AN OVERVIEW OF 1988/89 – THE EMERGING RECOVERY

In this article Bernard Hodgetts reviews economic developments in New Zealand over the past year.

Executive Summary

The New Zealand economy entered a recession in late 1987 which extended through until the first half of the 1988/89 year. Throughout the recession, export activity nevertheless remained firm and was the major factor responsible for a recovery in domestic demand which became evident after the September 1988 quarter. The upturn in domestic demand was seen primarily in consumption and residential building intentions. There were few signs of an imminent increase in business investment by the end of the 1988/89 year.

Economic developments have been shaped significantly by the impact of restructuring in recent years. Over the past year restructuring has been responsible for a large proportion of the employment losses seen both in the public and private sectors, quite apart from the impact of weak domestic activity. Recent labour productivity gains, which are most unusual during a recession, provide evidence of the impact of extensive restructuring on employment throughout the economy. Since 1984, restructuring has also impacted unevenly among the regions, initially falling heavily on the provinces. However, over the past year, the impact of restructuring on employment, combined with the reduction in domestic demand, has been felt primarily in the metropolitan areas. Moreover, the recent growth in export activity has also contributed to a change in fortunes between the provinces and the cities with the incidence of recent activity growth falling mainly on provincial areas.

Aggregate activity is expected to continue to recover gradually over 1989/90. The recovery is expected to be substantially export led. Reductions in unemployment can be expected to lag behind the upturn in activity as businesses meet the initial increase in demand by the use of excess capacity and greater use of overtime.

The New Zealand economy entered a recession in mid-1987/88 and domestic activity declined through until the September quarter of 1988. In contrast to the weakening of domestic demand, overall growth in export activity continued throughout the 1988/89 year. This growth acted partially to offset the effect on aggregate economic activity of the relatively weak domestic sector. Reflecting in part the flow-on effect to consumption expenditure from the buoyant export sector, a nascent recovery in aggregate economic activity became evident over the second half of 1988/89. Real gross domestic product measured on an expenditure basis is estimated to have expanded by around 1 per cent in the March 1988/89 year.

In many respects, the recession over the past two years is unparalleled with recessionary experiences of recent decades. In particular, restructuring has led to the loss of many more jobs – in both the public and private sectors – than could be attributed to the weak state of domestic activity alone (see the article on pages 124-126 of this Bulletin). Moreover, this particular impact of restructuring has, in turn, created the widely held perception of a much more depressed domestic economy than is borne out by the official measures of economic activity.

The past two years have also seen changes in the incidence of economic activity between the major North Island cities (Auckland and Wellington) and the regions. The cities, which prior to mid-1987 had experienced the benefits of a boom in commercial property development and the post deregulation expansion of the financial sector, currently face relatively depressed economic conditions. On the other hand, the provincial areas, whose activity and employment levels appeared to have borne much of the initial costs of restructuring and the Government's disinflation policy, now enjoy more favourable prospects. Those regions relying heavily on dairy farming and fine wool farming, in particular, have experienced growth in activity over the past year due to buoyant export demand for these commodity groups. Moreover, the gradual recovery in economic activity now underway is expected to be substantially led by further growth in exports. Reflecting this outlook, a gradual but sustained pick-up in activity – centered initially on the provinces – is anticipated over the year ahead.

This article reviews developments in the real economy over the past year. After discussing the trends in activity levels which have been experienced, the factors which have influenced a change in fortunes among the regions are then considered. The article then reviews the reasons for the rapid growth in unemployment. Finally, the outlook for the economic recovery and for employment is discussed.

Activity Trends in the Real Economy

The sharemarket crash of October 1987 marked an abrupt end to a buoyant phase in economic activity. A strong post-crash destocking phase in the December 1987 and March 1988 quarters and falling levels of construction and business investment resulted in a very sharp decline in economic activity. Expenditures on real Gross Domestic

