

## **LOWY INSTITUTE PERSPECTIVES**

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### **AUSTRALIA AND NEW ZEALAND IN A GLOBALISING WORLD**

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## **Australia and New Zealand in a Globalising World**

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Originally presented at the Fourth Annual  
Australia-New Zealand Leadership Forum, Sydney, 23-24 April 2007

### **Globalisation**

International economic integration – globalisation – is the defining feature of Australia and New Zealand’s current international economic environment. Arguably, it is also the defining feature of the overall international environment. Certainly, the ability of both countries to respond to the challenges and opportunities thrown up by the emerging global economy will go a long way to determining their economic *and* their political futures.

One aspect of globalisation that is especially relevant to both countries is the proposition that globalisation diminishes, or even removes altogether, the importance of geography. This argument has been around for a while, but has recently gained renewed prominence. Thus Kenichi Ohmae, a former partner at McKinsey and one of the world’s leading strategic thinkers – according to his Wikipedia entry he’s known as *Mr Strategy* – declared the emergence of an interlinked, ‘borderless’ world back in 1994.<sup>1</sup> Frances Cairncross, a former editor of *The Economist*, proclaimed the ‘Death of Distance’ in a book of that title first published in 1997.<sup>2</sup> More recently, New York Times columnist Thomas Friedman has told us that the world is flat.<sup>3</sup> In this latest take on the subject, Friedman describes three eras of globalisation, during which the world economy has shrunk progressively from a size large to a size tiny, accompanied in the third era, or Globalisation 3.0, by a ‘flattening’ of the global competitive playing field. With all this shrinking, flattening and dying going on, it is surely only a matter of time before someone goes the whole way and publishes a book declaring that ‘Geography is History’. As far as we know, no-one has yet snapped up this particular title.

Such a thesis is, of course, particularly pertinent to Australia and New Zealand given the importance of geography to both countries. After all, New Zealand is the most remote developed economy in the world, followed by Australia.<sup>4</sup> The theory of economic geography

tells us that, just as being close to the global centres of economic activity might be expected to bring economic benefits in the form of lower trade costs, easier access to information, and technological spillovers, so distance from markets tends to impose some significant economic costs. Taking some of these costs into account, one estimate suggests that Australia's GDP per capita might be 27% higher than its current level, if only Australia were 50% closer to its trading partners.<sup>5</sup> Similarly, work by the IMF finds that geographical isolation has significantly harmed growth in both countries.<sup>6</sup> Other analysis suggests that part of the productivity gaps between Australia and the United States, and between Australia and New Zealand, can be explained by distance.<sup>7</sup> Indeed, as far as the simplest models of economic geography are concerned, Australia and New Zealand are both striking outliers in an otherwise strongly inverse relationship between distance and prosperity.

To the extent that globalisation means that the 'geography is history' proposition now holds, this would represent a dramatic easing of some of the constraints facing both countries, with important consequences for future prosperity.

There certainly is *something* to the argument that globalisation has changed the world's economic geography. Examples are not hard to find. Air transportation has transformed the shipment of high-value manufactured goods, for example, while the IT and telecommunications revolutions mean that any service or product that can be turned into code can now be shipped at close to no cost. The so-called disintegration of production, the spread of international supply chains, and the growth of offshore outsourcing are all products of these developments.<sup>8</sup>

Despite all of this, however, the balance of evidence suggests that the world isn't flat, distance isn't dead, borders still matter, and geography isn't history. Friedman himself admits this, conceding (on page 460 in the revised and extended paperback version of his book) that 'I know the world is not flat. Don't worry. I know.' (Friedman goes on to remark that the world is in reality 'unflat', or at least, that substantial parts of it are, which ultimately is the same thing.)

In particular, it turns out that the idea that trade declines dramatically with distance is actually one of the few important findings in the economics of trade to survive both the passage of time and repeated applications of econometrics.<sup>9</sup> Roughly one quarter of all world trade still takes place between countries sharing a common border, for example, and about half of world trade still takes place between trading partners who are less than 3,000 kms apart.<sup>10</sup>

Economists have attempted to analyse the changing importance of distance in the global economy in several ways. One approach, seen in the work of David Hummels, for example, has been to track the evolution of transport costs. Here the evidence does indicate at least a weakening of the influence of geography, with technological change having driven sharp falls in the price of air freight.<sup>11</sup> For shipping, however, the evidence turns out to be more ambiguous, with little change in prices between 1952 and 1970, large *increases* from 1970 until the mid-1980s, followed by a 20-year decline, and now more recent signs that costs could again be on the rise.<sup>12</sup>

