

# Managing for Success: Small Economies in a Dangerous World



2012 Commonwealth Economic Forum, Taiwan

Murray Sherwin, NZ Productivity Commission Chair

## Introduction

The theme of this Forum is Asia's transformation and growth in a new era of risk. This is a very relevant theme. As we observe the continuing fallout from the Global Financial Crisis (GFC) which began in 2007, it seems clear, even from our rather distant vantage point in New Zealand, that we all face an extended period of challenge and risk. None of us can be immune. The question we face is how we can best increase our resilience in the face of those, and many other, risks.

Small, open economies inevitably are highly exposed to external developments. They are generally more engaged in international trade, proportionately, than are larger economies and by that route more exposed to international economic shocks. Also, small economies tend to have a relatively narrower economic base – meaning greater dependence on a smaller number of industries or sectors and therefore further exposure to volatility.

An advantage of small economies can be greater agility - quicker to adjust and reshape domestic policy settings to adapt to new information. In essence, there can be a greater capacity to convert risk to opportunity.

And while increased international trade may, in one sense, add an element of risk, one matter on which the economics profession has reached broad consensus is that the net benefits from trade are overwhelmingly positive.

This is the theme of my address today, and in discussing these matters, I will touch on the evolving New Zealand relationship with Taiwan.

My comments are set in the context of work now underway between our two economies to explore the feasibility of negotiating an Economic Cooperation Agreement. This follows on from earlier agreements that New Zealand negotiated with a number of other Asian partners including China, Hong Kong and the ASEAN countries, all of which have been important contributors to a rapid shift towards Asia in New Zealand's trading relationships in recent years.

For those unfamiliar with New Zealand, a few comparative statistics. We certainly qualify for the definition of a "small economy". Our population is just 4.4 million, while GDP amounts to around US\$150 billion pa, and the land area is around 270,000 square kilometers. Compared to Taiwan, we have around 1/5<sup>th</sup> the population, 1/3<sup>rd</sup> your GDP but around 8 times the land area.

## Christchurch earthquakes

We both inhabit mountainous islands situated on the geologically active Pacific "rim of fire"; meaning earthquakes are familiar to both of us.

In that respect, may I acknowledge the extraordinary series of earthquakes that have hit our second largest city, Christchurch, since 4 September 2010. Since then, a further 10,000 earthquakes have been recorded, more than 30 of those exceeding level 5 on the Richter scale. The most damaging, exactly one year ago, on 22 February 2011, resulted in the deaths of 184 people. These earthquakes will result in the demolition of around 60% of the commercial buildings in the Christchurch CBD including many of the heritage buildings that gave that beautiful city its distinctive charm. Beyond the CBD, around 10,000 suburban residential homes have been or will be demolished and a further 100,000 residential homes require some form of repair. Literally, this has been an earth-shattering episode.

However, even in tragedy we find connections. Amongst the fatalities was one young Taiwanese student. May I also acknowledge and thank the speedy response by the Taiwanese authorities, who immediately dispatched to Christchurch an urban search and rescue team. Their work was greatly appreciated.

Lives cannot be replaced. But for the survivors a speedy recovery of their shattered city is, by far, the best medicine. Thankfully, New Zealanders are well insured. Rebuilding homes, commercial buildings, roads and public infrastructure such as water, sewage, parks, sports and cultural facilities is expected to cost around NZ\$30 billion, equivalent to about 15% of GDP. It is likely that around 70% of that cost will be met from insurance claims, with much of that funding drawn from international re-insurance markets.

Christchurch provides a good example of how a small country can manage very large risks and build resilience on the back of careful planning and the right governance and institutional structures.

### **A brief economic history**

In terms of our economic geography, New Zealand is not just small, but very distant – indeed, amongst the OECD group of countries, New Zealand is further from its international markets than any other economy.

Our modern history, which began with the first significant European settlement from around 1850, has been one of deep international linkages. The new colony was built on immigration, imported financial, physical and human capital, and through trade.

Natural resource exploitation dominated early activity – whales, seals, and timber, gold – before pastoral agriculture became established as the dominant economic driver. The key market – indeed for a period almost the only market – was Britain, despite being quite literally the most distant point on the globe. As I began my professional career in the mid- 1970's, the overwhelming majority of our exports - around 85% - were shipped to Britain, which was also the source of most of our imports. All of this, of course, reflected family, personal and business relationships built on historical patterns of immigration.