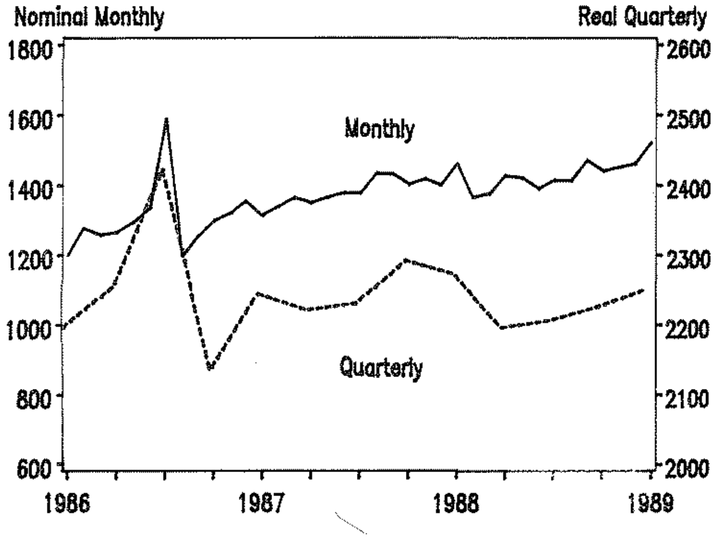
Product (GDP) fell by around 2.4 per cent in the year to March 1988. Economic activity then entered a trough period which extended through the June and September quarters of 1988.

The trough period was marked by a decline in consumption expenditures, most evident in the June 1988 quarter. The sharp decline in retail trade over the three months to June 1988 (see figure 1) reflected a lagged response to earlier declines in real disposable incomes and an ongoing adjustment by households to the reversal of stock market wealth effects over the past year; these wealth effects had previously sustained high levels of consumption in relation to disposable income. The perception of reduced wealth, in conjunction with persistent high real interest rates and deteriorating consumer sentiment (partly explained by job security concerns) encouraged households to increase savings and reduce consumption over the period.

A significant slowdown was also seen in real investment expenditures. Despite small declines in nominal mortgage servicing costs and lower growth in dwelling construction costs, residential investment fell significantly over the first half of 1988/89. Commercial building construction, which even prior to the sharemarket crash had been trending downwards from boom levels, also fell markedly; for the six months to September 1988, commercial building construction was 15 per cent lower than for the same period in 1987. Investment in transport equipment also declined significantly over the first half of the 1988/89 year. In contrast was plant and machinery investment, which continued to expand moderately over this period as firms sought new technology and productivity enhancing alternatives.

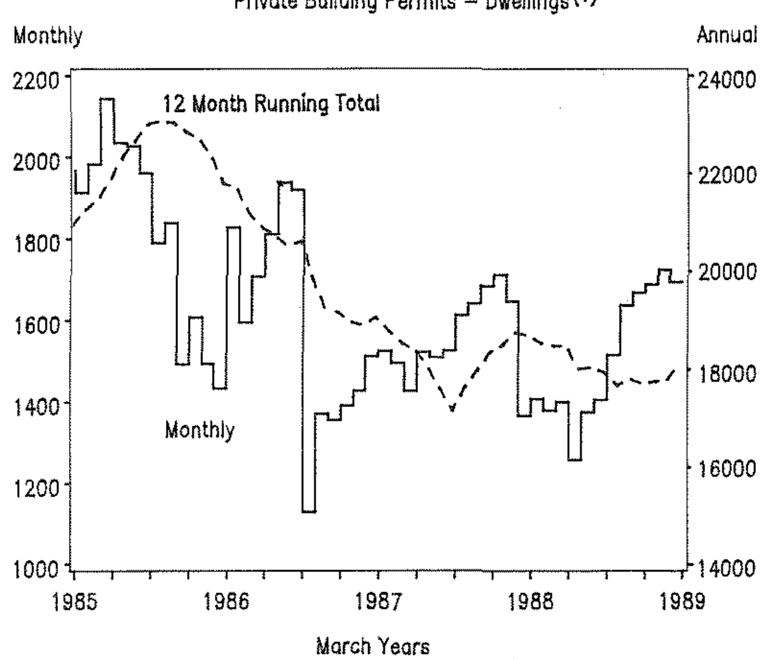
Over the second half of 1988/89, a nascent recovery in aggregate domestic demand became evident. Real retail sales bottomed out in the September quarter 1988 and rose by around 1 per cent in both the

Figure 1
Retail Trade (1)
Seasonally adjusted ($M)



(1): Retail Sales excluding the automotive sector

Figure 2
Private Building Permits – Dwellings (1)



(1): Seasonally adjusted and excluding additions and alterations

December 1988 and March 1989 quarters. Residential investment intentions (as represented by the number of new building permits issued) also increased from August 1988 (see figure 2) and over the December 1988 quarter there was an increase in the value of building work put into place. This recovery in consumption and residential investment activity is likely to be attributable to increases in personal disposable incomes (due to rises in export incomes and a small decline in mortgage servicing costs) and a reduction in the rate at which households are rebuilding savings.

