Reserve Bank Bulletin

QUARTERLY REVIEW OF THE EXTERNAL ECONOMY

GNP is estimated to have expanded by 4.9 per cent in industrial countries in 1984, but recent economic indication point to a deceleration in the output growth rate of these countries over the second half of that year. The IMF expects growth rates in this country grouping to decline to 3.1 per cent and 3.0 per cent in 1985 and 1986 respectively. The benefit to New Zealand of the buoyant international economic condition have been limited, however, by the restrictive trade policies applied to agricultural goods by some countries.

Introduction

The international economic recovery currently in progress has made an important contribution to New Zealand's relatively strong economic performance in the last 2 years. However, factors peculiar to some of New Zealand's export markets have limited the beneficial effects of that recovery. This article reviews recent developments in the international economy and describes their impact on New Zealand's external trade position. It is the first in a new series of quarterly articles planned to be published in the *Bulletin* which will examine issues related to the external sector.

The current article pays particular attention to the linkages which encourage the spread of recovery across countries. It has two main parts. The first part discusses the international economy, focusing on those factors which have facilitated the transmission of the North American recovery to the rest of the world. The second part of the article looks at the transmission mechanisms which enable New Zealand to benefit from international recovery and also identifies limiting factors.

Developments in the International Economy[1]

Country linkages through trade and capital flows have become more important during the present international recovery because of the different cyclical positions of the major industrial countries when compared with that of the previous recovery. Whereas United States domestic demand grew at an annual rate of almost 7.5 per cent from the second half of 1982 until the second half of 1984, the corresponding figure for the other industrial countries was only 2.3 per cent. On its own, this disparity could be expected to generate a strong demand for imports in the United States which would aid recovery elsewhere. But on this occasion other factors such as relatively high United States interest rates have reinforced this trend. They have led to the appreciation of the United States dollar and a further widening of the United States current account deficit, with the result that (according to IMF estimates)

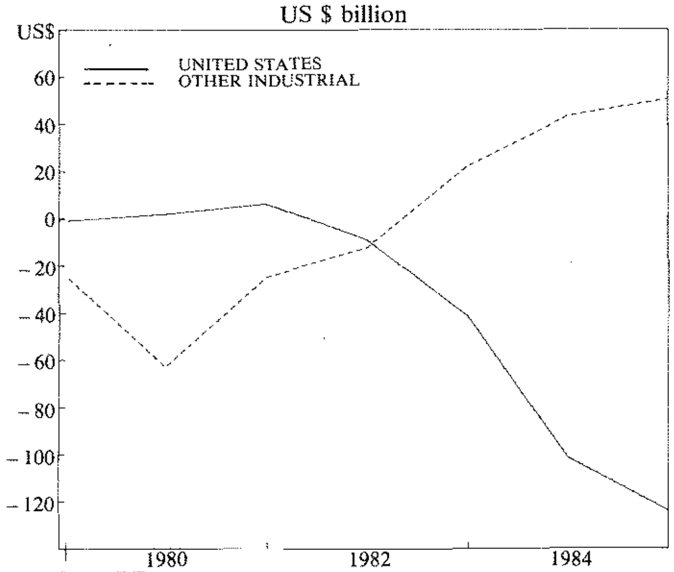
1 Forecasts presented in this section are based on International Monetary Fund projections published in *World Economic Outlook*, April 1985. Recent developments and projections in the major aggregates are presented in graphs 1 — 4.

an extra 0.75 per cent a year has been added to the output growth of industrial countries outside the United States.

The fiscal policy stance adopted by the United States as compared with that of other industrial countries has been a major factor associated with the appreciation of the United States dollar during a period when the country's current account was showing a significant deterioration. In the United States, tax cuts and increased expenditure on defence and debt servicing have resulted in a growing Federal budget deficit. Other industrial countries however, have pursued policies of fiscal restraint.