A second approach has relied on economic models. Here the economics profession has borrowed from the gravity model of Newtonian mechanics.<sup>13</sup> The trade version of the gravity model says that the amount of trade between two countries is proportional to the product of their economic masses (GDPs) and inversely proportional to the distance between them. Since distance is usually taken as a proxy for all trade-related costs, then globalisation-powered declines in the latter would be expected to translate into a fall in the size of the distance effect in estimates of the gravity model. Yet a recent comprehensive survey (in the jargon, a ‘meta-survey’) of such models, covering 78 econometric papers from leading journals with a total of 1,052 estimated distance effects between them, could find no evidence that the effect of distance on trade had fallen over time. Indeed, if anything, it appeared to have increased.<sup>14</sup> The same study also found that the average estimate of the elasticity of bilateral trade with respect to distance was (minus) 0.9. Or, to translate that into English, arguably the best estimate we have suggests that a doubling of the distance between two trading partners might be expected to reduce trade between them by about 90%.

Similar results hold for other economic interactions such as equity holdings, foreign direct investment, and the transfer of technology.<sup>15</sup> Distance, it seems, is alive and well.

The reality is that while globalisation *is* changing and reshaping the geography of the world economy in important ways, it hasn’t in any way abolished geography. Indeed, the combination of geography and globalisation is likely to present both Canberra and Wellington with some significant international policy opportunities *and* challenges in coming years. Take two examples.

First, let’s go back to globalisation and transportation costs. Transporting tangible goods (as opposed to intangible services) continues to be energy-(especially oil-) and therefore carbon-intensive. It is also becoming more security-intensive. On quite reasonable assumptions, the costs of both kinds of input could well *increase* significantly over coming years.<sup>16</sup> This could

represent an important challenge for relatively remote economies like Australia and New Zealand, and even more so for the island economies of the South Pacific.

Second, the continued importance of distance means that the geography of the world economy will continue to be determined by the interplay of centrifugal and centripetal forces. While the dispersion of activity implied by the former has tended to be good news for both economies, of which more below, some of the clustering or agglomeration effects – the tendency for economic activity to gather in a few centralised locations – generated by the latter may turn out to be more problematic. We’ve already seen signs, for example, that advances in communications technology, such as the reduction in the costs involved in overcoming distance between head offices and operations in more remote parts of the world economy, might work against the location of some forms of high-value economic activity like corporate leadership in remote countries like Australia and New Zealand – the so-called branch economy problem.<sup>17</sup>

## **East Asia**

Despite these potential challenges, it is nevertheless clear that the impact of globalisation on international economic geography to date has been an overwhelmingly positive one for both countries. This is because globalisation’s biggest success has turned out to be the continuing shift in the international distribution of economic weight back towards Asia in general, and towards East Asia in particular.

Intriguingly, in powering this relocation of economic activity, the current version of globalisation is effectively reversing the geographical consequences of its nineteenth century predecessor. The resulting swings in the location of economic activity have been truly dramatic. According to the economic historian Angus Maddison, before the Industrial Revolution took hold in Northern Europe, the mass of the world economy was concentrated in Asia. As late as 1820, China and India between them still accounted for almost half of world GDP (measured at purchasing power parity exchange rates).<sup>18</sup> The subsequent onset of the first age of global capitalism marked the start of the Great Divergence, a process that saw the relegation of both economies to relatively minor roles in the international economy, so that by 1980 their combined share of global output stood at less than 8%. The modern era of globalisation has replaced the Great Divergence with a Great Convergence, and by last year the two countries’ share of world output exceeded 21%. The share of Asia overall in the

world economy has similarly risen, from about 20% of world GDP in 1980 to more than 35% last year.<sup>19</sup> On most forecasts, both figures are expected to continue to rise.

This shift in the location of international economic activity has been positive for both Australia and New Zealand, not least because the move back towards a more Asia-centric world economy has reduced the distance of both countries from the locus of world economic activity. Asia's economic rise – and particularly East Asia's economic success – has already been good news for national prosperity. Australia has been a particular beneficiary of this shift, not least due to an abundant supply of minerals and energy that is now helping power Asia's accelerating industrialisation and urbanisation. As a consequence, Australia is currently enjoying its highest terms of trade – the ratio of its export to import prices – since the Korean War boom of the 1950s. New Zealand has also gained, albeit to a lesser extent.

Still, even success needs to be managed. As we point out in a forthcoming Lowy Institute Paper, we are now entering a situation in which significant parts of the developed world currently seem to be having second thoughts about the benefits of globalisation.<sup>20</sup> And most, although not all, of these second thoughts relate to the implications of the globalisation-powered rise of China and India. Some are scared by the success of globalisation in creating powerful new competitors in global markets or spooked by the security implications of the resultant shifts in economic power. Others are ill at ease with increases in inequality which appear to be correlated with intensified globalisation, and troubled by the implications of expanding trade ties with low income economies. New types of trade, in particular the extension of international competition into what were previously thought to be non-traded services, are another source of rich world anxiety. And the consequences for the environment and resource security of the industrialisation and urbanisation of the world's two most populous economies provide yet more reasons to worry. Meanwhile, the international institutions whose job it is to oversee the new global economy look increasingly uncomfortable in their role.

