

Foreign Direct Investment in New Zealand Forestry*

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Introduction

Foreign direct investment (FDI) is an emotionally charged subject. Its proponents often see it as a short cut to economic utopia. FDI's opponents present it as a major threat to our way of life.

The purpose of this paper is to cut through the emotion and present a dispassionate analysis of FDI in forestry.

In the sections that follow the paper:

- Defines what exactly is meant when we refer to FDI.
- Describes the nature and extent of FDI in New Zealand and, in particular, in our forestry and wood processing industries — we have seen some significant changes in less than a decade and the Asian crisis is already having an impact on the figures.
- Evaluates the claimed benefits and costs of FDI — we will discover that the truth lies somewhere in-between the accolades if FDI's proponents and the condemnations of its opponents, but resting more in favour of the proponents.
- Outlines some current proposed work that the New Zealand Institute of Economic Research (NZIER) is planning to undertake on the risks and opportunities facing forestry.

What is FDI?

Goods, services, money and people flow in and out of our national boundaries every day. These flows all interact and impact on each other. For example, a business immigrant may invest capital in New Zealand. He may also help open doors to export markets, and import intermediate goods as inputs into his newly established New Zealand based enterprise. The lines between the categories may not be as clear cut as they may first appear.

In this paper the focus is on just one of these flows — FDI — in particular, FDI in forestry.

The International Monetary Fund defines FDI as:

investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that

of the investor, the investor's purpose being to have an *effective voice* in the management of the enterprise.

In New Zealand the rule of thumb that has been adopted to classify FDI is 25% or more of the shares or voting rights are held offshore. The choice of threshold is clearly arbitrary. Many of us will be able to think of instances where less than 25% is sufficient to have an "effective voice". Indeed a large number of countries have opted for the lower threshold of 10%. However, working in the other direction, others of us may know of examples where 25% is insufficient to have an "effective voice". Bearing these caveats in mind, the 25% threshold has been adopted for the purposes of this paper.

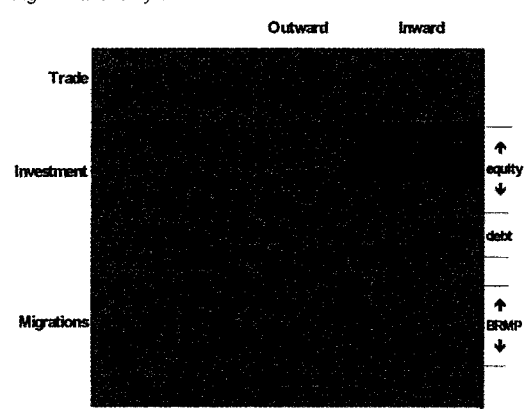
Where a foreign investor's share of the equity in an enterprise is less than 25% such is assumed to comprise "portfolio" investment: the investor has no say in the running of the enterprise, but desires a return on his or her investment.

Profile of FDI

FDI in New Zealand

FDI in New Zealand is significant. The stock of FDI in New Zealand that has built up over the years is equivalent to 45% of our gross domestic product. We rank third, after Singapore and Malaysia, out of the 45 countries reviewed in the *World Com-*

Fig. 1: Taxonomy of International Flows



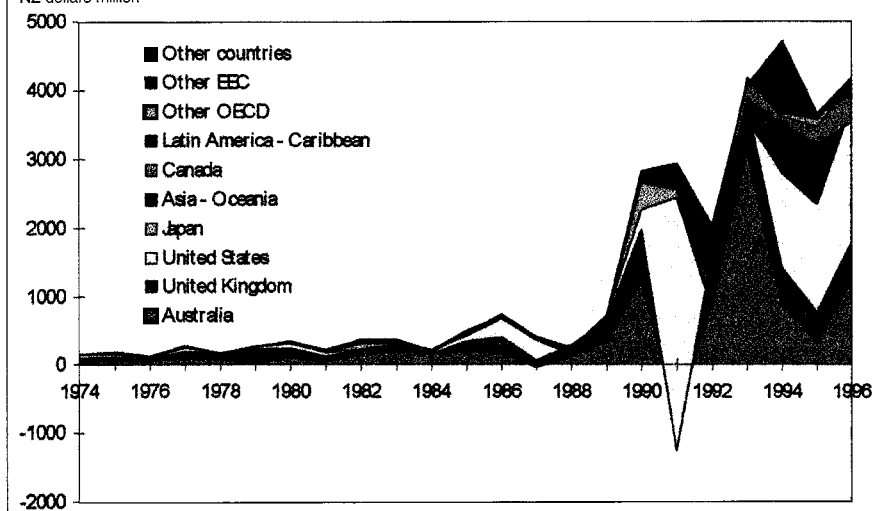
petitiveness Report 1997.

