Reserve Bank Bulletin

A QUARTERLY REVIEW OF THE NEW ZEALAND ECONOMY

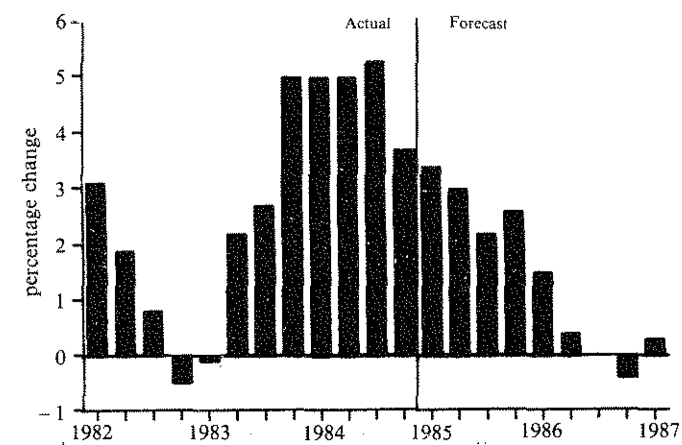
The strong economic growth apparent since mid-1983 peaked in the December 1984 quarter, with real GDP showing a decline in the March quarter. The Government's monetary and fiscal policies, combined with the natural cyclical slowdown in the recovery, have begun to curb the excessive domestic growth that has brought with it balance of payments problems and inflationary pressures. The economy is now entering a period of adjustment to a new policy environment, with little growth expected in the short-term.

After an eighteen month period of strong economic recovery it now appears that activity peaked in the December quarter 1984. The Department of Statistics real Gross Domestic Product series showed a 1 per cent decline (in seasonally adjusted terms) in the March quarter 1985, after seven consecutive quarters of growth. This was the first fall in real GDP recorded since the 0.6 per cent decrease in March 1983. However, the level of activity in March 1985 remains well above that recorded for March 1983, with growth in real GDP over this two year period estimated at 11.4 per cent.

The impetus for the expansion in domestic activity in 1983 and 1984 came from expansionary demand management policies in the period up to July 1984 as well as the recovery in the economies of the major OECD countries. Consumer expentiture growth was spurred on through 1984 by the development of strong inflationary expectations with the removal of the price freeze in early 1984 and the devaluation in mid-1984. Continued export volume growth was also a major factor in the somewhat unexpected durability of the upturn in activity throughout 1984. Non-pastoral exports in particular benefited from the introduction of Closer Economic Relations with Australia coupled with a strong world-wide economic recovery and the added impetus of the devaluation.

However, the rapid pace of growth could not be sustained. By late 1984 the economy was beginning to 'overheat': inflationary pressures were beginning to emerge, skilled labour was becoming difficult to hire, manufacturers were starting to run into capacity constraints, and the balance of payments current account was deteriorating sharply. The current account deficit for the year ended March 1985 was $2,706 million, or 6.8 per cent of (estimated) GDP, the largest current account deficit relative to GDP recorded since the mid-1970s.

REAL GROSS DOMESTIC PRODUCT
(annual % change on four quarter running totals)



Source: Reserve Bank estimates

From mid-1984, the Government moved to reduce the fiscal deficit and maintain a firm monetary stance which, in combination with the natural cyclical slowdown in the recovery, contributed to the apparent fall in real GDP over the March 1985 quarter.

Balance of Payments

March Years	Current Account Balance $M	Percentage of GDP
1975	−1,367	13.5
1976	−1,017	8.7
1977	− 787	5.6
1978	− 695	4.5
1979	− 472	2.7
1980	− 825	3.9
1981	− 823	3.4
1982	−1,628	5.6
1983	−2,004	6.2
1984	−1,614	4.6
1985	−2,706	6.8[1]

Source: Department of Statistics
1 Reserve Bank estimate of GDP.

