Reserve Bank Bulletin

A QUARTERLY REVIEW OF THE NEW ZEALAND ECONOMY

Most indicators of economic activity show that New Zealand is still in a period of economic recovery. However, declining real disposable incomes and the pursuit of a firmer monetary and fiscal stance are expected to depress economic expenditure. Indeed early signs of a slowdown are beginning to appear with weakening household consumption and falling investment in dwellings.

The Reserve Bank's econometric model forecasts that the economy will grow at a rate between 0 and 1 per cent in the year to March 1986 after growing by an estimated 4.9 per cent in the year to March 1985.

This article is the first quarterly review of the domestic economy to appear in the *Bulletin*. The article focuses on developments in the real sector of the domestic economy. Monetary and external developments are covered in separate quarterly articles.

The most notable development in the domestic economy in 1984 was the strength and durability of the recovery. This was reflected in the Department of Statistics quarterly series of real Gross Domestic Product which showed an increase (in seasonally adjusted terms) of 1 per cent in the December quarter following increases of 1.3 per cent and 1.5 per cent respectively in the June and September quarters. Over the year to December 1984, real GDP grew by 8.5 per cent which was the highest rate of growth since the early 1970s.

The increased activity was most pronounced in the manufacturing, construction and trade sectors while the only sector that failed to expand was that of goverment services. The upturn in activity commenced in mid-1983, largely through an expansionary fiscal stance adopted in the 1982 Budget and assisted by an accommodating monetary policy which allowed real money balances to grow rapidly over much of the upturn. These developments led to an increase in domestic expenditure during the period. In addition, consumption was boosted by strong inflationary expectations in early 1984 coinciding with the termination of the price freeze and again in the September quarter 1984 as a result of the devaluation. Initially businesses met the increase in domestic expenditure from existing stocks and stock/trade ratios fell. However, as the high level of activity continued through 1984 stock levels began to recover.

A recovery in house construction occurred in 1983 as falling building costs, lower interest rates and readily available credit encouraged building investment. Other private investment was slower to recover but began to do so in early 1984 as production expanded and manufacturer's used up previously unutilised capacity.

The labour market has also responded to the increased level of economic activity and to the reduction in real labour costs. There has been strong growth in private employment with a consequent downturn in the number of unemployed.

Another factor that contributed to the increase in activity in mid-1983 was a rise in export volumes in response to the recovery in world trade. The strong export growth continued in 1984 and with the added impetus of the devaluation, it is a major factor in the current strength of the economy.

The recovery has also brought a rapid expansion in import volumes. As a consequence the balance of payments current account deficit deteriorated significantly to $2,456 million in the year to December

1984 from a low point of $1,312 million in the year to September 1983. The larger deficit, and the perception that the New Zealand dollar was overvalued, placed severe pressure on foreign exchange markets during early 1984 and led to an exchange crisis in July of that year. On 18 July 1984 the exchange rate was devalued by 20 per cent. This was the first of many significant policy changes which have been introduced or foreshadowed, in order to address basic structural imbalances in the New Zealand economy. The symptoms of these have been reflected in recent years in large balance of payments deficits and a consequent accumulation of overseas debt, high rates of inflation, low growth, high levels of unemployment and large fiscal deficits.

The present Government's stated objective is to create an environment conducive to the efficient allocation of resources to the most productive areas of the economy. To achieve this the Government has moved to deregulate the financial sector at a fairly rapid pace. It has also increased access to imports, reduced industry assistance, removed exchange controls and floated the dollar. In the November 1984 Budget the Government introduced measures to reduce the size of the fiscal deficit for 1984/85 and the following two years. The Government also foreshadowed its plans to overhaul the tax collection system. In particular, it wished to reduce the burden of direct taxation on salary and wage earners in favour of an expenditure based tax.

However, policies introduced by the Government will have costs. In general, the economy is likely to undergo a period of slower growth than that recently experienced as excessive domestic expenditure growth is brought under control and industries adjust to the new competitive environment. In the medium-term, though, as investment occurs in those areas that are internationally competitive, a more sustained period of economic growth can be expected.

Some signs of a slowdown in activity are beginning to emerge. Household consumption expenditure appears to be weakening following the surge in September though retail sales, with the exception of the automotive sector, rose surprisingly strongly in January. Falling real money balances and higher interest rates are factors which are depressing consumption expenditure. These influences are also causing dwelling investment to fall from the peak achieved in the June 1984 quarter. Other private investment and stockbuilding also appears to have peaked in late 1984 as domestic demand weakened in the December quarter 1984 and businesses anticipated some further contraction. Import volumes appear to have fallen slightly in the December quarter of 1984 and forward order surveys indicate that a more pronounced decline in volumes can be expected towards the middle of 1985.

