RECENT ECONOMIC DEVELOPMENTS IN NEW ZEALAND — IMF ARTICLE

The following is the text of a recent article, attributed to Umberto Dell'Anno and Leigh Alexander, of the Maritime Division, European Department, International Monetary Fund. The article appeared in the 25th January 1982 edition of 'IMF Survey'.

The contents of the article should not be regarded as necessarily reflecting official IMF views. Neither should the article necessarily be regarded as a reflection of the official views of the Reserve Bank — it has been reproduced in the 'Bulletin' because of its potential wide interest within New Zealand, recognising that 'IMF Survey' is not widely circulated in this country. 'IMF Survey' regularly presents articles on economic developments in its member countries, along with other items relevant to the international economy and finance.

This article has been edited slightly to preserve factual integrity. The editing has not materially altered the content of the article.

New Zealand's Structural Adjustment Programme Seeks to Expand Exports and Facilitate Growth

Because of New Zealand's heavy dependence on exports of a limited number of primary commodities, changes in its external environment have traditionally had a major impact on domestic developments, as well as on its balance of payments, leading to sharper fluctuations in its growth rate and in its policy stance than are usual for most industrial countries. Although this has hastened efforts toward structural adjustment, progress in this area has been slow owing to institutional rigidities, certain government regulations, and restrictive private sector practices.

Exports and imports of goods and services in New Zealand have averaged close to 25 percent of gross domestic product (GDP) in recent years. Primary products — chiefly wool, dairy products, lamb, mutton and beef — comprise about 75 percent of merchandise exports, and the major part of manufacturing activity is divided between the further processing of primary products and the production or assembly of consumer durables for the limited domestic market.

Between the mid-1950s and fiscal 1972/73 (year beginning April 1), New Zealand's GDP grew at an average annual rate of about 4 percent, compared with the average rate of growth of 4.5 percent realised by the member countries of the Organization for Economic Cooperation and Development (OECD) as a whole in the same period to the end of 1973. Growth was accompanied by a slow but steady shift of resources into highly protected manufacturing activities and the initial development of the country's hydroelectric, geothermal, and natural gas resources. As satisfactory rates of growth, low levels of unemployment, and relatively moderate rates of inflation coincided with reasonable agreement between the social partners over distributive shares, the main objective during this period was the countercyclical stabilisation of incomes, prices, and employment, subject to some balance of payments contraint.

The deterioration in the terms of trade following the quadrupling of oil prices and the fall in primary commodity prices in 1974 was, however, of unprecedented severity and compounded the problems of access to a major export market after the United Kingdom's accession to the European Community in 1973. These changes in external circumstances contributed to the emergence of a substantial deficit in the current external balance, caused a reduction in the economic efficiency of the capital stock, and introduced a period of enhanced inflationary momentum. As unprecedented rates of inflation injected an unfamiliar consideration into the process of wage determination, the statutory system of wage arbitration and conciliation was challenged increasingly by organised labour. Adding to the uncertainty caused by the high rate of inflation and adversely affecting business confidence, investment, and the demand for labour, this situation contributed to the slowdown in the growth rate of the economy.

Since 1974 the New Zealand authorities have had to cope with problems different in kind from those to which demand management policies had previously been directed. The main emphasis of policy has now been shifted toward the restoration of external balance so as to facilitate the sustained growth of income. Accordingly, the authorities have begun to implement a medium-term programme designed to shift resources into export-oriented sectors, as well as into import substitution, while at the same time promoting the gradual removal of institutional rigidities. Although it is too early to assess the extent to which the adjustment programme has succeeded, there are clear indications of positive developments in some areas. Some problems still remain, however, and intensified efforts are needed to overcome them.

ECONOMIC POLICIES AND TRENDS.

