THE NEW ZEALAND ECONOMY: SIX MONTHLY REVIEW

INTRODUCTION AND SUMMARY

The New Zealand economy has grown rapidly over the latter half of 1983 and early 1984, in what is probably the most substantial upturn since the mid-1970s. Reserve Bank estimates of real GDP indicate that the economy may have grown by around 4 per cent over the year to March 1984, in a marked turnaround to the 0.8 per cent contraction recorded the previous year. The expansion was dominated by a surge in domestic consumption expenditure, with two secondary, though still significant factors underpinning different stages of the recovery. The strong growth in Government (major energy project) investment, while the level of activity in other sectors was still depressed, helped underpin the early stages of the recovery. A subsequent slow rise in export receipts (linked to the US-led OECD upturn) also contributed to the expansion, and is now an important element in the current strength of the economy.

Although the recovery has been the strongest experienced since the mid 1970s, and is also distinctive for the first sustained reduction in unemployment numbers since then, in other features it is not basically different from recent cyclical expansions. The rise in domestic expenditure and output was underpinned by strongly expansionary demand management policies. The expansionary stance taken by fiscal policy was initiated in the 1982 Budget (the income tax reductions in particular) and the large fiscal deficit which developed was backed up by accommodative monetary policy over much of the upturn.

Domestic consumption expenditure, as measured by the level of (real) retail turnover, began rising in early 1983, after falling steadily for most of the previous year. By the December quarter 1983, real retail sales had reached a level significantly above the level a year earlier (9.6 per cent higher than sales in the December quarter 1982). This recovery in domestic consumption was initially met from existing stocks. Business opinion surveys revealed that there had been some degree of unintended stock accumulation in the wake of the 1981 cyclical expansion, and as a result the initial effect of the rise in demand was only to reduce stock-trade ratios in the retail and wholesale sectors. From the middle of 1983, however, the effects of the domestic expansion had begun to filter through to the production (manufacturing) sector, and to the trade balance. Private sector investment then also exhibited the first signs of a recovery, with investment in (new) dwellings picking up strongly, and some upturn in plant and machinery investment appearing later in 1983 and in 1984 as production expanded.

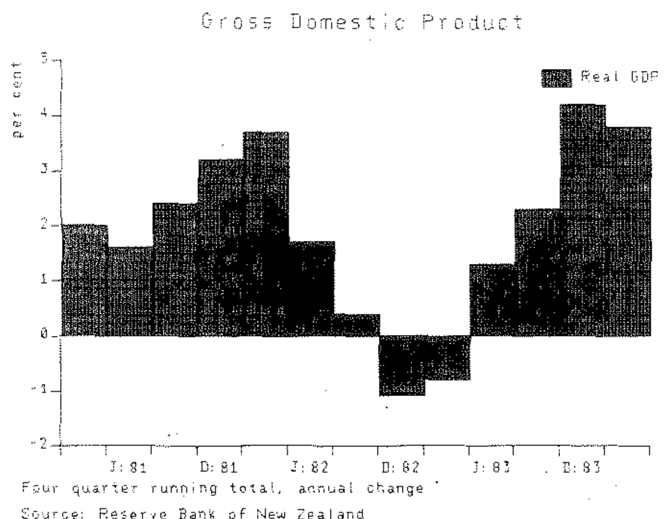
Over recent years domestically generated expansion in demand has had little medium-term effect on the rate of economic growth. The expansionary forces are dissipated relatively rapidly by rising inflation and through a higher current account outflow. These two 'stabilising mechanisms' act on the level of domestic demand and expenditure by reducing real disposable incomes and real money balances, and are usually supplemented towards the latter part of an upturn by an increased tax drain on incomes as a result of 'fiscal drag'. However, comprehensive price and interest rate controls resulted in a falling inflation rate and lower (nominal) interest rates, and hence had the opposite (i.e. pro-cyclical) income and wealth effects on consumption. The excess demand generated domestically was not neutralised by higher prices, and therefore was accommodated via the current account external balance.

The resurgence in the current account deficit reinforced public perception of a misaligned exchange rate, and the calling of an early general election for 14 July 1984 served to bring this sentiment into sharp focus. The policy responses embarked upon did not allay public concern, and were not effective in stemming a rapidly accelerating foreign exchange outflow. On 15 July, the foreign exchange markets were closed, and on 18 July, accompanied by a number of other policy measures, the New Zealand dollar was devalued by 20 per cent.

Although this represented the largest discrete depreciation against the currency basket since the 15 per cent devaluation in August 1975 (in response to the first oil shock) it has not been the only important policy development in recent months. In an eventful period following the devaluation package, agreement has been reached on long-term wage-fixing procedures, steps have been taken to phase out export incentives and reduce the overall level of import protection, and a number of barriers to competition and to the more efficient allocation of resources (particularly in the financial sector) have been dismantled. Important policy changes in other areas — in particular in the structure of the taxation system — have been foreshadowed.