The contraction of activity over the March 1985 quarter was concentrated in the manufacturing and construction sectors. The fall in manufacturing's contribution to real value added (3.2 per cent in seasonally adjusted terms) over the March quarter 1985 contrasts with the very strong growth displayed by this sector over the course of the economic recovery. Manufacturing's contribution to real GDP had grown for seven consecutive quarters prior to the March quarter 1985 decline, and still remains 17 per cent above the level recorded two years earlier in the March quarter 1983.

The contraction of real construction activity appears to reflect falling dwellings and non-residential building investment in response to high nominal interest rates, rising building costs and the flattening out of economic activity, as well as a winding down of major project construction as these projects approach completion.

Real Gross Domestic Product by Sector
(Seasonally adjusted quarterly percentage change)

	1983 Sept	1983 Dec	1984 Mar	1984 June	1984 Sept	1984 Dec	1985 Mar
Agriculture	3.3	−1.6	1.6	4.7	—	0.8	−0.7
Other Primary	10.6	−11.2	−8.1	16.7	7.6	3.9	−12.0
Manufacturing	3.9	1.9	8.3	—	1.7	3.3	−3.2
Electricity, Gas & Water	0.8	2.3	0.8	−1.5	1.5	−3.8	4.7
Construction	−2.2	2.2	2.2	—	5.3	1.0	−5.0
Trade, Restaurants & Hotels	2.0	2.0	2.9	1.9	0.9	−1.8	—
Owner-Occupied Dwellings	0.9	—	0.9	—	0.9	—	0.9
Transport, Comm. Bus & Per Serv	2.5	2.5	1.6	1.6	1.6	0.8	0.8
General Govt Services	0.9	—	−0.9	0.9	—	—	−0.9
Total GDP	2.7	1.2	2.7	1.7	1.5	0.7	−1.0

Source: Department of Statistics

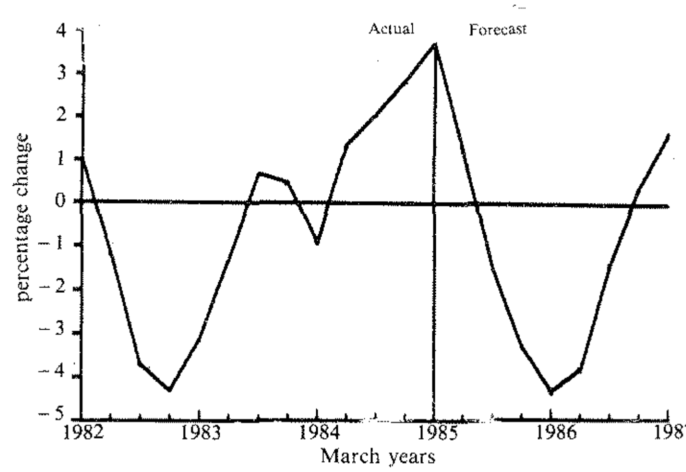
However, other economic indicators suggest that activity is unlikely to continue to decline at the rate recorded for the March quarter 1985. Certainly it is quite possible that the quarterly change could later be revised substantially upwards. Indicators of consumption and investment expenditures and surveys of business expectations are generally pointing to a flat picture for economic activity over the first half of 1985 and the Reserve Bank model indicates only a moderate decline in output thereafter.

Incomes

Aggregate real disposable income seems to have risen slightly over the March quarter 1985, although declines are likely in subsequent quarters.

The Department of Statistics real disposable income index, for salary and wage earners, showed a fall of 0.8 per cent for the March quarter 1985, and was 6.4 per cent below the level a year earlier. The increase in gross wage rates over this period was more than offset by consumer price increases and a rise in the average tax rate, partly due to 'fiscal drag'. However, the lowest fifth of income earners (those earning less than $10,900) experienced a 2.4 per cent increase in real disposable income, as they secured the greatest advantage from the introduction of the Family Care Programme in the November 1984 Budget. In contrast, the highest three fifths (those earning more than $14,700) took a fall in real disposable income of around 1.5 per cent.

REAL DISPOSABLE INCOME
(annual percentage change on four quarter running totals)



As the Statistics Department's real disposable income index measures salary and wage incomes for only one week in the quarter (at the mid-point), it is unlikely to have recorded the full impact of the latest wage round as many of the settlements would have affected wages after mid-February. When full account is taken of these later wage increases as well as employment growth of about 1.5 per cent in seasonally adjusted terms through the quarter, and the continued growth of other personal income, it is likely that there could have been a small rise in aggregate real disposable income over the March quarter.

