



Comments on NZ Treasury Productivity Paper:

International Connections and Productivity

The world economy is currently experiencing the worst economic crisis since the Great Depression in the 1930s. The bursting of the United States housing bubble has exposed the pervasive weaknesses in the global financial system, and the subprime mortgage crisis has not only led to a slowdown in the US domestic economy, it has also triggered a prolonged recession worldwide.

New Zealand economy has been in recession since June 2008. Despite this, as a commodity exporter, New Zealand was still considered as one of the few developed countries that were well positioned to deal with the current crisis. However, as international turmoil intensified and the commodity price bubble burst in mid 2008, it became clear that New Zealand is not immune to the global crisis, and a deeper recession is inevitable. In the December 2008 quarter, unemployment rose to 4.7%, and economic activity declined 0.9 percent; the fourth consecutive quarter of contraction in economic activity. Though the banking system remains fundamentally sound, the banks' heavy reliance on short term foreign wholesale funding could be a concern as a result of heightened risk aversion and a loss of global liquidity. According to a 2009 OECD economic survey of New Zealand, our economy is one of the most indebted in the OECD. Household debt reached 160% of disposable income, and the current account deficit is at 8.9% of GDP at the end of 2008. Economic conditions worsened further in early 2009, and significant deterioration of macroeconomic indicators is expected.

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Every cloud has a silver lining. The current crisis brings forward the overdue housing market correction. Falling asset prices along with sufficient job losses will scare people into forced saving, and reduce the country's indebtedness. The depreciation of the exchange rate encourages the redirection of resources from housing and consumption back to the tradeable sector. With these forces in place, the new Government is geared up to face the largest challenge - boosting productivity growth. The OECD recommended in its economic survey that the crisis should be seized as an opportunity to push forward the nation's productivity agenda in ways that might not be possible in 'normal' times.

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In 2008, a series of productivity papers by Treasury identified five drivers of productivity; these were innovation, enterprise, investment, skills and natural resources, while international connections were considered to be important for all five factors. The paper, International Connections and Productivity, distinguishes between being open and being connected, and assesses New Zealand's international connections from four areas of international flows. These are flows of people, flows of capital, flows of trade and flows of ideas. Three areas of focus have been identified to improve New Zealand's international connections. In the rest of this paper we will discuss and give feedback on each of these priorities.

Priority One: Domestic policy settings are critical to making the most of international opportunities.

- Ensure tax and regulatory settings encourage entrepreneurial and innovative activity in New Zealand.

Entrepreneurial and innovative activities are both costly and risky for most businesses. Especially under the current economic environment, many businesses will go back to the basic and forgo risky projects. The Association supports a tax-reform program that reduces the financial risk of innovation. Both lowering corporate tax rates below the OECD average, and shifting the tax base away from internationally mobile activities (e.g. income and profits) towards immobile base (e.g. land, consumption) support innovation and entrepreneurial activities based in New Zealand.

- Dampen exchange rate cycles to facilitate development of the tradeable sector.

The exchange rate is a key element in international trade. An overvalued currency will make New Zealand firms less competitive internationally, while extreme volatility in exchange rates induces unmanageable exchange rate risks, and creates an uncertain environment for investors. While reducing the risk of pro-cyclical fiscal policy and maintaining a sustainable, predictable and smooth medium-term adjustment path are necessary, we feel it will not be sufficient to dampen exchange rate cycles.

Other Government policies should take exchange rate impacts into account. For instance, under a floating exchange rate regime, monetary policy in New Zealand typically operates without exchange rate considerations. The conventional inflation control mechanism (i.e. the OCR) fails to address the exchange rate issue, and sacrifices exchange rate stability for price stability. A supplementary tool is required to help the RBNZ to combat inflation and minimise collateral exchange rate impacts. Differential inflation rates on the tradable and non-tradable sectors require separate, balanced and more targeted policy responses. Furthermore, monetary policy should be directed at the actual problem; tradeable inflation is well under control, so inflation in the non-tradeable sector should be the sole target of anti-inflationary policy.

- Develop a more integrated approach to international flows of people.