Since the onset of the first oil crisis, the stance of financial policy has been changed frequently and markedly. Initially, the authorities gave priority to maintaining domestic activity, but by late 1975/76 they moved decisively to tighten financial policies in an effort to contain inflation and reduce the external deficit in the current account. The extent of the shift can be gauged by the reduction in the budget deficit from the equivalent of 8.75 percent of GDP in 1975/76 to 3.75 percent in 1976/77. To reduce the ensuing large underutilisation of manpower and capital and to forestall further disinvestment, the authorities — facing a substantially worsened set of macroeconomic options — introduced a strongly reflationary budget in 1978/79, which raised the deficit to the equivalent of 8.25 percent of GDP. The intended effects of the budget were, however, largely negated and in part deflected by the

1979 oil price rise and the high level of uncertainty then prevailing in the private sector. There was a spurt in spending, including spending on imports, but the usual chain of secondary responses of stocks and production was weak and short-lived. There was a return to a more restrictive policy stance in 1979/80, at which time the Government acknowledged the need to avoid sharp reversals in short-term demand management in the future. Moderately expansionary policies were followed in 1980/81 to reinforce the relatively favourable influence of external factors. In 1981/82, however, policy seems to have become more expansionary.

Measures specifically designed to channel more resources toward the balance of payments have also been implemented, including two downward adjustments in the exchange rate in 1974 and 1975 (of 6 percent and 15 percent, respectively), and the introduction and gradual extension of various export incentive schemes. However, as these proved inadequate to induce a shift in resources, in mid-1979 the authorities again adjusted the exchange rate downward (by 5 percent), began to manage the exchange rate more flexibly, and rationalised the system of export incentives. Policies to contain wage increases have been pursued with varying degrees of determination, and in early 1979 controls on prices were virtually removed.

The results of this gradual evolution of policies away from short-term intervention toward medium-term adjustment have been mixed. Although the external current account deficit has been successfully reduced from the equivalent of 13.5 percent of GDP in 1974/75 to an estimated 3.5 percent in 1980/81, the trend in the movement of domestic output has remained virtually unchanged. During the 6 years ended 1979/80, real national disposable income (GDP adjusted for changes in the terms of trade) declined on average by more than 1 percent a year, compared with average annual increases of 4.5 percent over the 12 years to 1973/74. A strong recovery in the growth of export volumes (partially due to favourable weather) and the strength of export prices have sustained economic activity and the balance of payments in 1980/81. However, the external current account deficit appears to have widened considerably in 1981/82, partly reflecting the more expansionary policy stance, as well as the import of capital items for major energy-based projects. The unemployment rate, which prior to 1974/75 had averaged only a fraction of a percentage point, increased rapidly, reaching nearly 5 percent in mid-1981, and the usual net inflow of population from abroad was reversed. On the other hand, the rate of inflation, which had risen rapidly under the impact of the 1973/74 oil price rise, declined for two years consecutively, only to accelerate again in 1979/80 and subsequently maintained an unfavourable differential with the rate of inflation in other industrial countries. Much of this acceleration can be traced to steep rises in world commodity prices in 1979 and, to a lesser extent, to measures taken to strengthen the budgetary position, including reduced subsidies and increased government charges and indirect taxes. However, the momentum of inflation has been sustained by escalating wage costs, as wages have for the past three years increased at a faster pace than prices.

ADJUSTMENT POLICIES

Structural adjustment policies undertaken by New Zealand have become more refined since the mid-1970s and now comprise a wide-ranging programme including (1) the formulation of a set of industrial restructuring plans on an industry-to-industry basis, in the context of which the scope for a gradual reduction in the level of import protection is being explored; (2) the promotion of exports through broad economic instruments, such as the exchange rate, although various export incentives have been retained and in some cases extended; and (3) the implementation of a major investment programme in energy development with potentially large benefits for import substitution and the balance of payments. The main initiatives taken to date to reduce rigidities in the economy have included a relaxation of interest rate controls and the removal of most forms of controls on prices.

The programme of industrial restructuring that has evolved since 1975 focuses on the preparation of a series of independent studies of approximately 24 manufacturing industries. The studies will concentrate on industries in which domestic prices exceed prices of foreign substitutes by a wide margin and will make recommendations regarding the scope for phased reductions in the protection accorded to their inputs and outputs. Among the larger industries for which such reviews have been scheduled or completed are textiles, footwear, motor vehicles, electronics, packaging, and brewing and winemaking. The textile sector is the largest of the sectors to have been reviewed to date. As a result, with effect from July 1980, protection on imported inputs (synthetic fibres) was removed, and an increase to about 10 percent was allowed in the share of imported finished goods (apparel) in the domestic market. (Early in 1981 this liberalisation of 10 percent of the textile import share was changed from a value percentage to a volume percentage, thus effectively reducing its impact by about three fifths.) However, the public's perception that the restructuring effort in this sector contributed to the recent increase in unemployment brings into sharp focus the difficulties of proceeding at a fast pace in this field. The import licensing system has also been liberalised. Any manufacturing exporter may now obtain an import license for materials and components where it is established that equivalent goods available from domestic sources have price or other characteristics that jeopardise export performance.