The Reserve Bank econometric model forecasts, which were prepared in March 1985 and reported in the *Bulletin*, Vol. 48 No. 4, pp. 180 suggest that consumption and investment will fall over the year to March 1986, and Gross National Expenditure will decline by just over 4 per cent. A 2.8 per cent fall in real disposable incomes, coupled with lower real money balances and high interest rates, contribute to the weakening in domestic demand. Exports are expected to rise in real terms by around 5 per cent over the 1985/86 March year, mainly due to projected buoyant demand for non-traditional exports. In response to the lower domestic expenditure and the higher relative price of imports, import volumes are forecast to decline by 7 per cent for the March 1986 year. The positive contribution from the external sector offsets the predicted contraction in domestic expenditure and should generate growth in GDP of between 0 and 1 per cent.

Incomes

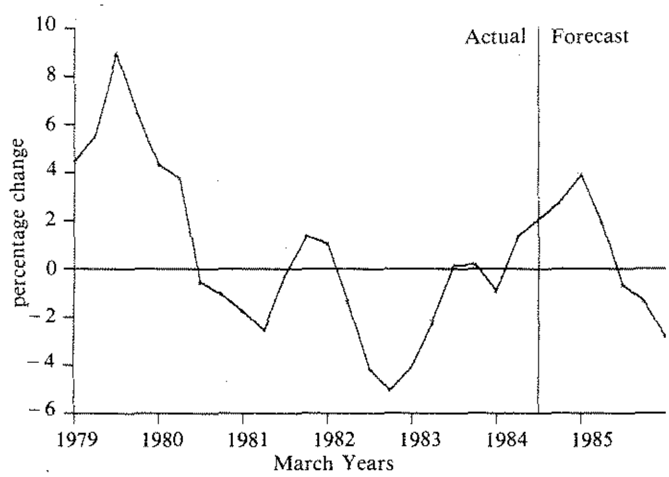
Some categories of income grew strongly in 1984/85 resulting in total real disposable incomes rising by an estimated 3.9 per cent.

The lack of an official Household Income and Outlay Account makes the interpretation of household income trends somewhat difficult. However, there are indications that real aggregate household incomes fell slightly over the December quarter 1984 mainly because there was no change in award wage rates when consumer prices were increasing quite sharply. The 1984/85 wage round which saw awards settled at around 7 per cent on average, coupled with the family care package should have increased real incomes in the March 1985 quarter but the trend over the subsequent two quarters, (through to the next wage round) is expected to be downwards, as consumer price increases continue.

Although average real wages fell over the March 1985 year, Reserve Bank model data shows that total real disposable incomes were up nearly 4 per cent, a relatively strong rate of increase. In part this is explained by the very rapid growth in private employment which occurred during the year. However, other categories of personal income grew strongly, due to the buoyant activity experienced by self-employed persons in the construction and services industries, and from the high interest rates in the last six months or so which boosted household interest receipts. Given an expected downturn in the domestic economy, and the construction industry in particular, other personal income growth is likely to slow over the coming year.

In addition, farm incomes in 1984/85, particularly the incomes of those farmers who were not heavily dependent on government subsidies, have been assisted by the July 1984 devaluation. A good growing season and low input price increases have also helped. However, the outlook is less promising. Product prices are not expected to rise significantly over 1985/86 and this combined with anticipated input price increases, the

Real Disposable Income
(annual percentage change on four quarter running totals)



removal of some subsidies, higher interest charges and a 'normal' growing season suggest a fall in net farm income.

Reserve Bank forecasts of household real disposable income for the 1985/86 March year point towards a likely fall of around 3 per cent. Salary and wage earners' and farmers' real incomes are expected to contribute most to the decline.

An accurate and timely measure of company income is unavailable but there appears to have been strong growth in profits over 1984, assisted by the expansion in output, increases in productivity, and low labour cost increases as a result of the wage freeze. In addition, the July devaluation benefited those companies in the export sector. With further export volume growth predicted, incomes in this sector are likely to remain buoyant though post-tax incomes will be affected by the winding-down of some export incentives.

Consumption

Consumption spending shows indications of having weakened.

It appears that private consumption peaked in the September quarter 1984 and then began to decline although interpretation of the available data is hampered by the rescheduling of consumer durables expenditures over this period. Consumer spending in the September 1984 quarter was boosted by devaluation induced inflationary expectations as consumers brought forward the purchase of consumer durables with a significant import content. This was particularly evident in the new cars purchased which jumped dramatically in July 1984.