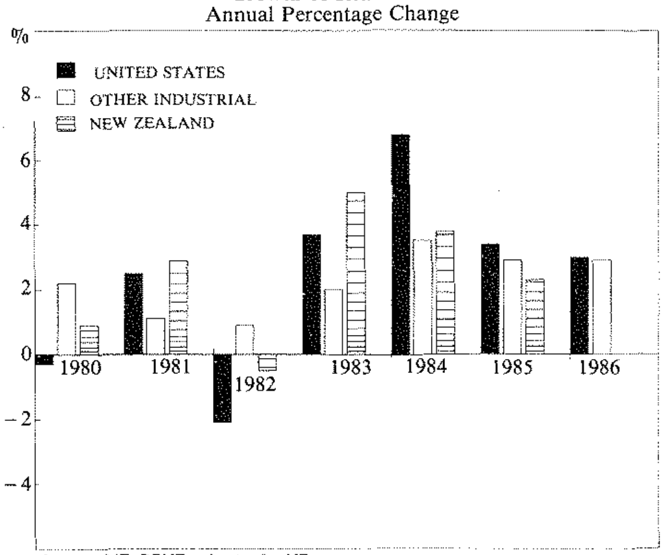
Among industrial countries Japan, Canada, Australia, Denmark and New Zealand recorded especially strong growth in real GNP in 1984. In Japan, West Germany and several of the smaller industrial countries the major stimulus to output growth was export demand. The only major industrial country in which output did not expand more rapidly in 1984 than in 1983 was the United Kingdom where the current expansion began in 1981 and where economic performance in 1984 was constrained in part by the effects of the coal miners' strike. Overall the IMF estimates that output in the industrial countries rose 4.9 per cent in 1984 compared with an increase of 2.6 per cent in 1983.

Current Account Balances
US $ billion



Source: IMF

Growth of Real GNP
Annual Percentage Change



Source: IMF, RBNZ estimates for NZ
Note: Data for NZ only available to 1985

The United States' tax cuts were designed to stimulate growth in output. It was thought that this increased activity would result in higher tax revenues and generate the increased savings needed to finance higher private sector investment. However, private savings in the United States have not been sufficient to finance both higher investment and the level of Government expenditure. Pursuit of the twin policy objectives of financing the growing fiscal deficit and limiting monetary aggregate growth caused domestic interest rates to rise to very high levels. These attracted very large capital flows from offshore which induced a strong appreciation of the United States dollar. This exacerbated the effect that the strength of the United States economy was having on developments in the United States external sector. In 1984 the United States recorded a current account deficit of US$101.6 billion, which was equivalent to almost 3 per cent of GNP, compared with a deficit of US$41.6 billion in 1983 (just over 1 per cent of GNP).

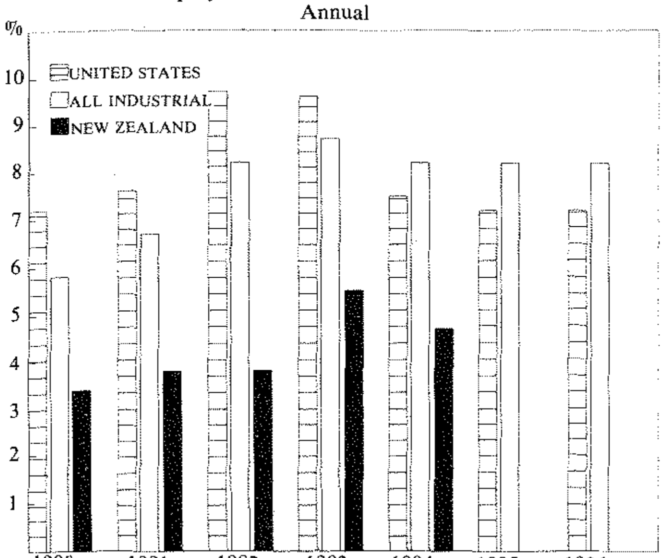
The past four years has seen a 43 per cent real appreciation of the United States dollar which has caused a sharp deterioriation in America's competitive position. As a result, the country has suffered a 23 per cent loss of export market share since 1980 and a 20 per cent increase in the ratio of import volume to real GNP.

The major counterpart within the industrial country grouping to the large United States current account deficits has been a growing Japanese current account surplus which reached US$35 billion last year.

Although output grew at a reasonable rate in most industrial countries during 1984, for the most part it was not accompanied by a significant reduction in unemployment. The composite unemployment rate for the industrial countries as a group fell 0.5 percentage points in 1984 to 8.2 per cent. This improvement stemmed very largely from a sharp drop in unemployment in the United States although Australia, New Zealand and Canada also achieved significant reductions. However, in three of the four largest European countries (the United Kingdom, France and Italy), unemployment reached or exceeded 10 per cent of the work force.