Despite the strength and duration of the recovery, it represents only the latest in a series of cyclical upturns. By the June quarter 1984 a careful analysis of domestic consumption patterns and related statistics (such as business opinion surveys) indicated that the upturn was already on the point of peaking. Although some domestic retrenchment appears likely, the full extent may be less than recent experience would suggest. In general terms, the outlook for the next two years is for slower growth, a short-term surge in prices, small increases in the level of real disposable incomes and moderate increases in the level of employment — all contingent upon an appropriate mix of economic policy measures.

This policy environment, together with the current



Four quarter running total, annual change
Source: Reserve Bank of New Zealand

state of the economy (balanced between a potentially more stable medium-term growth path and a return to the inflation-recession cyclical pattern of the recent past) makes identifying even the short-term prospects for output, employment and prices a more uncertain exercise than usual. Recent Reserve Bank forecasts suggest that the economy should grow by 3 to 4 per cent over the year to March 1985, but that the expansion may fade the following year. This growth will be primarily underpinned by the export sector. The areas likely to show the strongest growth will be in non-traditional agricultural products (for instance horticulture) and manufactured goods. Although growth prospects have been enhanced by the devaluation, it will in the short-term also have some inflationary consequences. The rate of inflation is likely to rise, but may peak around the June quarter of 1985, at an annual rate around 12 — 13 per cent. Given complementary non-inflationary (monetary) policies, the rate of inflation should then quite rapidly decline to around single figures by March 1986. The current account deficit may initially continue to deteriorate from its present level as the effects of the devaluation on import volumes will not be immediately apparent, but some improvement is likely during 1985/86.

Continued strong growth in private consumption is unlikely, given that there is little prospect of significant growth in real disposable incomes or real money balances over the immediate future. This in turn means that the present strong growth in investment in new houses is also likely to level off, with an additional factor being a likely higher rate of increase in building costs.

The growth in employment is likely to be mainly supported by growth in export industries, although this effect may be undercut if labour costs begin to rise strongly. Other private investment will probably display a declining trend as the economic expansion slows, but here again the main supporting factor will be the exporting sector.

In summary then, although positive growth is likely to continue over the immediate future, an economic slowdown — with little or no growth — is likely for 1985/86. The devaluation and other recent policy measures can potentially provide the basis for more sustained non-inflationary growth. The full effects will only be apparent over the medium-term however. In the interim, these measures will need to be supported by firm monetary policies and a consistent fiscal policy stance.

CONSUMPTION

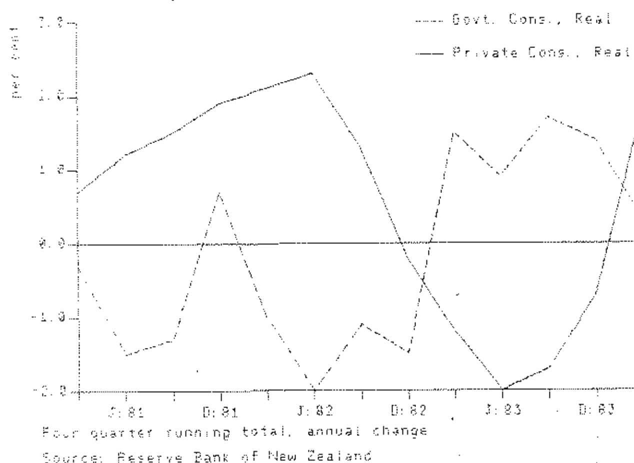
The first quarter 1984 marked a year of steadily rising domestic consumption expenditure. In real terms, retail turnover in the March quarter had reached a level 8.4 per cent above the level a year earlier, but, as was the case with turnover in the December quarter, the overall rise in sales was dominated by two areas of retail activity: household appliance stores and automotive stores. (This latter category covers both motor vehicle sales and services). Higher real money balances and lower interest rates allowed greater scope for discretionary household spending. However, a second and more important factor in this surge in turnover was the impact of expected price changes on purchase plans. The scheduled lifting of price controls in February 1984 generated a surge in the demand for consumer durables, in both the December 1983 and the March 1984 quarters. In real terms, and adjusted for seasonal factors, sales in these two categories rose 10.1 per cent and 7.6 per cent respectively over the December quarter, and then 16.8 per cent and 2.2 per cent over the three months to March.

By the June quarter these impulses had largely run their course. Real sales, seasonally adjusted, in the household appliance group fell 8.5 per cent and sales in automotive group stores fell 1.9 per cent over the period. The overall level of real retail turnover was unchanged over the quarter, with continued steady growth in sales in many other areas of retailing being offset by these fluctuations. The July devaluation then provided a second significant distortion to expenditure patterns. A substantial proportion of expenditure on consumer durables was rescheduled in anticipation of significant price rises.

As was the case following the 6 per cent devaluation in March 1983, new car registrations provided the first indications of the extent of this rescheduling. Despite relatively strong increases over previous months, registrations in July 1984 recorded an extremely sharp rise — 11,258 new cars were registered during the month, 117.5 per cent more than the number the previous July, and the surge in demand continued into the following month. Registrations in August (10,451) were 77.9 per cent above the level a year earlier. This volume of turnover reportedly accounted for a large proportion of (retail) stocks and (as was the case the following March 1983 devaluation) the subsequent readjustment in demand has seen turnover fall to much lower levels than it probably otherwise would have, as normal purchasing patterns were re-established.

