



ViewPoint

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Overcoming Obstacles to Investment in Productivity Growth

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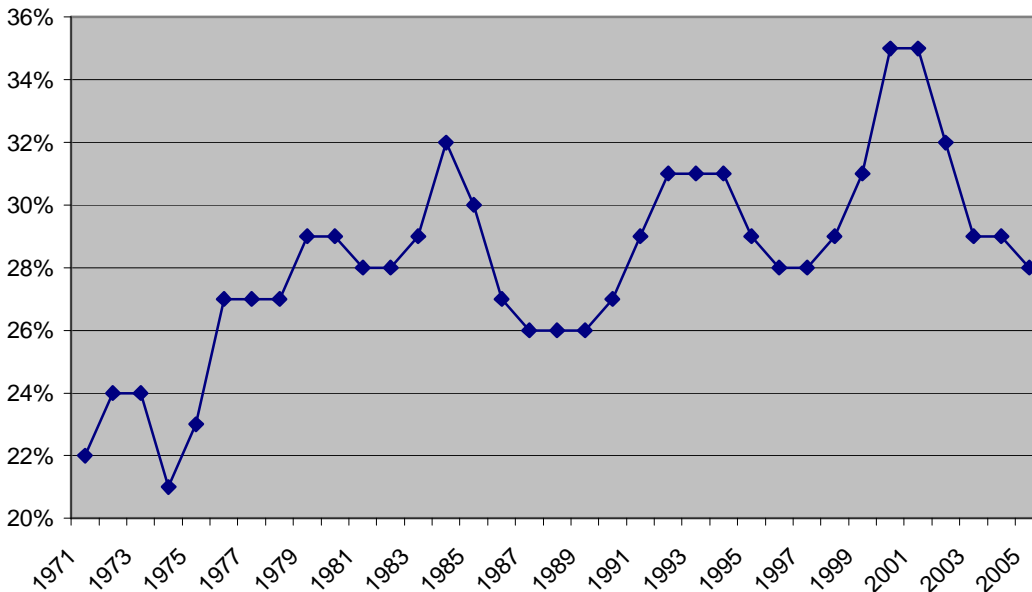
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New Zealand needs to grow its productivity if we are to achieve world-class living standards. There has not been sufficient investment in productivity growth in the past, so we need to look at the factors that inhibit this investment.

Productivity is the ratio of the value we produce to the value of the inputs used. Part of the picture can be seen from the value of New Zealand's outputs, measured in terms of our exports. The graph shows that this value has not grown much at all over the past two decades.

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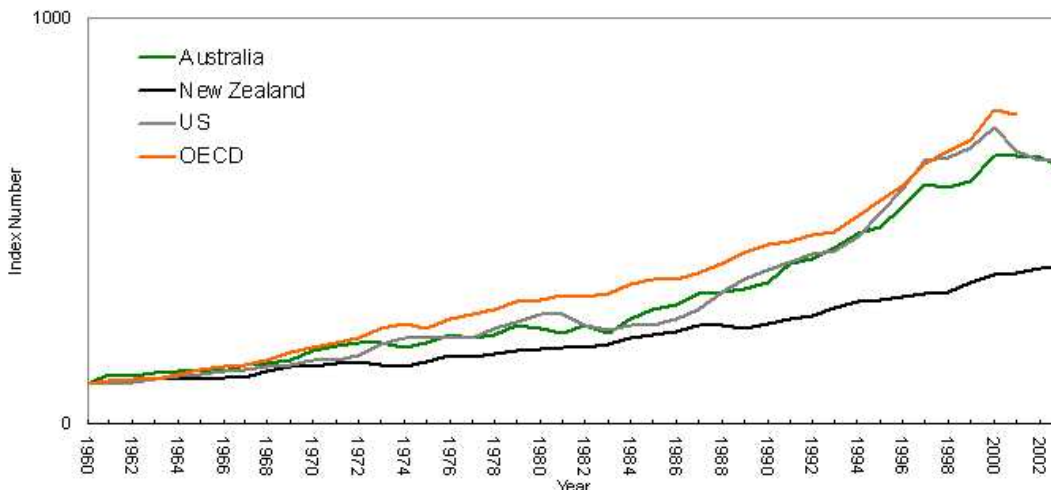
Export of Goods and Services as a Percentage of GDP



New Zealand has the highest cumulate trade balance deficit in the developed world.

The growth in exports as a percentage of GDP that occurred during the 1970s and 1980s slowed through the 1990s and 2000s, and exports have really just fluctuated with the level of the New Zealand dollar. As a result, New Zealand has the highest cumulative trade balance deficit in the developed world.

Exports growth per capita
1990 prices and exchange rates Index 1960 = 100



Other countries have increased their export trade considerably more than we have.

A comparison with some of our OECD competitors illustrates the problem. Other countries have increased their export trade considerably more than we have. This has caused New Zealand to slip further down the OECD rankings. We cannot blame our poor performance on New Zealand’s comparative isolation – it is not as if the continent of Australia has suddenly moved closer to its export markets, for instance! There must be some other reasons.