The results to date of the changes in the exchange rate system are among the promising developments. Since mid-1979, a more flexible exchange rate policy has been implemented both to remove the uncertainties and disruptions caused by major exchange rate movements and to ensure that exporters' profitability is not eroded by domestic inflation rates in excess of those prevailing in foreign markets. To enable this policy to operate more effectively, the New Zealand dollar was depreciated by 5 percent at the same time. Under the new arrangement, the peg is changed frequently in very small steps, determined mainly on the basis of the divergence forecast between the rate of cost increase in New Zealand and the rate of inflation in its main trading partners. Other factors bearing on the external position, such as sustained changes in the terms of trade, may also be taken into account. In line with this policy, the effective exchange rate has been depreciated at an average rate of about 0.5 percent a month, and by the end of 1981 it was 14 percent below its end-June 1979 level; the 'real' effective exchange rate has been roughly maintained.

While the evidence is incomplete, it appears that the Government's strategy of bringing about a shift of resources to the export sector is beginning to have results. As mentioned above, exports of primary commodities have grown rapidly since the second half of 1979. Although partly attributable to favourable weather, this growth took place despite increased protection of domestic output in New Zealand's export markets and the rather depressed state of the world economy. New Zealand has been notably successful in diversifying exports in recent years, both as regards commodity composition (horticultural products, venison, frozen fish, timber and paper products, and casein and other dried milk components) and geographical composition (lamb to the Middle East, wool and mutton to the USSR). The rapid growth of agricultural exports has stimulated investment in this sector of the economy, as indicated by the increase of 12.5 percent in the total number of sheep over the two years to mid-1981. Manufactured exports were also strong in the year following the modification of the exchange rate regime, growing by 9.5 percent in volume terms.

The authorities, however, have continued to rely on a rather extensive array of export incentives for manufactures and some processed goods, partly on the argument that they have a distinct effect in initiating the interest of potential exporters in overseas markets. Beginning in April 1980, a significant rationalisation of these schemes was achieved and their duration was extended to 1985. The new provisions encourage the use of local inputs over those of foreign origin and are extended to exports of services, including tourism; the amount of the subsidy involved is related directly to the domestic value added of qualifying exports and is estimated to be equivalent to a 14 percent improvement in export prices. On the other hand, support programmes for the rural sector since 1975 have relied increasingly less on input subsidies and production-related grants, and more on schemes that include provisions for setting aside earnings in good years in order to fund support payments in low-income years, and income subsidies through guaranteed minimum prices.

Import substitution policies have been pursued mainly through the development of the large indigenous supply of natural gas and its derivatives, including fertiliser and synthetic fuels, as well as petroleum recovered from the gas field and from a small onshore oilfield. Some success has already been achieved in curtailing imports of crude oil. Domestic energy prices have been adjusted upward to reflect price trends in international markets, conservation has been promoted with special tax and grant schemes favouring fuel-efficient vehicles and structures, and the capital cost of converting various energy-using acitivites from petroleum to coal or natural gas has been subsidised. In 1978 and 1979 energy policy for the medium-term was subjected to a thorough review, leading in 1980 to the first of a series of comprehensive energy plans. Natural gas will be an important energy resource during the 1980s and beyond. Major liquid fuel and petrochemical projects are due to be undertaken in the mid-1980s, while the use of natural gas as a premium fuel and in transport is expected to grow steadily. As a result, the share of imported oil in meeting total energy demand is expected to fall from the present 50 percent (60 percent in 1973) to about 25 percent by 1987. Additional hydroelectric capacity is being installed to provide power for energy-intensive industries, while coal production will expand at an unprecedented pace well beyond the 1990s. During the next ten years, investment in large-scale energy and energy-based projects is tentatively estimated to amount to $NZ 5 billion in 1980 prices, about one fifth of 1980 GDP. It is expected that, within six years, the resulting savings in exports and imports will contribute to a strengthening in the trade balance in an amount equal to 2-3 percentage points of GDP a year at present relative prices. There will be a substantial impact on investment, output, and employment in the shorter run, and technological effects will follow in later years.