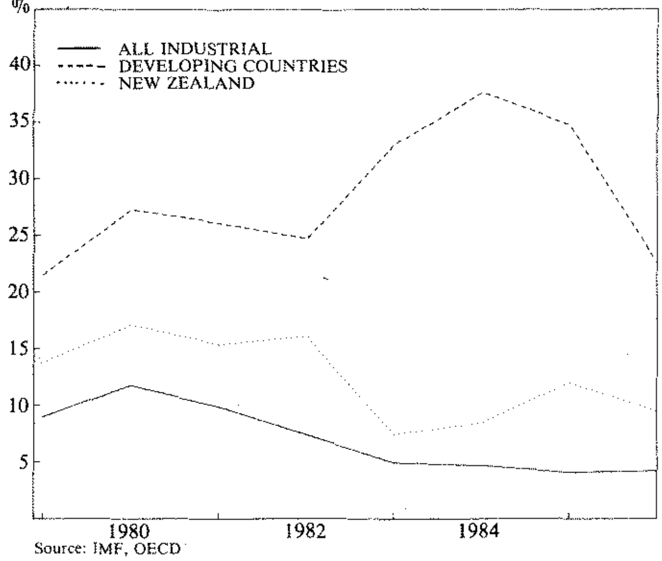
Employment growth accelerated in most industrial countries in 1984 but to a large degree this was matched by an expanding labour force. However, in Europe employment fell 0.2 per cent. A number of imperfections in the labour markets in Europe have been blamed for this poor employment performance. Real wage inflexibility resulting from wage indexation and legislated minimum wages has been identified as a

Unemployment as a Percent of Labour Force
Annual



Source: IMF, NZ Dept of Labour
Note: Forecasts for NZ unemployment *not* available

Consumer Price Inflation
Annual Percentage Change



Source: IMF, OECD

major factor. Rigidity generated by redundancy payment regulations has been suggested as another — the regulations making firms wary of hiring labour which they may find difficult to shed at a later date. Relatively high unemployment benefits paid in some European countries may act as a disincentive to work or dissuade workers from shifting to another area to find work.

A more positive feature of the current recovery has been the widespread and marked slowdown of inflation in the industrial countries. A major reason for this feature has been the high priority given to controlling inflation by governments using monetary, fiscal and incomes policies. Japan and West Germany have pursued this objective longer than most countries and as a result have experienced relatively low rates of price increase for several years. In other countries, especially the United States and the United Kingdom, there have been some dramatic declines in inflation.

Inflation performance in 1984 was also aided by moderate wage increases, stemming mainly from reduced inflationary expectations, and by stronger growth in labour productivity. Together these have meant that in most industrial countries unit labour costs showed little or no rise in 1984. Finally, low international commodity prices have caused less acceleration in the cost of imported raw materials. The combination of these factors resulted in consumer price inflation for industrial countries averaging 4.7 per cent in 1984, compared with 4.9 per cent the previous year.

In broad terms the developing countries have benefited from the recovery in industrial countries. With renewed demand for their exports, output growth accelerated to average 3.7 per cent in 1984 compared with 1.5 per cent in 1983. Increased export demand was also a factor underlying the sizeable improvement in the combined current account deficit of developing countries. In 1983 the deficit amounted to US$70.5 billion but this was reduced to US$43.9 billion in 1984.

However, this overall view hides marked differences in performance between different groups of developing countries. Asian countries have displayed relatively strong output growth while many countries in sub-Saharan Africa have lagged behind. In 1984 output grew on average by 6.4 per cent in Asia but only 1.5 per cent in sub-Saharan Africa.

A similar difference is apparent with respect to price inflation. In most developing countries inflation has tended to slow but a small group, including some of the larger developing countries, continued to experience rapid inflation. In these countries (Argentina, Bolivia, Brazil, Israel and Peru) the annual inflation rate accelerated from about 100 per cent in 1981 and 1982 to almost 260 per cent in 1984, largely because efforts to correct real exchange rates were undermined by sophisticated indexation and the lack of supporting financial policies. Elsewhere among developing countries inflation is more moderate, averaging about 14.5 per cent in 1984.

The convergence of inflation rates in industrial countries during the current recovery should have contributed to exchange rate stability and promoted growth. However, during 1984 and the first half of 1985, the major currencies displayed considerable volatility. The divergent growth trends in the main industrial economies, large United States fiscal deficits and high domestic interest rates in that country go some way to explaining the substantial realignments in major currencies which occurred.