The income of persons, other than salary and wage earners, is estimated to have risen significantly in real terms over the 1985 March year. Net farm income was bolstered by the devaluation in July of last year and a good growing season. Despite the removal of many subsidies, nominal net farm income increased by an estimated 28 per cent during the year. Self-employed persons in the services and construction industries benefited from the buoyant economic conditions throughout 1984 and household interest receipts were boosted by the high nominal interest rates prevailing in late 1984/85.

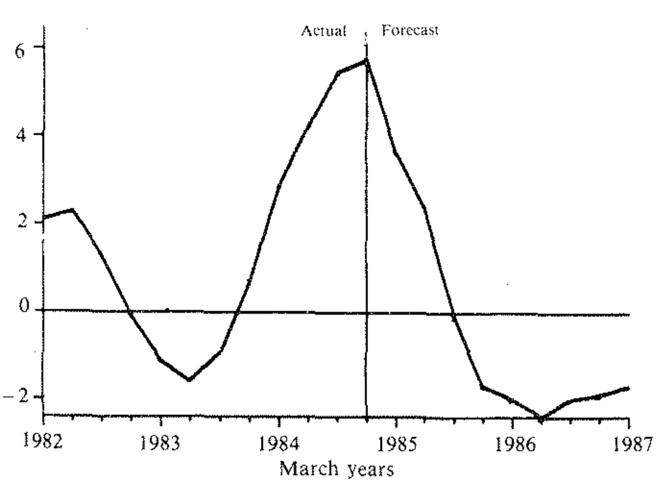
The immediate outlook is for a decline in most categories of real household income. Real salary and wage earners' disposable incomes are likely to fall through to late 1985 because of continued price increases and because no wage round is scheduled until later this year. Higher farm costs and further cuts in subsidies will see farm incomes fall while self-employed incomes will tend to be affected by the slowdown in domestic expenditure.

Consumption

Real household consumption expenditure appears to have declined over the March quarter.

Indicators of household consumption showed a steady decline over the December 1984 and March 1985 quarters after the September quarter 1984 peak. Real (seasonally adjusted) retail turnover declined by 2.7 per cent in the December quarter and by a further 1.8 per cent in the March quarter. The total retail trade figures were however distorted by the sharp swings in new car purchases following the devaluation (a large part of which represents business investment rather than consumption expenditure). Excluding the automotive sector gives a clearer picture of the trend in consumption. The real retail trade data shows a more moderate decline of about 1 per cent in both quarters. For the most part this decline represented a return to more normal levels of expenditure after consumers had brought forward purchases to the September quarter of 1984 in anticipation of price rises.

PRIVATE CONSUMPTON
(annual percentage change on four quarter running totals)



Recent monthly retail trade statistics have shown a possible continuation in April and May 1985 of the downward trend of consumption. Retail sales (excluding the automotive group, in nominal seasonally adjusted terms), grew by 2.7 and 0.1 per cent, in April and May 1985 respectively, implying a slight decline when adjusted for price changes. However, the number of new cars purchased by both households and businesses (on a seasonally adjusted basis) has shown a recovery since March of this year and an increase of 12.6 per cent was recorded in May 1985, the highest rise since the massive 68 per cent devaluation induced surge in July of last year. Unfortunately, because no split between households and businesses new car registrations is available, it is difficult to draw firm conclusions about household consumption trends. The introduction of the Fringe Benefit Tax has probably distorted the normal pattern of business purchases. Companies may have cut their purchases while they assessed the impact of the tax, and the resurgence of registrations in May, could represent a catch up after the earlier downturn. In June, the number of new car registrations was down 1.7 per cent (seasonally adjusted), thus confirming the special nature of the May increase.

Investment

Although investment eased over the March 1985 quarter, building permit statistics have not yet shown a clear downward trend. Businesses are still generally positive about future investment levels.