Of course, the combination of forces driving globalisation remains powerful: technological advances in transport and communications, and the self-sustaining effects of past deregulation and liberalisation will continue to be important forces driving cross-border integration. Even so, there now seems to be a growing possibility that in the future policymakers in the developed world will be more inclined to pursue policies that help temper or modify these forces, rather than reinforce them. Significantly less likely, but unfortunately not completely unthinkable, is the prospect of a swing to protectionism.

A second challenge raised by this success story is the need to deal with the evolving regional architecture, particularly in East Asia. Again, the logic of geography means that East Asia's integration into the global economy has been paralleled by an intensified regionalisation process. Even as East Asia's share of world trade has increased from about 10% in the 1970s to more than 25% now, so intra-regional trade has grown from about 35% of total trade in the 1980s to 55% by 2004, a degree of regional trade intensity second only to that displayed by the European Union. A large part of this process has been market-driven, but regional policy initiatives are now increasingly accompanying *de facto* economic integration. So, for example, the number of formal economic trade agreements between countries within East Asia is on the rise, with 24 new agreements concluded in the past decade, and 34 more under negotiation.<sup>21</sup>

To date, the evolution of a regional economic architecture in East Asia has been a relatively slow process, despite the temporary lift given by the effects of the 1997-98 financial crisis. Perhaps because of the latter, most of the early running took the form of financial initiatives such as the Asian Bond Markets and Chiang Mai Initiatives, but for now trade arrangements – in the form of preferential trade agreements – are in the vanguard. At this stage, these regional trade agreements are of widely varying quality and coverage, and the likely end game is far from clear. Will there eventually be some form of region-wide trading arrangement? And if so, what will it be based on?

Asian regionalism more generally is in a state of flux. There is no consensus on what form regional architecture should take, on what its functions should be, or on who should be in it. Should the principal organisations be trans-Pacific, including the United States (like APEC), or should they move south and west to incorporate Australia and New Zealand and India (like the East Asian Summit – ASEAN+6)? Or should they focus on East and Southeast Asia exclusively (ASEAN+3)? Some regional organisations like the ASEAN Regional Forum spread their membership even more broadly to include Europe. Each of these different models represents for its proponents a preferred shape of the coming power balance in the region. All we know for certain is that where we end up is likely to be very different from what we have now. Both Canberra and Wellington have an important strategic and economic interest in the outcome of this debate, ensuring that we are locked into, and not out of, any emerging regional economic arrangements.

## **The South Pacific**

We know that there are important benefits from being large, and from being close to markets. But in theory, small and remote economies should be able to overcome the constraints of limited internal markets through international trade and specialisation. And globalisation, by making that process easier, should have provided a significant boost to their development prospects. Unfortunately, things haven't worked out that way.

Australia and New Zealand and the countries of greatest importance to us in Asia have benefited from globalisation. But nearby parts of the world have had a different experience. The Pacific island states grew more slowly than any other region of the world between 1995 and 2003. For reasons either of scale, or policy design, or cultural and social disposition, much of the South Pacific has been left behind in the globalisation race,<sup>22</sup> except, arguably, in its least beneficial impacts. Illegal people movement, money laundering, health problems such as HIV/AIDS, and global warming, all of them problems in some regional states, are all at least partly manifestations of globalisation. Social indicators have been stagnant or slipping in many places, despite large aid flows, and per capita growth rates have been low over a decade. In the era of globalisation, large parts of the South Pacific have become more dependent, not more interdependent.

In an article published in the *Pacific Economic Bulletin*, Professor John Gibson from the University of Waikato examines the reasons for this slow growth and concludes that even when you control for geographical remoteness, the Pacific Island Countries still appear to grow more slowly than other parts of the world.<sup>23</sup>

The region we are talking about may be small in population but it is vast in its geographical range, and extraordinarily diverse. The challenges in each country are different. The Polynesian states are, on the whole, resource-poor (with the exception of fisheries); the Melanesian states are richer in resources. The social systems in each part of the Pacific differ greatly, with aristocratic social structures giving to Polynesian societies a cohesion that Melanesian communities lack.

Australia and New Zealand face more important foreign policy questions in the world than those of the South Pacific (for example, the rise of new global powers, environmental challenges like climate change and the proliferation of weapons of mass destruction). But we face none that are more complex or difficult to resolve. The questions of how we best encourage sustainable, internally-driven development in the countries of the South Pacific,

how we improve governance and prevent fragile states from becoming failing states, are genuinely hard.