A less attractive feature of the current recovery, stemming to some extent from the strength of the United States dollar, has been the re-appearance of protectionist sentiment with calls for more quantitative restrictions to be placed on international trade. Controls such as 'voluntary' restraints restrict the ability of countries to export, and in this way they have a direct impact on economic performance. For the most part, such restrictions aim to protect employment in particular countries but there is little evidence to show that they succeed in the longer run. Restriction of one type of imports tends, in the absence of any change in saving or investment behaviour, to exert upward pressure on the exchange rate and encourage other, non-restricted imports. In addition, restrictive measures involve efficiency costs which result in countries using resources in industries which are no longer economic, paying for this through higher prices for the finished products. Therefore any further moves to increase levels of protection which may stem from the difficulties of United States firms or European agriculture facing foreign competition should be seen as endangering the long-term prospects for the international economy as a whole.

Given the importance of the strength of United States domestic demand to the current recovery, prospects for the United States economy are of particular interest. It appears likely that growth in output over the next two years will be significantly slower than it was in 1984. Last year's growth rate was the highest since the early 1950s but this year there is already evidence that increased competition from foreign goods is restraining United States output. Domestic demand in the United States is likely to weaken and business investment is not expected to be able to sustain the rapid rate of increase recorded in 1984. Any successful moves to reduce the size of the United States fiscal deficit will also have a dampening effect on activity. The IMF forecasts that United States real GNP will increase by 3.4 per cent in 1985, half that recorded in 1984.

In some other industrial countries a slowdown in output growth is also projected for 1985 and 1986, especially in those countries which experienced quite rapid growth in 1984. Now that production in these countries has increased to near its capacity level, output growth is likely to return to a rate which is more consistent with the underlying growth in productive potential. As a result, a considerable convergence in the growth rates of industrial countries is expected. For the industrial country grouping as a whole real GNP is forecast by the IMF to grow 3.1 per cent in 1985. In 1986 average growth of 3 per cent is forecast with rates mainly clustered in the 2 — 3 per cent range. For the developing countries the outlook for 1985 and 1986 is for continued annual growth in output in the 4 — 4.5 per cent range.

With respect to current account positions, the IMF expects a continuation of the trends of the last two years over 1985 and 1986, especially given the likely lagged effects of changed competitive positions. Therefore, the current accounts of many industrial countries are expected to improve, but these improvements are likely to be more than offset by the deterioration in the United States position. As a result, the combined current account deficit of the industrial countries is expected to be more than US$80 billion in 1986 compared with US$58.3 billion last year.

IMF projections are for little further improvement in unemployment in industrial countries. The unemployment rate in the United States is not expected to fall much below its current level of 7.3 per cent although this will represent some improvement over the average for 1984 of 7.5 per cent. Some employment growth is expected in Europe but overall the unemployment rate for industrial countries is not expected to show any improvement, remaining about 8.2 per cent of the labour force for the next two years.

Developments in New Zealand's External Accounts

The developments in the international economy which have been described above have had a significant impact on New Zealand's external accounts. Economic recovery in New Zealand's major trading partners' economies has expanded demand for New Zealand's exports, increasing export earnings over what they would otherwise have been. The impact of the current international recovery on export earnings has been transmitted mainly via export volume growth. Total export volumes rose by 4.2 per cent and 7.3 per cent in 1983/84 and 1984/85 respectively[2], compared with an average of around 3 per cent during the previous two years. This export volume growth has occurred entirely in non-pastoral exports; pastoral export volumes declining in 1983/84 and remaining static in 1984/85.

In normal circumstances a sustained increase in pastoral production will lag by at least 2–3 years behind the demand conditions which induce it. Because the increased demand during an economic recovery is by nature transitory, it is not surprising that the main export volume response in pastoral production will on occasions appear after the upsurge in demand has passed its peak. But other factors, in particular the effects of surplus product disposal by the EEC and the United States, the rise of protectionist sentiment in those and other export markets, and adjustments made necessary by the phased removal of government support measures in New Zealand have constrained both the size of the demand stimulus generated by the present recovery and the sector's ability to respond to it.