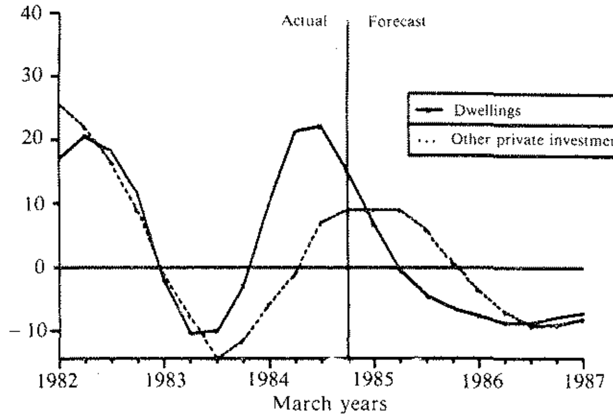
Since the peak in residential dwellings investment in the June quarter 1984, the real value of dwelling construction derived from 'work put in place' statistics has fallen steadily by around 1.5 per cent per quarter in seasonally adjusted terms, through to the first quarter of this year. On the demand side, the factors contributing to this slowdown include the high nominal interest rates experienced since mid-1984 which have significantly increased mortgage servicing costs; static real disposable incomes over the latter half of 1984/85; and the increase in permanent outward migration.

The major supply-side influence on dwelling construction has been the increase in building material costs, partly as a result of the Government's move to price the output of state-owned forests at a market level. With real household disposable incomes expected to fall over the next few quarters, investment in dwellings is likely to ease, though recent monthly building permit statistics through to May 1985 have remained at relatively high levels. The Government's housing package announced in March/April 1985 is likely to have played a significant part in partially offsetting the influence of falling real incomes.

Investment by the private sector in capital (other than residential dwellings) appears to have peaked in the last quarter of 1984, after strong growth over late 1984. In the March quarter 1985, expenditure on this category of investment is estimated to have fallen by just over 1 per cent in real seasonally adjusted terms. However, the level of investment still remains around 8 per cent higher than a year earlier. All types of capital formation in the other private investment group, except transport equipment, contributed to the fall in the first quarter of 1985. This slowdown mainly arises from output growth peaking in the December quarter 1984, combined with the rising user cost of capital as a result of high nominal interest rates.

The construction of non-residential buildings fell by around 3 per cent in real seasonally adjusted terms, over the March 1985 quarter, as indicated by 'work put in place' statistics, but still remained some 15 per cent above the March 1984 level in real terms. The major contribution to this fall came from a decrease in the construction of office and administration buildings,

PRIVATE INVESTMENT
(annual percentage change on four quarter running totals)



which outweighed the strong growth in construction of hotels, motels, factories and other buildings that reflects the present high level of investment in export and tourism sectors. A degree of uncertainty surrounds the apparent downward trend in non-residential construction, particularly as the value of new non-dwelling permits showed a real growth of around 3 per cent over the three months to April 1985. With long lags between the issue of these permits and the completion of the larger projects, the growth indicated by the building permit statistics should become evident in the 'work put in place' data for subsequent quarters, although historically investment in this area has been volatile.

It is difficult to draw firm conclusions about trends in plant machinery and transport equipment because of the lack of up to date and reliable indicators. Import volume indices for investment goods provide some evidence and appear to show that real investment in plant machinery and equipment fell slightly over the first quarter of this year whereas investment in transport goods rose slightly. It should be noted that because of the limited coverage of these indicator series they have not always been a reliable guide to the actual level of investment in the past, and they may have a downward bias at present if last year's devaluation has induced import substitution in the capital goods industries.

The latest Business Opinion Survey, conducted by the New Zealand Institute of Economic Research (NZIER) in June of this year, shows a degree of positive intent with regard to both building and plant, machinery and equipment investment over the coming year. This optimism is interesting considering the more pessimistic outlook for the general economic climate shown in the survey and the prospect of little growth in economic activity in the short-term. The survey results perhaps reflect a confidence in the medium-term prospects for the economy which is dominating the influence of short-term prospects on investment decisions. Government policy is likely to be contributing to the investment optimism by promoting a medium-term environment that encourages competition and innovation in the marketplace. It may be noted further that the essentially flat track in aggregate investment over the next two years, as forecast by the Reserve Bank's model, obscures the fact that there will be substantially divergent rates of growth between sectors in response to many of the policy changes introduced over the last year.