Neither of us has the option of closing our eyes to these problems. The humanitarian consequences of social collapse in neighbouring states, our historical and cultural links with the Pacific, and the potential impact on our own societies if the regional environment became more conducive to criminals, would all compel us to take action. For Australia and New Zealand, then, the Pacific is not so much an arc of instability as an arc of responsibility. And it is a responsibility that comes at a cost. Between us we will spend around \$1 billion in the region in 2006/07 on aid and security assistance programs. But is that money well spent?

Although we have similar policy objectives in the region, our two countries look at it from quite different angles. New Zealand tends to focus on Polynesia; Australia on Melanesia, especially PNG, East Timor and Solomon Islands.

More importantly, our senses of ourselves in the Pacific differ in an important way. New Zealand sees itself as part of the South Pacific, with cultural links deriving from its Maori population and later immigrants from the region. Approximately 300,000 people of Pacific Islands ethnicity are New Zealand citizens or residents, about 60 per cent of them born in New Zealand. The New Zealand resident population of people of Samoan, Cook Islands Maori and Niuean ethnicity is close to, or exceeds, the population living in the islands.

Australia, on the other hand, sees itself as a regional neighbour, a concerned onlooker, rather than an involved participant.

These different ways of thinking about ourselves in the Pacific generate different tones in our policy responses. New Zealand emphasises cohesion and regional unity, national sovereignty and consensus-building. Australia places greater weight on outcomes and speed of delivery.

Australia and New Zealand already coordinate policy closely and reasonably effectively. Our aid agencies, for example, work on harmonising aid policy and delivery. (In the Cook Islands we run a single co-funded aid program.)

We have also worked closely together militarily to restore and maintain order in Solomon Islands, East Timor, Tonga and earlier in Bougainville. At present 1,260 Australian and 194 New Zealand defence force personnel and 70 New Zealand police and 400 Australian police are stationed in the region.

The competitiveness which marked our relationship in the region in the past has not evaporated but it has become more restrained. Partly, we suspect, this is because there has been so much more immediate work to be done in recent years, and partly it is because of the very good management of the relationship by the senior leadership in both countries over the past decade. (It is one of the oddities of the trans-Tasman relationship that Australia and New Zealand seem to get on best when the two governments come from different political traditions. We seem to take more care not to give gratuitous offence.)

However, the problem we face is not really one of harmonisation or cooperation; it is one of knowing what to do, of identifying effective action. Our experience in East Timor, PNG, Solomon Islands, Fiji and the smaller island states shows how hard that is to measure and attain. As pointed out earlier, the best empirical measurements we have suggest that what we have been doing has delivered at best mixed success. That seems to us to place a premium on experimentation and diversity in our approaches to the region, on the imaginative use of a wide range of policy options. If there was ever a case for laying out as broad as possible a smorgasbord of new ideas and approaches to try, the South Pacific is it.

We think this means that Australia and New Zealand should maintain a diverse approach to the region, both politically and economically, but continue close contact so we can measure what works and to build from success. Harmonisation is important but uniformity is not.

One very important area of difference – and it is one where Australia will be able to learn directly from New Zealand – is that of temporary migration for seasonal workers from Pacific island states. This is a difficult policy question on which there are different, sensibly held, views. It is not just a matter of development assistance but also goes, in Australia's case, at least, to the nature of its long-standing immigration policy, which has emphasised settlement. However, New Zealand's new Recognised Seasonal Employer Work Visa scheme which comes into operation at the end of this month will give us important data on the way it works.

There are also differences between us in the way in which our security forces – both police and military – operate in the Pacific. In part this is because of the cultural experiences of New Zealand personnel, both Maori and non-Maori. Australian military officers who have served in the region believe Australia can learn from the New Zealand approach to providing security in these Pacific environments.

One important new change in the Pacific has been the intrusion of different outside forces. A policy objective of Canberra and Wellington in recent years has been to keep others – the former European colonial powers, the United States, Japan – interested and involved. But one big thing that has occurred with remarkably little attention is that China (and to a lesser extent Taiwan) has moved intensively into the region with aid, political involvement, investments and illegal immigration. We've already seen some consequences of this in anti-Chinese riots in Tonga and Solomon Islands. This is a new face of globalisation in the region.

### **The Trans-Tasman economic relationship**

Australia and New Zealand have also been significantly influenced by globalisation. Australia and New Zealand have clearly obtained much greater benefits from globalisation than have the South Pacific countries, as discussed above, but these benefits have not been as transformational in nature as they have for many of the Asian countries. In part this is due to the higher income levels that were enjoyed by Australia and New Zealand when the recent phase of globalisation commenced, relative to most Asian countries, but also because globalisation poses a significant competitive challenge for both Australia and (particularly) New Zealand.

The following discussion focuses on the impact of globalisation on Australia and New Zealand and considers how this process has influenced the trans-Tasman economic relationship.

