

I first of all need to explain the basis on which I am speaking to you today. If I had been a more cautious person, I perhaps would have found some polite excuse for apologising that I was no longer able to take up a speaking invitation I had accepted months ago. However, I am not a risk averse person by nature. Indeed I believe that one of NZ's problems is that we have too often lost the capacity to take carefully calculated risk. This in part lies behind the slide sideways that has marked our country's progress in recent years.

I am not any longer the spokesperson for the National Party on Trade or the Associate Finance Spokesperson.

Like all spokespersons in the former National Party Opposition, our formal mandates expired on election night. It is John Key's responsibility, in consultation with his senior colleagues, to allocate Ministerial and other responsibilities. So I will speak to you on the basis of some decades of professional involvement in international trade.

### **China and our economic relationship with China**

Given the circumstances, I will open with some remarks on China but I really want to put this in the broader context of the external economic challenges facing NZ.

If this were a different audience – that is, an audience without deep knowledge of China, I would no doubt devote a fair bit of time to telling the main story – the big picture about the transformation of the world's largest country. But you already know the main lines:

- In 1750 and before the Industrial Revolution, China was the dominant economy in the world. Economic historians have calculated it may have accounted for around 30% of world GDP at that time. Then, as the process of industrialisation proceeded from its base in what justifiably became known as Great Britain (the first country in the world to move from an agrarian society to an industrial society and experience sustained economic growth of approximately 2.2% for a hundred years) China began its long relative economic decline.
- Through the Boxer rebellion and through to the Cultural Revolution, China's share of world GDP plummeted. I have seen calculations that suggest its share of world GDP may have reached its nadir at around 5% sometime in the early 1970s.
- Then a great Leader emerged with an agenda of economic transformation: Deng Xiaoping. With his immortal words in 1978 – 'it is glorious to be rich' – he set China on a path of wealth creation on a scale and speed the world has never seen.
- Today China accounts for perhaps 18% of world GDP. It is the third largest economy in the world – second on a PPP basis.
- The Chinese people have benefited measurably from this as hundreds of millions of people have been lifted out of degrading poverty, normally considered to be \$1 a day or less, into the \$1-\$2 a day income band, where some 35% of the Chinese population lies – compared with 80% of India's (the other great emerging economic and political superpower) and 52% of Indonesia's. People

tend to forget Indonesia – the world's fourth largest country. But I don't. In the decades ahead, we will see in China the movement of hundreds of millions more to the next income bracket: \$2-\$10 a day.

Obviously, the task of economic transformation is far from complete and major economic, social, political and environmental challenges have yet to be met. That said, these simple metrics describe human progress on an extraordinary scale. And what is more, they are matched by enormous improvements on most, but not all, social indicators such as life expectancy, infant mortality.

But if you step back from this ludicrously brief description of Chinese economic history, what are we really seeing? I think what we are seeing is better considered not as something novel, but rather the reassertion of China's position in the world.

The implications of this are enormous, for NZ and globally.

For the world, it is an agenda about accommodating China's legitimate aspirations to shaping global agendas. And let me say this. The world's most important bilateral agenda is indisputably the US/China relationship. In my view, the political leadership of both countries over the last two decades has been remarkably successful in managing that relationship. There have been some low points, but by any realistic measure, they have managed this relationship well.

Consideration of the US/China bilateral relationship would, in another speech, lead on to another agenda: how the main instruments of global political power clearly need to be adjusted to deal with this reality, which is in part an even larger reality about the growing significance of developing countries. In my area of particular interest, the international trading system, I saw this explode in 2003 and 2004 when I had the privilege of chairing the WTO Agriculture Negotiations. Twenty years ago, the international trading system – the GATT as it then was – was utterly dominated by developed countries. China was not even a GATT member, except via a legal fiction.

But the formation of what was called the G20 – a group led by the great developing countries of Brazil, India and China – the moment had come to transform international trading relationships. We are still trying to work through the implications of this in terms of the WTO Doha Round. Similar issues arise in the architecture of world politics around climate change, and the UN system more generally.

### **The specifics of the challenge facing NZ**

We have here in the first instance an extraordinary opportunity. In the last six years our exports to China have grown at an annual average compound rate of 11%. China is now our second largest import market and fourth largest export market. I think there is every reason to believe that in the long term China will become NZ's largest single export market – it is already Australia's largest export market.

Further, we have the unique advantage of being the first developed country to have an FTA with this giant economic superpower. Shorn of technical qualifications, we will have free trade in a decade with a market that represents approximately one quarter of the world's consumers. For a country that, over the last thirty years, had to fight tooth and nail to have the right to sell its main exports, this is an opportunity of a lifetime.

The need to increase our exports is, at least in my mind, among the most important long-term challenges facing our country. You all know the dismal reality. Out of 15 small developed countries – defined as countries with less than 10 million people – NZ is number 15. We are bottom in terms of the ratio of exports to GDP. So much for our self-imposed myth that we are a small, but great, trading nation. We are mediocre.

Why does this matter? Fundamentally it is about our long-term productivity growth rate. Second, it is about reducing our country's vulnerability to relying on offshore capital to finance our voracious appetite for consuming more than we produce.

What we know is that country by country, and company by company within any developed country that you care to measure, there is an iron clad relationship between higher exports and higher total factor productivity. Now I am aware that there is some technical complexity around this issue. Essentially, the literature tells us it is a chicken and egg issue. Which comes first? Do you, as an exporter of skim milk powder or baby pushchairs first need to become more productive to become an exporter or is it the other way round?

