from new investment was a huge 4.2 percent per annum.

With a 1 percent labour contribution and 4.2 percent investment contribution the economy should have experienced potential GDP growth of 4.9 percent. Instead

New Zealand experienced massively negative total factor productivity. The contribution to potential expansion of output from productivity was minus 2.2 percent per annum.

Factor productivity growth results from the economy becoming more capital intensive, from technological progress and from an upgrading of workforce skills. The figures are telling us that over that period in the 1970s New Zealand experienced the opposite. We moved backwards away from a modern developed industrial economy and towards cottage industry at a rate of more than 2 percentage points per annum.

The picture in the 1980s improved somewhat but not greatly. Over the last decade investment in the New Zealand economy continued to expand rapidly at 3.8 percent per annum while the labour force contribution shrank at an average 0.5 percent a year. The trend of negative factor productivity continued with an annual average contribution to potential GDP of minus 1.6 percent. The stone age crept inexorably nearer and nearer.

The reasons for New Zealand's poor productivity performance have a lot to do with the distorted structure of the New Zealand economy and the extreme business cycles brought about by poor macroeconomic management.

But what of the future?

In the 1990s the working age population will grow at around 1.8 percent per annum (faster than growth in the population). In addition, the potential workforce can be expanded as the present level of unemployment falls towards the natural rate of unemployment which is probably less than 3 percent.

A turnaround in the trend of deteriorating labour skills has occurred since the mid-1980s and will add to the already high rate of growth in labour productivity which has been experienced in the last 4 years. So from the labour market side we have already identified a base from which the economy has the potential to grow at above recent trend rates.

There is a myth in New Zealand about a shortage of capital. As the figures I have quoted suggest, it has been poor capital productivity rather than a lack of capital *per se* which has contributed to New Zealand's relatively poor historical growth performance. In a country which was prone to extreme economic cycles, where many investment decision were made by governments or government entities, and where direct controls, import licences and tax subsidies shaped investment pattems, this result is not surprising.

Of course all that has gone now.

We are beginning to see a clear pattern of industries which were first deregulated and exposed to the disciplines of the international market investing more strongly, not only in upgrading their plant and equipment and expanding capacity but also in the 'soft' activities of improving marketing, design, sales and management.

In addition to these considerations there is the issue of capital deepening. There remains considerable potential for this in a number of industries which have emerged intact from the period of restructuring and are beginning to identify new opportunities for expansion. Telecommunications is the most obvious recent example of technological deepening occurring, but it is not the only one.

All of this suggests that, taking account of the normal investment that will accompany an expanding economy, capital investment will make a significant contribution to potential output in the 1990s. Even without considering the prospect of a stronger productivity performance it is possible to identity factors which would contribute to potential GDP growth rates of between 3.5 and 5 percent.

In addition, however, New Zealand should be able to achieve considerably better factor productivity growth in the 1990s than has been the case in either of the two earlier periods that I mentioned. There are two reasons for this assessment.

The first is that with the removal of many of the government-imposed distortions on the economy, less capital will be wasted on inappropriate investment projects. The second is that with a very much stronger macroeconomic 'rudder' in the form of an independent central bank, the likelihood of extreme cycles in the economy is much reduced. As a result there is a reduced risk of over-investment in the latter stages of booms which leads to redundancy in subsequent troughs. Life in New Zealand may be less exciting in terms of the normal boom and bust cycle, but the capital base of the economy is likely to be stronger as a result.

What I am focusing on here is the likely prosperity dividend for our seven-year investment in economic liberalisation. How large might the dividend be?

If we look at the major industrial economies we find they have achieved average factor productivity contributions to growth of close to 1 percent per annum. Singapore has achieved 2 percent and Japan nearer 3 percent.

Even if New Zealand, with its relatively high GDP per capita, only achieves factor productivity growth in line with the major industrial economies, we are still looking at potential growth rates in the mid- to late-1990s of between 4.5 and 6 percent per annum.

This may sound overly optimistic, but I believe that when we look at the potential for New Zealand to increase its trade exposure and the prospects for industries such as forestry, it is possible to see tangible ways in which this kind of growth can occur.