In past international economic recoveries, higher demand for pastoral exports has resulted in significant pastoral export price increases. During the first two years of the last international recovery, which started in 1976 and ran through to 1980, pastoral export prices (adjusted to exclude the effect of changes in New Zealand's exchange rate) rose by about 32 per cent[3]; well in excess of world inflation during those years Consumer prices rose at an annual rate of around 7.5 per cent in OECD countries between 1976 and 1978. Over the first two years of the current economic recovery, however, pastoral product export prices have fallen by around 2 per cent. Adverse pastoral product supply developments, such as large disposals from stockpiles, have more than offset the beneficial impact of economic recovery on pastoral export prices over the past two years. Mainly as a result of the low prices received for pastoral exports, overall prices for New Zealand's exports have risen more slowly than world inflation. Consequently, New Zealand's terms of trade have eased by about 1.5 per cent during the current recovery. By comparison, the terms of trade rose by around 8 per cent during the first two years of the last international recovery.

In this part of the article, developments in New Zealand's external accounts during the current international economic recovery are examined, with particular reference to performance in the various export sectors over the past year.

2 Years end in March in this part of the article, unless otherwise stated.

3 All prices in this section of the article are adjusted to exclude the effects of changes in New Zealand's exchange rate.

Pastoral Exports

Demand for New Zealand's pastoral exports usually rises during an international recovery for a variety of reasons. In the case of wool, there is a higher level of building activity and refurbishing of houses, both of which increase the demand for New Zealand wool in order to make carpets. People in overseas markets consume more cheese and butter when their incomes rise, increasing demand for New Zealand dairy exports. Higher incomes in the United States encourage greater consumption of hamburgers and other meals away from home, which raises demand for our meat exports.

Because production in the pastoral sector cannot normally respond quickly to the increase in demand associated with economic recovery, higher demand for pastoral products in any case during periods of recovery usually generates upward pressure on the prices received for these products ahead of any increase in the quantities exported. As might be expected, demand for wool tends to be more sensitive to international economic conditions than demand for either dairy or meat products.

In past international economic recoveries, *wool* prices have increased strongly before turning down quite sharply during periods of international recession. During the first two years of the last international recovery, wool prices rose by around 40 per cent; well in excess of world inflation during those years. During the current economic recovery, however, wool prices have only just kept pace with world inflation, rising by around 5 per cent in each of the past two years. The main reason for this poor wool price performance appears to have been greater competition from synthetic carpets over the last few years. Falling real oil prices have lowered the cost of producing synthetic carpets, making them more price competitive with wool carpets. Competition from synthetic carpets is expected to continue to moderate an expansion in the demand for wool during the next year or so, with the result that growth in wool prices is likely to remain modest during the remainder of the current international recovery which is anticipated to last at least until 1986/87.

Other factors have more than outweighed the positive effects of international economic recovery on *dairy product* prices over the past two years, with the result that prices have fallen quite sharply. Average dairy product prices received by New Zealand declined by 7 per cent and 14 per cent respectively in 1983/84 and 1984/85. Even if dairy product prices stabilise at their current level over the coming year, they will be on average 9 per cent lower than in 1984/85, since the sharp fall in dairy product prices which occurred in the second half of 1984/85 would be reflected in prices received over the whole of 1985/86.

The problems experienced in marketing dairy products in recent years have been mounting for some time as high subsidies and levels of protection in the EEC have encouraged a major expansion in EEC dairy production. At the same time, the high levels of protection afforded dairy production in EEC countries have resulted in high dairy product prices to the European consumer which have discouraged consumption of dairy products in Europe.

Large stockpiles of dairy products have accumulated in the EEC and United States over recent years and during the past two years increasing amounts of these stockpiles have been sold on international dairy markets. In order to sell the increasing quantities of dairy products, prices have been cut. The EEC lowered its prices sharply to below GATT minimum levels in the second half of 1984/85, resulting in a fall in the world price of butter and caseinates of around 20 — 25 per cent.

The United States has recently begun to reduce its stockpile of butter by offering it as a form of aid to developing countries. This is also likely to depress world dairy product prices. With the continuing disposal of large quantities of stockpiled butter, dairy prices are likely to remain depressed over the coming year. While they are likely to recover somewhat once stockpiles have reached more manageable levels, dairy prices are unlikely to return to the real levels prevailing even during the 1970s unless there is a fundamental reform of the EEC's Common Agricultural Policy (CAP).