New Zealand continues to attract significant FDI. The significance of current flows of FDI into New Zealand ranks us eighth in the world, not too far behind China and Ireland.

The growth of FDI in New Zealand has largely occurred since the late 1980s. Before then FDI into New Zealand was a mere trickle by comparison, although it seemed significant at the time.

Australia and the United States are the largest sources of FDI. Despite the mistaken beliefs of many, Asian businesses are not buying up New Zealand. And while Asian investment grew in the early 1990s, it dropped off in 1996 — before the advent of the Asian crisis. The Asian crisis is likely to see a continued decline in Asian investment over the current and following year.

Fig. 2: Sources of FDI in New Zealand
NZ dollars million



* This is a slightly abbreviated version of a paper presented at the NZIF Conference on Investment held in Wanganui on 21 April 1998.

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FDI in New Zealand Forestry

Investment in forest growing

The trends for FDI in New Zealand are reflected and amplified in our forest growing and wood processing industries.

Prior to 1990 the forestry industry was dominated by the government (which either owned or leased 52% of the forest estate) and a handful of large domestic corporates. Australian company Elders Resources NZFP was the only significant foreign investment in the industry.

The sale of Crown forest assets and subsequent private sector transactions brought about the most profound restructuring of commercial forestry to occur in the industry's history. The government now owns less than 7% of the planted forest area. New foreign players have entered the industry. The first round of forest sales in 1990 and 1991 saw the entry of Asian investors, who today account for just over 12% of the forest estate. The second round of forest sales, International Paper's acquisition of a controlling interest in Carter Holt Harvey in 1995, and the recent sale of Nelson forests to Weyerhaeuser, has meant that United States investors now account for a third of the New Zealand forest estate.

Investment in wood processing

FDI in wood processing has arisen through either the:

- Purchase of shares in an existing company, such as International Paper's acquisition of a controlling interest in Carter Holt Harvey.
- Direct purchase of existing mills, such as Sumitomo's acquisition of Nelson Pine.
- Establishment of new mills to process the wood coming out of recently purchased forests. Weyerhaeuser, for example, is currently investigating its options regarding establishing a manufacturing facility to add value to the wood from its Nelson forests.

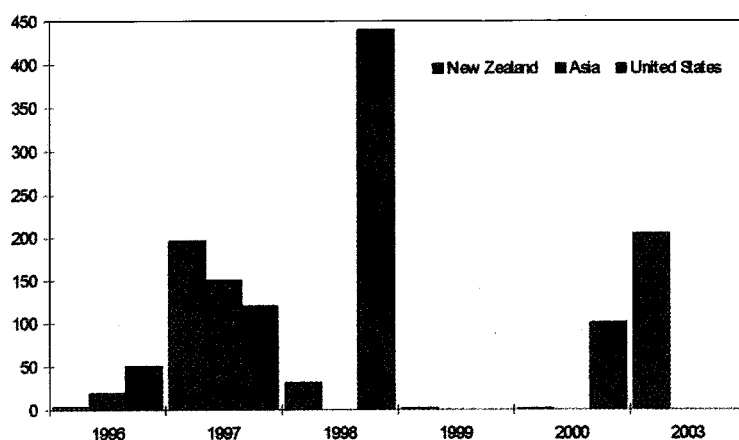
Announced investment intentions in wood processing suggest a loss of interest by Asian investors and the growing interest of United States investors. This parallels the situation for forest growing, and for FDI in New Zealand assets generally.