Retail turnover levels in July and August provided a record of the change in purchasing patterns. Total retail turnover (in nominal terms) for July and August was 22.3 and 23.7 per cent above the levels a year earlier, and (after allowing for seasonal influences) grew 3.7 per cent in July and 2.3 per cent in August. Sales in the household appliance group rose 22.9 per cent in June and fell 7.3 per cent in July, while sales in the automotive group increased by 7.3 per cent and 3.6 per cent respectively. Changes in this (very large) latter group though tend to dominate and obscure changes in other areas of retail activity. When the automotive stores category was excluded, the increase in retail sales in July and August was only 1.4 and 1.3 per cent respectively, a relatively small increase by comparison with the rises experienced in May (2.1 per cent) and in June (1.9 per cent).

Consumption



PRODUCTION

Turnover in the manufacturing sector began to increase in mid-1983 but the initial impact of the change in demand was accommodated from stocks. Manufacturers' stocks of materials only began rising from the December quarter 1983, and it was not until the March quarter 1984 when production had caught up with the higher demand, that stocks of finished goods also increased. By this time, the volume of production had risen to a level 22.3 per cent above the level in the March quarter 1983, and sales on the same comparison had increased 23.1 per cent.

June quarter figures, though still significantly higher in an annual comparison, suggest that a sharp slowdown in the level of activity may have occurred. After adjustment for seasonal factors, real output rose 11 per cent over the three months to March 1984, but then fell 2.6 per cent over the following three months. Sales are estimated to have fallen 0.2 per cent over the June quarter, after an 8.3 per cent rise in the March quarter (on a seasonally adjusted basis). These two developments together with a small upward shift in salary and wage payments (probably reflecting the $8 per week wage-order) underpin less favourable developments over a wide range of manufacturing sector indicators. In particular, stocks of materials may already be growing faster than the value of output, and stocks of finished goods faster than sales. Unit labour costs (seasonally adjusted) appear to have risen after four successive quarterly declines, while labour productivity may have fallen on the same basis, also after increasing over the previous four quarters. But buying associated with the devaluation may distort the figures for the September and December quarters.

It is possible that the June quarter statistics represent a temporary interruption to the pattern of growth established over previous quarters in the manufacturing sector. Seasonal adjustment may also have introduced a downward bias for these latest results. However, when considered in conjunction with other economic indicators (such as retail turnover) and with recent business opinion surveys, these indicators reinforce the general impression of overall growth in economic activity peaking in the June quarter 1984.

EMPLOYMENT

The sustained rise in employment levels over the last few months of 1983 and the first half of 1984 was one of the more distinctive features of the recent upturn. Even the strongest of the recent cyclical expansions — the 1978 and the 1981 expansions — were not marked by comparable reductions in the rate of unemployment. The recent upturn was also marked by a significant and sustained decline in labour costs — largely associated with the wage controls introduced in June 1982. The reduction in costs probably made the critical difference in labour market trends during this economic expansion. The end result was to allow the expansion in domestic demand to be translated into an upturn in the demand for labour, not only in the manufacturing sector, but also across a range of service industries.

The quarterly survey of employment conducted in May confirmed earlier indications of this more favourable outlook for the labour market. Earlier surveys mapped a significant rise in total hours worked and more modest increases in employment. Over the three months to May 1984 though, total employment (comprising full-time and part-time workers and working proprietors) rose 26,500 to reach 1,144,000. Although a large proportion of this increase (50 per cent or 13,260 jobs) occurred in part-time employment, a positive feature was that most of the overall expansion was accounted for by the private sector. Total private sector employment rose from 774,700 in February 1984 to 794,700 in May 1984. In the services sector, employment growth was largely confined to the retail and wholesale trade categories. In the manufacturing sector, most industry groups expanded their workforce — but this expansion was particularly marked in the mineral and metal products processing and fabricating industries.

These developments are reflected in unemployment numbers — which (after adjustment for seasonal factors) have been falling at around 1 to 2 per cent per month since December 1983, with large reductions being recorded in February and March. By August 1984 total unemployment (excluding vacation workers and seasonally adjusted) was 63,300, 20.4 per cent lower than at the peak in November 1983. The total number of unemployed, as a proportion of the estimated labour force has fallen from a peak of 5.8 per cent in August 1983 to 4.7 per cent in May 1984, and as an overall measure of trends in labour demand, the number of unemployed workers plus those on assisted employment schemes has declined from 8.5 per cent to 7.7 per cent on the same basis.

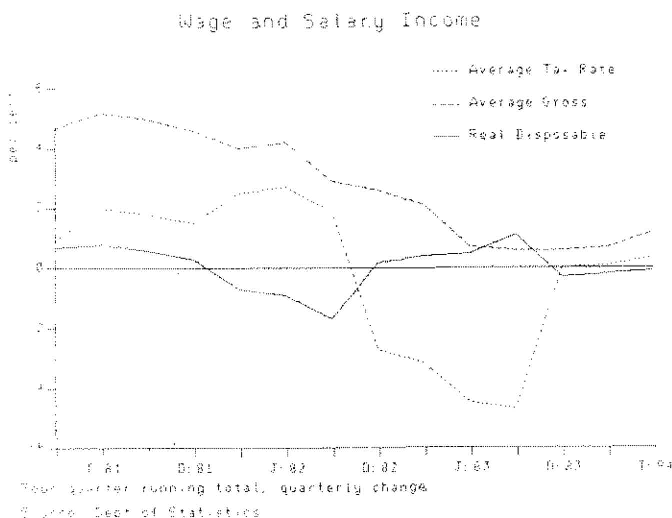
One further positive feature of recent developments has been the more than proportional decline in the number of long-term unemployed (those registered for 13 weeks or more). As a proportion of total registered unemployed, the number of long-term unemployed workers has declined from a peak of 45 per cent in October 1983 to 36.5 per cent on most recent figures (for August 1984).

