

Speech by Hugh Fletcher to Sir John Logan Campbell Executive-in-Residence Diner Lecture Series.

August 1998.

The Globalisation of Business - How can New Zealand
optimize its wealth?

In the fifteen years since the Lange Government was elected and New Zealand opened up to the forces of globalisation, we have performed dismally, both economically and socially.

Economically this is unarguable, since it is hard to fault the proposition that our primary economic objective should be improving per capita GNP, and on this we have declined by over 10% relative to both the OECD average and Australia. This is despite New Zealand having had an unparalleled period of drawing on the savings of foreigners, with differences between the New Zealand assets which foreigners own and the overseas assets which New Zealanders own more than doubling to around a year's GDP. In terms of improving per capita wealth our relative performance has been even more dismal than that on income.

Our performance on the social harmony front is more arguable, but I would suggest only in that there are no acknowledged agreed objectives; a reflection of the visionless New Zealand to which I will return later. Recent reports, such as those on the widening income differentials between top and bottom quartiles and the lack of any closure in Maori to Pakeha inequalities, as well as the deterioration over the fifteen years in statistics, such as those on crime and youth suicides etc all support the dismal performance assessment. Certainly we cannot suggest that we have chosen to sacrifice relative economic performance for greater relative gains on the social front.

The same dismal record exists at the enterprise level. Of the fifteen largest stock exchange listed New Zealand companies in 1984 only three exist today as New Zealand controlled entities, whilst the total annual return to shareholders of the top forty index, despite Telecom's stellar performance has been less than 4% per annum.

Admittedly we can claim to have been in a transition period from a very closed and regulated economy to an open one. That argument would be of more comfort if our current position revealed an improving trend rather than the current negative GDP growth, climbing unemployment and seven percent

external current account deficit. These suggest we should stop seeking refuge in denial and transfer of fault, such as to blame Asia, and have a more balanced contest of ideas as to how New Zealand can prosper in a globalised economy.

In my view we must play the game substantially different than we have been playing it for the last fifteen years. I use the word "game" deliberately, because I think there is much insight on how to enhance New Zealand's position to be obtained from Game Theory, and more so than continuing with our simplistic reliance on the theory of perfect markets.

It was suggested that I should outline "the possible scenarios for the business environment over the next ten years, from which you could draw conclusions as to how to prepare for the next decade." There are many possible scenarios, from the benign to the traumatic. Yes benign can happen, as best currently evidenced by the United States' remarkable last eight years. But so

can the traumatic, such as the falling apart of the Asian miracle. Similarly it is possible to project that the social disharmonies of globalisation will lead to a swing back to protectionism, or that religious divisions will re-raise the importance of military considerations.

There are indeed many possible scenarios, each with substantial varying impact on the effectiveness of the game plan of either a country or a business. Hence, the first conclusion that your game plan must be robust to different scenarios and your capabilities must include both an ability to monitor the evolving environment and to action contingent strategies decisively.

My own view though is that the most likely scenario, what we might call a base case scenario, is for random nasty exogenous shocks around a trend of increasing globalisation combined with reasonable global economic growth and peace. At the very least we must be sure our game plan will deliver in this scenario.

As Nigel has said globalisation is nothing new. There have been other periods when its influence was predominant. But we are all inclined to view change against the immediate past. For us in New Zealand this is with a closed and regulated economy, which had relatively high incomes and wealth from a controlled involvement in international trade exploiting some privileged comparative advantages. We have also opened up in a period where not only are others doing so, but also there is a wave of technological innovation. The result is we are getting drivers of change building on other drivers to create

massive movements in the relative competitiveness of nations and enterprises. When cross-border capital flows combine with a mobility of business best practice and the two combine with technological advances which make low skilled labour as productive as medium skilled and/or destroy the protection of geography, new winners get created and previous winners become losers. All this happens with a frightening pace, and with relentlessly fluctuating fortunes.

It is within this context that individual nations and enterprises must develop their game plan, and note this is the base case not a downside scenario. Within the apparent global benign-ness of the base case there is micro turbulence. And this turbulence is rough because globalisation and open-ness make, as Rodrik explains, all demand curves much more elastic. Thus the impacts of exogenous shocks on nations and enterprises, and all their stakeholders such as those enterprises' employees, are much greater than they were in a closed economy.

What can we do about this? I suggest this divides into two categories. What can we do about the trends and perturbations that we cannot control, and what can we do about those over which we do have some control? Dealing first with the uncontrollable.