This was a mutually beneficial arrangement. Britain needed the cheap meat, dairy products and wool that New Zealand could provide, and New Zealand grew wealthy on the trade. Through the first half the 20<sup>th</sup> century, New Zealand enjoyed per capita income levels that were amongst the highest in the world. Such are the advantages of international trade and open capital markets.

Life for New Zealand began to get much more difficult from around the 1960s. The volatility of our agriculture-based economy had led to a view that the future lay with manufacturing. In part, this reflected a sense that agriculture was in decline - a stronger and more sophisticated future lay with manufacturing that could provide the high paying urban jobs required as agriculture became relentlessly more productive and less labour intensive and our cities grew. It is a familiar story in many countries.

Declining international prices for agriculture products put pressure on New Zealand living standards, and Britain began discussions with its European partners with the objective of joining what we then knew as "The European Common Market". For New Zealand, this signaled the end of unlimited access for our agricultural products into British markets and the beginning of a long, unwelcome and difficult period of adjustment to new circumstances.

My knowledge of Taiwan's economic history is very limited, but I note that at around that same period, in the 1960s, Taiwan was also beginning a transition from an agricultural base to manufacturing. Your experience, and ours were clearly very different, as we see from the economic structures in the two economies today. Your transition into manufacturing, and especially electronics and sophisticated machine tools has been impressive. And while agriculture remains important here, its share of GDP is much reduced.

As Taiwan looks at where its next development phase will take it, New Zealand will be watching with interest to learn what we can from your experiences and processes. Your interest in the future of biotechnology and biomedicines could well provide opportunities for closer collaboration with our own biosciences community.

New Zealand's attempt during the 1950s and 1960s to encourage development of manufacturing behind a wall of import quotas, tariffs and subsidies was a dismal failure. Not only did it lead to expensive, poor quality and limited choices of products for consumers, it added to costs generally and thereby undermined the competitiveness of the one sector where New Zealand had been internationally successful – agriculture.

Agriculture is our Silicon Valley. It is a sophisticated, capital and science- intensive business and provides our largest companies and our biggest brands. On the back of decades of investment in research, agriculture is our high productivity sector and is our strongest source of export growth.

Yes, we do have a manufacturing sector - often based around quite sophisticated electronics & IT related products. Generally, it operates in smaller niche markets compatible with a very small domestic market base giving to rise small scale, specialist design and build producers.

And like all modern economies, services have become much more important drivers of activity – tourism, education services, professional services such engineering, accountancy and law, and more recently, and most unexpectedly, movies and related technical and production services, including special effects. This latter development, largely on the back of the creative genius and drive of Sir Peter Jackson and his colleagues in Wellington making movies such as the Lord of the Rings trilogy, Tintin, Avatar and currently The Hobbit. Peter Jackson's success serves as a constant reminder to politicians and bureaucrats that, however good we think we are, we will rarely predict the next source of growth. (New Zealand's success in movies is about as unlikely as a Taiwanese making it big as an NBL basketball player)

Being small, and in our case, geographically isolated also, is a fact of life. But it certainly does not mean that we must be poor or somehow limited in our aspirations. What matters is how well we play the cards we have been dealt – how we shape our public policies and how we work with our business sector and wider community to generate an economy and society in which our people are able to thrive and enjoy the highest possible standards of living.

## **The rise of Asia**

The rise in Asian economic influence has been profound. The ADB reports that Asia's share of global GDP has more than doubled over the past 50 years, and now exceeds 35%. Asia's share of global trade has similarly doubled.

The impact of this shift in New Zealand has been substantial. As a destination for NZ exports, Asia has moved from around 6% in 1960 to about 40% currently and growing rapidly. Not surprisingly, the source of New Zealand's imports has similarly shifted to Asia.

Even that trend understates the growing influence of Asia on New Zealand. New Zealand has also experienced a surge in trade with Australia which now accounts for around 20% of our trade. But Australia's great success in recent years has been driven off the back of its commodity exports to Asia, especially China. Around 70% of Australian exports are now shipped to Asia - which, amongst other things, means that the Asian economic influence in New Zealand is felt both directly, in our own trade relationship, and indirectly by way of Australia's exposure to Asia.

The shifting Asian influences run well beyond trade and the business cycle. Asia now provides more than a quarter of NZ's new migrants – a pattern that has emerged strongly over the past 20 years or so. Auckland City is the primary recipient of our new migrants. Those of Asian ethnicity now exceed those of Maori descent in our largest city.

After agriculture and tourism, education for foreign students has become a substantial business for New Zealand schools and universities. Around 75% of the international students seeking education in New Zealand are of Asian origin.