The EEC's assistance policies with respect to dairy products, together with a strong United States dollar, have made dairy farming extremely unprofitable in the United States. Consequently there has been a high rate of slaughter of the United States dairy cow herd in the past two years. Beef production in the United States has been significantly increased as a result of this dairy cow slaughter; production of beef is currently about 20 per cent above normal. The Common Agricultural Policy (CAP) has also adversely affected *meat* prices received by New Zealand during this economic recovery by encouraging rapid growth in EEC beef production. Large EEC beef stockpiles have been accumulated and sales from these stockpiles have recently been exerting downward pressure on prices received by New Zealand in third country markets, i.e. in markets other than the EEC, United States and Canada.

Another factor undermining meat prices in recent years has been the consumption trend away from red meats in favour of poultry and fish. These adverse developments have offset the favourable effect of international recovery on meat markets, with the result that meat prices have been stable during the past two years. Over the first two years of the previous international economic recovery, meat prices rose by 30 per cent, while by 1979/80 they were 95 per cent higher than in 1975/76. Meat prices are likely to remain quite stable over the next year but may improve somewhat during the remainder of this economic recovery. Price growth is not expected to match that which occurred in the late seventies.

Despite the poor pastoral product prices received during this international economic recovery, livestock numbers have been relatively stable. Decisions to reduce livestock numbers, such as those taken in the United States affecting its dairy industry, have not been taken in New Zealand. A factor contributing to this stability has been the agricultural assistance and stabilisation policies which have to some extent shielded producers from developments in world primary product markets.

Even though pastoral production has been reasonably stable, pastoral exports as a percentage of exports of goods and services have fallen from 53 per cent in 1982/83 to 46 per cent in 1983/84 and to an estimated 43 per cent in 1984/85.[4] This outcome has occurred because of the rapid growth in non-pastoral exports. If this trend continues, it is anticipated that pastoral exports will comprise around 39 per cent of total goods and services exports by the year ending March 1987.

Non-Pastoral Exports

Demand for New Zealand's non-pastoral exports tends to rise more during international recoveries than does demand for our pastoral exports. These increases in demand lead to higher prices and/or higher export volumes, depending upon each industry's ability to increase output. In addition to the increase in earnings in these industries that is attributable to periods of international economic growth, there has also been a long-term trend in New Zealand for non-pastoral export earnings to rise as more resources are devoted to the production of these goods and services.

Growth in *manufactured* exports has been particularly marked during this international recovery. The volume of manufactured exports rose by 19.5 per cent in 1983/84 and is estimated to have grown by a further 19 per cent in 1984/85. More than half of New Zealand's manufactured exports are sold to Australia, making manufactured export performance relatively dependent on economic developments in that country. The economic upturn in Australia, which began in mid-1983, has been stronger than in most other countries. In the calendar year 1984, for instance, Australia's real GDP grew by 4.6 per cent compared with a 3.2 per cent average growth rate in industrial countries (Source: IMF World Economic Outlook, April 1985). Improved access to the Australian market under the CER agreement has also greatly assisted growth in manufactured exports. Most of the remainder of New Zealand's manufactured exports are sold in Pacific rim countries, where economic recovery has also been stronger than for the world as a whole. An important factor underlying the recent growth in manufactured exports to all markets has been the large gain in competitiveness since September 1983.

Prices for manufactured exports rose in line with world inflation in 1983/84 but have weakend somewhat in 1984/85. Manufacturers appear to have taken the opportunity afforded by the July devaluation to cut prices so as to gain greater market share in their export markets. The price of manufactured exports is expected to rise in line with world inflation during the remainder of this recovery.

The international economic recovery has increased demand for *forest products*, especially for paper and sawn timber but, because capacity production levels have been reached during the past year, increases in export volume growth have been limited. Following strong (9 per cent) export volume growth in 1983/84 (which represented a return to more normal export volumes of newsprint), forest product export volumes are estimated to have grown by only 2 per cent in 1984/85. The supply of mature exotic timber currently constrains forestry sector production levels and that supply is determined by planting decisions taken 25 — 30 years ago. The availability of timber is likely to limit growth in forest product export volumes to moderate levels during the rest of this decade. However, substantial growth from the 1990s onwards can be expected, as the supply of mature timber increases dramatically due to the large planting programmes undertaken during the 1960s and 1970s.