The importance of this to trade is that it will be international trade which provides the major source of demand. There is already some evidence that in the past two years the New Zealand economy has been buoyed by rising external demand resulting from increasing domestic competitiveness. I believe this has been a factor in the relative strength of exports to Australia in that time despite the weakness of the Australian economy.

There is considerable potential for growth in exports of non-traditional manufactured products. Not only more sophisticated versions of traditional pastoral products - such as speciality cheeses, yoghurt, chocolate, ice cream, plywood, building materials, consumer-ready meat products and so on, but also products such as plastics and electronics and high value items like fashion clothing and boats.

In recent weeks there has been growing recognition of New Zealand as a manufacturing base with reports both from the OECD and the Syntec group pointing to the relative attractiveness of New Zealand as a country in which to manufacture . It may be hard for 'battle weary' New Zealanders to accept that such a revolution is taking place but almost every day there is some new example of an innovative product, process or piece of technology being made and exported from New Zealand.

A New Zealand company recently won a contract with the United Nations to supply berets to peacekeeping forces. Five years ago if such things occurred they were on a very limited scale and heavily assisted by government subsidies, export incentives or protective tariffs.

We are not quite at the point where one could say that New Zealand is turning into another Hongkong or Taiwan, but the seeds of stronger future economic performance have already been sown in a field which has become much more fertile over the past few years.

Neither Australia nor New Zealand is a particularly open economy. New Zealand with a trade ratio (exports plus imports to GDP) of just under 60 percent is a much more open economy than Australia at 34 percent. On this measure New Zealand sits in the middle of the large trading nations and has considerable scope to increase its trade ratio towards the levels of countries such as the Netherlands, Sweden, Austria and Belgium which have ratios of over 100 percent.

In the past we have attempted to expand the external side of the economy by restricting imports and encouraging exports. The success of that policy has been underwhelming and I believe it to be fundamentally flawed. It led to an over-emphasis on producing low value products for export. Resource exports tend to be minimally processed and the import substitution side of the economy tends to develop assembly and repackaging processes, rather than to restructure into a dynamic, competitive and innovative manufacturing sector. The services sector tends to be neglected as well.

Rather than restricting imports and encouraging exports we would be far better to reorientate our economy to encourage imports *and* exports. That may sound like heresy to people concerned about external imbalances, but it is the best way to develop the potential of our workforces and capital stock while stretching the capabilities of our best managers, traders, inventors, innovators and marketers.

It is possible to wrongly diagnose the state of the economy from its external accounts.

As Samuel Brittan pointed out in a recent article, some prosperous and growing economies, such as Spain, experience current account deficits simply because they are prosperous and growing whereas some genuine disaster areas, such as Northern Ireland, can show strong surpluses on their trade just because they are disaster areas.

It is also possible to make an inaccurate inference from the composition of exports and imports as to what is really going on in an economy. For example, an inflow of consumer goods which frees up resources for domestic capital formation makes just as strong a positive contribution to investment and future growth potential as imports of machine tools or transport equipment. So it is wrong in my view to attempt to interfere in the naturally developing patterns of trade in a healthy economy through tariffs or other government assistance.

I think a similar analysis can be made in the case of the labour market.

Reforms to liberalise the labour market in New Zealand have been the latest development with the passage earlier this year of the Employment Contracts Act. In this respect New Zealand is charting a completely different course from Australia.

Decentralised wage bargaining and competition between unions as bargaining agents, in combination with last December's substantial reduction in unemployment benefits and tightening of criteria for benefit eligibility, are creating a climate where the labour force must compete with a substantial pool of unemployed and discouraged job seekers.

Through this mechanism the pool of unemployed is gradually exerting a stronger influence on wage-setting behaviour and on the skill base of the workforce. The result of this process, once it has developed its full potential, will be to ensure New Zealand has higher rates of employment and lower rates of inflation than many other countries.

As you can see, my conception of where New Zealand will be in the middle and later years of this decade is somewhat at variance with most of the commentary that one hears on the current state of the economy.

But while one can have a high degree of confidence in the medium-term outlook, the hardest part of the process to understand is how we get from here to there.

The immediate prospects for the New Zealand economy are a strengthening of the external sector combined with a flat outlook for domestic demand. With rising corporate profitability stemming from changes in productivity, employment and wage trends, combined with a much lower and more stable interest and exchange rate outlook, there will be a revival of investment spending over the next two to three years.