Despite improving consumption demand and rising export demand, there were still few signs of an imminent recovery in business investment by the end of the review period. It was clear that several factors were acting to constrain new investment. First, although a significant improvement in business confidence was recorded in the NZIER's September 1988 Quarterly Survey of Business Opinion, business sentiment has since deteriorated and by March 1989 was once again (slightly) pessimistic (see figure 3). Secondly, according to recent NZIER surveys capacity utilisation by businesses remained low. Thirdly, high real interest rates and inadequate levels of capital were likely to be constraining the ability of some firms to invest.

For the 1988/89 year as a whole, real domestic demand (GDE) is estimated to have fallen by 1.4 per cent; estimates for growth in real consumption expenditure and real investment expenditure are respectively -0.8 per cent and -2.3 per cent. Weak domestic demand conditions have, in turn, depressed import demand, resulting in a 2.6 per cent decline in real imports of goods and services in 1988/89.

Export demand conditions have, however, been much more buoyant. Both export volumes and export prices increased in 1988/89, particularly for dairy, forestry and wool products. These increases reflected continued growth in the major world

Figure 3
Business Confidence
Quarterly Survey of Business Opinion

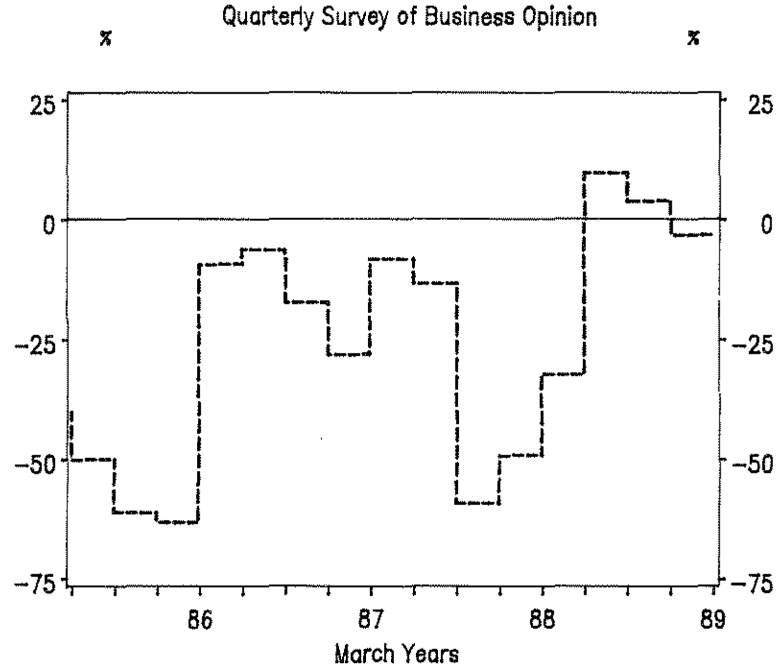
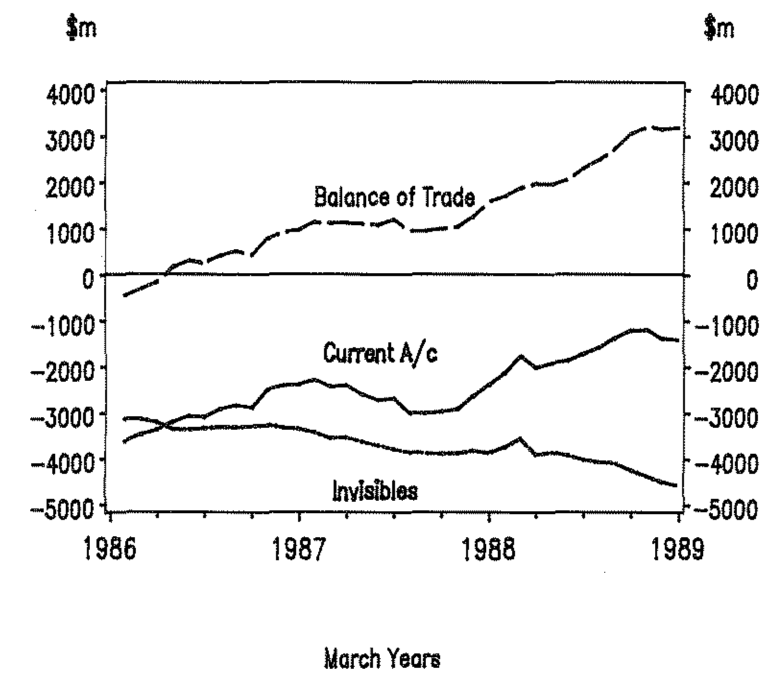
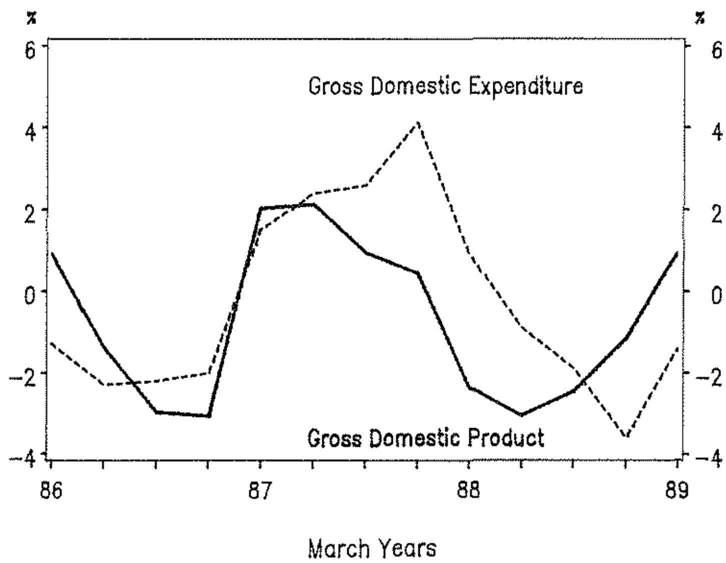


Figure 4
Balance of Payments



economies and, in respect of dairy products the reduction in EEC stock piles. The combination of rising exports and falling imports yielded a substantial improvement in New Zealand's current account balance from a deficit of $2,340 million (4 per cent of GDP) in the year to March 1988 to an estimated deficit of $1,369 million (2.2 per cent of GDP) in the year to March 1989 (see figure 4). This improvement in the balance of payments accounts for the estimated 0.9 per cent growth in expenditure on real GDP that occurred over 1988/89, even though domestic demand is estimated to have fallen over the same period (see figure 5).