The main impact of economic recovery on the forestry sector has been to increase prices. Over the past two March years, prices for forest products rose by 1.5 per cent and 7 per cent respectively. Increased demand has been strongest for paper and sawn timber and, accordingly, prices for these products have recorded the strongest growth. To capitalise on the demand for these products, production of paper and sawn timber has been increased at the expense of other forest products. Buoyant demand is likely to ensure that forest product prices rise more rapidly than world inflation over the remainder of the recovery.

Like many of New Zealand's primary product exports, production levels for commodities in the *other primary products* category[5] are largely determined by decisions made in previous years about future capacity levels of production; international recovery has had relatively little impact on other primary product export volumes. Decisions have been made since the late seventies which have increased production capacity over recent years in many industries within the other primary products category. The inception of New Zealand's 200 mile exclusive economic fishing zone in 1978 and the consequent development of the local fishing industry have increased production in that industry. Major planting programmes in the late 1970s and early 1980s have raised production levels in the kiwifruit and pipfruit (apple and pear) industries. Largely in response to these developments, other primary product export volumes have expanded rapidly over the past two years, rising by 21 per cent and 24 per cent respectively in 1983/84 and 1984/85. Growth in other primary product export volumes is anticipated to ease during the remainder of this recovery, mainly due to the restriction of the inshore fisheries' catch to more sustainable levels.

International recovery tends to affect other primary product export earnings through its positive influence on prices. However, offsetting factors (in particular, the very rapid volume increase in Kiwifruit exports) have been quite important during this recovery period, with the result that other primary product prices have only increased in line with world inflation over the past two years. Not evident from the aggregate figures is the strong price growth in some individual product

4 These ratios are calculated on a Balance of Payments basis for years ended March and, as noted, express pastoral exports as a percentage of total exports of goods and services. The ratios reported in the 'Non-Pastoral Exports article', which was published in the May 1985 *Bulletin*, were calculated on an OET basis for years ended June and expressed pastoral exports as a percentage of merchandise exports alone.

5 The other primary products category of exports is a residual aggregate that incorporates all of those exports that are derived directly from the land or sea but are not classified as pastoral or forestry exports.

categories. Fish prices in particular have risen strongly during this recovery; in 1984/85 alone fish prices are estimated to have increased by around 40 per cent. Underlying this rapid rate of fish price increase has been a shift in tastes in our major markets away from protein sources with high fat levels towards protein sources with a low fat content, such as fish. Only moderate price growth is anticipated in the other primary products category during the remainder of this recovery largely on account of weakening kiwifruit prices as supply continues to grow.

Export earnings in the tourist industry tend to be quite sensitive to international economic conditions. During the first full year of recovery (1983/84), export earnings from *tourism* grew by 26 per cent, compared with 2 per cent in the previous year. In the year ended March 1985, earnings from tourism are estimated to have increased by 58 per cent. These growth rates are well in excess of the growth in tourism world-wide and suggest that other factors have also been enhancing growth in New Zealand's tourist industry. Among these have been the July 1984 devaluation which made New Zealand a more price competitive tourist destination, improved marketing and the development of holiday packages that appeal to more affluent overseas travellers. The tourist industry is expected to continue to grow rapidly, albeit at a more modest pace than during the past year, and to exceed $1 billion in export earnings by 1986/87.

Conclusion

A number of features have distinguished the current world economic recovery from other recent recoveries. It has been characterised by a significant divergence in output growth rates among industrial countries with the United States economy expanding at a much greater rate than most other countries. In addition, inflation rates in the major industrial countries have tended to converge at a relatively low level. These developments, have helped promote the trade-based linkages between economies.

At the same time, however, there has been a tendency for some countries to add to existing trade restrictions and to adopt other artificial barriers that prevent the exploitation of competitive advantages. Many of these barriers have affected New Zealand's agricultural exports and have therefore limited the benefits to New Zealand of the world recovery.

Expansion in the industrial countries is expected to slow to an annual rate of about 3 per cent in 1985 and 1986 compared with 5 per cent in 1984. Also, the variation in growth rates across countries is expected to diminish. The extent to which New Zealand will benefit from this continued expansion will depend in large part on the trade policies of other countries. The short term outlook for many of New Zealand's pastoral exports is weak, although prospects for non-pastoral exports appear more favourable.