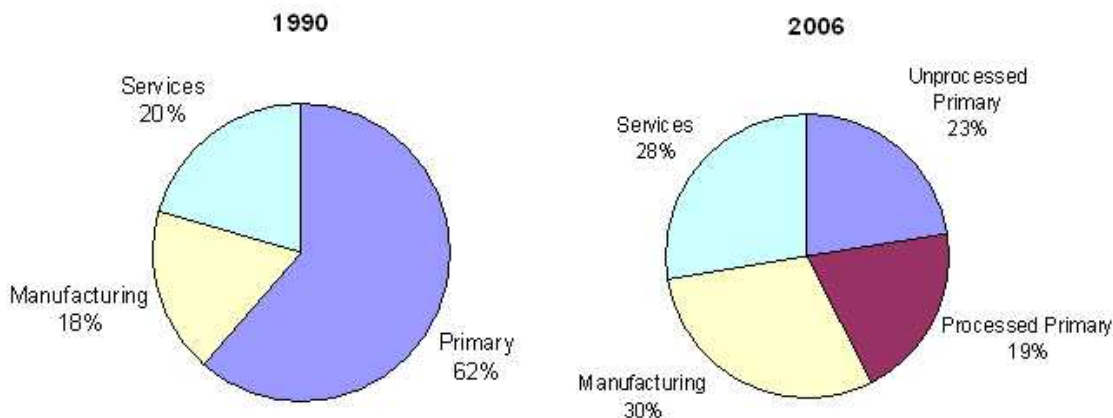
New Zealand’s industrial profile is weighted heavily towards primary production.

One reason for our poor performance is New Zealand’s industrial profile, which is weighted heavily towards primary production, meaning the rate of productivity improvement is limited by the time required to breed and grow improved animals and plants. Growth of the manufacturing sector could create a more balanced relative weighting, without diminishing the importance of the industries where many of New Zealand’s greatest strengths lie.

We have, of course, seen some growth in the manufacturing sector. In export terms that growth has actually outstripped other sectors and an increasing proportion of our primary production is being processed, at least to some extent. Industrial techniques and capability are key enablers of more effective post-primary processing, which adds value to primary products. The same infrastructure and supply chains that support industry can therefore be applied to increase the value of our primary production. As we can see, primary exports have reduced as a percentage of total exports in the last two decades (post primary exports were not measured until recently) but processed primary exports have been increasing

Export growth in the manufacturing sector has outstripped other sectors.

New Zealand’s Export Profile



There has been a prevailing view that our relatively high labour costs preclude industrial activity in New Zealand, because goods could be created or processed for less elsewhere. The healthy industrial sectors of other developed countries (such as Germany and Japan), despite even higher labour costs than our own, disprove this theory.

At the centre of this disconnect is innovation. Often, labour makes up less than 5% of input costs for manufactured goods created in western countries. This makes labour costs relatively unimportant compared to other drivers of competitiveness, such as innovation and overall productivity. However, significant investment is required to research and innovate products and processes in order to become more productive. This makes the willingness of business to make these investments a key issue.

Wild fluctuations in our exchange rates, caused by our inflation control mechanism, have made it difficult for exporters to make long-term investments¹. High interest rates targeted at reducing consumer demand and controlling cost price inflation have attracted offshore money to New Zealand, thereby driving up our exchange rate. Eventually, high interest rates slow the economy, the dollar starts to fall and interest rates ease. Often events conspire to lower exchange rates at the same time as global market conditions turn south, amplifying the pain of the economic cycle.

With the exchange rate changing rapidly, an activity that was profitable when an investment was made, may cease to be profitable a couple of years later when returns may still not have covered the investment. This type of experience tends to make exporters invest in shorter-term projects so that they are not caught out by these changing conditions. Unfortunately, these short-term projects do not involve the same investment in people, plant and products and therefore do not generally increase productivity or generate the same benefit, over time, to the economy.

To address this issue the link between inflation control and the exchange rate must be broken. This link attracts speculative foreign money to New Zealand, driving up the supply of money and forcing the Reserve Bank to raise interest rates again. It is this policy that is the most damaging to the tradeable sector and it is an issue that must be addressed.

In the long run New Zealand's interests will be best served through economic diversification. More diversity would provide more stability because it would reduce the effects of weather and commodity price variations on our economy. Diversifying our industrial profile would also give us much stronger capabilities to transform our agricultural production into high-value, niche products for which our customers will be willing to pay higher prices.

An ability to create elaborately transformed products will make it easier to capture more of the value chain between production and consumption. Identifying and supplying valuable consumer attributes associated with processed primary products and carrying out end-to-end system optimisation will also increase productivity. New Zealand has existing strengths in these areas, so it makes sense to base new diversified industries on those strengths.

Elaborate transformation requires long-term investment, and long-term investment requires an expectation of stability and a market large enough to make that investment worthwhile. In New Zealand, that means export markets.

Our export profile can develop in two ways: we can take the commodity trajectory, specialise in fewer and fewer items, and have our whole economy at the mercy of varying international demand for those items, or we can embrace elaborate transformation and export an increasingly diverse set of products. A complex export profile would provide a resilient and genuinely world-class economy.

Significant investment is required to research and innovate products.

New Zealand's interests will be best served through economic diversification.

¹ 'Innovation, Growth and the High Cash Rate', <http://www.mea.org.nz/document.ashx?id=38>