Figure 5
Expenditures on Real Gross Domestic Product (1)
Annual Percent Changes



(1): Reserve Bank Estimates

Sectoral Activity Trends

During the past eighteen months the major North Island cities (Auckland and Wellington) and the provinces have experienced a reversal of fortunes. Prior to the October 1987 sharemarket crash, the major North Island cities were buoyant and the regions depressed. Since then, however, the cities have become more depressed and the regions more buoyant. Up until the sharemarket crash, the cities had benefited from a boom in commercial property development and the post-deregulation expansion of the financial sector. Moreover, the wealth effects of the buoyant sharemarket on consumer demand had been felt primarily within the metropolitan areas. For these reasons, economic activity remained firm within the cities – in the face of the Government's disinflation policy and restructuring – right up until the sharemarket crash.

However, the sharemarket crash, the sharp fall-off in commercial construction and the reduced demand for financial services all depressed activity levels in the major urban centres. In addition, the progressive reductions in import protection resulted in the loss of many manufacturing jobs in Auckland. Meanwhile, public sector restructuring impacted severely on employment levels in Wellington; public sector employment in aggregate fell by 3.8 per cent between November 1987 and November 1988. These job losses dealt a further blow to consumer confidence and thereby acted to reduce further real consumption expenditures and activity levels within Auckland and Wellington. To date, despite signs of a recovery in domestic expenditures, activity levels within the major metropolitan areas still appear to remain depressed.