Stockbuilding

The stock cycle appears to have peaked in late 1984.

Reserve Bank estimates indicate that stockbuilding made a large contribution to growth in real GDP over the 1984/85 year. Part of this increase was unrelated to the business stocks cycle. Agricultural livestock numbers were up and the stocks of standing timber continued to grow at an almost exponential rate. Manufacturers' raw material stocks however, have increased in line with the rapid growth in manufacturing output over the 1985 March year (up 10.3 per cent in real terms on the previous year), with the ratio of raw material stocks to sales also having risen.

The stocks to sales ratio for retail stores rose in the March quarter 1985 for the second quarter in succession to 0.43, a level that is still well below the average for the past five years. The NZIER Business Opinion Survey indicates a degree of concern that stocks were too high in June 1985, with merchants on balance expecting to run down the volume of stocks over the September quarter 1985. It thus seems that some involuntary stockbuilding has occurred to the point where destocking is seen as necessary.

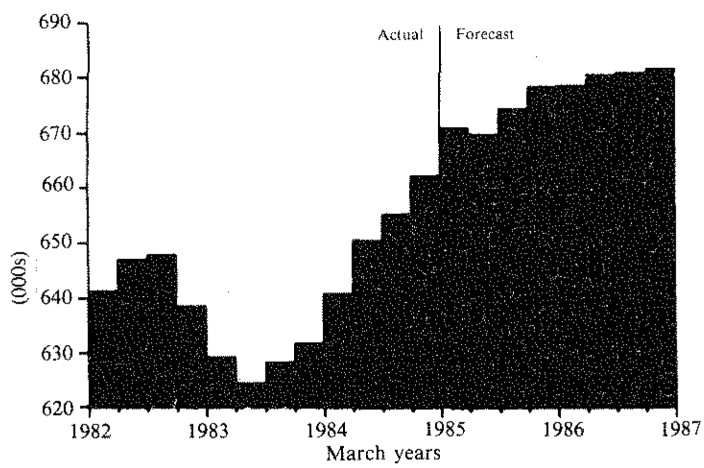
From Reserve Bank estimates it is quite apparent that the stock cycle peaked in the September quarter 1984. Stocks are still expected to increase over the next two years, but at a much slower rate of accumulation than in the past year with the major contributions coming from the agricultural and forestry sectors.

Employment

The expansion in employment continues to reduce unemployment levels.

Although growth in activity is showing signs of flattening, employment is still growing strongly. The results of the latest quarterly employment survey in February 1985 show a growth rate in total full-time equivalent employment (full-timers, working proprietors and half-part-timers) of 4 per cent or approximately 41,000 extra jobs over the full year. Virtually all of this growth occurred in the private sector and was spread across a wide range of industries. Part-time employment in particular rose strongly in the year

PRIVATE SECTOR
full-time employment (seasonally adjusted)



to February 1985 recording an annual growth rate of over 8 per cent.

The major factors contributing to the expansion in employment have been the increase in private sector output over 1984 and the reduction in unit labour costs relative to output prices.

Unemployment is continuing to improve as a consequence of the employment growth and because of a recent sharp reversal in migrant flows towards a net outflow of skilled labour, attracted it seems by higher real wages in Australia. The latest unemployment data extends the downward trend exhibited since the peak in December 1983, with the number of registered unemployed persons falling to 48,139 in June 1985 as compared with 83,597 in December 1983.