Reserve Bank forecasts point to the possibility of full-time employment growth of around 15,000 in both 1984/85 and 1985/86, but this depends crucially on the assumptions that Government policy measures will be essentially unchanged and that there will be only limited movement in wage rates over the period. This suggests that there is the potential for further growth in employment, though this may not be sufficient for a continued downward trend in unemployment numbers.

INCOMES

Household incomes have changed very little over the term of the wage/price freeze. The only significant change in gross wages and salaries since the imposition of the freeze has been the $8 per week general wage order, which applied from 1 April 1984. 'Wage drift' — the autonomous upward trend in the average wage rate as a result of technological and structural changes in the economy — has been minimal. Recent changes in real disposable incomes have therefore largely been the product of only two factors — the 1982 Budget tax cuts, and more recently, this $8 per week wage order. The Department of Statistics' real disposable incomes index (which measures full time salary and wage incomes after allowing for the effects of income taxes and the rate of inflation) fell 0.7 per cent over the year to March 1984 and 0.5 per cent over the year to June 1984. The quarterly changes were 1.3 per cent and −0.6 per cent respectively, with the March quarter 1984 reflecting the last effects of the 1982 tax cuts on real disposable incomes. These tax adjustments were primarily aimed at reducing the high marginal tax rates faced by middle

income earners, and consequently the lower-paid wage and salary earners did not benefit to a similar extent from these measures. This pattern was reversed with the April 1984 wage order — with the effect that lower income earners' real disposable incomes rose during the June quarter while middle and upper income earners experienced a decline.



Wage rates were also largely static over the term of the freeze. The index of prevailing weekly wages rose only 0.1 per cent over the March quarter 1984, with this minimal amount of 'wage drift' taking the index back to its March 1983 level. The effects of the April wage order were then seen in a strong 2.9 per cent rise over the three months to June 1984, and since there had been on average no movement in the index over the previous three quarters, this also represented the annual increase. When the effects of inflation are taken into account though, the index recorded a fall of 0.7 per cent over the March quarter, and a decline over the year to March 1984 of 3.4 per cent. The index adjusted for inflation rose 0.7 per cent over the following quarter, but there was still a net decline of 1.8 per cent between June 1983 and June 1984.

Even with the impending end of existing controls on wages and salaries, real disposable incomes will probably not grow significantly over the coming year. The long-term wage fixing process recently negotiated allows for a resumption of (tripartite) wage negotiations. However, a taxation/transfer payments package, with the primary aim of alleviating the declines in low-income households' real disposable incomes, has been foreshadowed for the Budget in November. Participants in the wage negotiations are expected to assess this package before committing themselves to a particular bargaining stance in these talks and in subsequent direct employer-union negotiations.

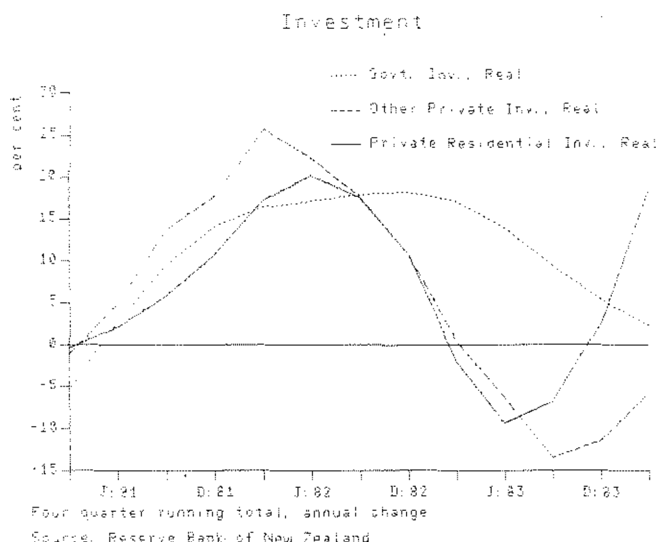
The outlook for other categories of household income is more favourable. Farm incomes will be assisted by the devaluation, particularly in those sectors which have not been heavily dependent on price support schemes. The fact that export incentives are to be phased out gradually rather than immediately removed, means that exporters in general will receive a further boost to their incomes. This improvement in export incomes will have flow on effects to the domestic business sector, which should also benefit since gains in productivity and production costs are unlikely to be significantly eroded over the short-term.