Through those mechanisms, an export- and profit-led expansion, the economy will climb slowly out of the current recession while locking in many of the gains which have been made through the process of restructuring. The importance of trade in this context is obvious. I believe the faster we expose ourselves to more competitive markets and more innovative competitors the sooner New Zealand producers and traders will become recognised as international leaders.

The Closer Economic Relations agreement with Australia has been an important influence in fostering a more outward-looking manufacturing sector in New Zealand. One of the strengths of CER has been that the agreement has operated as a working document and has not grown a bureaucracy of its own. If there is a criticism of the agreement, I think it is that a focus on Australia has diverted the attention of New Zealand producers away from potentially more dynamic but more difficult markets further to the north. With the language, cultural, economic, legal, tax and regulatory similarities between Australia and New Zealand, it is a natural thing for first time New Zealand exporters to look across the Tasman. But in some respects it might be said that the ease of doing business in a familiar business climate does not adequately prepare them for conditions they will encounter in other markets.

Nevertheless, I think it is useful to have the agreement in place and for it to be extended into areas such as services and investment-related issues and to encompass greater harmonisation of regulatory and tax practices. However, we should also not lose sight of the gains from unilateral convergence and we should not trade off concessions in one country against the other while excluding third country participants.

I have to admit to some maverick views on trade arrangements, including the view that any country which meets the basic criteria should be admitted to the agreement.

It is interesting to see the widening of the European Community as it has embraced a number of southern European countries and received applications from countries in Africa, Central Asia, the Nordic countries and Eastern Europe to join the original twelve. It is not a tongue in cheek statement to suggest that Australia and New Zealand have a greater claim to membership of the Community than do many of these countries such as Morocco and Turkey. The basis of that is a longstanding trading relationship, comparable income levels, similar fiscal systems, market-based economies, cultural affinity and, for large proportions of our populations, the right of residence in Europe.

In the recent Gulf conflict New Zealand and Australia proved themselves much more willing and able to defend the mutual interests of Europe than some of the leading countries in the Community. Perhaps a new strategy if the current GATT round stalls might be for Australia and New Zealand to actively pursue member-ship of the emerging trade blocs in Europe and the Americas. If that does nothing else it will focus attention on the folly of erecting trade barriers against efficient producers.

However, we have further to go to complete liberalisation of trade. New Zealand still has a number of favoured industries which receive above-average levels of protection despite the fact that they are largely industries with little prospect of successful expansion. Car assembly must be the worst example, especially as the protection granted to it puts at risk a larger number of jobs in downstream industries.

With low, stable inflation and a progressively expanding economy, there will be a considerable shift in attitudes. At the moment most people are sceptical of the benefits of restructuring and that scepticism lies at the root of very low business and consumer confidence.

To a large extent this is mirrored in the popularity of our political leaders.

There is more to be done to improve the flexibility of the economy but the major hurdles have already been cleared. As a result the foundations for sustainable growth have been laid.

Economic growth can only come from business growth. In the process small firms become profitable, expand, spawn other businesses or are absorbed into larger entities. At the same time other businesses wither away as the previous source of their advantage disappears.

Sustainable growth comes from continual upgrading which is in turn the fruit of ongoing research and investment in new activities and new ideas. Universally the process involves risks and requires a positive attitude to change. Growth is dynamic, requiring a spread of start-up, developing and mature business units. Innovation, change, and the ability to manage change are key strategic strengths which are necessary for success.

At the end of the day it is individuals with capital at risk who will determine when and to what extent growth will occur. Those individuals will search out the opportunities to do things cheaper, smarter and better than is done at present.

For too long New Zealand has resisted change instead of understanding the process and harnessing it to our advantage. We spent much of the 1970s, for example, trying to pretend that Britain had not entered the European Community. We spent much of the early l980s trying to pretend that oil prices had not fallen. We have a society which tends to reward conventional thinking and disparage people who attempt to break the mould and try something new and different.

So it requires confidence to be unconventional, to accept the need to adapt, to be willing to innovate, to explore the mundane, everyday and familiar for new ways of doing old things.

It is these attitudes which, combined with a more flexible and dynamic economic base, can lay the foundations for a stronger trading performance in the 1990s and rising prosperity and living standards.