Connecting with Asia: How do we Deepen our Integration into the Region?

Speech delivered by Gabriel Makhlouf, Secretary to the Treasury

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Good afternoon. It's a pleasure to be here.

The global economy is changing rapidly, and the Asia-Pacific region lies at the heart of that change. The countries that participate in the APEC forum, which includes most of Asia and the Pacific Rim, contain 2.8 billion people, account for nearly 60% of world output and 50% of world trade.[1] If we include India, we are talking about a region that contains just over half of the world's population. And the majority of countries in the region have GDP per capita that is lower than New Zealand's, suggesting significant potential for further growth.

We in New Zealand have strong connections on both sides of the Asia-Pacific region, which puts us closer to the driving force of global economic activity than ever before. I want to come back to the importance of the Eastern Pacific at a later date. Today, I want to speak about Asia.

You may be wondering why the Treasury has a particular interest in Asia. We know that several decades of rapid economic growth in Asia have been a major factor in New Zealand's own growth. Our economic future is increasingly bound up in Asia's. So the question I want to pose today is this: As the world's economic centre of gravity continues to shift east, how do we deepen our integration into the Asia region?

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[1] Source: APEC in Charts 2015

International connectedness is at the heart of the Treasury's thinking

Two years ago the Treasury released a paper called 'Holding On and Letting Go' as part of our briefing to the incoming Minister of Finance. This set out our view of the medium-term opportunities and challenges for New Zealand's economic performance. At the heart of that analysis was a view that the key strategic economic challenge we face is how we lift productivity growth. A higher level of prosperity is vital in tackling issues of social inclusion and improving New Zealanders' living standards. As the Indian economist Reuben Abraham told a Treasury audience a few years back, "you can't redistribute poverty."

While New Zealand has significantly improved its economic performance since the early 1990s, income per person still lags behind the better performing advanced economies. Narrowing this gap will depend on boosting productivity and international connections, which are intertwined. A productive economy attracts international flows of trade, people, capital and ideas. And international connections boost productivity by bringing scale, competition, investment and ideas.

While we certainly have businesses and organisations that are well connected internationally, overall we're not performing as well as you might think. New Zealand ranks only 43rd in McKinsey's Connectedness Index, which measures how connected countries are into the world economy.[2] This suggests that we need to do more.

We need to develop a richer understanding of the complexities of Asian markets

The importance of China – with 30 years of growth at 10 percent a year – is a well-rehearsed theme, but the scale of this achievement remains staggering. In that time over half a billion people have been lifted out of poverty, which represents the single most successful transition out of poverty in the history of humanity.

But Asia's economy is far broader and more complex than China alone. India is now growing faster than China, and many commentators think it will succeed China as the next large economy in Asia to develop as a market and trading partner for New Zealand. Japan, although growing more slowly, remains the third largest economy in the world and a critical trading partner for high value products and an important source of investment. And the combined economic power of the ASEAN nations puts them at the seventh largest economy in the world.

Within the Asia region, the complexity and importance of regional trade and investment links has also expanded rapidly. Asia is second only to Europe in terms of

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[2] Source: McKinsey Global Institute, *Global flows in a digital age: How trade finance, people, and data connect the world economy*, 2014

intra-regional trade, with just over 50 percent of merchandise goods traded within the region.[3] But it's important to recognise the diversity within the region. For example, South Asia, now one of the fastest growing regions in the world, is one of the least integrated. Intra-regional trade accounts for only 5 percent of South Asia's GDP, compared to 25 percent of East Asia's. Meanwhile, with a population of 1.6 billion, South Asia hosts one of the largest untapped talent pools.

There is also room for a more subtle understanding of the diversity of development within each country. Last year I was in China with the Minister of Finance and we visited the western cities of Xining, Chengdu and Chongqing which offer enormous opportunities for exporters willing to take a closer look. While China's official growth rate is falling to around (or even below) 7 percent a year, Chongqing is tracking to annual growth of around 11 percent.

These are also very different cities. Xining, for example, is rural city of 2.2 million people which is still early on in its development journey and heavily reliant on agriculture. In fact, scientists from Lincoln University are currently undertaking a 'sustainable grasslands' research programme on the nearby Qinghai-Tibetan Plateau, comparing New Zealand and Tibetan high altitude grasslands.

Chongqing, on the other hand, has a population of well over 20 million and is a sophisticated, modern port city situated in a lush river valley. Both cities, however, are investing heavily in infrastructure. I came away from this visit with the impression that New Zealand businesses need to develop a more sophisticated understanding of the markets they seek to serve.

Unsurprisingly, while we were in China (and since we returned) we observed a lot of excitement about the 'One Belt, One Road' initiative. Among other things, this initiative aims to promote the connectivity of Asian, European and African continents and their seas. Greater global connectivity, particularly within the Asia region, will also benefit New Zealand.