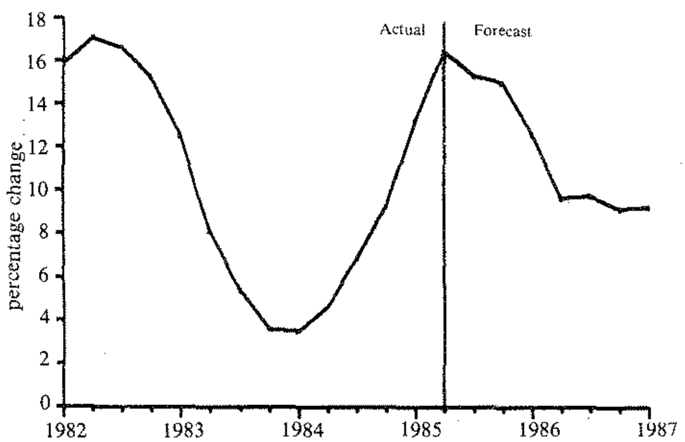
A shortage of skilled labour, especially in the Auckland region, has developed as a result of the buoyancy in the labour market. This is confirmed by vacancies data from the Labour Department, and by the NZIER Business Opinion Survey which indicates that businesses are facing increased difficulty in finding both skilled and unskilled labour.

Prices

The annual rate of consumer price inflation is likely to have peaked in the June quarter 1985.

Consumer prices in the June quarter 1985 increased by 5.1 per cent, the largest quarterly change recorded since the December quarter 1947. This rise brought the annual change in consumer prices to 16.6 per cent for the year to June 1985. The large quarterly increase was not unexpected. The removal of the remaining rental controls on 1 April 1985, after a thirtythree month long period of control, led to a 18.2 per cent increase in dwelling rentals, which was the largest sub-group contribution to the all groups increase. The petrol price rise in April of this year, largely attributed to the cost over-runs and commissioning delays on the Marsden Point refinery expansion project, accounted for much of the 4.8 per cent quarterly increase in the private transport sub-group, the second largest contribution to the increase in the all groups index. Other major contributions came from increased Government charges on electricity and coal, and from price rises for certain alcoholic drinks.

CPI
Annual Percent Change



The food sub-group of the CPI is thought to have peaked in March 1985 at 2.5 per cent (in monthly percentage change terms). The subsequent monthly percentage increases through to June 1985 have been much lower at 1.7, 0.6 and 0.7 per cent for April, May and June respectively. It appears that the main effects of the July 1984 devaluation have now flowed through and that food price inflation is now falling back to a lower underlying rate.

Government Sector

The projected fiscal deficit in 1985/86 has been cut to 2.8 per cent of forecast GDP.

The most significant feature of the recently announced Government Budget was the dramatic cut in the fiscal deficit from $2,784 million in 1984/85 to an estimated $1,286 million in the 1985/86 year. This represents a fall in the size of the deficit, relative to GDP, from 8.9 per cent in 1983/84 and 6.9 per cent in 1984/85 to 2.8 per cent in 1985/86, the lowest level as a proportion of GDP since 1973/74. However, while the relative size of the deficit should be similar to that for 1973/74, the Government's net expenditure relative to GDP has since increased greatly from 29.1 per cent in 1973/74 to 38.2 per cent in 1985/86. The level of expenditure in 1985/86 is nonetheless lower than the peak of 40.8 per cent of GDP reached in 1983/84, largely as a result of discretionary changes in Government policies enacted over the last year.

The reduced deficit forecast has enabled Government to reduce its borrowing requirement through the stock tender programme and combined with a heightened overseas interest in investing in New Zealand, this contributed to a 2 per cent fall in interest rates on government stock tendered in June 1985.

Conclusion

Signs of a slowdown in economic activity are beginning to emerge. The rapid growth in total output and expenditures, from the recovery in mid-1983 through to the December 1984 quarter, was clearly unsustainable. To meet the expansion in domestic demand over this period import volumes rose significantly and, despite strong growth in export volumes over the same period, the balance of payments current account deficit deteriorated considerably. The excessive increase in domestic demand was also beginning to place upward pressure on prices, thereby jeopardising the Government's anti-inflationary objectives. In view of these strains, the slowdown in the economy over the next year or so will not be an unwelcome respite. It will provide a more conducive environment for the Government's anti-inflationary policies to take hold, as well as encouraging the structural changes in the economy that will follow from the Government's policies designed to promote economic efficiency.