INVESTMENT

The recovery in investment was initially confined to the building sector — with investment in (new) dwellings responding strongly to the economic upturn and the rising level of domestic liquidity. Stockbuilding and other private investment have taken longer to reflect the general expansion, but from the March quarter 1984 a more positive trend appeared in the level of wholesale and retail stocks, and business fixed investment appears to have picked up from around the December quarter 1983.

Businesses have not built up the relative level of stocks over this upturn to the same extent that they did in previous upturns. Retail stocks have remained at what are comparatively low levels in relation to turnover, with the increases in stocks over the path of the upturn keeping on average only marginally ahead of sales. The retail stock/trade ratio between 1979 and 1981 for example averaged around 49 per cent — well above the approximately 42 per cent level at which it is now. The wholesale stockbuilding rate presents a similar picture. Wholesale turnover rose relatively strongly over the December and March quarters, but stock levels have yet to respond significantly. The wholesale stock/trade ratio fell every quarter from March 1983 to March 1984 and steadied in June, and the ratio as it stands at present (around 55 per cent) is not markedly different from the average over 1959–79 of 54.6 per cent. Reserve Bank estimates and forecasts suggest that changes in stocks exerted a net contractionary influence on the rate of economic growth over 1983/84, but suggest a more positive influence from stock building on the overall level of demand for the 1984/85 year. The magnitude of this effect may be constrained by the expected fall off in demand and by interest rates over the short to medium term. Equilibrium stock levels in any event are likely to be lower now than they were in earlier years — with new technologies and a more efficient transportation system complementing improved stock management techniques developed over the period of the wage/price freeze.

Private sector fixed investment appears to have picked up from late 1983, but interpretation is hampered by the lack of a comprehensive aggregate investment series. Wholesale trade in machinery has been rising since the December quarter 1983, and by the June quarter 1984, the four quarter running total of wholesale trade was 12.1 per cent above the level a year earlier. Machinery, electrical and transport equipment imports have provided further general confirmation of a more positive outlook for fixed productive investment. The quarterly survey of business opinion conducted by the New Zealand Institute of Economic Research in March 1984 found that business confidence in short-term prospects was high, after six months of buoyant domestic demand, an upturn in exports and a marked improvement in profitability. The capacity utilisation index derived from survey data had reached its highest level for a decade (89.7 per cent) and investment intentions were therefore strong. Although the next survey coincided with the announcement of the early general election, and the survey results were clouded by uncertainty as to the business climate and the stance of economic policy following the election, business investment intentions were still relatively strong. Manufacturers and exporters indicated further investment in plant and machinery was planned, but the outlook for investment in buildings was less strong. Building industry statistics indicate that an upturn in non-residential building (which includes both private sector and public sector construction activity) began



Four quarter running total, annual change

Source: Reserve Bank of New Zealand

around the start of 1984. Construction activity in this area is traditionally quite volatile, with large variations reflecting the smaller number of projects involved and the greater potential difference in their size and cost relative to dwellings construction. The level of activity in this area has however been more stable recently, with steady but only very moderate growth over the first half of 1984.

The main expansion in private sector investment has been in (new) houses. Dwelling permit numbers and other building industry statistics indicate that the upturn in expenditure in this area began from around August 1983, a period from which the broadly based monetary aggregate M3 began growing strongly. Higher levels of liquidity, the constraining of building costs as a result of the price freeze and (later) a reduction in interest rates combined to spark a strong recovery in house construction and alteration work to existing houses. The number of dwellings started each month over the latter half of 1983 and the first half of 1984 has been between 15 and 60 per cent higher than the level over the same months a year earlier. The value of building work put in place over the March quarter 1984 was 51.5 per cent above the same quarter a year earlier, and the value of work over the June quarter correspondingly 52.3 per cent higher.

Although a strong upturn in housing construction has occurred the pattern of events over previous cyclical upturns suggests that the rise could have been even more pronounced, given the rate of increase in money and credit aggregates over most of the recovery. Interest rate controls over the latter part of the upturn had the effect of diverting funds away from the mortgage markets to other potentially higher yielding (and less regulated) areas of investment. Restrictions imposed on financial institutions and aimed at constraining the rate of growth of their lending probably also exerted a disproportionate effect on the supply of housing mortgage finance. Personal loans granted by trading banks for housing construction or house improvement for example show a clear pattern of slower growth over the second quarter 1984, while other areas of lending were still expanding very strongly.

Building permit numbers granted in recent months indicate that the upturn in this sector will continue over the short-term, but at a reduced level. More effective control over the rate of growth in monetary aggregates and market determined interest rates may have a contractionary effect on the building industry (and on expenditure on existing houses as well) but these factors should be counter-balanced by the improved availability of housing finance following the removal of most interest rate and lending restrictions. Further increases in building costs may result in a lower level of activity in the building industry, and the limited scope for further improvements in real disposable incomes over 1984/85 and 1985/86 will be another constraint.

The outlook for other forms of investment is difficult to gauge beyond the short-term. Given the generally favourable public reception to most recent economic policy measures, it is likely that a high level of business fixed investment will continue over 1984/85, though this is likely to be concentrated in the manufacturing sector and in other areas of exporting. This more favourable outlook for private sector investment should counter-balance the smaller increase in government investment expenditure likely over 1984/85, as the major energy based projects near completion.