Consumption Indicators

	Retail Trade Turnover[1]		*New Car Registrations*	
	Total (excl. Autos) ($m)	*Quarterly Per Cent Change*	*(Number)*	*Quarterly Per Cent Change*
1983				
Mar.	2,033	—	22,403	—
June	2,033	0.0	16,036	−28.4
Sep.	2,081	2.4	18,152	13.2
Dec.	2,082	0.0	19,260	6.1
1984				
Mar.	2,147	3.1	24,517	27.3
June	2,171	1.1	21,788	−11.1
Sep.	2,210	1.8	30,339	39.2
Dec.	2,191	−0.9	21,793	−28.0

1. Seasonally adjusted, real 1980 prices.

Retail trade turnover (excluding automotive sales) which is the most useful indicator of household consumption, fell by just under 1 per cent in the December quarter 1984 in real, seasonally adjusted terms. These sales rose strongly again in January but then fell in February. It would appear that consumer spending on durables with a high import content showed the most marked decline after the September surge. New car purchases have fallen away from the July 1984 peak at an average rate of around 10 per cent per month through to February 1985 (in seasonally adjusted terms) and appear to be trending towards the low level that existed prior to the cyclical upturn in domestic activity in mid-1983. Apart from the expenditure rescheduling effects, other factors that contributed to the weakening in consumption over the December quarter were a decline in real disposable incomes and an increase in nominal interest rates. Although the latest wage round and the family care package will increase wage and salary real disposable incomes temporarily, this is unlikely to affect the other factors and consumption should moderate further during 1985.

Investment

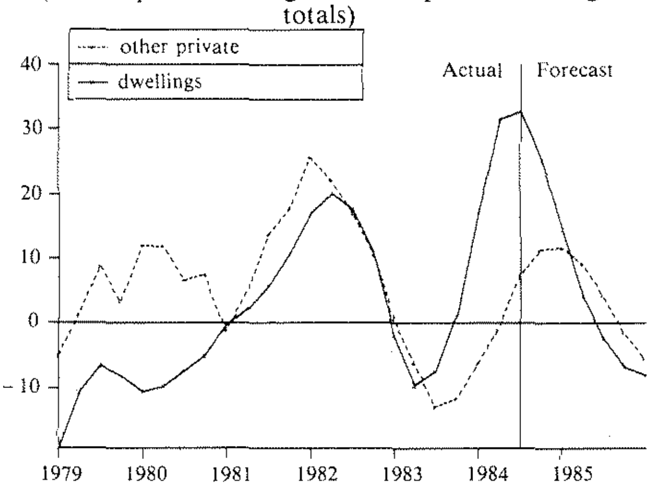
With the exception of residential building activity most indicators of investment are still showing reasonably strong growth.

The interpretation of investment trends is subject to a high degree of uncertainty because of a lack of comprehensive aggregate data. Nevertheless, the available indicators suggest that the strong growth in total real private investment, evident since late 1983, continued through to the end of 1984. However, the expansion is not expected to continue, and any further private investment growth is likely to be largely confined to the export sector.

The residential buildings component of investment seems to have peaked in the June quarter of 1984, and expenditure in real seasonally adjusted terms is estimated to have fallen by around 1 per cent per quarter over the latter half of 1984. The downturn arises from the recent sharp increases in interest rates and building costs, and an outward flow of permanent migrants. The impact of these influences should in part be offset by the Government's recently announced housing package. This package includes an increase in housing finance available to low income earners through the Post Office and the Housing Corporation; an expansion of the public sector owned rental housing stock; and assistance to low income earners renting privately owned dwellings.

Other real private investment rose significantly over the September and December quarters. It is estimated that in seasonally adjusted terms quarterly average increases of around 4 per cent occurred. Non-residential building investment was a strong contributor to this increase along with expenditure on plant, machinery and other equipment and transport equipment.

Real Private Investment
(annual percent change on four quarter running totals)



Non-residential buildings investment has historically been quite volatile, and unlike dwellings investment there is a large variation in the size and cost of the projects involved. The recovery in activity in this area was slower than with dwellings construction and only began in early 1984. The building activity statistics indicate that actual work put in place in the latter half of 1984 is approximately 25 per cent above that of the same period in the previous year. Office and administration building activity in particular grew rapidly in late 1984, possibly in response to the growth in output and profitability of the service industries throughout 1984.

The value of building permits issued for other dwellings, a leading indicator series, showed reasonably strong growth in late 1984, and with the long lags between the issue of the permit and the completion of many of the larger projects, construction activity in this area is likely to remain buoyant for several quarters in 1985.