As mentioned previously, the adjustment effort has been assisted by the removal of some of the rigidities built into the economic system. In 1976 a series of measures was introduced, aimed at improving the efficiency of monetary management by diminishing the role of direct controls and increasing that of a more active interest rate policy. With the removal of all controls on interest rates paid and charged by financial institutions except savings banks, a significant measure of competition was introduced in the financial markets. As a result, there was a significant reduction in the role of the non-institutional financial market. However, new regulations were introduced in November 1981 to prevent any increase in lending rates except in exceptional circumstances. Another important measure was the removal in early 1979 of the 1974 price regulations, which released a large portion of goods from direct control of prices and profit margins; in early 1981 a number of significant consumer items in the budget were removed from the list of items still subject to specific controls, and some deregulation initiatives were also taken relating to a number of goods and services.

MEDIUM-TERM PROSPECTS AND ISSUES

The policy decisions taken by the authorities to strengthen their strategy of medium-term structural adjustment and to gradually restore stable domestic financial conditions have already begun to exert a positive impact on the economy. They have provided a measure of optimism about the medium-term outlook deriving from the existence of large reserves of energy resources and the plans to exploit them.

Despite its high import content, the ambitious energy-based investment programme — together with continued investment in agriculture and further progress toward restructuring — is expected to generate over the current decade a rate of economic growth sufficient to permit a gradual decline in the rate of unemployment. Tentative estimates suggest that an export volume growth of 4-5 percent a year on average over the 1980s is attainable, with the growth of agricultural and manufacturing exports averaging 2 percent and 8 percent a year, respectively. Assuming a small improvement in the terms of trade on average during the present decade and the maintenance of the present level of foreign borrowing, preliminary estimates by the New Zealand Planning Council (NZPC) indicate that the average growth of real GDP warranted by the balance of payments might be 4 percent a year after 1985 and about 2 percent a year until then.

However, economic policy in New Zealand is faced with important short-term and medium-term issues. While the NZPC regards the balance of payments as an important constraint to growth, it recognises that the persistence of a high rate of inflation and shortages of skilled labour could, if unattended, jeopardise future growth performance. Skilled labour shortages are at present not significant but could become a major constraint if there is a continuing exodus to relatively higher-paying jobs in Australia, where a major resource-related investment boom is already under way.

Though external developments are contributing to the present high level of inflation in New Zealand, price developments are being affected by a number of interacting domestic factors, including the widespread formal and informal indexation linkages between prices and incomes, the heavy reliance on quantitative import restrictions, and certain features of the tax system. Efforts to break the indexation linkages have been attempted, including a tax-wage trade-off, whereby a reduction in the degree of fiscal drag would be matched by wage restraint, but no consensus has yet been reached.

The high progressivity of the personal income tax structure and the narrowness of the indirect tax base tend to discourage effort and initiative, encourage tax avoidance and evasion, and divert resources to unproductive investment, while at the same time adding to wage-push pressures. Attempts at achieving a relative shift from direct to indirect taxes have been made in the past, but a major switch has been avoided out of concern that, without acceptance by the unions that the changes were fully compensating, it would add greatly to inflationary pressures. If progress could be made to slow the rise in government transfers to the personal sector or to reduce export subsidies, a reduction in the tax burden would be feasible.

The NZPC also agrees that a more significant liberalisation of the import licensing system than is being sought in the context of the industrial rationalisation and restructuring programme would make a major contribution in reducing inflationary pressures both by increasing competition within the economy and by boosting productivity growth. However, the ability to make changes is contrained by the slack in the labour market, the inability of industry to adjust at too rapid a pace, and the difficulty of achieving domestic consensus as long as other countries continue to place severe restrictions on New Zealand's access to their markets.