#### *The benefits of globalisation*

The ability of New Zealand and Australia to generate high levels of productivity and income is heavily dependent on accessing global markets for both inputs and outputs. The substantial growth in global trade and investment, together with communications technology and new business models that make it easier to go global from a distance, has therefore delivered significant benefit to the two countries.

New Zealand and Australia have both grown their levels of exports and outward foreign direct investment as firms from both countries have expanded into foreign markets. Between 1990 and 2005, New Zealand's exports grew from 27% to 29% of GDP and Australian exports grew from 16% to 21% of GDP. Australian firm growth achieved through outward direct investment has been particularly strong, rising from under 10% of GDP in 1990 to 23%

of GDP in 2005. Both Australia and New Zealand have benefited from the growth of Asian markets, with Asia becoming an increasingly important market for firms from both countries. In addition, booming demand for commodity products – be it minerals or milk – has supported the terms of trade for both countries.

It is fair to say that New Zealand has not participated in globalisation as actively as might be hoped in terms of exports and outward direct investment.<sup>24</sup> While New Zealand's international engagement has grown in absolute terms, it does not compare well to other countries of similar population size. This partly reflects the challenging nature of going global from relatively distant domestic economies – a challenge also faced by Australian firms<sup>25</sup> – but this is an issue of the extent of the gains that have been obtained, rather than an issue as to whether international engagement is positive.

Of course, both Australia and New Zealand are voracious consumers of imports of foreign goods, services and capital. Globalisation has also allowed countries to access a broader range of much cheaper goods and services, a trend reinforced by generally reduced tariffs, as well as foreign capital. New Zealand, for example, has one of the highest levels of inward FDI to GDP in the OECD, at over 50% (Australia's level is 30% of GDP). The ability to access cheaper goods and services has enhanced the welfare of both countries.

One of the consequences of this process has been the ongoing current account deficits that Australia and New Zealand have been running; currently 9% of GDP in New Zealand and about 6% of GDP in Australia. These deficits have been financed by foreign lenders who have been willing to advance capital to our countries. Without this ability to access foreign capital readily, the growth profile of Australia and New Zealand over the past decades would have been compromised. However, whether such reliance on foreign capital is sustainable or desirable in the long term is far from clear.

These global trends are mirrored in the growth of the trans-Tasman economic relationship over the past 25 years, since the introduction of CER in 1983. New Zealand and Australian firms operate in what is effectively now a single economic market in terms of the free movement of goods, services, people and capital. Work is under way through the Single Economic Market (SEM) agenda process to remove what impediments remain.

Merchandise trade growth has been strong between the two countries over the past few decades, and trans-Tasman FDI and portfolio investment have also grown substantially. This

has delivered benefits on both sides of the Tasman as Australian and New Zealand firms have been able to access larger output markets and greater investment opportunities.

Accordingly, both Australia and New Zealand have a clear stake in ongoing growth and prosperity of the global economy. We both stand to benefit from the successful conclusion of the Doha Round and we have both been active participants in attempting to secure multilateral trade liberalisation. On the other hand, both Australia and New Zealand have a significant economic exposure to the process of globalisation slowing down, or to the fragmentation of the global trading system (e.g. if preferential trade arrangements grow in importance).

### *The challenges of globalisation*

In addition to these benefits, however, globalisation has also exposed Australia and New Zealand to increased competition with respect to the location of economic activity. Both Australia and New Zealand are relatively distant from major global centres of economic activity in the US, Europe, and Asia. This is particularly the case for New Zealand given its unique combination of physical remoteness and a small domestic market. As indicated earlier, there is an observed worldwide tendency towards agglomeration, which makes it more challenging for Australia, and particularly New Zealand, to attract and retain skilled people, company head offices, and the like.

To give a sense of the scale of the challenge, consider the large populations of Australians and New Zealanders living offshore. The OECD estimates that 25% of New Zealand's skilled population live offshore, the highest proportion in the OECD, with 14% of Australia's skilled population abroad. Rough estimates suggest that slightly less than 1 million New Zealanders live permanently overseas, a significant share of a 4 million person resident population, while the Australian diaspora is estimated to be about 760,000, a large number but less than 5% of the Australian resident population.<sup>26</sup>

Companies have a tendency to relocate aspects of their activity offshore. New Zealand has seen the relocation of companies to overseas jurisdictions, including Australia, over the past decade or so. As companies become large, and grow significantly into international markets, it becomes likely that they move their presence closer to consumer markets – and if the company has a significant foreign ownership stake, there is also pressure to move the head office to be closer to shareholders. This pressure has been widely remarked on in both

Australia and New Zealand. This means that Australia and New Zealand need to compete hard in order to remain relevant.

However, if Australia is exposed to these forces, then New Zealand is several rungs down the food chain in terms of its ability to compete in global markets. New Zealand can be seen as ‘the canary down the mine of the global economy’.<sup>27</sup> New Zealand is more exposed to the exit of people and firms to other locations, and it is difficult for New Zealand to provide a compelling value proposition to locate economic activity in New Zealand relative to other locations – including Australia.