By definition if we can't control a value driver there is little point in looking to do so. What is required is to face up to the likely global reality - to be insightful in assessing discontinuities, creative in developing winning strategies and effective in executing them. All easily said but difficult to achieve, whether you are talking about a nation, an industry or an enterprise.

In New Zealand's case it is even harder because many of these uncontrollable globalisation drivers are reducing New Zealand's relative competitiveness across the field. This is true not only generically in the destruction of the comparative advantage of moderately skilled labour but also industry specific. An example of the specific is the advances in understanding of fibres and the development of new processing technologies, which together are enabling low quality wood residues such as palm oil trees and used newspapers to be turned into quality end-products at the points of end-use, thus destroying the cost based export competitiveness of New Zealand in products such as low grade logs and pulp, medium density fibreboard and paper.

It is not surprising New Zealanders take little comfort from statements that we

are better off engaging in free trade than withdrawing from it, when the across the board destruction of our comparative advantage means engaging still requires major reductions in our income and wealth from where we have recently been.

What we must first face up to is the magnitude of the task. New Zealand must establish external current account equilibrium (ideally run a surplus to reduce non-residents' percentage claim on our GDP). And we must do this with a base case scenario which is likely to perpetuate declining terms of trade.

I suggest, if we do consider this honestly, we will be skeptical that a laissez-faire approach at the national and industry levels relying solely on the initiative of individual enterprises will deliver the goods.

Since industries and enterprises that have based their competitiveness on cost are particularly vulnerable, we must find the ways to shift their focus to strategies based on difficult to duplicate product or service differentiation. As David has said, we need to make customers and capital dependent on uniquely New Zealand resident capabilities. There are at least two reasons why this requires a collective response as well as individual entrepreneurship. The first is economies of scale and critical mass. New Zealand and its residents' enterprises are economically tiny. If we are going to invest in the creation of differentiation which is material, sustainable and owned by New Zealand residents we must in some activities aggregate to apply the necessary critical mass. In many of our industries it is unrealistic to expect that individual enterprises have the scale to undertake the research and development needed to generate differentiation let alone to put in place the distribution systems to capitalise on an innovation. When even the World's largest drug companies are amalgamating for this reason, can we really expect to have more than one domestic player in areas such as the bio-technology of trees? Similarly, rather than disaggregating components of the relatively successful dairy industry shouldn't we look at where greater aggregation of components of the relatively unsuccessful meat industry would serve us better?

Secondly, there is the fallacy of composition, or the free-rider problem associated with common goods. While it may benefit all New Zealand players for certain initiatives to be undertaken, it will not benefit one player to do so in isolation. Successive Governments understand this for the billion dollars they anachronistically spend on defence, but can't grasp this for our life-blood, the internationally tradeable goods and services sector. The under-spend on infrastructure components which support our tourism industry, from the Auckland Museum (the most visited tourist attraction) to our roading network, is an obvious example of this.

Turning to the economic drivers over whom we can have some control, here obviously there is no escaping the need for a consensus and for that consensus to get it right. We have not had this correct consensus.

Primacy must be given to the best interests of the internationally tradeable sector and the objective of external current account equilibrium. Above all this requires two substantial policy changes

First, the exchange rate cannot be hostage to inflation objective. I have already referred to how open-ness and globalisation make demand curves much more elastic. When we hike our real exchange rate through high and inverse interest yield curves we administer an exogenous shock in the demand curves of all our internationally tradeable goods and services, and hence traumatically reduce employment and returns to capital. This is what has caused our recession and current account disaster, not the Asian crisis, and this is what, having soured the confidence of enterprises in the tradeable sector, is going to take some time to overcome. A correct consensus on this includes changing the Reserve Bank Act to require price stability to be achieved in association with current account equilibrium.

Secondly, we must have an effective savings policy so that New Zealanders fund the required level of investment. Here a correct consensus requires compulsory superannuation. Just as few people will pay tax voluntarily, few will forgo current consumption for future consumption by saving if through the taxpayer they are guaranteed a level of consumption in the future similar to that of the present. If we can increase New Zealand's private savings hopefully we can also increase the availability of venture capital, which together with business mentoring 1) is often the critical need for emerging businesses, particular those with innovative products and services.

Having regard to the difficulty of the task of prospering in today's globalisation of business, we need a consensus behind renewed passion for foreign exchange earning. This passion must legitimise generic initiatives, which assist our multitude of small enterprises as well as industry specific initiatives.

