17/2010

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Insight

In defence of foreign investment

Poll-driven policies could cost us all

Globalisation does not rest easily with all. Recent public and political outcries over foreign investment in our farms and manufacturing plants attest to this. A recent TV3 poll indicates that over three-quarters of Kiwis want overseas investment rules tightened, and the Prime Minister is concerned about “the risk that New Zealanders become tenants in their own land” (NZPA 9 August 2010).

But restricting overseas investors’ access to the NZ economy, or certain sectors in it, is a damaging policy prescription. It would increase our country risk premium, causing borrowing costs to rise for households, firms and the government.

Given New Zealand’s debt levels, this will reduce economic growth and income: hardly a sensible way of trying to close the gap with Australia.

The main benefit of additional restrictions on foreign investment will be ‘feeling better’ for owning our own backyard. But this note uses a simple cost benefit analysis to show that this ‘feel good’ factor would come at considerable cost. New Zealand simply doesn’t have the capital market depth to afford to be so picky.

We want other economies to welcome our products...

The debate over how New Zealand interacts with the world has always been fraught. Most New Zealanders are well aware that an open economy is important for economic growth. There is very broad support for additional trade liberalisation either via the World Trade Organisation (WTO) or – more recently – through Free Trade Agreements (FTAs). That’s because we know that when other countries remove subsidies or tariffs on the things we produce, we become more competitive and this lifts our income. We also want to be able to invest in overseas projects and travel freely for business purposes.

...but get a bit nervy about opening our own borders

However, some parts of globalisation do not sit easily with some sections of the New Zealand population. Migration and foreign direct investment (FDI) are the two main examples (although there is little focus on the huge sums foreign funds use to finance our mortgages and business lending). Politicians in their polling pick up on any latent unease; hence headlines in the media that “worry about” or criticise aspects of the way we connect with the world. The latest instance of this are the “concerns” voiced by the Prime Minister about rules and regulations governing inward FDI. It is with some irony that the current storm over the potential sale of land to foreigners has come about because of the collapse of a New Zealand business that, according to newspaper reports, not only over extended itself borrowing money, but failed to look after its workers, and disregarded its environmental obligations.

Land investments: global hot property

The commodity boom and a bright outlook for agricultural prices have driven a world wide interest in acquiring agricultural land. Between 2006 and 2007 inward FDI grew almost four-fold to US$5.5 billion (UNCTAD WIR, 2008). There has been also a similar increase in investment in food processing.

New Zealand has not been immune from this worldwide growth in inward foreign investment flows over the past 25 years. We have a long history of significant foreign investment. Indeed, foreigners had $293 billion invested in our $187 billion a year economy in March 2009.

But to date, land-based acquisitions by foreigners have not been particularly dramatic. According to Statistics New Zealand, the stock of land-based foreign holdings was $4.8 billion in 2009 (1% of the 2009 total), while around $27 billion (9%) was invested in manufacturing[1] and $192 billion (61%) in finance and insurance.

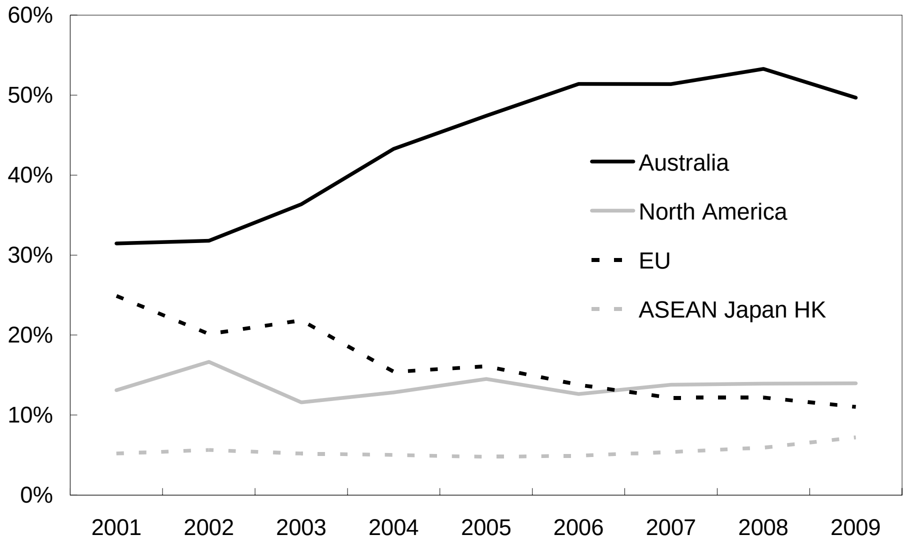
Asian FDI in New Zealand is a small proportion of the total

Most of New Zealand’s inward FDI comes from Australia (Figure 1). FDI from Europe and North America has been declining slightly over the past 10 years while inward FDI from Asia has risen slightly, albeit still at low levels. More individual applications for land purchases have come from France, the Netherlands and Australia than from Asian sources (Hartevelt, 4th August 2010). FDI from China is too small to be reported separately. Flows from Hong Kong are about 1% of total (China FDI often flows through Hong Kong).

[1] Food processing is not reported separately, so this figure is for total manufacturing.

Figure 1 NZ foreign direct investment stock by source

Countries or groups of countries, % of total FDI



Source: Derived from SNZ BoP and International Investment data

The pros and cons of limiting FDI

One way to weigh up the pros and cons of FDI is through a cost benefit analysis (CBA) framework. CBA is useful because it takes a society-wide perspective. The Prime Minister has expressed a desire for a similar analysis from officials: "I just think if we are going to allow [foreigners to buy New Zealand land] to happen on a wholesale basis, we should do that with our eyes open...we should be aware of what that means" (NZPA, 9 August 2010).