Evaluating the Benefits and Costs of FDI

Those who claim that FDI will transform the New Zealand economy variously point to:

- The quantity of capital it brings into the economy.
- Improvements in the competitive structure of industries.
- Jobs that are created.
- The expanded pool of intellectual capital arising from the introduction of new skills and ways of doing things.
- Improved linkages in international markets.

Fig. 3: Announced investment intentions in wood processing
NZ dollars millions



Those arguing against FDI do so in terms of the:

- Loss of sovereignty to New Zealand.
- Loss of value added.
- Current account deficit.

What is the real story and what has been the experience of forestry?

Benefits?

Let us first go through each of the claimed benefits one-by-one before turning our attention to the claimed costs.

New capital inflows

It has been estimated that, based on the volume of wood coming on stream between 1996 and 2010, the wood processing industry has the capacity to support between \$4.1 and \$6.6 billion in new capital investments (Ministry of Forestry 1995b).

In 1997 the value of announced wood processing investment intentions was \$4.7 million. If the industry was to achieve its capacity level of investment then sums considerably larger than this will need to be invested in the industry each year over the next decade and a bit.

However, economics may suggest that the optimal level of investment is significantly less than capacity. The investment may derive from both domestic and foreign sources. If New Zealand improved its savings performance then the potential would be created for a lot more investment to be sourced domestically.

FDI, nevertheless, plays a positive role if it helps New Zealand to fund a higher level of investment than it could otherwise afford by itself. In many instances foreign investors are able to take on board greater risk than domestic investors. This may be due to factors such as these investors having a more diversified portfolio of assets, economies of scale, or a good financial reputation. In these instances FDI will help to raise production possibilities in New Zealand beyond what they would otherwise be if we had to rely upon our own savings to fund investment.

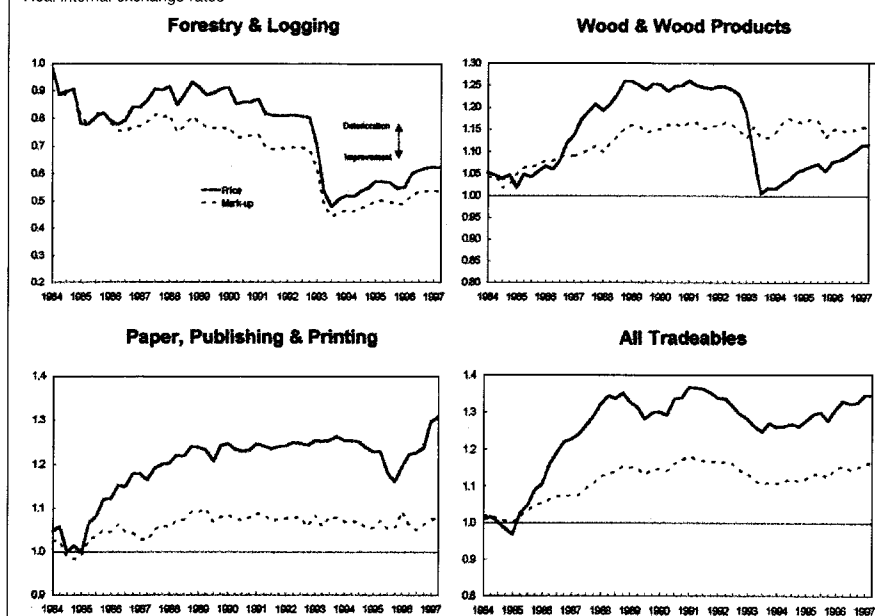
Improved competitive structure

FDI can act to expose industries with dominant market players to a more competitive environment by increasing the number of players in such industries and creating a climate of contestability. To remain profitable in such an environment, enterprises will have a strong incentive to adopt the most efficient technologies and organisational arrangements, to pass on cost savings to customers, and to produce what consumers desire most.