Whatever. What we know is that there is a virtual circle between higher participation in exporting and higher productivity. It is no coincidence that the first comprehensive study of total factor productivity that I became aware of ten years ago – the Diewart and Laurence study completed for the NZ Treasury – showed that in a 20 year period from 1978 to 1998 total factor productivity of NZ agriculture was almost three times higher than total factor productivity for the economy as a whole – and that included the contribution of NZ agriculture.

Why? Because NZ agriculture generally regards the NZ domestic market as an abstraction. 90 per cent plus of what NZ agriculture produces is for the world market, not NZ. NZ agriculture – and that is far broader than just our farmers since it includes our marketers, our scientists and our trade negotiators are involved in a virtual circle of innovation, product excellence and expanding market opportunities, or they fall away. Our objective is to move an additional 10% of GDP into that space. Or, technically expressed in terms of the National Party External Strategies Paper, our Government will aim to increase the ratio of exports to GDP by 10 percentage points by 2020. It is achievable, though I do not expect that our people will use the language I am using here. There is unlikely to be a new NGO called 'friends of total factor productivity'.

But what is at the end of the total factor productivity sausage machine is higher real wages. That is something every New Zealander can relate to. Every New Zealander knows we have a problem here: our real wages are too low. That is a principal reason why we are bleeding people. And not just bleeding over 80,000 New Zealanders a year – but bleeding young people. 80% of the people who left NZ last year were under the age of 40. Some 30% of our tertiary educated people do not live in their own country – an unprecedented proportion. We need to get NZ back into the top half of the OECD where we were when I grew up. We recognise it will take years and years of sustained effort, but frankly, it is where we belong. Raising productivity growth is central to that. Raising our exporting performance is an absolute key. And the Chinese market is a large part of that story.

### **San Lu - in personal terms**

When I heard that perhaps up to 50,000 babies and infants had been poisoned by contaminated milk – milk not from NZ sources but from some 20 odd Chinese dairy companies, including one with a commercial relationship with NZ, San Lu – the first thing I did was ring my daughter-in-law. Her baby, and my first *mokapuna* – an enchanting little girl of some 18 months called Lucia and who lives in Hong Kong with her Mum and Dad, my son – had been weaned some nine months ago and has, as you would expect, been consuming infant formula for some time.

I leave it to your imagination as to the discussion that occurred on a personal level and it will remain private. It was, no doubt, a conversation that had been paralleled within China by a million other grandfathers and their daughters-in-law in Cantonese, Mandarin, Shanghainese and other dialects as well as, in our family's case, Kiwi English. Happily in my granddaughter's case, there appears no issue.

The issue of food safety has no doubt shot to the top of the Chinese agenda. I am very pleased that Fonterra has taken the initiative of contributing some US\$5million to the China Soong Ching Ling Foundation, with the strong support of the Chinese Government. My understanding is that this will be spent over the next five years to assist in health, welfare and infant nutritional programmes in China. As the incoming Government, we will be expecting a full briefing from officials and Fonterra on the situation. I am sure that we will be wanting to explore how we might work in the future with the Chinese authorities on the food supply chain and how it can be improved.

### **The impact of the global financial turmoil on our long term trade prospects**

In the time available, I can hardly undertake any analysis. Obviously, the Wall Street – Main Street, linkage, or 'financial markets-real economy' linkage – is crucial and no-one really knows the depth of the adjustment ahead. Instead of an analysis, I will go straight to the operational conclusion – and I will put it terms of our premier goods export industry, dairy, although I could say similar things about our medium term tourism or other export prospects.

The impact has been savage and immediate. World dairy prices have fallen at least 20-25% from the extraordinary highs. Some highly leveraged farmers who are recent entrants to the industry or who expanded aggressively are going to be facing tough times. The extraordinarily optimistic picture painted only in the recent past suddenly looks very different. Of course, like others who have lived in or around this industry for over a quarter of a century, we always knew that the improved picture for dairy did not mean the end of sharp fluctuations – rather, it would be the normal sharp fluctuations around a higher long term equilibrium price.

But I am going to take a punt. In NZ we have been in a recession, as normally defined, since February – well before the financial meltdown. We face some tough times ahead. I can assure you that the incoming Government led by John Key is only too well aware of this. We can expect globally slow growth at best, for, say, a couple of years. Of course, we and the global economy are hugely benefited by the fact that developing countries, led by China, are now a much larger part of the global economy and will offset to some extent the downturn in the Eurozone and the US. But it is not going to be easy. We know that.

However, the Government that John Key is going to lead as our next Prime Minister is determined to adopt both policies and an approach that will grow our way out of this situation. Globally, there needs to be a rebalancing of balance sheets and NZ will not escape this. But looking beyond the medium term, we also the fundamentals have not changed. This country – our country – has great assets. The world will get through this large and unavoidable correction but in time the fundamental realities underlying our country's future will reassert themselves. It is a good future.

We are a food basket for the world. China, for example, with 24% of the world's population, 9% of the world's arable land and acute water problems, will look to NZ to meet the increasingly sophisticated food needs of its people. Many other rapidly developing countries will do likewise. We are a hotel for the world – no-one should be surprised that John Key took our number one export earner, tourism, as his single dedicated Ministerial portfolio. Chinese tourism is simply crucial to that vision. We can aspire to be a school for the world – I do not believe we have scratched the bottom of our potential to provide education for Asia's middle class. And, as John has said, we can see our future as a creative studio – a metaphor for kiwi creativity, across niche manufacturing, film, specialised services exports.

China will loom large in all this.