To illustrate the impact of possible restrictions on FDI we examine the economic costs and benefits on three groups within society: households, businesses and government. This is summarised in Table 1. Note that even if there are no policy changes around FDI, the perception that overseas investment is less welcome could create uncertainty, making investors less likely to consider New Zealand as an attractive investment option.

Table 1: Costs and benefits of curtailing foreign investment

Costs	Benefits
Households	
Higher interest rates making households poorer Reduced innovation and competition increases prices and decreases choice Higher unemployment due to reduced household spending	"Feel good factor" - New Zealanders own the land
Businesses	
Reduced access to capital/higher interest rates	New Zealand owned firms in some industries benefit – selected firms do very well without foreign competition
Reduced size of domestic market (households poorer) Potential reduction in access to new technology from overseas Reduced international trading or investment opportunities due to possible retaliation by foreign governments Over time possible capital flight of New Zealand firms to more profitable markets	Export revenue and returns to capital accrue to New Zealand, not foreign owners
Government	
Costs of implementing different rules & regulations that apply to different players Implications for CER if Australians considered foreigners Higher debt servicing costs	Improved popularity of government – in the short term

Source: NZIER

Impact on households

For households, the main cost impact of restrictions on FDI will be an increase in interest rates. Separate rules on land ownership for foreigners will discourage investment in New Zealand and cause confusion and uncertainty among foreign investors. International rating agencies will react by increasing New Zealand's (already high) credit risk rating.

We know this because one of the most consistent pieces of advice given to the government by domestic and international agencies to improve economic growth is to have an open investment regime. This is supported most recently by Jones and Romer (2010) in their review of what drives world growth. Any move away from this policy will be seen as diminishing New Zealand's growth potential and investors and credit agencies will react accordingly. The cost of borrowing for banks will increase and they will pass these costs on to consumers in the form of higher interest rates.

New Zealanders will therefore be poorer. Higher interest rates mean that spending on food, consumer, and other items could decrease. Reduced consumer spending is likely to reduce employment, further affecting household spending.

At the margin, dual rules for landownership will also impact on foreign companies wanting to invest in New Zealand more generally. Any drop in interest in the New Zealand economy from foreign firms could lessen competition and stifle innovation. Since most innovative products and services are imported into New Zealand this is important for the New Zealand economy. The impact on households will be less choice and higher prices relative to a situation where more restrictive land ownership rules were not in place.

The main benefit for households is the intrinsic “feel good” factor that New Zealanders have from maintaining control over their country. However, that control is largely illusory, since to support our standard of living we rely on the world to buy our exports, fund our housing market, and provide us with the latest consumer gadgets.

Impact on business

Similar to households, businesses and the financial sector will also experience increased costs because of rising interest rates.[2] Financial markets will also be affected by the rising interest rates and a shrinking equity market. Their ability to thrive in this market will be restricted.

Also worryingly for businesses, is the size of their domestic market will shrink as consumers spend more money on debt financing. At the margin, a lack of interest in New Zealand by foreign business will also restrict access to new technology and new ways of organising business activity. This will mainly impact on dynamic efficiency, those small imperceptible improvements that are the main drivers of productivity changes. Longer term, it could also drive New Zealand firms offshore. This “capital flight” will be driven by a stagnating local market and lack of opportunities to improve their product mix.

There is also the question of whether New Zealand businesses would be comfortable with a government that wants to restrict FDI in the land based sector at a time when various firms are entering into arrangements with overseas interests (e.g. in Chile and Uruguay) to draw on their resources. The possibility of retaliatory action by foreign governments could put such investments at risk.

The potential benefits for individual firms in some sectors is less competition and more opportunities to exercise market power. This of course will be at the expense of consumers.

Impact on government

The main question the government faces is how will they deal with the Closer Economic Relations (CER) agreement with Australia, since around 50% of our FDI comes from across the Tasman (see Figure 1). Any reneging on the ‘spirit’ of the CER agreement is likely to have negative impacts on New Zealand and is bound to be matched by retaliation from Australia. The government will have to spend time and resources limiting the damage done to the wider CER

[2] In addition, if a New Zealand firm wanted to buy land in the place of foreign investors, it would most likely need to borrow from overseas to fund this purchase. This lifts the stock of national debt at the same time that the interest rates on that stock are also increasing.

relationship that includes moves towards a single market and potential collaboration with Australia in third markets.

The government would also have to develop relatively complex access rules for different classes of investors. These will be time consuming for investors to navigate and for officials to implement and monitor. The higher country risk premium mentioned above will mean that servicing government debt becomes more expensive, diverting taxpayers' money away from other, more productive, forms government spending.

The only real benefit for government may be a short term increase in popularity. However, the reaction of money markets to any such policy changes is usually relatively swift so as the cost of borrowing money increases, the increase in popularity might be short lived.

Conclusion

New Zealand is inexorably intertwined with the global economy through trade and investments. Poll-driven reactions to the possibility of foreign investment are clearly unhelpful. A simple cost benefit analysis framework shows that any permanent government response to concerns about foreign ownership of land will impose a wide range of costs on all parts of the New Zealand economy, primarily through higher borrowing costs and the risk of retaliatory action by other governments.

It is unlikely that any 'feel good' factor associated with limiting foreign investment will compensate New Zealanders for the 'feel bad' consequences of a lower standard of living.

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