Responding to Global Challenges: New Zealand's Productivity Deficit

Murray Sherwin, Chair, New Zealand Productivity Commission
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Introduction

Thank you for the invitation to do this opening address. I'm a big fan of GEN and the motivations behind its establishment. Providing a vehicle by which our economists can hear and share ideas, engage with the best local and international economists, and be excited about doing good things with good economics is surely a very worthwhile venture. Attracting guests of the calibre and standing of those who will address us today reinforces the worth of the GEN conference.

The topic for today, "Responding to Global Challenges", is well chosen. We're currently facing a gnarly set of challenges, particularly with the pervasive influence of new technologies for which we don't yet fully understand the social, political or economic consequences. A long standing international consensus regarding the merits of trade liberalisation is clearly under stress, at least in some important parts of our world. An issue that New Zealand has wrestled with for several decades, that of sluggish productivity growth, has now become a more general concern in developed and some developing countries. Add to that the most unambiguously international challenge of our era, climate change and the transition to low emissions economies, and the theme of Global Challenges is particularly apt.

Global challenges are not new

A little over 40 years ago I arrived in Wellington with a freshly minted degree in economics to take up a job at the Reserve Bank. My first role involved monitoring and reporting on developments in the international economy and working on policy issues arising in connection with the major international economic institutions – primarily the IMF, OECD, and World Bank.

The 1970's provided plenty to monitor and report on. It was an era of turmoil – the first oil shock of 1973 was still reverberating. Nixon had taken the US off the gold standard in late 1971. With the Bretton Woods arrangements of fixed but adjustable exchange rates broken, currencies had become uncomfortably volatile and, in the minds of many, unsustainably so. Almost everywhere, inflation was high and rising, unemployment likewise. The new word of the era was "stagflation". The UK was edging towards a bailout package from the IMF.

In the face of this, in late 1975, prompted by Gerald Ford, French President Valerie Giscard d'Estaing convened a summit meeting of the G6 at the Chateau de Rambouillet near Paris. Given the context, the themes of their communique are interesting. The leaders committed to open, democratic societies dedicated to individual liberty and social advancement. They called for an acceleration of multilateral trade negotiations seeking the maximum possible level of trade liberalisation, believing that to be the best way to overcome high unemployment, continuing inflation and serious energy problems.

Today, leaders of the major economies worry about persistently low inflation. Where the G6 worried about high oil prices and energy shortages, today's discussion is more likely to be about the impact of fossil fuel consumption on global warming. As in 1975, calls for "accelerated multilateral trade negotiations seeking the maximum possible level of trade liberalisation" may still be heard, but the WTO's Doha round negotiations sit unfinished and unmoving 17 years after Mike Moore, as WTO Secretary General, launched them.

In New Zealand, we monitored, reported on and worried about the state of the international economy and the international economic institutions because they mattered to our prospects. Our terms of trade were low but highly unstable reflecting the forces at play internationally – high inflation, volatile exchange rates, high oil prices and high unemployment. A heavy burden of trade barriers against our agricultural products promised to get worse with British entry to the EU.

Attempts to support living standards here in the face of declining prices for our commodity exports had led to large and rising fiscal deficits which, with a fixed exchange rate, quickly generated large and rising current account deficits and hefty Government foreign currency debt. New Zealand's access to international capital markets was becoming a point of real vulnerability.

In the 1970's, bodies such as the Monetary and Economic Council and later the Planning Council, were already drawing attention to our weak productivity growth and the associated decline in relative living standards.

When the policy response belatedly came, it was born in crisis and remains controversial for many. That response was largely of a macro and institutional nature.

Fast forward to today and the current policy diagnosis seems to me to both less clear-cut and more subtle – including importantly, how we should be thinking about the role of the government as regulator and shaper of outcomes beyond simple market interventions.

My list is not comprehensive, but the issues at play now include new technologies that bring great potential but are disruptive and change the nature of work to the benefit of some and detriment of others; ongoing globalisation and the internationalisation of production – including the entry into international trade of China and India – and associated reverberations in global labour markets; the rise of services and corresponding relative shrinkage of primary and industrial activities; the rise of intangible assets and the assertion of "winner-takes-all" dynamics, at a global scale, in key growth industries. Add to that the pervasive but often underplayed impact of demographic influences and, of course, the demands of climate change – both mitigation and adaptation.

Slowing global productivity growth and New Zealand's productivity history

So slow productivity growth has been a feature of the New Zealand economic story since the 1960s. There were marked upward steps in New Zealand's performance in the post 1980s reform era, but these were steps in productivity levels rather than sustained increases in productivity growth rates.