The economic literature makes a case for enhancing competitiveness through FDI when barriers to entry in an industry are high, import competition is low, and where the government plays a large and direct role in the industry. This parallels the situation of New Zealand forestry prior to deregulation in the mid- to late-1980s, restructuring and privatisation in the 1990s. In the previous section we saw how FDI has markedly changed the structure of the industry.

How has New Zealand forestry and wood processing fared given its more foreign face and a deregulated environment? This is not easy to gauge. Internal real exchange rates provide a guide. They measure the relative ability of the selected sectors — in this case the sectors of the forestry industry — to attract resources from other sectors of the economy. There are a number of ways to construct these rates. Here I will examine only two — relative output prices and relative rates of mark-up on input prices. The rates are constructed by dividing the observed values (price and mark-up) in the non-tradeables sector by the same for the forestry and logging, wood and wood products, and paper, printing and publishing sectors (these are the sectorial breakdowns used in the official data). Graphically, an upwards movement in either rate represents a deterioration in competitiveness and, conversely, a downwards movement represents an improvement. The results for forestry are plotted below. The outcome for all tradeables relative to non-tradeables has also been plotted in order to provide a benchmark against

Fig. 4: Competitiveness of forestry
Real internal exchange rates



which to judge the rest.

Figure 4 illustrates a number of interesting points.

- Forestry and logging has improved its competitive position since the late 1980s. However, the fact that output prices and mark-up rates tend to move together suggests that the key driver is price, rather than costs. The effect of the 1993 log price spike is hard to miss; so too the erosion in competitiveness with the subsequent falls in price.
- The wood and wood products output price real exchange rate follows a similar path to forestry and logging. However, the relative stability of the mark-up rate suggests that costs have matched price changes. The cost of logs is likely to be a major culprit.
- The rates for paper, printing and publishing reflect a relative stability in sectoral competitiveness for much of the period examined.
- Trends in the competitiveness of the sectors in the forestry industry compare favourably to the experience of all the tradeable goods sectors combined.

Can we credit FDI with the relative attractiveness of the various sectors in the forestry industry? This would require us to have a view on what the counterfactual would be if the industry had not restructured and government had not privatised its activities. Certainly, the log price increases would have benefited the industry regardless of who owned the forests. Thus the key question is whether the mark-up real exchange rate, which reflects costs as well as prices, would have followed a less favourable path. Economic theory suggests that if there were fewer players in the industry the competitive pressure to contain prices would have been less. The reality is

a function of more things than the number of players.

Jobs

Whether jobs are gained or lost as a result of FDI is a debate that has generated more heat than light — there is an unfortunate scarcity of analysis on this issue.

While more than 18% of persons employed in New Zealand hold jobs in foreign-owned enterprises (Statistics New Zealand 1997a), it cannot be concluded that new jobs have been created (or lost) as a result of FDI. Jobs may have simply been transferred following acquisition.

The mixed experiences of forestry illustrates the murkiness of this issue. On the positive side of the ledger:

- The Ngati Porou Hansol Forestry joint venture is projected to have positive direct and indirect employment impli-

cations associated with its forest planting activities in the East Coast.

- Juken Nissho's new investments in wood processing, following its acquisition of Crown Lease Forests, has created new jobs.
- The number of full-time and contract staff employed by Wenita has increased significantly above its 1990 start-up level.

On the negative side of the ledger:

- The Fletcher Challenge, Brierley Investments and Citifor joint venture has rationalised its activities following its acquisition of Crown forest assets in the Bay of Plenty.
- Forestry companies are shedding staff and contractors in the wake of the Asian market crisis.