#### *Implications for the trans-Tasman economic relationship*

Considerable progress has been made over the past 25 years in reducing barriers to the trans-Tasman flow of people, goods, services, and capital. Initially, this was through CER and now through the Single Economic Market (SEM) agenda. A key motivation for this process is to ensure that firms can more easily access larger markets on either side of the Tasman. And as mentioned earlier, international flows of goods and services, capital and people have grown significantly over the past couple of decades.

This has generated gains both for companies, in terms of larger output markets and more efficient production and distribution arrangements, as well as benefits to consumers. It has cemented the importance of the Australian and New Zealand economies to each other. Australia is very easily New Zealand’s most important economic relationship; Australia is New Zealand’s biggest import and export partner, source and destination of foreign capital, and is New Zealand’s biggest tourism market.

New Zealand is also an important economic market for Australia, representing an additional 20% increment to the economic mass of Australia. The economic relevance of the New Zealand market to Australia can be seen in terms of the number of Australian firms investing significantly in New Zealand.

If the aim is to move towards the creation of a single Australasian market by removing barriers to trans-Tasman economic activity, it is important to consider the implications of the creation of a single market for the location choices of people and firms. In particular, the agglomeration tendency for people and firms to move from the periphery to the core is useful for understanding the likely development of the trans-Tasman economic relationship.<sup>28</sup>

Australia exerts a significant gravitational pull on New Zealand, attracting people and companies away from New Zealand. On average, over the last 25 years or so, an annual (net) average of 15,000 New Zealanders have exited New Zealand for Australia on a permanent or long-term basis. As an aside, it is instructive that New Zealand was a net recipient of Australian migration until the early 1970s, which is approximately when Australian per capita income became larger than New Zealand.

Over the past decade or so, too, there has also been a steady stream of head-office relocations with companies shifting their primary presence from New Zealand to Australia. This is often driven by a change in the location of ownership of these companies. These location choices of people and firms are perhaps one of the most significant drivers of the current trans-Tasman economic relationship.

The forces at work in the trans-Tasman process can also be seen within the Australian economy, with the tendency for people and firms to move from relatively peripheral regions, such as Tasmania, to larger centres. This is not deterministic or one-way traffic – look at the return of company head offices to Brisbane, for example – but it is a significant driver of location decisions.

In this sense, it is not surprising that the same process is increasingly observed as the reasonably peripheral New Zealand economy becomes more closely integrated into the Australian economy. The obvious difference, of course, is that New Zealand does not receive transfers from Canberra in the way that, say, Tasmania does.

In summary, Australia and New Zealand have both gained from globalisation. Nonetheless, with the upside generated from globalisation also comes a significantly more competitive global environment. Countries such as Australia and New Zealand need to compete to attract and retain people and firms to counteract the agglomeration tendency. This is particularly the case for New Zealand, given that it also has an exposure to people and companies relocating across the Tasman.

The overall challenge for Australia and New Zealand is to maximise the gains obtained from being able to access much larger global markets, while competing effectively to attract and retain internationally mobile people and firms. This is a challenge confronting every country, but perhaps it demands a more aggressive response from Australia and New Zealand because of our higher levels of exposure to agglomeration.

There are no easy or simple answers in this regard. In a world of increasingly mobile factors of production, it becomes increasingly important to develop immobile assets that make internationally mobile factors more productive in Australia or New Zealand and so create a reason for people and companies to locate Down Under.<sup>29</sup> This may involve investment in transport and, increasingly, communications infrastructure, developing strong capital markets, and investing in distinctive strengths in the skills and expertise in the workforce.

The nature of these investments will vary across countries, and between New Zealand and Australia, but the overall message is the need for Australia and New Zealand to develop a clear and compelling value proposition that will enable both countries to successfully compete.

### **What should we do?**

Where are some possible areas of ongoing work/collaboration between Australia and New Zealand over the next year in advance of the 2008 Leadership Forum?

#### *Globalisation*

Just as both economies have been winners from globalisation, so sustaining that process is a common national interest. To the extent that one of the more significant threats to international economic integration at present is the possibility of a backlash in some of the leading developed economies (the United States and Western Europe), the direct influence that Canberra and Wellington can wield is limited. However, there still remain important areas where both countries can work together. For example, the repair and upgrade of the international economic architecture is a pressing challenge – witness the travails of the Doha Round of international trade negotiations and the struggles of the IMF and World Bank to reinvent themselves – and while progress here ultimately requires the buy-in of the major powers, both Australia and New Zealand have the intellectual firepower to contribute to the debate. They also have the ability to act as honest brokers in the discussion over the direction of reform.