In contrast, activity and employment levels within the provincial areas (i.e. the remaining areas of the North Island, and the whole of the South Island) bore the brunt of the costs of restructuring and the Government's disinflation policy *prior* to 1988. Government assistance to exporters, who are mostly located in the regions, was reduced much more quickly than was import protection; indeed, assistance to exporters remains much lower than that accorded to producers of import substitutes (see *Bulletin*, March 1989, pp. 27-36). Moreover, the adoption of a disinflationary monetary policy but relatively slow progress in reducing the fiscal deficit and deregulating the labour market resulted in a considerable appreciation of the real exchange rate. On top of these factors, restructuring within the State Owned Enterprises resulted in large numbers of job losses in industries such as forestry and mining, which are again located in the regions. Hence while economic activity remained firm in the urban centres up until mid-1987, production and consumer demand within provincial districts had already fallen away.

Over the past year sustained export volume growth in conjunction with a marked lift in commodity prices initiated a recovery in activity in a number of provincial areas. The 10 per cent depreciation of the New Zealand dollar in August 1988 further boosted exporters' incomes and hence, the momentum of recovery in the provinces. Areas to benefit most from these factors appear to be those heavily reliant upon dairy farming, such as Waikato, Taranaki and Manawatu/Horowhenua.

The improving economic performance of provincial areas relative to the major cities is evident in the latest Dominion-United survey of consumer confidence. The March survey found that consumer confidence in provincial areas had increased markedly since the survey began in June 1988. Meanwhile, consumer confidence in Wellington had declined and in Auckland had only increased moderately.

Unemployment

Unemployment measured by the Household Labour Force Survey (HLFS) rose markedly over the year from 5 per cent of the labour force in March 1988 to 7.4 per cent in March 1989 (see figure 6); this increase in unemployment amounts to 36,000 people. This measure of unemployment defines as unemployed those people who are without paid work, actively seeking work and available to work immediately. Registered unemployment was both significantly higher and increased more over the year. By March 1989, the number of registered unemployed had reached 147,000, up from 90,000 in March 1988. This apparent disparity between the two measures suggests that many of those registered as unemployed became discouraged from seeking work, a conclusion supported by the relatively sharp increase in the level of long-term registered unemployed over the year; in March 1989, 65.7 per cent of the total registered as unemployed had been registered for thirteen or more weeks, up from 46.5 per cent in March 1988.

The overall increase in unemployment cannot be explained by reference to activity trends alone, particularly as aggregate activity is expected to have expanded slightly over the year to March 1989. Although relatively weak domestic demand certainly led to some employment losses, the historically high and rapidly increasing levels of unemployment appear to have been due, in large part, to restructuring within both the public and private sectors.