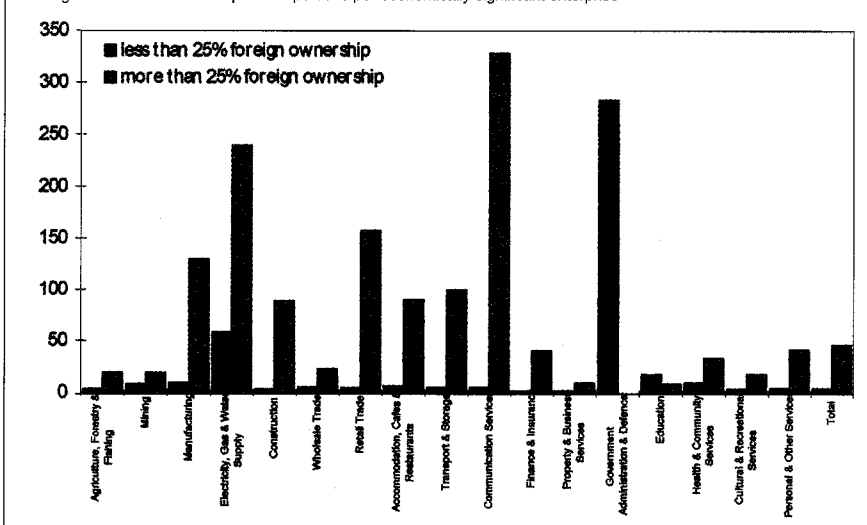
Both the gains and the losses will have been driven by productive efficiency considerations.

Whatever the net outcome for forestry, one should not place too much weight on its importance: forestry is not the fountain of jobs that many perceive it to be, regardless of ownership. The average number of persons employed in foreign owned agriculture, forestry and fishing enterprises is 19. While this is certainly greater than an average of three for domestic enterprises in the same industries, it is a long way off the average for foreign owned enterprises in the communication services industry, for example, which is more than 300.

And the larger numbers of people employed on average by foreign enterprises is insufficient to prove that FDI leads to net positive employment outcomes. In the case of forestry, at least, more plausible explanations include the larger sizes of foreign enterprises and that the official statistics would treat a number of forestry contractors as statistically insignificant (if their profit is less than \$30,000) and, thus, not count them.

Fig. 5: Average number of employees per enterprise

Average number of full time equivalent persons per economically significant enterprise



Intellectual capital

FDI is sometimes referred to as trade in entrepreneurial services and ideas (see, for example, Ruffin 1993), as distinct from merely trade in assets. FDI is seen as offering the key advantage of bringing new knowledge and entrepreneurial ideas and, thereby, being one of the driving forces of economic growth. Empirical research by NZIER supports this theory (Duncan 1994). It found that the causal links between FDI and economic growth cannot be taken as self-evident. The linkages are through the **quality** of the investment rather than through the quantum.

New skills:

A variant on the job creation argument is that foreign owned businesses often provide workers with the opportunities to develop new skills (United Nations 1994). That is, rather than gains in the number of persons employed, FDI's most significant impact is on the competencies of the workforce. The experiences of New Zealand's wood processing enterprises support this claim. For example, when Thunderbird Moldings took over Radiata Components in Southland, the company brought in specialised graders from the United States to train its New Zealand employees in the production of high quality moldings and components for the quality conscious United States do-it-yourself market.

New ways of doing things:

Tachikawa Forest Products does things a little differently. Rather than seeking ways to hasten the speed of production, as many New Zealand owned sawmills had sought to do, it introduced into New Zealand slow sawing technology that maximises recovery and cuts timber precisely according to the requirements of customers. This focus on customer requirements has provided an important lesson to New Zealand producers.

International linkages

A not so well documented benefit of FDI is the role it has played in strengthening New Zealand's linkages with international markets. The benefits have manifested themselves on at least three levels: market promotion, market access, and access to international distribution networks. Japanese joint venture company Juken Nissho provides a useful case study of the potential for FDI to have a positive influence in each of these respects.

Market promotion:

By championing products produced in New Zealand in their home and other markets, foreign entrants have helped to gain market acceptance.