The nature of the economic challenges facing Asian economies is also changing in fundamental ways as countries seek new sources of growth and respond to some of the challenges they face. In China, for example, the authorities are trying to engineer major changes in the sources of economic demand, with less reliance on exports and investment and greater reliance on domestic consumption.

Growth in household consumption in China is running above 10 percent per annum, whereas investment growth slowed to just above 7 percent last year. Services as a share of the economy increased to just above 50 percent in 2015 from 48 percent the year before. While still short of the share of services in high-income, developed economies (at around 60-70% percent of GDP), this does show that patterns of

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[3] Source: WTO trade database

expenditure and economic activity are changing in China. This will continue as incomes keep rising and more people move from rural to urban areas.

China is also increasingly turning its attention to supply-side reform, with a focus on reducing overcapacity, destocking, deleveraging, reducing business costs and shoring up weak growth areas.

At the same time, China is seeking to deal with a legacy of large increases in domestic debt – estimated to be 282 percent of GDP – and a transition to more environmentally sustainable production.[4]

The nature of the economic change implied here is extremely large. These changes will continue to impact the New Zealand economy. Borrowing a framework from previous Australian Treasury Secretary, Martin Parkinson QSM, the impact of the rise of Asia can be thought of in waves:

- The first wave was a massive increase in the world supply of cheap and relatively skilled labour. While this resulted in some adjustment for parts of the New Zealand economy, the overall impact was positive as the relative price of manufactured goods we largely import fell.

- The second wave was the sharp increase in demand for harder commodity resources. This pushed prices for commodities – energy and metal in particular – to levels not seen since the 1970s. This had a large impact on Australian incomes, pushed their terms of trade to all-time highs and spurred a massive mining investment boom. This phase has peaked.

- The third wave is demand for the sort of agricultural commodities that New Zealand produces – high quality and sustainable food products. This has driven the strong gains in commodity prices – a positive shock that has helped sustain income growth in New Zealand through the last decade. However, income gains from further price rises are unlikely.

- The last wave is the increase in income and changing demand patterns that lead to a higher demand for high quality services. We are starting to see this with the large increase in the number of Chinese tourists and students coming to New Zealand.

Because of the scale of the Chinese economy, these changes amount to a huge transformation in regional and global activity, which brings both opportunities and challenges for New Zealand. The challenge for New Zealand firms and businesses is how to meet the growing demand for sophisticated services and food products in an extremely competitive market. This will require different approaches and greater diversification than in the past.

[4] Source: Wall Street Journal, McKinsey

Risks

Strengthening our ties with Asia is not without risk. The economic slowdown in China and events of the last six months (particularly the share market volatility in China) have seen a shift in the debate over the risks of a more rapid slowdown. And certain sectors and regions in China are experiencing a much sharper slowdown than others.

While I think the worry about China's growth could be overstated, we remain alert to these risks. But this slowdown is predictable. In fact it's in line with the government's strategy to rebalance its economy from investment to consumption, and will mean better quality, more sustainable growth in the long run.

Perhaps a greater risk is that medium-term economic prospects in China may now be even lower than expected. Even if this risk materialises, the size of the Chinese economy means that even with a growth rate of around 6 percent per annum, its contribution to world growth and demand remains high.

The speed of the Chinese transition has also raised questions about whether New Zealand's trade has become too reliant on China and too narrowly focused on particular commodities in high demand. With New Zealand's comparative advantage in soft commodity exports, the planned rebalancing of the Chinese economy should provide a stable and dependable source of export demand.

All these aspects – while interesting and important – are outside of New Zealand's control. To the extent that further shocks may materialise, we have sufficient space for macroeconomic policy to weather a further slowdown. Concerns about risk concentration are probably best dealt with by ensuring our economy is well placed to diversify. Perhaps the greatest risk New Zealand faces is that it does not make the most of the opportunities posed by Asia.

Now I would like to discuss three areas that we think are essential for deepening our connections with Asia: the flows of trade, capital, and people. These flows are closely connected. More trade also tends to lead to greater investment flows. And flows of trade, capital and people are all vehicles for exposure to new ideas and technology, which is one of the most important ingredients for economic growth.

Strengthening our trade relationships

In the past decade we've made great progress on building stronger trade relationships with Asia. China is our second-largest trading partner and Japan, Singapore and Korea are in the fifth, sixth and seventh spots. And trade with many other Asian economies is growing in importance. Malaysia, Thailand, Taiwan, Indonesia, India, Viet Nam and the Philippines are all top twenty trading partners for New Zealand.

Growth in trade is not just positive for exporters. It also benefits consumers. Imports manufactured in Asia have helped to keep costs down and drive the technological revolution that continues to transform our everyday lives.