THE GOVERNMENT SECTOR

Although the fiscal deficit for the 1983/84 year was a record $2,984 million, this was still lower than had been allowed for in the 1983 Budget. The upturn in the level of economic activity produced a corresponding rise in taxation revenue (from indirect taxes and tariffs rather than income taxes) and this partially offset the concessions on income tax granted in the 1982 Budget. The deficit for 1984/85 may be of approximately the same order as that reached over 1983/84, but the relatively late presentation of the Budget (planned for 8 November 1984) prevents any firm conclusions being drawn as to the eventual magnitude of the deficit. Although the fiscal deficit for the five months to August 1984, at $1,633.2 million was substantially lower (18.9 per cent) than the deficit for the same months of the previous year, the figures do not yet reflect the effects of recent exchange rate and monetary policy measures.

The Government has, however, stated its intention to reduce the relative size of the fiscal deficit, in order to allow interest rates over the medium term to fall, and to reduce the potential for further inflationary surges. A reduction in the structural component of the deficit requires corresponding structural changes — with reforms to the way government revenue is obtained (changes to the tax system) and changes in the responsibilities and operations of the Government and quasi-government organisations. The phasing out of export incentives (supplementary minimum prices and export tax incentives) is the most important recent example in this respect.

MONETARY DEVELOPMENTS

By mid-1983, the wage/price freeze had begun to exert an appreciable influence on the rate of inflation, and increasing emphasis was then given to reducing interest rates as well. Although the Government had not abandoned its intention of retaining control of the rate of growth in the money supply, its interest rate goal gradually came to assume precedence over the monetary control objective. Despite the commencement of a programme of government stock tenders in mid-1983, public debt policy took a generally less active stance. Bank reserves, deposits and lending expanded strongly, and the growth in money and credit aggregates reflected these trends. By the December quarter 1983, private sector credit (PSC) for example had risen 14 per cent above the same period in 1982, while the broad monetary aggregate M3 had expanded 12.4 per cent.

Given the approaching end of the wage/price freeze, there was a clear need to achieve more moderate

increases in the growth of money and credit in order to prevent a significant post-freeze surge in prices. The Government's approach, in attempting to attain both interest rate and monetary control objectives, was to frame monetary policy primarily in terms of direct controls and regulations. With regard to interest rates, the framework of regulatory controls which had been in force since November 1981 was progressively widened in a bid to reduce rates. Comprehensive coverage of financial transactions was gradually established — mortgage and hire purchase finance, the discounting of bills of exchange, buy-back agreements, overdrafts and personal loans, and revolving credit facilities for example were all subject to interest rate controls.

In order to simultaneously constrain the rate of monetary growth, financial institutions were subject to lending growth guidelines (a ceiling of 1 per cent per month) backed up by measures intended to penalise those institutions which breached the specified limit. Overall credit growth was generally outside the guidelines however, and these restrictive measures were progressively tightened over the first half of 1984. The Government's response to the rate of growth in trading bank lending was to tighten reserve ratio requirements (which specify the proportion of government stock to be held relative to deposits) and to raise the cost of penal borrowing. Government securities ratios for finance companies and building societies (the other institutions targeted for excessive lending growth) were also raised, and finance companies were later also required to hold additional government stock, in proportion to their individual lending in excess of the credit guidelines.

The degree of control exercised over the growth in money and credit within this framework was neither precise nor effective, and the underlying cause of this growth — the large fiscal deficit — was never adequately addressed. The effectiveness of the stock tender scheme in soaking up excess liquidity was severely constrained by the requirement that upward pressure not be exerted on interest rates. This contradicted the primary rationale for the tenders — to neutralise the fiscal injection through higher voluntary holdings of government stock. A large number of bids in some tenders were rejected because they implied 'excessively' high yields. Several tenders closed heavily undersubscribed, and of the $2,100 million in stock offered in tenders during the 1983/84 fiscal year, bids accepted comprised only 64.5 per cent. Without an effective counter to the substantial fiscal injection, the rapid expansion in money and credit continued, increasingly counterbalanced however by a rising current account outflow.

News of an early general election in July sparked a sharp acceleration in the net flow of funds out through the external current account, as importers brought forward their scheduled payments and exporters delayed repatriating receipts. These moves were in turn associated with a fall in bank deposits and a rise in lending, and with generally tightening liquidity conditions. Apart from Reserve Bank intervention in the forward foreign exchange market, the primary Government policy response to the outflow was to refrain from alleviating the tightening liquidity conditions. However, the equilibrating mechanism which should have reconciled the demand for domestic funds with the demand for foreign exchange — interest rates — could not operate. 'Retail' interest rates (i.e. those rates paid to depositors and charged to borrowers) were prevented by regulations from adjusting. There was therefore no incentive for exporters and importers to refrain from rescheduling foreign exchange receipts and payments flows. Furthermore, a large volume of unexercised credit limits (overdrafts) existed, and financial institutions had limited ability to exert immediate control over the surge in credit. The effects of the outflow were therefore transmitted to the 'wholesale' market (the market for inter-institutional loans) as institutions competed for liquid funds. Wholesale interest rates were also subject to regulatory control and quickly reached the 17 per cent maximum limit. By early July the scale of the foreign exchange outflow had tightened liquidity to a degree which posed potential problems for the continued normal operation of some financial institutions. The broad monetary aggregate M3 fell marginally (seasonally adjusted) in June, following successive monthly rises of 2 per cent and 1.1 per cent.