A second issue of importance to both economies is the impact of security, energy and environmental factors on the future trajectory of transport costs. The aftermath of the terrorist attacks on September 11, 2001 saw a lot of discussion about the possibility that security measures could drive up transport costs, and even undermine globalisation. (Remember also

that the US air transportation system shut down for four days, for example.) Industry experts at the time estimated that the costs of enhanced security measures could be up to 1-3% *ad valorem* – or about the same order of magnitude as the 2½ percentage point reduction in bound tariffs on industrial goods agreed by the Uruguay Round.<sup>30</sup> More recently, the focus on future drivers of increased costs has switched to energy and particularly environmental issues. One example is the future of air transport, with the Stern Report highlighting the forecast that CO<sub>2</sub> emissions from aviation are predicted to grow threefold over the period to 2050, making it one of the fastest growing sources of emissions. If the additional global warming effects of emissions from aircraft are taken into account, then aviation is forecast to account for 5% of the total projected warming effect. It seems likely therefore that aviation will be subject to carbon taxes or similar policy initiatives, with implications for its cost. A related example is the way that some consumer groups in Europe have been pushing the concept of ‘food miles’, which could potentially have adverse consequences for Australian and New Zealand food producers.<sup>31</sup> Monitoring such developments and seeking to inform and influence the associated debate could provide another source of future collaboration.

A third possibility for cooperation would be in regard to the emerging regional architecture, where both Canberra and Wellington have significant strategic and economic interests in ensuring that Australasia is included in any resulting regional arrangements.

### *South Pacific*

Although Australia and New Zealand undertake a good deal of joint work already on the Pacific, this usually takes place at the operational level, and between individual departments and agencies on each side of the Tasman. We believe there are opportunities for a broader trans-Tasman focus on the region to look at what works and what does not, and on the changing environment. This is not in any way to minimise the importance of engaging the countries of the Pacific themselves: we take it for granted that any successful policies will be based on deep interaction with regional governments and communities. But there could be advantage, for example, in an annual confidential exchange of views between Australia and New Zealand about effective approaches to the region. This would be a “Whole of Governments” review, involving aid, military, police, trade. The objective would not be to coordinate a joint foreign policy but to shape two more effective individual foreign policies. We think it should be pitched at a high operational level; that is, in the Australian case, at division head level officials and their equivalents in other agencies. It would be a question for government of whether to involve business people and academic researchers, or in what form.

Prospects for unskilled and low-skilled labour from the region in a globalised world will be particularly important. A paper on *Migration and Development in the Pacific Islands; Lessons from the New Zealand Experience*, by Professors Stahl and Appleyard for AusAID released this month, argues, for example, that Australia should help unskilled and low-skilled Pacific Islanders access the extensive Asian and Middle East contract labour markets. We should monitor closely New Zealand's experiences with its Recognised Seasonal Employer Work Visa scheme.

#### *Trans-Tasman*

There is a need for ongoing monitoring and discussion of the trans-Tasman economic relationship. In particular, there is a need to understand better the functioning and dynamics of the single Australasian market in terms of location choices. What can we learn from internal Australian movements of people and capital that may be instructive for understanding the trans-Tasman relationship?

In addition, it is worthwhile to have a discussion on where Australia and New Zealand would like the trans-Tasman relationship to be in 10-20 years' time? What level of economic integration is desired, what sort of outcomes ought we aspire to? What are the policy implications in terms of making progress towards achieving this aspiration?