Indicators of investment in plant, machinery and other equipment and transport equipment suggest that further real growth occurred in the September/December quarters 1984. Though a sectoral breakdown is unavailable, the export sector is likely to have been the main contributor to the expanded investment. Factors such as strong demand for non-traditional exports and near-peak utilisation of existing capacity should encourage further investment. The NZIER's December quarterly Business Opinion Survey indicated a degree of optimism with regard to investment amongst manufacturers, especially non-building investment.

The rapid pace of structural change in the economy may assist investment, particularly for those sectors which have been most affected by deregulation and the rationalisation of subsidy and protection policies. Investment will also be encouraged more broadly if the Government manages to reduce its borrowing requirements and interest rates fall.

Stockbuilding

The overall level of stocks is expected to decline in 1985/86

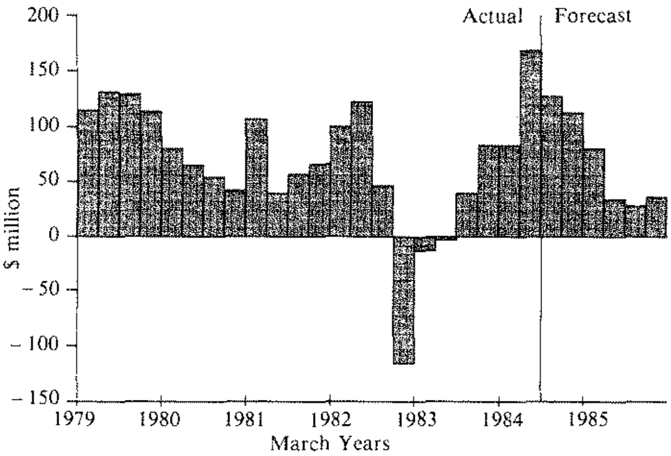
The retail stock/trade ratio fell slightly in the September quarter 1984 as retailers accommodated some of the increase in durable goods expenditure in this quarter by running down stocks. In the December quarter 1984 the stock/trade ratio rose again to 42 per cent but still remains well below the average level of 49 per cent for the period 1979 to 1982.

It is unlikely that the volume of stocks will be built up to reach the level of the historical stock/trade ratio. Merchants surveyed in the NZIER's Business Opinion Survey, on balance, regard the present level of stocks to be too high and expect it to be run down over the March 1985 quarter. This may be due in part to an expected downturn in consumption expenditure and to a desire by merchants to avoid costly involuntary stockbuilding. High interest rates may also be important in this respect. In addition, equilibrium stock levels are likely to be lower now than in earlier years because of the development of new computerised technology and stock management techniques, combined with a more efficient transport system partly as the result of deregulation.

Manufacturers' real raw materials stocks built up quickly over the September quarter 1984 and although real finished goods stocks fell, probably because of the consumption surge, the overall level of stocks was up. It seems that the rise in materials stocks may have been in anticipation of increased production in the December quarter. From the NZIER's Business Opinion Survey, manufacturers do not appear to be unduly concerned about the increasing material stocks with only a small proportion on balance expecting to reduce stocks over the March 1985 quarter.

The Reserve Bank's forecasts indicate that stockbuilding will contribute strongly to growth in GDP over the 1984/85 March year, notably from the manufacturing sector, and thereafter detract from growth in GDP through 1985, due in part to falling domestic demand.

Change in Inventories
(Quarterly seasonally adjusted, real)



Employment

A strong expansion in private sector employment has resulted in a sharp decline in unemployment levels

One of the brightest aspects of the upturn in activity has been the expansion in employment, which has in turn lead to a steady fall in the level of unemployment. The rise in numbers employed was primarily due to an increase in private sector output in response to growing domestic demand but an important contributing factor has, it is believed, been the fall in labour costs, relative to the cost of capital, over the period of the wage/price freeze.

The latest data, from the November 1984 quarterly survey of employment, shows sustained growth in both employment and overtime hours worked. Total employment (measured in full-time equivalents, i.e. full time and half part-time workers plus working proprietors) rose by 3.4 per cent over the twelve months to November 1984. This amounts to 35,000 extra jobs — the strongest annual growth since the mid-1970s. The manufacturing and distribution industries recorded the strongest growth in numbers employed although increased employment was widespread across all industries in the private sector.

A feature of this expansion is that all the growth in employment occurred in the private sector with employment levels in the general government sector remaining static. This contrasts with the experience of the mid-1970s when a considerable part of the strong employment growth then occurred in the government sector.