Where trade and people move, so follows capital and investment. To date, Japan has been the most significant Asian source of FDI into New Zealand, but overall flows continue to be dominated by Australia, the US and Europe. Given the changing patterns of trade and migration already seen, it seems likely that an increase in the Asian share of investment flows, in and out of New Zealand, is not far away.

## **A world of risk**

A key theme of this forum is risk. For smaller economies, having a strong risk management culture matters a great deal. As already noted, smaller economies tend to be more heavily exposed to international trade and to operate from a narrower economic base. Both characteristics make them more vulnerable to shocks of all sorts.

Successful economies try hard to understand the risks they are exposed to, and devise means to reduce their exposure and build resilience in the face of risks.

It is easy to build a long list of potential major risks right now. For the immediate future, the attention of international policy makers will be focused on the Eurozone and the public sector balance sheet stresses now be experienced there.

These stresses are large and dangerous for all of us. Inevitably, Europe seems destined for a long and challenging period of fiscal stringency as it drags public debt ratios back into better balance. This implies not just a prolonged period of slow growth for Europe, but also stresses in the democratic governance fabric of the worst affected societies as they make their large, slow and painful adjustments. We see this playing out in Greece daily.

To date, Asia has been spared most of the fallout from European and US troubles, largely as a consequence of strong domestic savings rates and continuing strength of demand from China. We all watch for any indication that the European troubles could spread to other parts of the globe. In particular, we watch for any signs of emerging Chinese weakness, conscious of the implications that could follow for the global economy generally, but the wider Asian region in particular.

But looking beyond the Eurozone stresses, there is no shortage of challenges that could ensure that the second decade of this millennium will be a more challenging period than the first. I will highlight just a few of them.

## 1. Financial markets

- The Eurozone is but one part of a linked set of financial market challenges that include highly indebted governments reliant on continuous and large scale access to borrowing, but facing growing risk aversion on the part of investors, weaker financial market intermediaries and, subsequently, weak debt markets.
- Beyond the weak government balance sheets lay others that could readily add to those debts. Here I have in mind under-funded public and private pension schemes –where governments could come under intense pressure to meet the expectations of retirees. In a number of countries, state and local government balance sheets are also stretched to breaking point and, again, central governments could feel compelled to step in and assume those obligations.

## 2. Demographics

- We know enough about demographic patterns to be reasonably certain that the next 50 years or so will not look like the last 50 years. In terms of how our economies perform, demographic patterns matter a great deal. Aging and shrinking populations in many countries imply a very different dynamic to future economies – including shortages of labour, depopulation of some towns and regions, and rapidly increased costs of health care.

## 3. Hazards of nature

- Earlier, I referred to the Christchurch earthquake and the impact that has had on New Zealand. A key part of our capacity to recover from such events lies in high levels of insurance cover and a well-practiced, capable civil defense structure with great linkages to counterpart organisations internationally. The capacity to marshal assistance and ensure the safety of our people and then move quickly to recovery mode is an essential attribute for any modern government. Earthquakes, tsunamis, volcanic eruptions, floods,

droughts and cyclones become ever more destructive as populations grow and urban development becomes more intense. We must plan for them.

- Into this category of natural hazards we should also add biological risks – influenzas and other human diseases plus a variety of plant and animal pests and diseases which present all of the same risk potential. In New Zealand's case, we worry a great deal about the potential impact of diseases on our agriculture industries. It is calculated that an outbreak of foot and mouth disease in our livestock could cause economic and trade disruptions equivalent to around 8% of GDP, potentially prolonged over a number of years. We work very hard to manage these risks.
- Likewise, environmental risks are persistently elevated in our consciousness as threats to the health, safety and wellbeing of our populations. Air and water quality are obvious targets for government action. But the sheer challenge of coping with the needs of a global population of 7 billion means ever more pressure on our ecosystems and on the natural resource base that supports us. Inevitably, governments will be obliged to devote ever more attention and policy effort to better understanding and managing these stresses.

### Small country strategies

Recent work by my countryman, David Skilling<sup>1</sup> highlights that small, developed countries, defined as those with populations of less than 20 million,

*"...have performed strongly over the past couple of decades, out-ranking large countries on many economic and social measures. Of the 34 advanced economies, as defined by the IMF, 23 have populations of less than 20 million. These small countries make up 11 of the top 15 advanced economies by per capita income, 4 out of the top 5 positions in the World Economic Forum's 2011/12 global competitiveness ranking, and 14 of the 20 positions in the UN's Human Development Index."*

Skilling notes that, historically, there has tended to be a benefit in being larger - countries with larger domestic markets tended to perform relatively better. In explaining this he refers to the strong evidence on the economics of agglomeration, in which larger economic units support investment, innovation and economic activity that may not be feasible in smaller units.