To some degree over recent years, New Zealand's productivity weakness has been masked by income growth from other sources. Our labour market works in the sense that it provides jobs, including for the low skilled, and hours worked per person in New Zealand are high by international comparison. So more hours worked, plus relatively strong terms of trade over the past decade or more, have supported growth in household incomes and GDP.

Drawing large numbers of people into work is certainly a whole lot better than unemployment and for that reason should be enthusiastically welcomed. But we can't hide behind those labour market trends for ever – labour force participation rates and average hours worked will reach their limits – and our terms of trade won't continue to increase.

The missing ingredient is productivity which is ultimately what drives our incomes, well-being and gives us flexibility and quality choices for future. We have the sense of an economy pushing at the limits – of our workforce, our environment, and our infrastructure.

What do we know about the reasons for our productivity weaknesses?

Through our research, we have explored many different aspects of New Zealand's productivity malaise. I would love to be able to say that we have this fully worked out. But we haven't. We've learned a lot over the years about the proximate and deeper drivers of productivity and what might be different about New Zealand. But our understanding remains partial, and probably always will.

We know, for instance, that investment is relatively low in New Zealand given how fast the labour market has been growing. In part, this is because New Zealand firms face comparatively high costs of capital for reasons that nobody seems able to convincingly articulate. And in some industries I have observed, firms prefer the flexibility of adding or removing labour as a low risk business strategy in the face of small markets and unstable demand. Done well, investing in capital is likely to yield higher productivity and profitability. But the consequence of greater capital intensity is usually higher debt, bringing both higher fixed costs and inflexibility. Comparatively low capital intensity remains a feature of New Zealand firms.

Particularly relevant to this conference are two interrelated reasons for New Zealand's poor productivity performance - weak international connection and a lacklustre group of leading New Zealand firms.

Economic geography

New Zealand is small and uncommonly distant from its key global markets. Small doesn't have to be a disadvantage. It wasn't in the past and, as David Skilling reminds us regularly, small economies are amongst the best performing globally, with stronger internal governance, social coherence and agility offsetting the diseconomies of small scale.

Distance wasn't an issue for us in the past either, even in an era of much slower and more expensive transport. Historical ties and preferential access to the UK market, together with a strong comparative advantage in pastoral agriculture was enough to overcome the negative impact of distance on our trade performance.

Until recently, global trade flows have persistently grown more quickly than the global economy. International trade patterns have also changed in character, with much greater interchange of components and intermediate goods across borders within integrated global value chains (GVCs).

This is a development that has largely by-passed us. New Zealand firms typically do not participate in GVCs – as we will see in one of Catherine Mann's charts later today. This matters because the interconnected and shared performance nature of GVCs means all partners participate in an ecosystem oriented to continuous improvement.

Our trade performance more generally is also disappointing, with export intensity in decline and FDI becoming less important relative to other OECD economies. More

encouraging is that data flows across the NZ border are growing strongly from a small base and elements of the ICT sector are thriving in international markets.

Weaknesses in international connection restrict the flow of new ideas and technologies into the economy. The small size of domestic markets also means that productive firms can struggle to grow and expand while unproductive firms are less likely to feel the heat of competition and exit. We worried about this in the 1970s and we worry about it today because it is a key driver of productivity.

Firm structure and performance: where are our growth champions?

Other reasons for New Zealand's poor productivity performance can be found in Statistics New Zealand's comprehensive and world-leading firm-level database. Over the past 3 or 4 years, the Commission and our colleagues working through the Productivity Hub have been exploring this data to better understand productivity at the firm level. Usefully, the OECD and other member countries have been exploring the same issues. A "big-picture" summary of this work and the policy conclusions that flow from it can be found in our research paper "Achieving New Zealand's Productivity Potential".

By and large, the international evidence is that high productivity firms operating at the technological frontier of their industry are large, innovative, skills and capital intensive, and internationally connected (via ownership or markets, including participation in GVCs). However, in New Zealand, the productivity performance of our leading firms is often well short of leading international firms in the same industry.

While that insight may be a little obvious to observers of the New Zealand corporate sector, it does raise important issues about the extent to which New Zealand firms have embraced and benefited from new frontier technologies. Just who are our (productivity) growth champions?

Amongst the $1 billion pa turnover group of New Zealand firms we find a preponderance of farmer-owned cooperatives, and SOE's – some partly privatised. These co-ops and SOE's face different ownership interests, but share a reluctance to provide capital for growth, and a strong aversion to risk, especially that associated with expansion into overseas markets.