The devaluation on 18 July resulted in a virtually immediate reversal of domestic liquidity conditions. Trading bank reserve assets, reflecting the large post-devaluation inflow of funds, rose by more than $1,000 million over July and had reached an 'all time high' of just under $3,000 million by early August. Retail rates moved up following the lifting of interest rate controls, to reflect more closely the real cost of finance, and as institutions competed for business. The framework built up over previous months to regulate interest rates was dismantled, and an active public debt sales programme installed.

An important shift has taken place with regard to the priorities and method of implementation of monetary policy. Of the $1,550 million in stock offered in tenders between mid-July and mid-October 1984, 92.2 per cent was allocated. Higher interest rates have been accepted in order to finance the fiscal deficit in a non-inflationary manner. One positive outcome is that the lending growth guidelines have been able to be removed. In addition to being an ineffectual constraint on the overall rate of credit growth, the guidelines had distorted the competitive position of institutions, and had put at a disadvantage certain categories of borrowers (for instance low income earners without well-established credit records) and certain areas of financing (most notably, housing finance). Two other long-standing restrictions, the 30 day rule and the 3 per cent ordinary deposit rate, have also been revoked recently. The '30 day rule' prevented interest rates being paid on trading bank deposits of less than 30 days. It was introduced in 1964, and was designed to protect a sector of the money market which had been given official recognition. The need for this protection had long since disappeared (as had the rationale for this official recognition — itself withdrawn on 28 September 1984). The '3 per cent rule' (a measure dating back to the 1930s) limited interest payments on ordinary call savings bank accounts to 3 per cent. This measure had also long since ceased to be justified, and had imposed a substantial penalty on those with relatively small savings. Such changes are essential if monetary policy is to be conducted in a way which is 'institutionally neutral'; in other words, in a way which does not penalise some institutions to the advantage of others by imposing selective or unequal constraints upon particular operations or services. This should encourage the development of a more competitive and efficient financial system.

PRICES

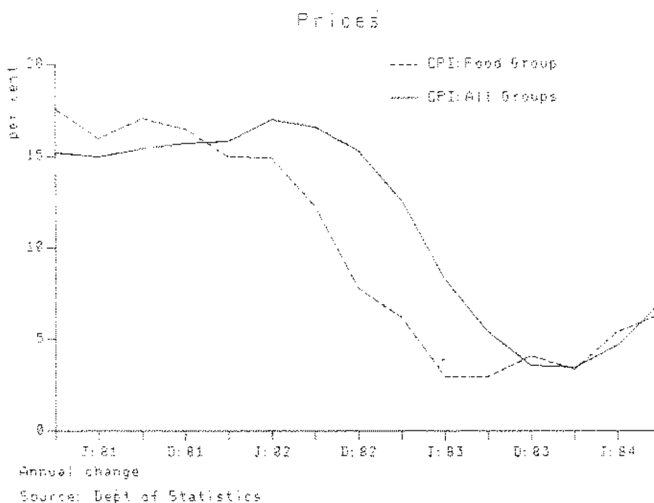
Some cost increases could be passed on over the period of the 1982–84 wage/price freeze, and certain

categories of goods and services were exempted from the regulations. Nevertheless, the rate of inflation was steadily reduced while the controls were in place. Towards the end of the freeze the recorded rate of inflation had fallen to levels comparable to the lowest increases experienced over the past two decades. The quarterly increases in September and December 1983 and March 1984 were only 0.8, 0.9 and 0.7 per cent respectively, and the increase over the year to March 1984 was held to 3.5 per cent. A similarly small increase (3.4 per cent) was last recorded in the year to June 1968.

The pace of the domestic expansion together with the rate of increase in money and credit over the 12 months to March 1984 though were clearly at odds with measured price increases in this range. Some degree of repressed inflation was likely to be revealed when the freeze ended. The first full quarter following the freeze and under the price surveillance regime saw a sharp increase (2.2 per cent) in the Consumers' Price Index (CPI), bringing the four quarter rise to 4.7 per cent.

In the September quarter prices rose a further 3 per cent bringing the annual increase to 7 per cent. Within the CPI, the all foods, housing and miscellaneous groups, with weightings of about one-fifth in the overall CPI, each rose by around 5 percentage points in the six months to September. Household operations and apparel rose 2.6 per cent and 1.9 per cent respectively, while the transportation groups with an 18 per cent weight, rose 9.3 percentage points during the six month period reflecting in part the petrol price rise announced a few weeks after the devaluation.

The rate of inflation for the year to March 1985 had, prior to the devaluation, already been expected in the range of 7 per cent. This is now likely to be exceeded, but the inflationary surge is still expected to be temporary, given the appropriate stance for economic policy. Reserve Bank estimates compiled in August suggest the inflation rate will be about 12.5 per cent for the year to March 1985 and 8.5 per cent over the following year.