As a main driver of productivity, skills enhance the contribution of the labour force to growth. We are agreed that targeting skills and ensuring a net positive inflow of people are particularly important for a small country like New Zealand. As “migration broadly represents a ‘brain exchange’”, it is critical for the exchange to be productivity enhancing. The immigration selection process should be designed to maximise the benefit of the exchange.

- Reduce barriers faced by New Zealand firms doing business abroad.

It is agreed that a more effective offshore presence would help reduce barriers faced by New Zealand exporters, however, both trade and technical barriers will need to be reduced. For elaborately transformed manufacturers, reducing technical barriers can be more important than tariff reductions. The NZ-China Free Trade Agreement for example contains an agreement on the mutual recognition of conformity assessment for electrical and electric equipment (EEEMRA), which intended to reduce technical barriers by giving suppliers in both countries an alternative way to demonstrate compliance with electrical safety and electromagnetic compatibility regulatory requirements.

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“An overvalued currency will influence medium term investment and ultimately make New Zealand firms less competitive internationally.”

“technical barriers to trade remain a problem, not well addressed by current negotiating practice”

However, the Agreement only concerns electrical and electronic products that are subject to the China Compulsory Certification (CCC) system and to the requirements of New Zealand supplier declarations of conformity for such products. In New Zealand according to the Energy Safety Services, only products that are considered to offer a medium or high safety risk are covered by a Supplier Declaration of Compliance (SDoC) by the supplier of the product prior to sale. This means that manufacturers exporting non-declared products would not be able to benefit from EEEMRA; the limited declared product range seriously discounted the potential benefit of FTA.

Despite the limited benefits, there is a fundamental fault within the arrangement. New Zealand has implemented a post-market auditing process that applies to all except the declared articles, which means end-consumers are responsible for reporting sub-standard or unsafe energy products, otherwise compliance is automatically assumed. Since the CCC mark only applies to 19 different product categories, most imports can enter the New Zealand market without any official border check, while the pre-market (compliance testing prior to sale) auditing system in China acts as a barrier for exporting non-declared products. One way to readjust the inequity is to set up a mutual agreement such that Testing Reports produced by recognised testing laboratories can be used for compliance purposes in the other country, hence the benefit of FTA can be maximised. Put simply in elaborate products the problem starts once the FTA is signed, at that point for commodities the job is done – it is vital the MFAT understands and builds into the negotiation process that there is more to New Zealand's offensive trade interests than milk, meat and fibre.

- Maintain a well-functioning innovation system that facilitates international knowledge transfer.

Innovation is a key determinant of multi-factor productivity. The Association considers the non-discretionary schemes (e.g. R&D tax credit) as the preferred policy instruments for stimulating private sector R&D. Twenty-one OECD countries provided R&D tax incentives in 2008. Unfortunately, the 15% R&D tax credit was repealed after the 2008 election, and even with a lower company tax, companies that carry out R&D in New Zealand are considerably disadvantaged in comparison to other countries.

Prior to the introducing of the tax credit, the previous Government devoted a considerable amount of effort to policy design and fine-tuning, and firms have invested large amounts of time and money to maximise the advantage and implement systems to support the tax credit claims. Since the tax credit will not apply beyond 2008 income year all these efforts have been wasted, and many innovative firms are likely to review their R&D activity. Our position is to support an approach targeted at behaviours that are precursors to successful commercial innovation as opposed to trying to pick winners or winning sectors.

- Allocate natural resources more efficiently.

The efficient allocation and accessible exploitation of natural resources is supported by the Association. The Resource Management Act (Simplifying and Streamlining) Amendment Bill 2009 has been introduced into Parliament and referred to the Local Government and Environment Committee for consideration. The reform is a step in the right direction as we need to find a better balance between environment conservation and sustainable economic development.

- Argue for a fair post-Kyoto framework.