In Japan radiata pine is not as well regarded as it could be. Its predominant uses continues to be packaging, pulp and chip. Juken Nissho is helping to change perceptions. By converting its New Zealand-made timber and panel products into staircases, window sills, tables, counter tops and other high value end uses at Juken Sanyo's mills in Japan, it is helping to educate Japanese consumers about the benefits of radiata pine as a value added multi-use timber.

Market access:

Foreign entrants have also advocated the reduction of trade barriers in their home and other markets.

Both parties to the Juken Nissho joint venture have acted on occasion as political advocates in Japan for less restrictive trade barriers. The major barriers are tariffs and building standards. Juken Sanyo has made representations to the Japanese Government on the tariff issue. And Nissho Iwai, an influential trading company, has campaigned in Japan for the use of radiata as a construction material and finishing timber.

Access to international distribution networks:

FDI has assisted us in gaining access to international distribution networks.

Nissho Iwai is the sixth largest sogo shosha, or general trading company, in Japan. It holds more than a quarter of the market share of timber exported from New Zealand, and is the largest of the sogo shosha importing New Zealand logs.

Costs?

What of the claimed costs?

Loss of sovereignty

This is where the emotions of New Zealanders run wild clouding rational debate. Has sovereignty really been lost? The answer is confused by the lack of consensus of what it means to be a sovereign nation. In the absence of such, in this paper sovereignty is examined from two different angles — ownership and control.

Ownership:

FDI has meant that a proportion of New Zealand's productive capacity is owned by overseas interests. Earlier in this paper it was identified that:

- The stock and flow of FDI in New Zealand are increasing and represent a significant proportion of GDP.
- In less than a decade the New Zealand forestry industry has changed from being predominantly domestically owned to predominantly foreign owned.

However, ownership has only been 'lost'

if the investment merely facilitated a change in ownership. If FDI represents new investment then nothing has been 'lost'. As noted earlier, there may be reasons why foreign investors will put their money in ventures that domestic investors would not.

There has been much new investment in forest growing and wood processing since the 1990s. The data for wood processing, considered in the previous section, was all new investment, and much of this has been by North American, Asian and other foreign interests. The data on forest growing demonstrates both a growth in the planted forest estate and significant transfers in ownership. New planting levels since 1990 have achieved record highs. While small growers are doing much of this planting some foreign enterprises have played an important part in this growth.

Control:

If sovereignty is taken to mean control, then the 'loss' of control as a result of FDI is arguably small. All New Zealand businesses, whether owned domestically or by foreign interests are obliged to comply with New Zealand laws and regulations, sustainably manage their resources, pay New Zealand taxes and tariffs, and pay at least a minimum wage to staff.

Beyond being governed by the provisions of the Resource Management Act and the indigenous forest provisions of the Forests Act, the sustainable management of forests in New Zealand is further ensured by foreign owned forestry enterprises voluntarily signing up to agreements such as the New Zealand Forest Accord 1989, and its 1995 companion document, Principles for Commercial Plantation Forest Management in New Zealand.

Loss of value added

'Value added' is used here in the economic sense, rather than the further processing interpretation that is often applied in forestry circles.

GDP measures total value added in New Zealand. It is the sum of:

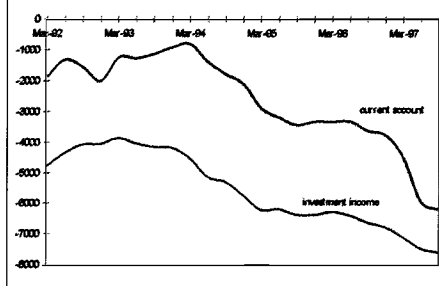
- payments to employees;
- + the value of capital usage (depreciation);
- + profits before interest and tax;
- + taxes;
- subsidies.

This equation also applies to value added at the industry level.

If FDI represents new investment, rather than the transfer of ownership of an existing enterprise then, by definition the total value added will be positive.