## NOTES

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- <sup>1</sup> Kenichi Ohmae, *The borderless world: power and strategy in the interlinked economy*. London, HarperCollins, 1994.
- <sup>2</sup> Frances Cairncross, *The death of distance: how the communications revolution will change our lives*. London, Orion, 1997.
- <sup>3</sup> Thomas L Friedman, *The world is flat: a brief history of the twenty-first century*, Revised and extended paperback ed. London, Penguin Books, 2006.
- <sup>4</sup> See for example Robert Ewing and Bryn Battersby, Measuring recent trends in Australia's economic remoteness. *Treasury Economic Roundup Summer 2004-05* 2005.
- <sup>5</sup> Stephen Redding and Anthony J Venables, Economic geography and international inequality. *Journal of International Economics* 62 2004.
- <sup>6</sup> Abdelhak Senhadji, Sources of economic growth in New Zealand: a comparative analysis, in *Selected Issues - New Zealand*. Washington DC, International Monetary Fund, 2004. See Table 4, p 10.
- <sup>7</sup> Bryn Battersby, *Does distance matter? The effect of geographic isolation on productivity levels*. Treasury Working Paper 2006-03. Canberra, Australian Treasury, 2006. Graeme Davis and Robert Ewing, *Why has Australia done better than New Zealand? Good luck or good management?* Treasury Working Paper 2005-01. Canberra, Australian Treasury, 2005.
- <sup>8</sup> The changing nature of international trade is the subject of chapter 1 in Mark Thirlwell, *The new terms of trade*. Lowy Institute Paper 07. Sydney, Lowy Institute for International Policy, 2005.
- <sup>9</sup> Edward E Leamer, A flat world, a level playing field, a small world after all, or none of the above? *Journal of Economic Literature* 45 (1) 2007. According to Peter Kennedy, Econometrics is the art of drawing a crooked line from an unproved assumption to a foregone conclusion. Peter Kennedy, *A guide to econometrics*. Cambridge, MA, MIT Press, 1992.
- <sup>10</sup> Matias Berthelon and Caroline L Freund, *On the conservation of distance in international trade*. World Bank Policy Research Working Paper 3293. Washington DC, World Bank, 2004.
- <sup>11</sup> In 2001/02 about 82% of Australian merchandise exports and 71% of merchandise imports by value were transported by sea, while 18% of exports and 29% of imports were transported by air freight.
- <sup>12</sup> David Hummels, Transportation costs and international trade over time. *Journal of Economic Perspectives* Forthcoming.
- <sup>13</sup> This is the model which says that the gravitational force between any two objects is proportional to the products of their masses and inversely proportional to the square of the distance between them.
- <sup>14</sup> Anne-Celia Disdier and Keith Head, The puzzling persistence of the distance effect on bilateral trade. *Review of Economics and Statistics* Forthcoming.
- <sup>15</sup> Anthony J Venables, *Shifts in economic geography and their causes* (paper presented at the Symposium sponsored by the Federal Reserve Bank of Kansas. The new economic geography: effects and policy implications., Jackson Hole, Wyoming, August 24-26 2006).
- <sup>16</sup> Ibid.
- <sup>17</sup> Ross Garnaut, *Australia as a branch office economy* (paper presented at the 2002 Conference of the Australian Agricultural and Resource Economics Society (AARES), Canberra, 13 February 2002).
- <sup>18</sup> Angus Maddison, *The world economy: historical statistics*. Development Centre Studies. Paris, OECD, 2003.
- <sup>19</sup> Data for 1980 and estimates for 2006 are from the IMF April 2007 World Economic Outlook database.
- <sup>20</sup> Mark Thirlwell, *Second thoughts on globalisation. Can the developed world cope with the rise of China and India?* Lowy Institute Paper 18. Sydney, Lowy Institute for International Policy, 2007 (Forthcoming).
- <sup>21</sup> Indermit Gil and Homi Kharas, *An East Asian renaissance: ideas for economic growth*. Washington DC, World Bank, 2006. Especially chapter 1.
- <sup>22</sup> Harvey Armstrong and Robert Read, Geographical 'handicaps' and small states: Some implications for the Pacific from a global perspective. *Asia Pacific Viewpoint* 47 (1) 2006.
- <sup>23</sup> John Gibson, Is remoteness a cause of slow growth in the Pacific? A spatial-econometric analysis. *Pacific Economic Bulletin* 22 (1) 2007.
- <sup>24</sup> David Skilling and Danielle Boven, *Dancing with the stars?* New Zealand Institute Discussion Paper 2005/04. Auckland, New Zealand Institute, 2005.
- <sup>25</sup> David Skilling and Danielle Boven, *So far yet so close: connecting New Zealand to the global economy*. New Zealand Institute Discussion Paper 2007/01. Auckland, New Zealand Institute, 2007.
- <sup>26</sup> Michael Fullilove and Chloë Flutter, *Diaspora: the world wide web of Australians*. Lowy Institute Paper 04. Sydney, Lowy Institute for International Policy, 2004.

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<sup>27</sup> David Skilling, *Lessons from the world's economic laboratory: what can Australia learn from the New Zealand experience?* New Zealand Institute Essay. Auckland, New Zealand Institute, 2006.

<sup>28</sup> David Skilling, *Competing and cooperating: growing New Zealand's economic relationship with Australia.* New Zealand Institute Essay. Auckland, New Zealand Institute, 2007.

<sup>29</sup> David Skilling, *Choosing to compete: increasing the magnetism of the New Zealand economy*. New Zealand Institute Essay. Auckland, New Zealand Institute, 2006.

<sup>30</sup> World Bank, Reducing trading costs in a new era of security, in *Global economic prospects 2004: realizing the development promise of the Doha Agenda.* Washington, DC, World Bank, 2003.

<sup>31</sup> A simple definition of food miles is the number of miles a product has to be transported from the farmer to the final consumer. The implication is the greater the transportation distance involved, the greater the energy required to move the food, and hence the greater the environmental damage. For one critique of this simple definition, see Caroline Saunders, Andrew Barber and Greg Taylor, *Food miles - comparative energy/emissions performance of New Zealand's agriculture industry.* Research Report 285. Lincoln, Agribusiness & Economics Research Unit, Lincoln University, 2006.

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