THE EXTERNAL SECTOR

When the first signs of an economic upturn appeared in early 1983, the current account was still recovering from the substantial deficits built up following the 1981 expansion. The improvement in the current account balance largely reflected developments in the trade balance, and in fact the overall trend in the balance of payments over the past year has been dominated by fluctuations in the trade balance and the level of imports. Imports began rising from mid-1983, but were partly countered by a simultaneous rise in export receipts. A comparison between the year to June 1984 and the year to June 1983 shows imports to be 23.7 per cent higher, but the rise in exports was not far behind — at 20.3 per cent. This was nevertheless sufficient to bring about a large deterioration in the trade balance, and coupled with a continued steady rise in the invisibles deficit meant that the current account deficit for the year to June 1984 rose to $1,967 million, 26.7 per cent above the deficit for the year to June 1983.

The widening current account deficit was one of the primary elements in the foreign exchange crisis in July. Overseas exchange transactions (OET) data, which measure balance of payments receipt and payment cash flows as they actually enter and leave the country, indicate a sudden change in the pattern of remittances in the two months prior to the election. OET import payments in May 1984 were 32.4 per cent higher than payments in May 1983, while export receipts had risen only 4.5 per cent during the same period. Comparable figures for June 1984 show payments (at $727 million) 48.9 per cent higher but receipts (at $261 million) up only 3.2 per cent. The invisibles balance (receipts and payments for services) showed a similar pattern — invisibles payments in June were 12.1 per cent higher than payments in June 1983, while receipts actually fell, on an annual comparative basis, by 17.4 per cent.

The OET current account deficit in the June 1984 month rose to $406 million (equivalent to the combined deficit over the previous five months) and the deficit over the June quarter rose to $670 million, from $152 million for the previous three months. These sharp switches in OET flows resulted in a surge in demand for foreign exchange, and placed existing reserves (and supplementary lines of credit) under pressure. There was the need for prompt action to avert difficulties. In addition, two important adjustment mechanisms — flexible management of the exchange rate, and flexible interest rates — could not operate in the prevailing policy environment. This proved to be a significant constraint on the authorities' ability to respond effectively to the developing problem. In order to take some of the pressure off the spot exchange markets, the Reserve Bank was instructed to enter the forward exchange market on 18 June. Forward exchange contracts totalling NZ$1,222 million were written. Despite this, over the few weeks prior to the election NZ$1,391 million in spot foreign exchange was sold. The foreign exchange markets were closed on 15 July. Three days later, the New Zealand dollar was devalued by 20 per cent.

It is not yet possible to clearly identify the path the current account will take over the next few years. Import volumes are likely to fall relative to domestic economic activity, and this will reinforce a movement which would have appeared with the slowing pace of the domestic economic expansion.

An overall improvement in the current account is likely to be delayed until this occurs. The upturn in export volumes over the short-term is likely to be most pronounced in manufactured goods, although capacity constraints in manufacturing and production lags in pastoral products will set an initial limit on the responsiveness of total export volumes. For the farming industry, the devaluation and the reductions in export incentives signal a move to prices more in line with market conditions. Sheepmeats for example accounted for a large proportion of supplementary minimum price (SMP) payouts over the 1983/84 year, and the devaluation will have little immediate net effect on receipts to farmers here. Other areas such as beef farming and horticulture are likely to benefit more significantly. The outlook for dairy products however remains cloudy — large international stockpiles have kept, and may continue to keep, prices low.

It should perhaps be noted that the devaluation will have a 'scaling' effect on the current account deficit (when expressed in terms of New Zealand dollars), but the deficit for the year to March 1986 is still likely to be reduced, potentially to a much lower level in proportion to GDP. If this progress is made, there would be a moderation in the rate of increase in official overseas debt and the cost of debt servicing, and there should not be the need to make frequent compensatory adjustments in the exchange rate itself.

CONCLUSION

The past year and a half has seen a rapid expansion in domestic output and employment, fuelled largely by expansionary Government demand management policies, and accompanied by a rapid increase in the balance of payments deficit. This upturn has probably peaked, the exchange rate has been devalued, some pent-up inflationary pressure is being felt, and significant changes in some areas of economic policy have occurred.

The events over the past year and a half illustrate once more the limits to the effectiveness of expansionary demand management policies. The experiences of OECD countries over the past decade do not support the notion that in the current international economic environment, expansionary fiscal and monetary policies are alone sufficient to enable full employment to be achieved and maintained. New Zealand faces a number of structural economic problems. These problems arise from a lack of flexibility and competitiveness in the tradeable goods sector, i.e. import substituting and exporting industries. They are reflected in recurring difficulties with the balance of payments and with inflation, which in turn prevent any domestically-generated expansion from being transmitted into a sustained real economic upturn.

Demand management policies alone will therefore not allow a more than transient improvement in economic conditions even if output were at a relatively low level and unemployment high by historical standards. Alternative policies to resolve these economic difficulties (over the medium term) have been formulated, with the general approach being to enhance the flexibility and competitiveness of the exporting and import competing industries, and to remove as many of the present structural barriers to economic change as possible. These policies in turn are being taken up. They are not likely to bring results immediately. It is therefore important that public expectations as to the rate of economic progress which can reasonably be achieved in the short-term remain realistic.