For the former 2), I would suggest, for example, that much more beneficial than a cut in the corporate income tax rate would be a move towards cash flow based taxation providing an immediate deduction in some if not all forms of investment.

On the industry specific initiatives we must galvanise investment in those industries where there is a prospect of developing sustainable differentiation and customer and investor dependence on New Zealand. The Porter concept of clusters is insightful here. Clearly, despite all the macro and micro reforms, we have failed to raise capital productivity. We do not seem to be capturing the potential

of the technological revolution that is around us. Maybe this gets back to the critical mass point. If so, then there is a need for leadership, a leadership which, with three and a half million people, probably encompasses politicians and civil servants as well as industry participants. I think of the horse industry in this regard. An industry where the cluster spanning the breeding of horses, their rearing, training, riding, equipping and then their relationship to entertainment and related business processes is one where we should aspire to global pre-eminence. But this will not happen without a New Zealand game plan, which explicitly set out the role for co-operative collective initiatives as against the areas for competitive individual initiatives. Together these initiatives must exploit the total potential to apply leading edge knowledge and business best practice and wisdom to this particular industry.

We will not have this consensus passion for foreign exchange earning activities unless we can harmonise its pursuit with progress on the social front. To me this must start off with a re-instilled pride in a consensus Vision of what makes New Zealand and being a New Zealander different. Having been involved in writing a number of corporates' Statements of Purpose, such a Vision must ignore the many fine sentiments which should be common across the globe's nations and instead focus on the unique differentiation of New Zealand.

An obvious unique differentiation, which we should delight in, is our Maori dimension. So taking our Maori dimension, how do we then integrate it into the primacy to generate foreign exchange and the achievement of broad social consensus? I would suggest we don't do this by having a petty minded Scrooge approach to settling legitimate Treaty of Waitangi claims nor do we

do this by adopting a Pontius Pilate approach post settlement. For example the Fisheries settlement should be just the beginning of an integrated plan with continuing active Government sponsorship all aimed at maximising both Maori economic and social gain from the resource and New Zealand's foreign exchange earnings. Surely this requires imaginative total game plan for the industry which has defined and integrated roles for the public sector, the education sector 3), the research sector as well as the Pakeha commercial fishing sector and the recreational and tourist sectors. So too must welfare and tax policy be integrated. There is a huge social as well as economic prize in raising the level of Maori to that of Pakeha.

Globalisation will not permit the taxation level on internationally mobile labour and capital to be raised materially. Just from this fiscal perspective we must continue the efforts to enhance the attractiveness of employment versus welfare dependency, but there is also the Vision element. Surely we all want New Zealand to be a uniquely safe place. If we could agree on this we might go on to acknowledge that, rather than spend one billion a year on an invisible foreign enemy 4) (most of the candidates are buying us anyway), we might

invest it in initiatives which will get at the root causes of our deterioration of the crime front 5). The greatest threat to the New Zealand way of life is from within not from without.

In conclusion, Game Theory tells us that a small player's best prospect of winning comes from playing the game differently. But we keep playing conventionally 6). Prospering in an age of globalisation requires us to determine very simply and very clearly what really important to us, and then focusing on insightful and unconventional strategies which will deliver success on these matters. That requires us to exploit not only the spirit and drive of competitive individual entrepreneurship but also power of co-operative endeavour. Both must be harnessed to make New Zealand residents the "owners" of unique capabilities so that overseas customers and capital are dependent on this New Zealand resident capability. We want the economic surplus to be captured by New Zealand residents. While superior productivity and hence competitive cost will always be a requirement we will increasingly need to gain our winning advantage from either a continuous stream of product or service innovations or a difficult to duplicate and remarkable customer intimacy. These require great ability to integrate ideas and execution. Individually and collectively we must be focused on doing this.

1 Business in the Community, the business mentoring service, is a good example of valuable collective action.

2 All but 1300 enterprises of our 250,000 employ less than a hundred people.

3 There is a lot of evidence that the most effective way is by integrating education with doing - the strong need to boost industry and enterprise based learning

4 The proposition that we have to pull our weight in the world to obtain trade access has no foundation in international trade policy or practice and if it was true would be the most gigantic subsidy to a limited range of experts. Nowhere else is such hidden subsidisation tolerated.

5 And the relative slippage in the quality of our roads

6 If we must succumb to the emotion of playing our defence part why not substitute for our entire defence forces a rapid deployment mercenary peace keeping force, which we sell to the United Nations gifting the first quarter of a billion of expenditure. Turn it into a foreign exchange earner instead of a chronic drain.