We have another category of large firms that are also orientated to domestic markets – those which are foreign owned and where the owners are unlikely to be interested in launching an international expansion from their New Zealand branch or subsidiary. The major banks, amongst our largest domestic businesses, fit in this category along with some other parts of the financial services sector. It is difficult to envisage their boards embarking on a substantial international growth strategy out of their New Zealand entities.

That's not an argument against foreign investment - there are generally gains from access to capital, innovations and expertise. But it is a recognition that the motivation behind investment in New Zealand can be mostly related to gaining a share of the domestic market, not establishing a base for international expansion.

Labour market implications

Let's shift from product markets to the labour market. A theme that will come up repeatedly today is that in a number of OECD economies, a widening productivity dispersion across firms projects into the labour market and contributes to increasing income inequality. But in New Zealand, with a scarcity of high-productivity firms, we may not be seeing these pressures on income inequality coming out of the labour market to the same extent as other OECD economies over recent years.

Do the current global challenges present us with an opportunity?

It is possible that the great antidote to remoteness and small markets might be found in internet technology that allows us to connect seamlessly over the longest distances. The evidence to date provides a more nuanced view of that proposition. Yes, a great deal can be achieved over distance using internet technology. But modern collaborative and creative activities often seem to place a premium on proximity and direct personal engagement – as we see in great urban agglomerations.

That caveat aside, we see examples of New Zealand firms taking advantage of internet and computer technology to prosper at a distance from key markets - think Xero, Weta Workshops and many others running strongly with the "born digital, born global" mind-set.

My earlier look back at the 1970's was to remind us that a world filled with uncertainty and risk is nothing new. But we now face a different set of disruptions, risks and uncertainties. Rapid technological change and globalisation put a premium on skills, flexibility, creativity, openness and capacity to spot and exploit opportunities early. The public policy role in this environment is a subtle blend of stabilizing and reinforcing the base (e.g., fiscal and monetary frameworks) while facilitating innovation and change (e.g., competition policy, R & D support, education and training).

In our inquiries, the Productivity Commission undertakes deep dives into a diverse set of issues, but with a strong focus on public administration, regulation and public policy. Our ten completed inquiries have covered topics such as housing affordability and urban planning, the services sector, international freight services, regulatory

systems, social services and tertiary education. We tend to take a whole of system perspective and look for areas where gains can be made. In each case, we have found opportunities for lifting performance and well-being.

Some, but certainly not all, of our recommendations are being acted on. That's positive but we need to bear in mind that other countries continue to lift their productivity performance. Good policy is a continuous improvement business, not a one-shot exercise.

Transition to a low emissions economy

I want to end by mentioning another critical global challenge: climate change. The Productivity Commission was asked by the previous government to undertake an inquiry into how we might efficiently transition to a low emissions economy. The new Labour-led government and James Shaw as the new Climate Change Minister have asked us to continue with that inquiry on the basis of our existing Terms of Reference.

We have only one planet, and one global atmosphere. If ever there was an issue requiring a global response, this is it.

We observe the development of new technologies that reduce emissions and costs, especially in electricity generation and land transport. Uptake of those technologies is relatively easy and likely to be market-led.

Other parts of our economy don't face such obvious pathways to lower emissions and that is where the policy, implementation and political challenges will mostly lie. As our issues paper for this inquiry noted, "the shift from the old economy to a new, low-emissions economy will be profound and widespread, transforming land use, the energy system, production methods and technology, regulatory frameworks and institutions, and business and political culture".

For our inquiry, we are asked to "identify options for how New Zealand could reduce its domestic greenhouse gas emission through a transition towards a lower emissions future, while at the same time continuing to grow incomes and wellbeing". We are also asked "what opportunities exist….to maximise the benefits and minimise the cost of that transition…"

Necessity being the mother of invention, and me being a technology optimist, I'm confident that there are viable pathways to a low emissions future. Not all of those pathways have revealed themselves as yet, but it is astonishing to see how quickly some of the essential new technologies are progressing and finding their way into the marketplace. As our terms of reference suggest, there will be opportunities for us.

The trick for New Zealand is to use the impetus of change driven by climate change targets to accelerate progress towards other goals as well – stronger, more productive and agile businesses, better incomes, wider gains for our environment and remarkable biodiversity, enhanced community and cultural strength and further progress towards the vibrant, creative society where, to use the words of Sir Paul Callaghan, talent wants to live.