New Zealand is now party to a series of Free Trade Agreements in the Asia-Pacific region. The recently signed Trans-Pacific Partnership incorporates 800 million people and 25 percent of world trade, and is a very good example of how we are drawing closer to our Asian regional partners.[5] Japan and key ASEAN partners (with whom we already have an FTA in place) are included: Brunei, Singapore, Malaysia and Viet Nam. Other countries such as Korea and Indonesia have signalled their interest in joining. The TPP will remove barriers to trade for many exporters of New Zealand goods and services in the Asia-Pacific region, which will help to grow our businesses and create more jobs for New Zealanders.

Free trade agreements are the first building blocks of closer trade and economic links. But the work doesn't stop there. These agreements are a springboard that we can use to better understand overseas markets, and importantly, to better understand consumers. I want to think about a world where our trade relationships with Asia are as close as they are with Australia.

Building on our base of Free Trade Agreements goes beyond negotiating further agreements. FTAs are not an end in themselves, and for benefits to fully accrue, trade agreements need to be used and leveraged by exporters. We also need to ask ourselves if there are other, more effective ways to meet New Zealand's trade objectives over the short and the longer term. We need to think differently.

For example, New Zealand has a Closer Economic Relations (or CER) agreement with Australia, which goes beyond free trade to harmonising policy and regulatory settings. What would it look like if we had a similar agreement with the ASEAN nations?

We also need to think about how trade is changing. Technology is changing the way we trade and also what we produce. Global data flows are 45 times larger than they were in 2005.[6] These changes have the potential to be of great benefit to New Zealand as they can help us to overcome our distance from markets.

We will have an opportunity to explore where we go next as part of the forthcoming update of our trade strategy, which is being led by our colleagues at the Ministry of Foreign Affairs and Trade. We see this as a really important opportunity to build on the work we've done to date in Asia, but with a strong eye to the future. The goal is to identify what needs to happen next to really deepen and embed our economic integration. We are no longer a country of agricultural exporters alone, we are a country of innovators and experts who can step up, in smart ways, to meet global demand.

[5] Source: Economic Outlook for Southeast Asia, China and India 2016: enhancing regional ties, OECD 2016

[6] Source: *Digital Globalization: The New Era of Global Flows*, McKinsey Global Institute, 2016

Increasing overseas investment

As our trade relationship with Asia grows, we expect that higher levels of overseas investment will follow.

At the end of last year, the Government published a report called *International Investment for Growth* alongside its new investment attraction strategy. This report makes a clear and compelling case that a prosperous New Zealand will continue to need both inward and outward flows of international capital.

While there is a lot of noise made about foreign capital and its impact on Auckland house prices, there is worryingly little discussion about the importance of foreign investment for business, or even informed debate on where that investment is from or how the source of investment may change over time.

The growth and wealth in emerging Asia, and China in particular, has yet to be reflected fully in our overseas investment statistics. Australia is still by far New Zealand's largest source of foreign direct investment, representing 52 percent of the total stock (the majority of which is in the financial and insurance sector), followed by the US at 8 percent, Hong Kong at 6 percent, and the UK, Singapore and Japan each at around 5 percent.[7]

Unlike our trade relationships, where Asia now dominates, investment from emerging Asia remains at a fairly low level given its relative economic size and the significant two-way trade relationship. Asia is the destination for around 40 percent of New Zealand exports but represents only 16 percent of our foreign direct investment stocks.[8] Over time we expect that Asia will become an increasingly important source of foreign capital for New Zealand.

And the benefits of such investment are significant. Greater investment from Asia in the productive, value-adding sectors of our economy means that we can grow our businesses and reach markets that most firms here could not reach by themselves. And growing businesses mean more jobs and higher wages for New Zealanders. Just as we should celebrate Fonterra investing billions of dollars in farms in China, we should be seeking out far greater investment from Asia. An important part of this increased investment will likely occur through portfolio and other financial flows, providing an important opportunity to deepen our financial markets.

At the same time, we are aware of concerns that New Zealanders have about foreign direct investment, especially regarding the ownership of land. The overseas investment screening regime weighs up the benefits of foreign investment against other things that New Zealanders value. But we shouldn't lose sight of the real benefits that foreign

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7 Source: Statistics New Zealand, 2015

8 Source: Statistics New Zealand, *Global New Zealand – International trade, investment, and travel profile: Year ended June 2015*, 2015; New Zealand Government, *International Investment for Growth*, 2015

investment has to offer. This is a discussion that we will continue to have as a country, and I encourage each of you here today to promote informed debate on the costs and benefits involved.