Since December 1983, registered unemployment (excluding vacation workers) has exhibited a downward trend with particularly large falls occurring in the months of February, March and December of 1984 and February 1985. Total registered unemployment and assisted employment dropped from over 8 per cent of the labour force in late 1983 to around 7 per cent in November 1984.

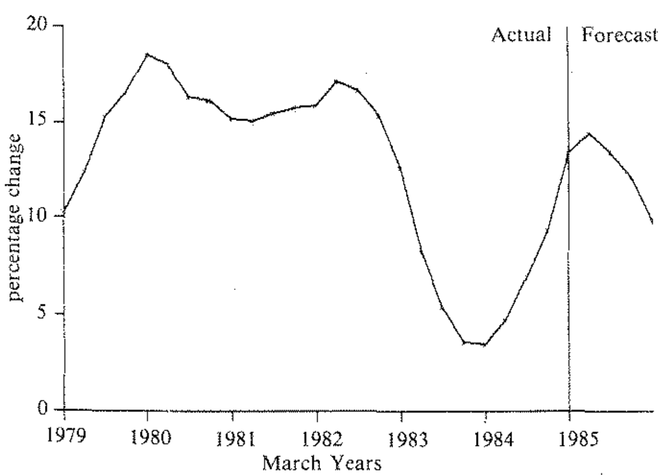
Coinciding with the improvement in the labour market was a shortage of skilled labour, particularly in the Auckland area. The NZIER's December 1984 Business Opinion Survey indicated that employers found difficulty in obtaining skilled labour and that labour turnover had increased. Labour Department data on vacancies shows that the number of vacancies for the three months to January 1985 was almost double the level during the same period a year ago. There has been a recent turnaround in emigration patterns towards a net outflow, which has seemingly been encouraged by higher real wages in Australia. The present labour shortages may put upward pressure on wage rates in some centres as employers compete to retain skilled staff.

Prices

Inflation is forecast to peak in the middle of 1985 and thereafter decline

Primarily as a result of the July 1984 devaluation the consumer price increase for the March 1985 quarter (4.4 per cent) was the largest quarterly increase since June 1982. The transportation sub-group contributed strongly to the increase, mostly because of a devaluation-induced rise in car and fuel prices. The housing sub-group also showed large price increases due to lagged adjustment to the nominal mortgage value used in the index (linked to house prices) and the rise in interest rates. Further large contributions came from the tobacco and alcoholic drink and other food sub-groups.

Consumer Price Index
(annual percent change)



The producer price indices rose sharply over the December 1984 quarter with quarterly percentage increases of 4.7 and 4 per cent for inputs and outputs respectively. These changes are of similar magnitude to the September quarter 1984 increases, though well ahead of the quarterly changes a year earlier which averaged below 1 per cent.

However, given that the price freeze was only removed in mid-November 1984, it could be expected that inflation, on an annual basis, will continue to rise in the June 1985 quarter. The March 1985 wage round and increased Government charges (principally electricity and road user charges) that became effective in April 1985 will add to the devaluation-induced rise in prices.

The Reserve Bank forecasts, prepared in March of this year, suggest that consumer price inflation will peak (in annual percentage terms) in the June 1985 quarter at between 14 and 15 per cent, and thereafter fall away steadily to be around 10 per cent (in annual percentage change terms) by the March quarter 1986.

Conclusion

In the eighteen months through to late 1984 the New Zealand economy experienced the strongest growth in GDP and employment for a decade. This growth was initially caused by expansionary domestic demand management policies, and was aided by increased exports, particularly in the latter stages of the upturn.

By December 1984 the economy had been growing for seven successive quarters and output had reached a point 13.4 per cent above the low point of the 1982/83 recession. However, there were signs that the economy was beginning to 'overheat' with some sectors of the labour market becoming quite tight and industry beginning to run into capacity constraints. In December 1984 the NZIER's measure of capacity utilisation reached its highest level (0.91) since September 1974.

Clearly this pace of expansion can not be sustained. The balance of payments current account deficit increased quite sharply reaching $2,456 million in the year to December 1984 and there was a risk that too high a level of domestic activity could place the Government's anti-inflationary programme at risk. The natural cyclical slowdown of the economy, combined with the measures which have already been taken to reduce the fiscal deficit, and the continued application of a firm monetary policy should dampen these pressures. In fact the latest available indicators suggest that the recovery may have peaked in the December quarter of 1984.

In the short run the prospect is for a flat economy as businesses adjust to the policy changes which have been implemented or announced since the election of the new Government. Beyond that, the wide range of measures which have been taken to improve the efficiency with which resources are allocated in the economy should create an environment more conducive to sustained economic growth.