Figure 6
Household Labour Force Survey
Unemployment Rate

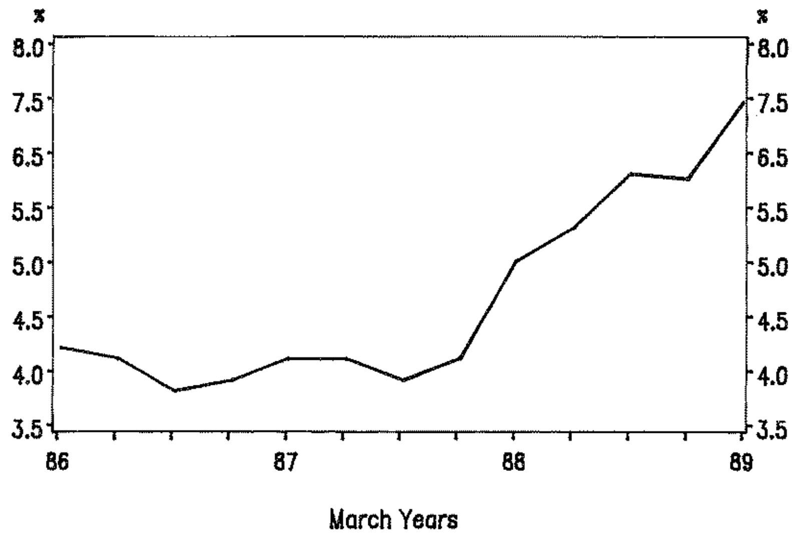
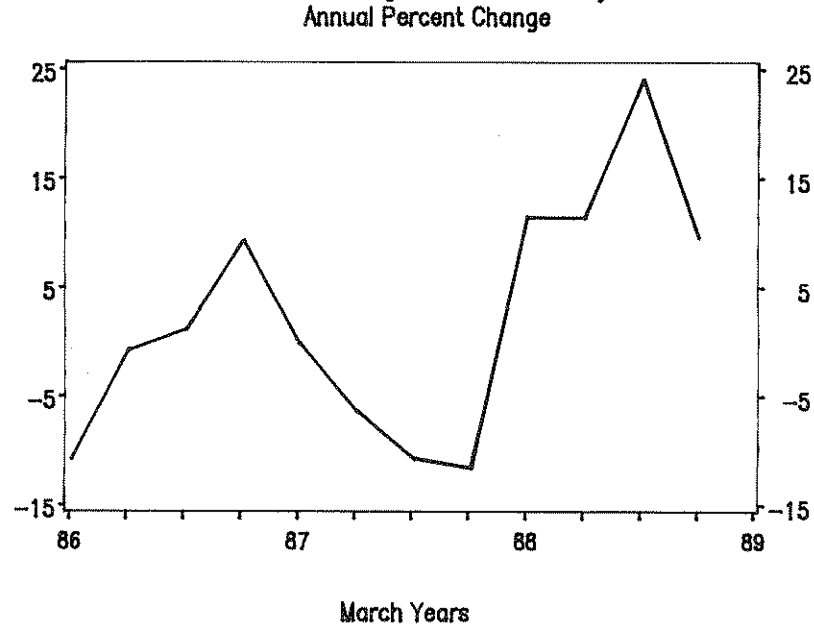


Figure 7
Manufacturing Labour Productivity (1)
Annual Percent Change



(1): Real Value Added/hours worked

Unfortunately, a lack of data prevent measurement of the productivity gains in many sectors brought about largely by restructuring. There are, however, available data for the manufacturing sector and these show large increases (see figure 7); labour productivity increased by 9.3 per cent between December 1987 and December 1988. Such large increases in labour productivity are very unusual during a recession. Typically, labour productivity falls in a recession due to under-employment of labour. This unusual labour productivity behaviour is almost certainly the result of extensive restructuring in the manufacturing sector.

Outlook

Overall, the outlook for aggregate activity is for a continued gradual recovery over 1989/90; real GDP is forecast to expand by around 1.4 per cent bringing the level of activity back to 1987/88 peaks. The gradual recovery is expected to be based on continued growth in export volumes, a further pick-up in consumption expenditure and stockbuilding. The balance of payments on current account is expected to deteriorate slightly this year to around 2.5 per cent of GDP. This expected deterioration reflects growth in import demand and a flat terms of trade outlook.

The recently announced increase in GST to 12.5 per cent in July will temporarily depress disposable incomes and therefore consumption expenditure. However, moderate declines in interest rates, together with rising exporter incomes can be expected to offset this negative impact on consumption for the year as a whole. It is likely that activity within the provinces will benefit significantly in the early stages of the recovery, given the key role of the export sector in influencing demand and income levels. However, the excess capacity and low business confidence levels currently existing are likely to restrain investment expenditures over the year ahead.

Unemployment can be expected to deteriorate through until late 1989, with sustained improvements not likely to occur until the 1990/91 fiscal year. In particular, businesses may be expected to meet the initial upturn in domestic demand by utilising spare plant capacity and by increasing the amount of overtime worked. A possible reduction in net outward migration may also serve to dampen the response of unemployment to the anticipated recovery in activity. In the interim, any measures taken to deregulate the labour market, to assist the unemployed in 'pricing' themselves back into the workforce and to enhance the skills possessed by the long-term unemployed would help to bring forward and reinforce the expected decline in unemployment.