The Association recognises that ongoing economic growth is reliant on the sustainable use of resources. Currently, a range of programmes have been put in place or being developed to reduce emissions to 1990 levels. In November 2008 the new National-led Government announced that it would delay implementation of the ETS pending a full review of climate change policy. From an industry perspective, it is important that NZ ETS does not erode the competitive position of the tradable sector. Adding cost to New Zealand producers that is not faced by our competitors makes no sense.

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Any activity lost to New Zealand as a due to the costs of the Kyoto regulations is likely to go developing countries which do not have to comply with these rules increasing the environmental damage caused by the activity. At least we should try to minimise the impact of the ETS on firms' international competitiveness, especially for those energy intensive industries.

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Priority Two: New Zealand should aim to be an integral part of an Asian-Pacific regional economic market.

- Maintain a clear strategy for engagement in the Asia-Pacific region; continue moves towards a single economic market with Australia as part of the wider aim.

It is true that the Asia-Pacific region is important for New Zealand's external sector. Australia remains New Zealand's biggest export market; total exports to Australia were worth \$9.2 billion in the year ended June 2008, Japan was New Zealand's third-largest export market receiving \$3.4 billion, and New Zealand's fourth-largest export destination was China, where exports were worth \$2.1 billion. However, that does not mean we should ignore markets outside of Asia-Pacific Region, particularly the US market. In 2008 June year, the United States was New Zealand's second-largest export market. For agricultural products, the United States is the most popular export destination, worth \$2.27 billion or 10.46 percent of total agriculture exports, followed by Australia (9.6%), Japan (7%) and China (5%). Whereas for non-agricultural products, 38.7 of exports go to Australia, followed by Japan (9.8%), the United States (9.5%) and China (4.8%).

According to the above figures, the US market is also crucial for New Zealand. Therefore, the scope of the integration should be wider than the Asian-Pacific region, namely, the Pacific Rim. There are geopolitical implications for policy and trade in this regard.

Priority Three: Further reducing barriers at the border to support greater economic integration.

- Phase out all remaining import tariffs.

Currently around 95% of goods in New Zealand are imported tariff free. The Global Competitiveness Report 2008-2009 gave New Zealand the third highest score of 6.2 out of 7 for the non-prevalence of trade barriers. It is true that some countries have lower import tariffs than New Zealand, but the Association considers that there is no point reducing tariffs just for the sake of it. Without a well established domestic and export sector, further reduction of import tariffs will yield very little benefit. It is also questionable whether imports will provide access to foreign knowledge thought embedded technology as New Zealand firms tend to be technology creators rather than followers. In the elaborate sector technical barriers, both offensive and defensive, are far more important than tariffs.

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- Remove investment screening, or improve the screening regime; reduce costs of ports and customs; ensure high-speed, low-cost broadband is available for business; reduce the cost of international capital.

The Association supports the above position. However, there are some issues around mandatory safety and compliance standards. The non-compliance in hot water cylinders (absence of pressure relief valves on imported products), refrigerators that do not comply with energy efficiency ratings, refrigerant or temperature limits (keeping food cold) and the import of non-compliant CFCs in vehicles and refrigerators that is banned in bulk are examples that come to mind. Policy responses that hold the importer responsible, and require declarations of compliance and mandatory insurance cover are common for elaborate products in other countries.

- Negotiate hard for market access in multilateral, plurilateral, and bilateral forums.

The Association suggests that government officials should try to improve both quantity and quality of their communication with firms when negotiating for market access. After all, they are the people who will benefit from the negotiation. If, as in the China FTA nothing changes from the particular firm's perspective, what is the rationale for the FTA efforts?

The Association fundamentally supports open trade. For most firms, the New Zealand market alone is too small to amortise development costs, which means that overseas market access is vital to the development of an elaborately transformed sector. In these circumstances trade openness must mean the provision of a level playing field wherever possible. Elaborate products have the capacity to create a minefield of technical barriers that require a more effective policy response than we have seen in the past.

Policy contrasts between New Zealand and other jurisdictions need care. Whether it is monetary, trade or fiscal policy, we need to work harder to avoid the major cost falling to the virtuous, and respond quickly when policy differences open up major competitive differences in the tradeable sector.

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We are happy to provide more detail on the issues raised in this paper.