People flows

Now I want to turn my focus to people. We live in globalised times. Nowhere is this clearer than in the short-term movement of people. New Zealand has a long history of people links to other parts of the world. Today, we have one of the world's largest Diasporas as a proportion of our population, with an estimated one million New Zealanders living overseas, and around quarter of our population is foreign-born.

PwC's latest CEO Survey found that New Zealand CEOs see the availability of skills as the number one threat to business growth.[9] Migration has a part to play in lifting the skill level of the New Zealand workforce and ensuring that firms have the skills they need to improve labour productivity growth. As incomes and human capital have risen in Asia, these countries have increasingly been represented in our migration flows.

People of Asian ethnicity make up 12 percent of our population, and by 2038 this figure is projected to rise to around 20 percent.[10] This change in the population will increase the number of bilateral links, likely leading to changed cultural attitudes and increased knowledge of Asia, which will have a positive effect on our Asian relationships. But we need to start thinking now about how our organisations can make use of the skills of our current Asian employees to develop stronger connections with the region.

Short-term flows of tourists and students are also significant sources of demand for New Zealand. As an emerging Asian middle class has developed and patterns of consumption have changed, there has been increased demand for New Zealand's tourism and education services. Total tourist arrivals have increased by a third in the past decade.[11] China has risen rapidly to become our second largest source of tourists, and is forecast to overtake Australia within five years.[12] Visitor growth from India and Indonesia is also likely to be significant, albeit from a much smaller base.[13]

Flows of migrants and visitors are clearly an important part of connecting with Asia, but both the public and private sectors need to be thinking more systematically and holistically about becoming more Asia-capable. This raises questions about how the education sector supports and enables our young people to have a greater understanding of Asian languages and cultures.

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9 Source: PwC's 19th Annual Global CEO Survey, 2016

10 Source: Statistics New Zealand

11 Source: Statistics New Zealand

12 Source: New Zealand Tourism Forecasts 2015-2021, MBIE, 2015

13 Source: New Zealand Tourism Forecasts 2015-2021, MBIE, 2015

We estimate that around 45% of our young people heading overseas for their OE go to Australia and 20% go to the UK. Contrast this with 5% heading to China, and around 2% to each of Japan and Korea.[14] How can we change cultural norms so that overseas experience in Asia becomes as commonplace as going to Australia or the UK?

But we cannot wait for the young people of tomorrow to grow up before we begin to adopt a greater degree of Asian capability. Our organisations need to think about how we can become more diverse and inclusive to bring new ideas and fresh perspectives in the same way as we might think about gender or Maori diversity as adding value. In the 2013 census almost one in four people resident in Auckland identified themselves as ethnically Asian.[15] How many firms could benefit from having the insights into the culture and thinking of their overseas markets customers? Indeed, how many companies are thinking of the opportunities within New Zealand of targeting these potential customers and employees?

What the Treasury is doing

The public sector is still in the midst of coming to grips with the rapid and fundamental shift in economic ties with emerging Asia, but finally I want to mention what the Treasury has been doing at a practical level.

Firstly, I am personally proud of the effort the Treasury has made to improve the diversity of our own staff, which has introduced a much greater range of perspectives and ways of thinking to our work. And we have been lifting our effort with key countries – among them China, Indonesia and India. This includes a strategy of regular and systematic visits aimed at developing relationships with our counter-parts as well as research that focuses on understanding the economic links with Asia.

Critical to developing longer-term relationships has been pursuing common practical projects that have value for bilateral trade and investment flows and the wider region. A few examples help illustrate this:

1. The Treasury played a role in developing direct trading between the Renminbi and the New Zealand dollar. Over time as the RMB becomes a more important part of the world financial system we expect this could help deliver lower transactions costs to bilateral trade and investment.

2. New Zealand was the first western developed country to join the negotiations to set up the Asian Infrastructure Investment Bank. The Treasury and the Ministry of Foreign Affairs and Trade have ensured that New Zealand was able to assist the development of this institution into an important regional body that reflects well on our strong relationship with China.

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[14] Source: Statistics New Zealand. Based on 20-29 year olds leaving New Zealand for more than a year.

[15] Source: Statistics New Zealand

3. Through the New Zealand Export Credit Office the Treasury is involved in supporting trade into Asia and looking to strengthen its relationship with key Asian financial institutions. Over the last 18 months, NZECO has underwritten NZD160 million in export transactions into the Asia-Pacific region.

Conclusion

New Zealand's small size and large distance from markets make it more difficult to connect internationally. But this makes it all the more important that we do. And the opportunities in Asia bring us closer to the global economy than ever before.

Every sector in society needs to think about how we can better integrate ourselves into the Asia region. We need to grasp hold of the opportunities presented to us. Government has a role to play, but so do you as business leaders. This is an exciting time for New Zealand. And we want to hear from you about what the future should look like.