But the historical advantages of large scale are being overcome by counteracting influences. Influences favouring smaller economies may include:

- A stronger sense of social cohesion in smaller societies
- More effective governance with stronger strategic coherence, better policy making and policy implementation capability plus greater capacity to adapt to changing circumstances.
- A relatively more favourable international trading environment in recent years as multilateral trade liberalisation provided greater and fairer access for small economies to large economy markets, thereby easing the disadvantages of small domestic markets.

---

<sup>1</sup> Skilling, David, "In Uncertain Seas, positioning small countries to succeed in a Challenging World". Landfall Strategy Group, Discussion Paper – forthcoming. ([www.landfallstrategy.com](http://www.landfallstrategy.com))

Translating these considerations into New Zealand's setting, the strategies in my view are quite clear cut:

- Fiscal policy matters. Resilience in the face of international instability means retaining a tight grip on public sector debt, where possible extending the maturity profile of existing debt and generally trying to reduce dependency on international capital markets.
- Monetary policy targeted at price stability, transparent and predictable in its management, but responsive to unexpected developments that may cause exchange rates or demand conditions to change quickly.
- Prudential policy – sound regulation and supervision of banks and other financial institutions to promote sound lending policies, resilience on their part in the face of the potential for rapid shifts in asset values, and capacity to retain the confidence of their depositors and other creditors.
- Regulatory quality – supporting competition and efficiency in domestic markets, and ensuring private incentives for investors and other private decisions makers are compatible with efficient resource allocations. The quality of regulation can be a key element in national competitive advantage.
- Strong basic institutions such as protection of property rights, rule of law, strong public services with an absence of corruption, and availability of quality education system. Guarding those basic elements as the foundations of a strong modern economy is critical.
- Social cohesion – finding ways to ensure that our people feel a strong sense of participation in the benefits of modern society. Emerging concerns about income distribution is one important element of the social cohesion challenge, and perhaps the most challenging public policy issue ahead of us at present. While we may be getting better at understanding the sources of growing inequality, we are much less clear about the effective responses at this stage.

## **The trade agenda**

Skilling's reference to a more supportive international trade environment assisting small economies has particular relevance to us. New Zealand has long been a vigorous advocate of trade liberalisation and is active in multilateral agencies such as the WTO, APEC and elsewhere to pursue open trade arrangements.

This attitude is borne of lessons from our own experience during the 1960s and 1970s when an attempt to grow domestic manufacturing behind a wall of protection proved to be very damaging to our own longer-term interests.

New Zealand has also faced pervasive protectionism elsewhere impeding our access to markets, especially for agricultural products. Despite the substantial progress made in reducing agricultural protectionism in the Uruguay Round of trade negotiations which concluded in 1994, New Zealand still faces very high rates of protection on many products and in many markets.

Small economies have a very strong interest in the multilateral processes that provide rules and orderly behavior to shape international relationships, including trade. We are deeply disappointed by the lack of progress in the Doha trade round.

In recent years, as WTO processes have stalled, New Zealand has chosen to pursue bi-lateral and pluri-lateral trade liberalisation arrangements also including, importantly, with our Asian trading partners.

### **Concluding comments**

When we look at small economies around us, the fundamental difference between the high performers and rest generally is more related to the quality of institutions and public policy than to resource endowment or other intrinsic advantages or disadvantages for each country. In essence, economies create their own success paths.

Getting the basics right matters – macro policy settings such as fiscal, monetary and regulatory policies – are at the heart of building resilience in the face of the multitude of risks that hit unexpectedly and threaten to throw us off course. They are also at the heart of allowing and encouraging the private sector to thrive, to invest and innovate with confidence and build its own agility and resilience to survive in tough, fast moving and volatile markets.

Open trading policies are a part of that basic policy framework. For small economies, trade opens up opportunities to operate at a scale not possible in domestic markets alone, and allows the pursuit of the sort of specialization that drives innovation and efficiency in modern economies. As multilateral processes stall, bi-lateral agreements become essential if we are to resist the slide back into damaging trade protectionism globally.

New Zealand and Taiwan are two small economies with great capability and high ambitions. I see very strong opportunities for us to engage in a deeper and mutually beneficial set of relationships – covering trade, investment, science, research and education as well as social and cultural engagements

Thank you.