If we are interested in how much value added is **retained** in New Zealand then we

Fig. 6: Current account and investment income
Dollars million



need to subtract from the above identity the repatriation of profits and income overseas. At the aggregate level, the resultant figure is New Zealand's gross national expenditure (GNE). Even under circumstances of 100% repatriation New Zealand will still gain from new investment. That is, the foreign company will pay its New Zealand employees and pay New Zealand taxes. Only where subsidies are very large could a situation arise where FDI leads to a loss in value added. The potential for this in New Zealand, and, most particularly, in our forestry industry, is very small, given the progressive removal of government assistance since the mid-eighties.

If FDI does not represent new investment, then the repatriation of profits and interest *may* constitute of loss of value to New Zealand. Or it may not. If the transfer of ownership leads to a net gain in jobs or fatter pay packets to existing employees; if it consumes more domestic capital; if it becomes more profitable and, thereby, pays more taxes in New Zealand; or if it repatriates only a small proportion of its profits and interest overseas, then FDI *may not* constitute loss of value added.

Current account deficit

At 6.4% of GDP New Zealand has one of the largest current account deficits in the OECD. There is an ongoing debate in economic circles regarding whether or not this is a 'bad' thing, which I will allude to only briefly here. The current account measures the share of investments in New Zealand funded by foreign savings. If it reflects quality investments then it could very well be a 'good' thing. However, to the extent that important others, such as international credit agencies, perceive the deficit to indicate instability or risk, the deficit could very well be 'bad' if they downgrade our credit rating and, thereby, encourage both domestic and foreign investors to move their investments elsewhere.

FDI is copping a lot of the blame for our current account deficit relative to GDP. Is this fair? The current account balance is the payments New Zealand receives from overseas less the payments it makes to overseas entities. It is made up of four components: merchandise trade, services trade, interna-

tional investment income, and net transfers. The increasingly negative balance on the investment income account reflects the fact that foreign enterprises in New Zealand are earning more than New Zealand enterprises overseas. There is little doubt that this is contributing to the deficit.

However, it would be a leap in logic to conclude that net effect of FDI is negative. Three points are relevant:

- FDI encourages export growth (Bollard 1997). In the analysis of the benefits we saw how FDI has eased the access of New Zealand's forest products in export markets. Export growth improves the merchandise trade account which, in turn, improves the current account balance. Any improvement, however, will be modified by the extent to which FDI also encourages the import of inputs into the production processes of foreign enterprises.
- What matters to international credit agencies and the like is not the absolute dollar amount of our current account deficit, but what it is as a proportion of our GDP. As I have just demonstrated, new FDI adds value at the sectorial level and increases our GDP.
- The privatisation of our forests and other state assets enabled the foreign portion of our public debt to be paid off. Credit agencies generally view foreign owned equity more favourably than foreign debt.

Future Risks and Opportunities

Up until now the focus of this paper has been on the current state of FDI in New Zealand forestry and its claimed benefits and costs. In this final section we take a brief glimpse at what will be the major factors that shape the future of FDI in forestry.

The extent and quality of future investments in forestry, whether by foreign or domestic interests will depend on how well the risks and opportunities facing the industry are managed.

At NZIER we are soon to embark upon an economic analysis of the operating environment for forestry. Factors that impact on this environment include:

- **External influences**, such as world business cycles, commodity price fluctuations, growth in global wood supply, and changes in consumer demand.
- **Internal influences**, such as our regulatory environment, macro- and micro-economic reform, and business confidence.
- The **competitive structure** of the industry, which is determined by the extent of barriers to entry, rivalry, competition from substitute goods, buyer power, seller power, and vertical and horizontal integration.
- **Conduct and performance**, namely

the strategies of individual and collective enterprises and their effectiveness. Included under this heading are strategies to differentiate products, markets and processes, and investments in research and technology and intellectual capital.

FDI will be both an input into and outcome of the environment. As an input, by strengthening our linkages into the international environment the opportunity to turn external influences in our favour increases. Through the introduction of new players in the industry, FDI can help to enhance the competitive structure of the industry. The quality of FDI in New Zealand will reflect upon the conduct and performance of the industry.

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